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Not-for-profit entities

Partially updated November 2022

About the Not-for-profit entities guide

PwC is pleased to offer our updated *Not-for-profit entities* guide. This guide addresses the accounting and reporting for not-for-profit entities under US GAAP.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Consolidation (CG)*
- *Derivatives and hedging (DH)*
- *Fair value measurements (FV)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Loans and investments (LI)*
- *Property, plant, equipment and other assets (PPE)*
- *Revenue from contracts with customers (RR)*

Summary of significant changes

Following is a summary of the noteworthy revisions. Additional updates may be made to keep pace with significant developments.

Revisions made in November 2022

Chapter 11, Bonds payable and derivatives

- **NP 11.3.3** was added to address forward delivery bonds.
- **NP 11.8**, **NP 11.8.1**, and **NP 11.8.2** were updated for the impacts of ASU 2017-12.
- **NP 11.8.2** was updated to clarify income statement presentation of derivatives that do not use hedge accounting.

Revisions made in April 2022

Chapter 7, Contributions received and made – noncash gifts/promises to give

- **NP 7.3.1** was updated to clarify the elements of a promise to give and to distinguish between an intention to give and a promise to give.
- **NP 7.3.3** was updated to remove guidance superseded by ASU 2018-08.
- **NP 7.4.1.1** was updated for the supersession of Concepts Statement 6 and the issuance of Concepts Statement 8.
- **NP 7.4.4** was updated to clarify whether the ASC 825 fair value option may be elected for promises to give noncash assets.
- **NP 7.4.6** was added to reflect the disclosure requirements for gifts of nonfinancial assets required by ASU 2020-07.
- **NP 7.6** was updated to clarify the accounting for contributed use of space or facilities.

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Chapter 1:
***Overview of the not-for-profit
accounting and reporting
framework***

1.1 Overview of the not-for-profit reporting framework

Not-for-profit entities (NFPs), like SEC registrants and private companies, are a core constituency of the FASB. This chapter provides an overview of the accounting and reporting framework applicable to NFPs that apply FASB standards, including:

- Which entities apply FASB’s specialized guidance for NFPs
- Public/nonpublic distinctions for NFPs
- The primary sources of guidance for NFPs
- The framework for NFP financial reporting

Question NP 1-1 addresses the distinction between the terms “nonprofit” and “not-for-profit.”

Question NP 1-1

Do the terms “nonprofit” and “not-for-profit” have the same meaning?

PwC response

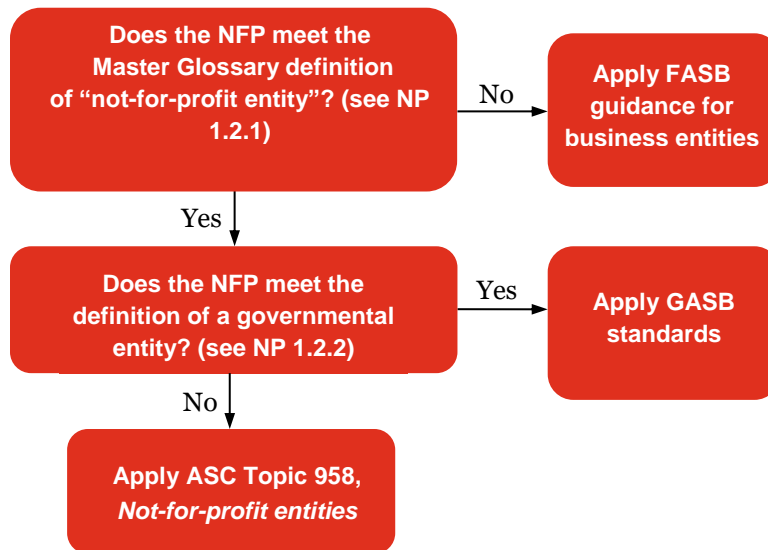
While certain nonprofit, legal, and academic circles make subtle distinctions between the terms, for accounting purposes they generally are used interchangeably.

1.2 Which entities apply NFP guidance?

US GAAP contains a significant body of guidance—primarily in ASC 958—designed to address the unique characteristics and transactions of NFPs. However, not all entities organized as NFP corporations will apply the FASB NFP guidance. Some NFPs—such as those established by state and local governments – must apply accounting standards issued by the Governmental Accounting Standards Board (GASB), a separate accounting framework not covered in this guide (see NP 1.2.2). Others, although formed as an NFP, do not meet the GAAP definition of an NFP and therefore must disregard the NFP-specific guidance and apply the same FASB standards as for-profit entities (see NP 1.2.1). The determination of which GAAP framework to apply is not a choice. An NFP cannot opt to follow either GASB or FASB standards, or to report as a commercial entity rather than as an NFP. The appropriate reporting model is determined by evaluating the organization’s characteristics against definitions provided in accounting literature, using the process shown in Figure NP 1-1.

Figure NP 1-1

Determining the appropriate GAAP framework to apply to an NFP

**1.2.1 Definition of "not-for-profit"**

For accounting and financial reporting purposes, an NFP is an entity that possesses certain characteristics that distinguish it from a business enterprise. The ASC Master Glossary defines a not-for-profit entity as follows:

Definition from ASC Master Glossary

Not-for-profit entity: An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

The absence of ownership interests is often the key factor in distinguishing an NFP from a business entity. While one NFP can legally control another NFP (see NP 5), NFPs generally are not owned by individuals in the same way that stockholders own for-profit corporations. Thus, a general characteristic shared by nearly all NFPs is that they do not have defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization.

Question NP 1-2 provides an example of an organization formed legally as a not-for-profit and granted tax-exempt status by the IRS that does not meet the GAAP definition of an NFP.

Question NP 1-2

Two hospitals (both IRS tax-exempt organizations) jointly form an LLC to operate urgent care clinics in their service area. The LLC is also granted tax-exempt status by the IRS. For accounting and financial reporting purposes, does the LLC meet the definition of a not-for-profit entity?

PwC response

For financial reporting purposes, the LLC is considered a business entity because each hospital has an ownership interest in the LLC, even though the purpose of the venture is to carry out a nonprofit activity. An NFP formed as a stock corporation, partnership, LP or LLC that provides its participants with ownership interests would not meet the Master Glossary definition of a not-for-profit entity.

The Master Glossary definition explicitly excludes “entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants.” Certain specific types of entities, such as mutual insurance companies, credit unions, and certain other cooperatives, typically operate on a cooperative basis for the benefit of their members and distribute net earnings on a patronage basis. While such organizations might be legally organized as not-for-profit corporations, they are regarded as business entities for accounting and reporting purposes.

Question NP 1-3 addresses the question as to whether a caption such as “members’ equity” precludes application of ASC 958.

Question NP 1-3

A not-for-profit insurance entity was formed to provide coverage to not-for-profit member organizations. Its balance sheet displays a “members’ equity” section. Does the fact that entities record “members’ equity” preclude them from meeting the definition of an NFP?

PwC response

No, using the caption or recording amounts as members’ equity does not preclude an entity from meeting the definition of an NFP.

If the nonprofit insurer operates for the benefit of its membership in general, and members do not have ownership interests in the manner of a cooperative, it would likely meet the definition of a not-for-profit entity for accounting purposes and thus, would apply ASC 958. In that situation, the “members’ equity” is simply the surplus, if any, after the organization’s obligations have been paid.

Describing that amount as “members’ equity” might simply indicate that any surpluses are retained to keep the entity self-sustaining.

On the other hand, nonprofit insurers that are formed on a cooperative basis provide benefits to their members directly and proportionately to their membership interests and distribute net earnings on a patronage basis in a manner similar to dividends in a stock company. Typically, each member has a capital account that increases or decreases as a result of the entity’s operations. If the NFP insurance entity has these characteristics, it would not meet the Master Glossary definition of a not-for-profit entity and, therefore, would not apply ASC 958.

NFPs possess other characteristics noted in the ASC Master Glossary definition to varying degrees. For example, while some NFPs derive most of their support from contributions, others obtain their financial resources from sales of goods and services, with little if any support from contributions. The latter group, in charging for goods or services they provide, have motivations that differ from those of commercial enterprises. The ultimate objective of sales by a commercial enterprise is to realize net profits for its owners; for an NFP, it is to generate resources to be self-sustaining in order to continue to fulfill its mission. The fact that NFPs do not seek to generate profit for purposes of distributing it to owners or investors does not mean that they cannot generate a profit. In order to be financially viable, an NFP must, over the long run, receive at least as much in resource inflows as is needed to both (1) provide goods and services and (2) replace capital assets.

Question NP 1-4 addresses whether tax-exempt status conferred by the IRS or other state regulations is a factor in accounting for an entity as an NFP.

Question NP 1-4

To apply ASC 958, does a not-for-profit entity need to qualify for IRS tax-exempt status?

PwC response

No. An entity’s tax status is not part of the definition of a not-for-profit entity in the ASC Master Glossary, and, thus, is not a factor in determining the applicable reporting framework.

1.2.2 Governmental not-for-profit entities

The definition of a governmental entity appears in various AICPA audit and accounting guides, including the *Audit and Accounting Guide: Not-for-Profit Entities* (AAG-NFP) and the *Audit and Accounting Guide: Health Care Entities* (AAG-HCO), and is codified in GASB Cod. Sec.1000:

GASB Cod. Sec. 1000, *The hierarchy of Generally Accepted Accounting Principles*

.801 Definition of government

Public corporations and bodies corporate and politic are governmental entities. Other entities are governmental entities if they have one or more of the following characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments

- The potential for unilateral dissolution by a government, with the net assets reverting to a government
- The power to enact and enforce a tax levy.

Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence.

This definition is used to distinguish organizations that must apply GASB standards from those that must apply FASB standards. Not-for-profit entities meeting this definition are considered “governmental entities” for financial reporting purposes and must follow accounting and reporting standards issued by the GASB.

As used in this definition, the phrase “public corporations and bodies corporate and politic” distinguishes entities whose corporate identity is established by a state legislature (and whose corporate powers reside within a state’s laws or administrative code) from entities that are incorporated under a state’s for-profit or not-for-profit corporation laws. The latter entities are the “other entities” referenced in the definition. Most commonly, for-profit and NFP corporations are deemed to be governmental when a controlling majority of their governing board is appointed by a governmental entity. For example, if a state university appoints a controlling majority of the board of its related NFP fund-raising foundation, the foundation would report using GASB standards rather than FASB standards.

1.3 **“Public” NFPs**

Some FASB standards require entities that issue securities that trade in public markets to provide more extensive disclosures, or to adopt new standards sooner than other entities. While SEC registrants are the most common example, such requirements sometimes apply to NFPs that issue bonds that are bought and sold in the public over-the-counter bond market (see NP 11 for a description of these debt obligations). Sometimes, NFPs issue bonds directly to investors and those bonds may trade in the over-the-counter market. More commonly, NFPs issue bonds via a municipal authority (e.g., a state financing authority or county development agency). Informally, NFPs that issue these securities are sometimes referred to as “public” NFPs or “not-for-profit conduit bond obligors.”

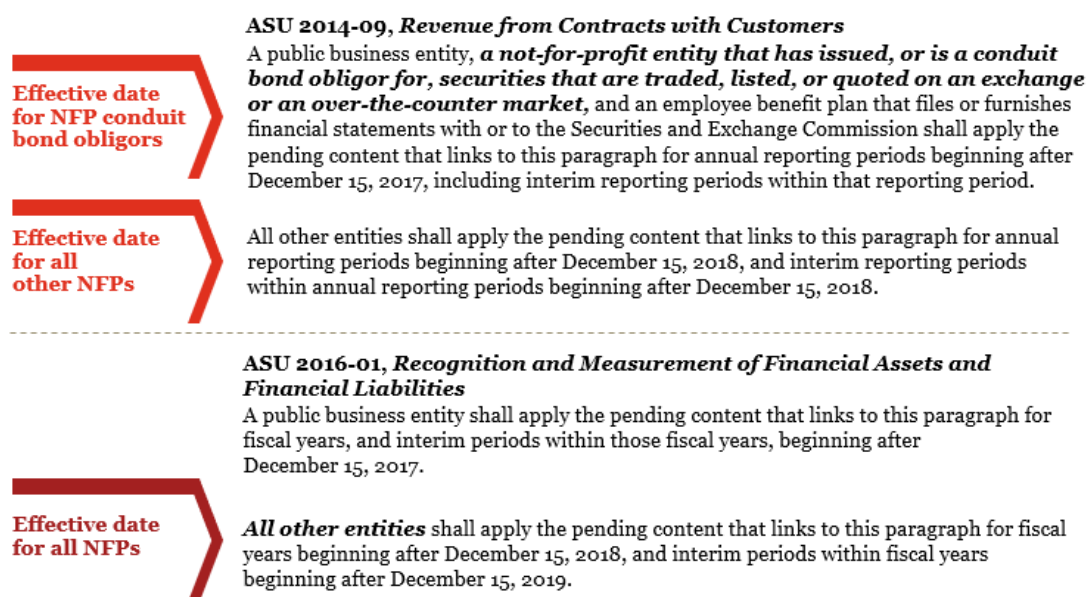
The FASB codification uses various terms to describe the classes of entities to which these different requirements apply, discussed in NP 1.3.1 and NP 1.3.2.

1.3.1 *Public business entity*

The term *public business entity*, which is widely used throughout the FASB's accounting standards codification, categorically excludes NFPs. For certain standards, the FASB requires "public" NFPs (i.e., those NFPs that have issued, or are a conduit bond obligor for, securities that are traded, listed, or quoted in an exchange or over-the-counter market) to adopt the standard at the same time and/or provide the same disclosures as public business entities. For example, the effective date provisions of ASU 2014-09, *Revenue from Contracts with Customers*, included a specific reference to NFP conduit bond obligors, making it clear these entities were subject to the same requirements as public business entities. Alternatively, ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, established different effective date requirements for public business entities, but did not specify different requirements for NFP conduit bond obligors. In that standard, all NFPs (including NFP conduit bond obligors) apply the effective date requirements for nonpublic entities, as can be seen in Figure NP 1-2.

Figure NP 1-2

Comparison of effective date provisions for NFP conduit bond obligors (emphasis added)



1.3.2 *Public entity, publicly-traded entity, publicly-traded company*

The FASB's codification uses terms such as *public entity*, *publicly-traded entity*, *publicly-traded company*, or *nonpublic entity* to denote the scope of different guidance. The ASC Master Glossary contains definitions of these terms (sometimes more than one), which can include or exclude NFP conduit bond obligors depending on the specific subtopic in which the term is used. If a term that applies to conduit bond obligors is included in a subtopic that includes NFPs within its scope, an NFP conduit bond obligor must apply it. For example, as used in ASC 740, *Income taxes*, the definition of public entity includes conduit bond obligors. Because ASC 740 is applicable to NFPs, NFP conduit bond obligors must apply the public entity disclosures for income taxes. As used in ASC 470-20, *Debt with conversion and other options*, however, the definition of public entity excludes entities that do

not issue equity securities and thus disclosures required for public entities do not apply to NFP conduit bond obligors.

Similarly, the term “nonpublic entity” has multiple definitions within the ASC Master Glossary and might include or exclude NFP conduit bond obligors depending on the specific codification section in which the term is used.

Figure NP 1-3 illustrates how codification subtopics that are applicable to NFPs use these terms and whether they include or exclude NFP conduit bond obligors.

Figure NP 1-3

Applicability of “public” terminology to NFP conduit bond obligors

Master Glossary term	Includes NFP conduit bond obligors	Excludes NFP conduit bond obligors
<i>Public entity</i>	ASC 740, <i>Income taxes</i> ASC 805, <i>Business combinations</i> ASC 954-805, <i>Health Care Entities – Business combinations</i> ASC 958-805, <i>NFPs – Business combinations</i>	ASC 470-20, <i>Debt with conversion and other options</i>
<i>Publicly-traded company</i>	ASC 220, <i>Comprehensive income</i> ASC 270, <i>Interim reporting</i> ASC 325, <i>Other investments</i> ASC 825, <i>Fair value option</i>	ASC 932, <i>Extractive entities – oil and gas</i>
<i>Publicly-traded entity</i>	ASC 715, <i>Compensation – retirement benefits</i>	None
<i>Nonpublic entity</i>	ASC 480, <i>Distinguishing liabilities from equity</i>	Numerous instances (e.g., ASC 740, <i>Income taxes</i> ; ASC 825, <i>Fair value option</i>)

1.4 Primary sources of accounting guidance for NFPs

NFP-specific accounting and reporting guidance is contained in ASC 958, *Not-for-profit entities*, and certain subsections of ASC 954, *Health care entities*. In addition, NFPs must apply guidance in all other FASB Codification Topics and subtopics unless the scope of any individual section explicitly excludes NFPs or the nature of the subject matter would not apply to NFPs (for example, ASC 718, *Stock Compensation*).

The nonauthoritative AICPA audit and accounting guides discussed in NP 1.4.2 provide helpful background, commentary, and context on the codification’s guidance for NFPs.

1.4.1 Authoritative US GAAP for NFPs

NFP-specific accounting and reporting guidance is contained in ASC 958, *Not-for-profit entities*, and certain subsections of ASC 954, *Health care entities*.

1.4.1.1 **ASC 958, Not-for-profit entities**

The guidance in ASC 958 applies to all nongovernmental entities that meet the definition of an NFP, as discussed at NP 1.2.1.

As a rule, the FASB has taken a differences-based approach when developing specialized accounting and reporting guidance for NFPs. That is, the guidance developed for NFPs is based on the guidance applied by business entities unless departures are justified by characteristics or transactions unique to NFPs. As can be seen in Figure NP 1-4, while some subtopics within ASC 958 provide core guidance that is unique to NFPs, most subtopics are incremental to the general codification. The incremental guidance is divided into subtopics that mirror the general topic structure and follows the same numbering conventions. For example, ASC 810 contains general guidance on consolidation matters, whereas ASC 958-810 contains incremental specialized NFP consolidation guidance.

Figure NP 1-4
ASC 958's subtopics

Core guidance unique to NFPs	
958-10	Overall
958-20	Financially-interrelated entities
958-30	Split-interest agreements
958-605	Contributions
Incremental guidance for NFPs	
958-205	Presentation of financial statements
958-210	Balance sheet
958-220	Income statement – comprehensive income
958-230	Statement of cash flows
958-310	Receivables
958-320	Investments – debt and equity securities
958-321	Investments – equity securities
958-325	Investments – other
958-360	Property, plant and equipment
958-405	Liabilities
958-450	Contingencies
958-470	Debt
958-715	Compensation – retirement benefits
958-720	Other expenses
958-805	Business combinations
958-810	Consolidation
958-815	Derivatives and hedging

1.4.1.2 **NFP subsections of ASC 954, Health care entities**

The scope of ASC 954, *Health Care Entities*, is described by ASC 954-10-15-1A and ASC 954-10-05-2. It includes “business-oriented” NFPs whose principal operations consist of providing or agreeing to provide health care services.

ASC 954-10-15-1A

The Health Care Entities Topic applies to health care entities, which are the following types of entities:

- a. Entities whose principal operations consist of providing or agreeing to provide health care services and that derive all or almost all of their revenues from the sale of goods or services

- b. Entities whose primary activities are the planning, organization, and oversight of such entities, such as parent or holding companies of health care providers

ASC 954-10-05-2

Within the Health Care Entities Topic, health care entities usually can be classified into the following categories on the basis of their operating characteristics:

- a. *Investor-owned health care entities.* These are owned by investors or others with a private equity interest and provide goods or services with the objective of making a profit
- b. *Not-for-profit business-oriented entities.* These are characterized by no ownership interests and essentially are self-sustaining from fees charged for goods and services. The fees charged by such entities generally are intended to help the entity maintain its self-sustaining status rather than to maximize profits for the owner's benefit. Such entities often are exempt from federal income taxes and may receive contributions of relatively small amounts from resource providers that do not expect commensurate or proportionate pecuniary return.

“Business-oriented” means that the NFP’s primary source of revenues is fees from the sale of goods and services, consistent with the investor-owned health care organizations (HCOs) that are also within the scope of ASC 954. For these NFPs, the amount of contributions received (if any) is relatively small in comparison to the revenues generated from the sale of goods or services. These characteristics distinguish the NFP HCOs within the scope of ASC 954 from NFP HCOs that are primarily supported by gifts and grants (for example, certain research hospitals). The latter are exclusively within the scope of ASC 958 and, if primarily supported by contributions from the general public, are considered *voluntary health and welfare entities*, as defined in the ASC Master Glossary.

Unless otherwise indicated, the guidance in ASC 958 applies to NFP HCOs within the scope of ASC 954. In areas where the FASB has established accounting or reporting guidance that is unique to NFP organizations, business-oriented NFP HCOs should first look to the guidance in ASC 958, and then consider whether ASC 954 provides incremental guidance.

The incremental guidance within ASC 954 tailors the model in ASC 958 to more closely resemble the accounting and reporting used by investor-owned HCOs. As discussed in NP 1.5.2, this “tailoring” relates primarily to the earnings measure (performance indicator) that is required for NFP HCOs but not for other NFPs. Figure NP 1-5 shows ASC 954’s subtopics that are applicable to NFP HCOs, including those that contain this tailored guidance.

Figure NP 1-5

ASC 954’s subtopics applicable to NFPs

954-10 Overall	954-450 Contingencies
954-205 Presentation of financial statements*	954-460 Guarantees
954-210 Balance sheet*	954-470 Debt
954-220 Income statement – comprehensive income*	954-605 Revenue recognition
954-310 Receivables	954-720 Other expenses
954-320 Investments – debt and equity securities*	954-740 Income taxes
954-325 Investments – other	954-805 Business combinations*

954-340 Other assets and deferred costs	954-810 Consolidation*
954-360 Property, plant and equipment	954-815 Derivatives and hedging*
954-405 Liabilities	954-825 Financial instruments*
954-440 Commitments	

* Contains tailored guidance related to NFP reporting model

1.4.1.3 **Other industry-specific ASC Topics**

An NFP that carries out activities addressed in other industry-specific topics of the codification should apply that industry-specific guidance. For example, an NFP public broadcasting television station should apply the guidance in ASC 920, *Broadcasters*, to its transactions and activities that are unique to the broadcasting industry; similarly, an NFP insurance entity should apply ASC 944, *Financial services – insurance*, to its insurance activities. If aspects of the ASC 958’s financial statement presentation model discussed in NP 1.5 conflict with financial statement presentation guidance in an industry topic, ASC 958 should be applied. However, because of the inherent flexibility afforded by the NFP financial reporting model, it is likely that many of the industry-specific financial reporting conventions can be accommodated within the parameters of the NFP reporting model.

1.4.2 **AICPA audit and accounting guides**

For many years, the AICPA’s audit and accounting guides *Not-for-Profit Entities* (AAG-NFP) and *Health Care Entities* (AAG-HCO) were the primary sources of industry-specific accounting guidance for those entities. When the FASB codification became the single source of authoritative GAAP for nongovernmental entities in 2009, authoritative guidance contained in AAG-NFP was codified in ASC 958, together with all of the not-for-profit standards previously issued by the FASB. Similarly, the healthcare accounting principles established by the AICPA in AAG-HCO became the basis for ASC 954.

Although no longer considered authoritative from a GAAP perspective, the AICPA guides provide background, commentary, and context on a wide array of transactions that are unique to or prevalent among NFPs and NFP HCOs, and they help preparers better understand the industry-specific accounting requirements set forth in the codification. In certain areas, they provide non-authoritative views of the AICPA’s Financial Reporting Executive Committee (FinREC) as “best practices” in areas where the codification is silent.

The guidance in AAG-NFP is directed towards nongovernmental NFPs except those within the scope of AAG-HCO. AAG-HCO applies to all entities—investor-owned, not-for-profit, or governmental—whose principal operations provide health care services to individuals.

Frequently, an NFP within the scope of one guide will have a subsidiary of the type described within another guide. For example, a university or medical school within the scope of AAG-NFP might have a subsidiary hospital, or a hospital within the scope of AAG-HCO might have a consolidated fund-raising foundation. When preparing standalone financial statements for the subsidiary, the applicable guide is the one aligned with the subsidiary’s operations. To the extent there are measurement or accounting differences, the specialized industry principles applied by the subsidiary are typically retained in consolidation in accordance with ASC 810-10-25-15 (see NP 5).

If an organization has health care as a component of a larger more diversified organization (for example, a hospital as part of a university), per AAG-HCO 1.05, FinREC believes that the recognition

and measurement guidance contained in AAG-HCO for those unique transactions would be applicable and that professional judgment should be exercised in making those determinations.

1.4.3 AICPA Technical Questions and Answers (TQAs)

The AICPA provides a Technical Hotline service to its members. Selected questions received by the Hotline and other sources within the AICPA, along with responses prepared by AICPA staff, are organized by topic/industry in the AICPA publication *Technical Questions and Answers* (TQA). Section 6140 contains TQAs related to AAG-NFP. Section 6400 contains TQAs specific to AAG-HCO. Section 7100 contains TQAs applicable to conduit bond obligors.

Although TQAs are non-authoritative, accounting TQAs are reviewed by FinREC and the FASB staff prior to publication, and the AICPA staff believe they are useful and relevant for users of the AICPA guides.

1.5 Overview of NFP financial reporting framework

NFPs utilize a customized financial statement presentation framework based on the financial reporting model used by business entities, tailored to accommodate some of the transactions and characteristics unique to not-for-profit organizations. For example:

- Many NFPs have revenues that arise from contributions
- NFPs are not “owned” in the traditional sense and thus do not report shareholders’ equity
- With the exception of NFP HCOs, NFPs are not required to report an earnings measure

The model provides flexibility with regard to presentation, recognizing that the information needs of users of financial statements of NFPs primarily supported by donations may differ from the needs of users of statements of NFPs whose revenues arise from sales of goods or services. This flexibility allows NFPs that operate in specific industries (for example, health care) to provide statements that are generally comparable with those of their business entity counterparts, while staying within the broad parameters established for NFP reporting.

1.5.1 Sources of GAAP for the NFP reporting framework

FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, established the comprehensive financial statement presentation model for NFPs that was later updated by ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*. This guidance is detailed in the following sections of the FASB codification:

- ASC 958-205, *Not-for-Profit Entities—Presentation of Financial Statements*
- ASC 958-210, *Not-for-Profit Entities – Balance Sheet*
- ASC 958-220, *Not-for-Profit Entities – Income Statement – Reporting Comprehensive Income*
- ASC 958-230, *Not-for-Profit Entities – Statement of Cash Flows*

With the exception of ASC 220, the codification’s general presentation topics (ASC 205, ASC 210, and ASC 230) also apply to NFPs.

NFP health care organizations (HCOs) within the scope of ASC 954 apply a modified version of this framework. According to ASC 954-205-05-1, financial reporting by those HCOs is generally consistent with financial reporting by investor-owned HCOs.

ASC 954-205-05-1

The financial reporting for not-for-profit, business-oriented entities and investor-owned health care entities is consistent except for transactions that clearly are not applicable. For example, not-for-profit, business-oriented entities would have nothing to report for shareholders' equity. On the other hand, investor-owned health care entities typically would not have anything to report for contributions.

Consequently, the following sections of ASC 954 tailor the NFP reporting model to more closely correspond with business entity reporting.

- ASC 954-205, *Health Care Entities—Presentation of Financial Statements*
- ASC 954-210, *Health Care Entities – Balance Sheet*
- ASC 954-220, *Health Care Entities – Income Statement – Reporting Comprehensive Income*

1.5.2 The three basic NFP financial statements

ASC 958-205-05-5 establishes the base external reporting model and requires three financial statements: a statement of financial position (balance sheet), a statement of activities (the NFP equivalent of an income statement), and a statement of cash flows.

ASC 958-205-05-5

General-purpose external financial statements provided by an NFP include a statement of financial position, a statement of activities, and a statement of cash flows. Individual financial statements provide different information, and the information each statement provides generally complements information in other financial statements.

ASC 954 modifies the base NFP reporting model to establish a framework regarded as the NFP equivalent of reporting by commercial enterprises. Its use is required for NFP health care organizations (HCOs), but other NFPs can voluntarily apply it if desired. Its principal difference from the base model is a requirement to report a defined performance indicator that is the NFP equivalent of net income of a commercial enterprise (or income from continuing operations, if discontinued operations are present). Under this framework, the statement of activities for an NFP HCO is divided into two statements: a statement of operations and a statement of changes in net assets, as described in ASC 954-205-45-1.

ASC 954-205-45-1

The basic financial statements of health care entities consist of a balance sheet, a statement of operations, a statement of changes in equity (or net assets), a statement of cash flows, and notes to the financial statements.

ASC 958-205-55-2 (the base model for NFPs) and ASC 954-205-45-2 (for HCOs) describe the titling of NFP financial statements. Some flexibility in the titles is permitted, as long as they are appropriately descriptive.

Excerpt from ASC 958-205-55-2

The terms *statement of financial position* and *statement of activities* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. For example, a statement reporting financial position could be called a balance sheet. Current practice and the statement's purpose suggest, however, that a statement of cash flows only be titled statement of cash flows.

ASC 954-205-45-2

The terms *balance sheet* and *statement of operations* indicate the content and purpose of the respective statements and serve as possible titles for those statements. Other appropriately descriptive titles may also be used. For example, a statement reporting financial position could be called a statement of financial position as well as a balance sheet. Current practice and purpose suggest, however, that a statement of cash flows only be titled Statement of Cash Flows.

The NFP reporting model permits, but does not require, an additional statement that details expenses by their functional and natural classifications in a matrix format. This voluntary statement is discussed in NP 3.5.2.

1.5.2.1 General format considerations for NFP statements

According to ASC 958-205-45-5, the financial statements of NFPs must include all information required by generally accepted accounting principles or required by applicable specialized accounting and reporting principles and practices unless NFPs are specifically exempt from providing that information.

Because the NFP reporting model is grounded in the financial reporting model used by business entities, the FASB has endeavored to minimize differences in reporting between NFPs and business enterprises, except when those characteristics warrant. ASC 958-205-45-1 identifies these guiding principles.

Excerpt from ASC 958-205-45-1

This Subtopic specifies certain basic information to be reported in financial statements of not-for-profit entities (NFPs). The requirements generally are no more stringent than requirements for business entities. The degree of aggregation and order of presentation of items of assets and liabilities in statements of financial position or of items of revenues and expenses in statements of activities of NFPs, although not specified, generally should be similar to those required or permitted for business entities. Particular formats for a statement of financial position, a statement of activities, or a statement of cash flows, are neither prescribed nor prohibited in part because similar prescriptions and proscriptions do not exist for business entities.

NFPs have a fiduciary responsibility to use contributions in accordance with donor instructions, if provided. As a result, NFP balance sheets and statements of activities classify and report activity using two broad classifications. Resources and activities associated with donor-restricted giving are reported

in *net assets with donor restrictions* (see NP 2.5.2), and all other resources and activity is reported within *net assets without donor restrictions* (see NP 2.5.1).

Apart from mandating the separate reporting of activities associated with donor-restricted contributions and requiring certain basic totals and subtotals, the format for NFP financial statements is not prescribed. To accommodate reporting activities by net asset class, NFPs can choose to use single-column, multi-column, single-page, or multi-page formats. This flexibility allows organizations to provide information in a way that is most relevant and understandable to their donors, creditors, and other external financial statement users. Along with this flexibility comes a requirement to ensure that the captions and labels used are appropriately descriptive. ASC 958-205-55 provides examples of financial statements that illustrate the basic requirements using a variety of formats.

The presentation and disclosure requirements for expenses are more extensive for NFPs than they are for business entities. Because most NFPs have no single indicator of performance comparable to a business entity's net income, the FASB determined that other information related to performance (such as more detailed information on expenses incurred in carrying out service efforts) were needed. NP 3.5.1 provides information on these requirements.

Chapter 3 in AAG-NFP and chapter 3 in AAG-HCO provide commentary and additional helpful guidance related to applying the model's requirements.

1.5.3 ***Comparative financial statements***

Consistent with the baseline reporting requirements for business entities, ASC 958-205-45-7 encourages but does not require presentation of comparative financial statements. However, contractual agreements, such as municipal bond continuing disclosure covenants, may require that comparative information be provided.

When statements report classes of activities using multi-column formats, NFPs will sometimes present comparative information for prior years only in total rather than by net asset class (referred to as summarized comparative reporting). ASC 958-205-45-8 provides explicit instructions for those situations.

ASC 958-205-45-8

NFPs sometimes present comparative information for a prior year or years only in total rather than by net asset class. Such summarized information may not include sufficient detail to constitute a presentation in conformity with GAAP. If the prior year's financial information is summarized and does not include the minimum information required by this Topic (for example, if the statement of activities does not present revenues, expenses, gains, and losses by net asset class), the nature of the prior-year information shall be described by the use of appropriate titles on the face of the financial statement and in a note to financial statements. The use of appropriate titles includes a phrase such as *with summarized financial information for the year ended June 30, 19PY*, following the title of the statement or column headings that indicate the summarized nature of the information. Labeling the prior-year summarized financial information for comparative purposes only without further disclosure in the notes to financial statements would not constitute the use of an appropriate title.

ASC 958-205-45-8 refers to a required note disclosure describing the nature of the summarized prior period information. AAG-NFP 3.60 provides an example of such a note.

Excerpt from AAG-NFP 3.60

The financial statements include certain prior year 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, 20PY, from which the summarized information was derived.

1.6 Issuance of financial statements and subsequent events period

The period extending from the financial statement date until release of the statements is the subsequent events period. Prior to finalizing an organization's financial statements, management must evaluate events that occur during this period to determine whether they affect amounts reported in the financial statements or require disclosure in the notes to the financial statements. ASC 855, *Subsequent events*, describes two types of subsequent events: adjusting and non-adjusting. See FSP 28 for additional discussion on evaluating subsequent events.

In accordance with ASC 855-10-50-1, the financial statements must disclose the date through which management evaluated subsequent events, which is either the date the financial statements are actually issued or, if not widely distributed, the date the financial statements were available to be issued.

ASC 855-10-50-1

If an entity is not an SEC filer, then the entity shall disclose both of the following:

- a. The date through which subsequent events have been evaluated
- b. Whether that date is either of the following:
 1. The date the financial statements were issued
 2. The date the financial statements were available to be issued.

If wide distribution is expected, management is required to evaluate subsequent events through the date that the financial statements are issued, which, as defined in the ASC Master Glossary, is the date of the first wide distribution. See NP 1.6.1 for a description of "wide distribution."

ASC Master Glossary

Financial statements are issued: Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP.

1.6.1 *Meaning of “wide distribution” when determining issuance date*

Most NFP conduit bond obligors whose securities trade in public markets are required to file their financial statements electronically with the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access (EMMA) website (see NP 11.7). For those entities, the date of first wide distribution (and thus, the financial statement issuance date) is typically the date that the financial statements are posted to EMMA and are broadly available to the investing public.

We believe that posting financial statements to an entity’s website or filing statements with state or federal regulators that make the information available to the public through their websites (as some state charities regulators do) would also constitute “wide distribution.”

1.6.2 *When financial statements are “available to be issued”*

Entities that do not widely distribute their financial statements must evaluate subsequent events through the date that the financial statements are available to be issued. This is the date when they are complete in a form and format that complies with GAAP and have all of the approvals (for example, from management and the governing board) necessary for issuance. The ASC Master Glossary describes the date financial statements are available to be issued.

ASC Master Glossary

Financial statements are available to be issued: Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity’s management and corporate governance structure as well as statutory and regulatory requirements.

Chapter 2:

Statement of financial position (balance sheet)

2.1 *Statement of financial position overview*

This chapter provides an overview of the key elements of balance sheets prepared under the NFP reporting model, including the statement's format, organization, and contents. Although it is more formally referred to as the statement of financial position, the term "balance sheet" is used throughout this chapter.

The presentation requirements are set forth in ASC 958-205, *Not-for-Profit Entities—Presentation of Financial Statements*, and ASC 958-210, *Not-for-Profit Entities – Statement of Financial Position*. Incremental requirements for NFP HCOs are found in ASC 954-205, *Health Care Entities—Presentation of Financial Statements*, and ASC 954-210, *Health Care Entities – Statement of Financial Position*. In addition, NFPs are within the scope of ASC 205, *Presentation of Financial Statements*, and ASC 210, *Balance Sheet*.

The NFP-specific requirements are based on the requirements used by business entities, and generally are no more stringent. The principal differences appear in the equity section. Because NFPs are not owned in the same sense as business enterprises, there are no capital accounts or shares to report. Another difference is that NFPs are subject to fiduciary requirements associated with use of donor-restricted contributions received, which generally do not apply to business entities. As a result, equity under the NFP reporting model is comprised of two broad classes: net assets without donor restrictions (see NP 2.5.1) and net assets with donor restrictions (see NP 2.5.2).

In addition, most NFPs utilize an unclassified balance sheet, whereas most business entities present classified balance sheets. This is discussed in NP 2.3.

2.2 *General presentation requirements*

The balance sheet provides information about an NFP's assets, liabilities, and net assets as of a point in time. ASC 958-20-45-1 specifies the minimum presentation requirements.

ASC 958-210-45-1

A statement of financial position shall focus on the not-for-profit entity (NFP) as a whole and shall report all of the following amounts:

- a. Total assets
- b. Total liabilities
- c. Total net assets
- d. Total net assets with donor restrictions
- e. Total net assets without donor restrictions

GAAP does not prescribe a particular statement format but permits significant flexibility in display as long as the required totals and subtotals are presented. NFPs are encouraged to provide information in ways that are most relevant and understandable to donors, creditors, and other external users of their financial statements. For example, ASC 958-205 permits a side-by-side (assets on the left, liabilities

and net assets on the right) or top-to-bottom (assets above, liabilities and net assets below) format as well as flexibility in the extent of aggregation or disaggregation of assets and liabilities (single-column, multi-column, single-page, or multi-page). See ASC 958-205-55-9 and ASC 958-210-55-8 for illustrations of commonly-used formats.

2.3 *Presentation of assets and liabilities*

When displaying assets and liabilities, NFPs are required to aggregate items that possess similar characteristics into reasonably homogeneous groups, and sequence or classify them in ways that provide relevant information about their interrelationships, liquidity, and financial flexibility. ASC 958-210-45-8 permits either sequencing according to nearness of conversion to or use of cash (in an unclassified balance sheet) or grouping into current and noncurrent categories (in a classified balance sheet).

ASC 958-210-45-8

[I]nformation about liquidity shall be provided by any of the following:

- a. Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash
- b. Classifying assets and liabilities as current and noncurrent, as defined by Subtopic 210-10 (required by paragraph 954-210-45-1 for statements of financial position prepared by not-for-profit, business-oriented health care entities)
- c. Disclosing in notes to financial statements any additional relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets.

An unclassified balance sheet lists all assets in their order of liquidity, so that cash available for operations is presented first and long-lived assets used in the entity's operations (for example, fixed assets) are generally presented last. The sequencing should incorporate the effects of restrictions on liquidity due to donor-imposed and other contractual restrictions, which is discussed in NP 2.3.1. Liabilities are presented in order of when they are due, so that accounts payable are listed first and items such as long-term debt are listed last. See ASC 958-205-55-9 for an illustration of an unclassified balance sheet.

In a classified balance sheet, "current" refers to the reporting entity's operating cycle, which for most NFPs is one year. If no limitations on their use exist, cash and assets that are expected to be converted to cash within one year are classified as current. Financial assets that are not expected to be converted to cash within one year are classified as noncurrent, as are the long-lived assets used in carrying out the NFP's activities. Obligations expected to be paid within one year are considered current liabilities; liabilities whose settlement is more than a year away are considered noncurrent. See ASC 958-210-55-8 for an illustration of a classified balance sheet.

Apart from NFP HCOs (which, with the exception of continuing-care retirement communities, are required to present a classified balance sheet), NFPs are free to choose either format. Unlike business entities (which most often provide classified balance sheets), most NFPs use an unclassified format.

2.3.1 *Impact of constraints on classification and sequencing of assets*

According to ASC 958-210-45-4, the classification and sequencing of assets in the balance sheet should reflect the effects of restrictions on liquidity due to long-term donor-imposed and other contractual restrictions. This requires aggregating assets that have similar characteristics and segregating them from assets that have different characteristics, as required by ASC 958-210-45-5.

Excerpt from ASC 958-210-45-4

A statement of financial position...provides relevant information about liquidity, financial flexibility, and the interrelationship of an NFP's assets and liabilities. That information generally is provided by aggregating assets and liabilities that possess similar characteristics into reasonably homogeneous groups that include the effects of donor-imposed restrictions as well as other contractual restrictions.

Excerpt from ASC 958-210-45-5

Classifying and aggregating items with similar characteristics into reasonably homogeneous groups and separating items with differing characteristics is a basic reporting practice that increases the usefulness of information.

As a result, when liquid assets, such as cash and cash equivalents, current pledges receivable, and marketable securities are subject to limitations on use that override their natural liquidity, they should be reported separate from similar assets that are not subject to those limitations. Such limitations might arise from donor restrictions for long-term purposes (see NP 2.3.1.1), from contractual or legal restrictions (see NP 2.3.1.2), or from assets set aside for long-term purposes in connection with board designations of net assets (see NP 2.3.1.3).

In a classified balance sheet, such constraints will cause assets that normally would be reported as current to be classified as noncurrent. According to ASC 210-10-45-4, current assets exclude assets that will not be used in current operations, are restricted for acquisition or construction of noncurrent assets, or are restricted for liquidation of long-term debt. ASC 954-305-45-1 provides similar guidance that, in addition, explicitly refers to limitations imposed by donor restrictions for long-term purposes.

ASC 954-305-45-1

Cash and claims to cash that meet any of the following conditions shall be reported separately and shall be excluded from current assets:

- a. They are restricted as to withdrawal or use for other than current operations.
- b. They are designated for expenditure in the acquisition or construction of noncurrent assets.
- c. They are required to be segregated for the liquidation of long-term debts.
- d. They are limited to use for long-term purposes by a donor-imposed restriction.

In an unclassified balance sheet, NFPs must segregate assets that are nonhomogeneous due to liquidity restrictions and report them separate from assets that are available to meet current operating requirements. For example, cash and claims to cash restricted as to withdrawal for use for other than current operations should not be combined with operating cash and cash equivalents, because they are

not homogeneous items. For similar reasons, cash held within a donor-restricted endowment awaiting investment must be displayed apart from operating cash.

AAG-NFP discusses several ways in which resources might be presented in an unclassified balance sheet to clearly communicate their unavailability for use in current operations. For example, they could be separately displayed on the face of the balance sheet in a position of longer-term relative liquidity as compared to similar assets available for current operating purposes (for example, a line item captioned “assets restricted to investment in property and equipment” that is displayed near the line item for property and equipment). Alternatively, they could be aggregated with other assets that are limited to long-term purposes and reported in a line such as “long-term investments” or “assets whose use is limited” that is sequenced with other assets that will be consumed in a similar term. If the amount and purpose of a donor-restriction or board designation on assets whose use is limited is not clear from the description on the face of the balance sheet, ASC 958-210-45-6 requires disclosure of that information in the notes. AAG-NFP 3.12 discusses similar disclosure for limitations imposed by law or contract.

For additional discussion of the effects of limitations on display of assets, see AAG-NFP 3.09 through AAG-NFP 3.23, AAG-NFP 4.74 through AAG-NFP 4.76, AAG-HCO 4.07 through AAG-HCO 4.11, and AAG-HCO 9.16 through AAG-HCO 9.17.

2.3.1.1 Constraints imposed by donor restrictions

The general rules described in NP 2.3 for classification and sequencing of assets are based on principles underlying reporting by business entities. Because contribution transactions are unique to NFPs, ASC 958-210-45-6 provides specific guidance regarding classification and sequencing of assets that are limited to use established by donor restrictions.

Excerpt from ASC 958-210-45-6

Generally...restrictions apply to net assets, not to specific assets. Assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use; for example, cash available for current use and without donor restrictions need not be reported separately from cash received with donor-imposed restrictions that is also available for current use. However, cash or other assets received with a donor-imposed restriction that limits their use to long-term purposes shall not be classified with cash or other assets that are without donor restrictions and are available for current use.

This guidance makes two key points. The first is that while donors will sometimes restrict specific assets (for example, require that their gift be separately invested), donor restrictions generally apply to a donee’s net assets, rather than to specific assets. As a result, contributed assets need not be disaggregated simply because a donor restriction exists.

The second point provides an exception to that general rule. In situations when cash or other assets are received with a donor restriction limiting their use to long-term purposes (for example, cash, investment, or pledges associated with donor-restricted gifts to acquire property, plant, and equipment; donor-restricted cash gifts or pledges that must be invested in perpetuity or for a specified time period), those resources should not be classified with cash or other assets that are unrestricted and available for current use. Combining them would violate the principle of aggregating assets with similar characteristics and separating assets with different characteristics.

In many cases, the amounts associated with long-term donor restrictions will not be directly traceable to specific assets. For example, cash gifts for constructing a new building might be invested together with resources that are available for current operating purposes. According to AAG-NFP 3.14, in such circumstances, a portion of the investments corresponding to the amount of the donor-restricted gifts would be segregated and captioned as “long-term investments” or “assets restricted to investment in property, plant and equipment.”

Question NP 2-1 addresses the display of assets received with donor-restrictions that do not pertain to long-term purposes.

Question NP 2-1

College has a June 30 year end. On June 29, it receives a receives a \$1 million donor-restricted gift of cash that must be used to provide scholarships for general studies. The proceeds are deposited in the operating account. Each year, College routinely awards at least \$2 million in general studies scholarships. Is College required to classify these resources apart from operating cash in the balance sheet in its June 30 financial statements?

PwC response

According to ASC 958-210-45-6, cash received with donor-imposed restrictions that is available for current use need not be reported separately from cash that did not arise from donor restricted gifts that is also available for current use. In this fact pattern, the contributed resources are available for current use, as they will clearly be used in the coming year to fund scholarships that are part of College’s regular ongoing programs. Thus, the \$1,000,000 cash gift received is not required to be reported separate from operating cash (but could be reported separately if desired, as discussed in AAG-NFP 3.19).

2.3.1.2 Constraints imposed by contract or law

Assets might be unavailable for use in current operations due to the existence of contractual or legal provisions or laws that impose long-term limitations on their use. Figure NP 2-1 shows examples of such external limitations that might override the natural liquidity of otherwise liquid assets. In such circumstances, those assets must be reported separate from similar assets that are not subject to limitations, as discussed in NP 2.3.1.

Figure NP 2-1**Examples of external limitations that can constrain liquidity**

-
- Cash in banks held to meet compensating balance requirements
 - Cash and investments held within trusts for use in accordance with requirements of a bond indenture (unexpended debt proceeds for construction, bond sinking fund, debt service reserve funds)
 - Cash and investments set aside in self-insurance trusts for payment of an entity's obligations (for example, workers' compensation or malpractice)
 - Cash and investments held within split-interest trusts for which NFP serves as trustee
 - Cash and investments associated with charitable gift annuity agreements that are required by state law to be separately invested
 - Cash and investments set aside under state insurance regulations (HMO or annuity statutory reserve requirements)
 - Cash collateral held by custodian in securities lending transactions
-

A common contractual limitation on the use of liquid assets arises in connection with issuance of long-term debt, particularly municipal bonds. Such arrangements often require cash or investments to be set aside in special accounts that can only be used for debt- or capital-related purposes, such as when unexpended proceeds of debt issues or funds deposited with a trustee are limited to use in accordance with the requirements of a bond indenture or similar document (for example, sinking funds, debt reserve funds, or defeasance-related escrows).

When classifying these limited-use assets in a classified balance sheet, special considerations apply, because the classification of assets set aside for payment of a specific liability should be based on the classification of that liability. If a portion of the liability is classified as current, ASC 210-10-45-4(a) indicates that the assets that will be used to satisfy the current installment of the liability should also be classified as current, with the remainder of the assets classified as noncurrent.

Excerpt from ASC 210-10-45-4(a)

Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes shall ... be excluded from current assets. However, if such funds are considered to offset maturing debt that has properly been set up as a current liability, they may be included within the current asset classification.

Example NP 2-1 illustrates how assets set aside for liquidation of a liability might be displayed in a classified balance sheet. In this example, the NFP aggregates assets limited to use for various long-term purposes under an "assets whose use is limited" heading (a reporting convention that is widely used by NFP HCOs.)

EXAMPLE NP 2-1**Assets whose use is limited – classified balance sheet**

Hospital has tax-exempt bonds outstanding. Under the terms of the bond indenture, Hospital is required to make payments to a bond sinking fund and a debt service reserve fund, both of which are held by a trustee. The total amount on deposit with trustees for future debt service payments is \$25 million. During the coming year, \$900,000 of bonds are coming due and are classified as a current liability. In addition, Hospital has \$10 million of assets that are donor-restricted for capital acquisition, and \$3 million of assets designated by its governing board for capital acquisition.

Hospital uses a reporting convention of aggregating its limited-use assets using an “assets whose use is limited” heading or caption. How would the assets described above be reflected in Hospital’s classified balance sheet?

Analysis

The \$13 million of assets that are restricted or designated for capital acquisitions would be classified entirely as noncurrent. Of the \$25 million held by trustees for debt service, a portion that corresponds to the amount that will be used to liquidate debt maturing in the next year (and thus, classified as a current liability) may be classified as current (\$900,000), with the remaining \$24.1 million classified as noncurrent.

If Hospital chooses to disclose information on the face of the balance sheet regarding the nature and amounts of the limited-use assets, all of the limited-use assets would be reported in the noncurrent section of the balance sheet with a subtotal, with a reclassification to current assets displayed for the portion of “assets whose use is limited” that will be used to liquidate the current installment of debt, as follows.

<i>(amounts in thousands)</i>	
Current assets:	
Assets limited as to use	\$ 900
Noncurrent assets:	
Assets limited as to use:	
Internally designated for capital acquisition	\$ 3,000
Donor-restricted for capital acquisition	10,000
Held by trustees under indenture agreement	25,000
	<u>38,000</u>
Less amount required to meet current obligations	(900)
Assets limited as to use, noncurrent portion	<u>\$37,100</u>

Alternatively, Hospital might choose to provide the detailed information regarding nature and amount of limitations in the notes. In that case, the face of the balance sheet would display the following amounts.

<i>(amounts in thousands)</i>	
Current assets:	
Assets limited as to use	\$ 900
Noncurrent assets:	
Assets limited as to use	\$37,100

Sometimes the details regarding the nature and amount of limitations will be provided in conjunction with an entity's investment disclosures. If Hospital utilizes that approach, the information within the investments disclosure might appear as follows.

Assets limited as to use	
Internally designated for capital acquisition:	
Money market fund	\$3,000
Donor-restricted for capital acquisition:	
Money market fund	10,000
Held by trustee under indenture agreement:	
Cash	750
US Treasury obligations	24,000
Interest receivable	250
	<u>25,000</u>
Total	<u>\$38,000</u>

2.3.1.3 Constraints imposed by governing boards

Governing board internal designations of net assets are discussed in NP 2.5.1.1. In those situations, if the governing board “funds” the designation of net assets by requiring that a corresponding amount of financial resources be set aside, those assets are subject to long-term limitations on their use. For example, assets might be set aside for long-term purposes in connection with governing board designations related to debt service reserves, quasi endowment, or the future acquisition of property and equipment.

In those cases, the considerations discussed in NP 2.3.1.3 would apply to classifying the assets. In a classified balance sheet, they would be reported as noncurrent. In an unclassified balance sheet, AAG-NFP 3.15 indicates that they should be sequenced with other assets that will be consumed in a similar term. If the nature and amount of the limitation is not apparent from the details provided on the face, that information should be provided in the notes to the financial statements, as required by ASC 958-210-50-1.

Excerpt from ASC 958-210-50-1

An NFP shall disclose in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including...self-imposed limits on the use of particular items, in addition to information provided on the face of the statement of financial position, if shown, in accordance with paragraph 958-210-45-8.

A key distinction between constraints imposed by governing boards and the externally-imposed limitations discussed in NP 2.3.1.1 and NP 2.3.1.2 is a governing board's ability to "de-designate" those resources, if necessary, to meet an unforeseen liquidity need. Accordingly, ASC 954-210-45-4 requires NFP HCOs to distinguish internally-designated funds from those whose use is contractually limited by external parties or donors, either on the face of the balance sheet or in the notes. For other types of NFPs, AAG-NFP 3.15 states that it is "best practice" to report board-designated assets separate from assets subject to external limitations, either on the face of the balance sheet or in the notes.

2.4 *Disclosures about liquidity and availability*

In addition to properly sequencing and classifying assets on the face of the balance sheet, NFPs are required by ASC 958-210-50-1 and ASC 958-210-50-3 to disclose information about liquidity and the availability of assets in the notes to the financial statements.

Excerpt from ASC 958-210-50-1

An NFP shall disclose in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions and self-imposed limits on the use of particular items, in addition to information provided on the face of the statement of financial position, if shown, in accordance with paragraph 958-210-45-8.

ASC 958-210-50-3

Section 958-210-45 discusses the following items that are required to be included in the notes to financial statements if they are not provided on the face of the statement of financial position:

- a. A description of the kind of asset whose use is limited (see paragraph 958-210-45-6)
- b. Information about the nature and amount of limitations on the use of cash and cash equivalents (see paragraph 958-210-45-7(a))
- c. Contractual limitations on the use of particular assets (see paragraph 958-210-45-7(b))
- d. Information about the nature and amounts of different types of restrictions that affect how and when, if ever, the resources (net assets) can be used (see paragraph 958-210-45-9)
- e. Subparagraph superseded by Accounting Standards Update No. 2016-14
- f. Information about additional limitations placed on net assets, such as information about the amounts and purposes of board designations of net assets without donor restrictions required in accordance with paragraph 958-210-45-11.

ASC 958-210-50-1A also requires specific disclosures about the amount of assets that are both liquid and available at the balance sheet date to meet near term cash needs for operations, along with high-level information on how the board manages liquidity (“liquidity and availability disclosures”).

ASC 958-210-50-1A

An NFP shall disclose the following:

- a. Qualitative information in the notes to financial statements that is useful in assessing an entity’s liquidity and that communicates how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the date of the statement of financial position.
- b. Quantitative information either on the face of the statement of financial position or in the notes, and additional qualitative information in the notes as necessary, that communicates the availability of an NFP’s financial assets at the date of the statement of financial position to meet cash needs for general expenditures within one year of the date of the statement of financial position (see paragraph 958-210-45-7(c)). Availability of a financial asset may be affected by:
 1. Its nature,
 2. External limits imposed by donors, laws, contracts with others, and
 3. Internal limits imposed by governing board decisions.

See example note disclosures in paragraphs ASC 958-210-55-5 through ASC 958-210-55-8 and ASC 958-205-55-21.

2.4.1 Qualitative disclosure about liquidity

The qualitative (i.e., non-numeric) disclosure required by ASC 958-210-50-1A(a) discusses how an entity manages its liquidity and related liquidity risks. It should provide strategy or policy information about how management ensures it has cash to pay its obligations as they come due, which might include:

- An NFP’s policy of attempting to align availability of its financial assets to the timing of its general expenditures, or the settlement or maturity dates of its liabilities and other obligations
- An NFP’s policy to invest cash in excess of daily requirements in short-term investments
- In the event of unanticipated liquidity needs, the NFP’s ability to draw upon resources such as lines of credit or, if applicable, a quasi-endowment or liquidity reserve
- For an entity with a donor-restricted endowment, the flexibility under state laws that govern endowment spending (discussed in NP 9) to access endowment principal under the concept of “prudent spending,” if applicable.

The qualitative disclosure should also include information about potential cash requirements in the next 12 months that are not apparent from the balance sheet. For example, an NFP that invests in a venture capital fund may be subject to future funding commitments that could be called in the next 12 months.

2.4.2 Quantitative disclosure about availability

The quantitative (numeric) disclosure required by ASC 958-210-50-1A(b) should inform the reader of the amount of an NFP's financial assets at the balance sheet date that are available to meet cash needs for general expenditures in the coming year. This is a standardized measure that must be disclosed in the notes and accompanied by narrative explanation, if necessary. It requires an entity to consider a one-year time horizon and should be focused solely on the entity's financial assets. The measure should consider:

- **The aggregate amount of financial assets at the balance sheet date.** Financial assets are cash, contracts to receive cash (such as receivables and debt securities), and evidence of equity ownership in another entity (such as equity securities). The required focus on financial assets eliminates illiquid assets such as fixed assets, intangible assets, inventory, and prepaid expenses.
- **Amounts of financial assets that won't be converted to cash during the next year.** The one-year time horizon eliminates financial assets (or portions of financial assets such as the non-current portion of multi-year contributions receivable) that are not scheduled to be collected in the coming year and thus would not be available to fund general expenditures in the next year. Similarly, lock-up provisions that restrict the NFP from selling or transferring certain alternative investments until a certain date might similarly limit the availability of those financial assets.
- **Amounts of financial assets that will not be available for general expenditure during the next year due to externally-imposed limitations.** As discussed in NP 2.3.1.1 and NP 2.3.1.2, financial assets would not likely to be available to fund general expenditures if they are subject to long-term limitations imposed externally by contracts, laws, or donors.
- **Amounts of financial assets that will not be available for general expenditure during the next year due to internally-imposed limitations.** Some NFPs regard board-designated funds as a key aspect of management's plan for covering liquidity risk exposures. Although such resources have been formally set aside for a specific purpose through a board resolution, the board can de-designate them if necessary to meet an unforeseen liquidity need (see NP 2.3.1.3). While these resources would need to be excluded from available financial assets in calculating the amount available for general expenditure, the NFP should clearly indicate that while they are expected to be invested in accordance with the designation, they are available to meet unexpected liquidity challenges.

GAAP does not define the term *available for general expenditures*. As a result, some flexibility exists in how it is interpreted with regard to whether assets with donor restrictions are included in the measure. The example disclosures in the codification treat all financial assets subject to donor restrictions as unavailable for general expenditure. However, if an NFP believes that certain restrictions are so general in relation to the organization's mission that they do not affect the organization's liquidity or funds flow (i.e., leaving the organization broad ability to use those assets), the associated assets would not need to be excluded from the bottom line measure as long as the NFP provides additional qualitative disclosure that explains to users the approach that has been taken. The ASC Master Glossary includes a definition of liquidity.

Excerpt from ASC Master Glossary

Liquidity: An asset's or liability's nearness to cash. Donor-imposed restrictions may influence the liquidity or cash flow patterns of certain assets. For example, a donor stipulation that donated cash be used to acquire land and buildings limits an entity's ability to take effective actions to respond to unexpected opportunities or needs, such as emergency disaster relief. On the other hand, some donor-imposed restrictions have little or no influence on cash flow patterns or an entity's financial flexibility. For example, a gift of cash with a donor stipulation that it be used for emergency-relief efforts has a negligible impact on an entity if emergency relief is one of its major ongoing programs.

Question NP 2-2 discusses how an NFP may consider which financial assets are available for general expenditures.

Question NP 2-2

College has a June 30 year end. On June 29, it receives a \$1 million donor-restricted gift that must be used to provide scholarships for general studies. Each year, College routinely awards at least \$2 million in general studies scholarships. How should College consider this gift when calculating the amount of "financial assets available to meet cash needs for general expenditures within one year" for the availability of resources disclosure in its June 30 financial statements?

PwC response

If College considers all financial resources associated with donor-restricted gifts as unavailable for general expenditures (the "default" view used in the illustrative disclosures in the FASB codification), it would exclude the \$1 million gift when calculating the measure.

On the other hand, College might view financial resources associated with gifts that are donor-restricted for purposes related to its regular ongoing programs as being available for general expenditure. In that case, it would likely conclude that the \$1 million is available for general expenditure based on the nature of the restriction and the fact that the resources could clearly be used in the coming year to fund scholarships as part of its regular, ongoing programs.

In this situation, College would include the \$1 million gift when calculating the availability measure and should supplement the quantitative disclosure with an explanation regarding the nature and amount of donor restrictions that it views as being available for general expenditures.

Question NP 2-3 describes when appropriations from an endowment may be included as financial assets available for general expenditures.

Question NP 2-3

NFP A's fiscal year end is June 30, 20X1. On May 1, 20X1, the governing board approves the annual spending appropriation from NFP A's endowment. In its fiscal year 20X1 availability of resources disclosure, would NFP A consider the appropriated amount as "available for general expenditures"?

PwC response

Yes, as long as all of the following are true:

- ☐ NFP A may use the appropriated resources to fund general expenditure in the next 12 months
- ☐ The board approved the appropriation prior to the balance sheet date
- ☐ The appropriation was in accordance with donor restrictions and applicable law

Question NP 2-4 describes the impact of internal designations on financial assets available for general expenditures.

Question NP 2-4

NFP B's fiscal year end is June 30, 20X1. On May 1, 20X1, NFP B's governing board designated \$100,000 of cash and investments to be used for future fixed asset purchases. On August 1, 20X1, prior to the issuance of the fiscal year 20X1 financial statements, NFP B's governing board approves a measure to remove the self-imposed limitation on the \$100,000. In its fiscal year 20X1 availability of resources disclosure, should NFP B consider this amount "available for general expenditures"?

PwC response

No. The availability of resources disclosure is made as of the balance sheet date. At June 30, 20X1, the \$100,000 was internally designated by the governing board and was therefore not available for general expenditures. If desired, management could add qualitative disclosure to indicate that the internal designation was released subsequent to the balance sheet date.

2.4.3 Format of liquidity and availability disclosures

Entities can combine the disclosures about availability and liquidity into a single note or present them in separate notes.

The qualitative liquidity disclosure will typically be in a narrative format. The availability disclosure's quantitative information will often be provided in a table, accompanied by narrative commentary as necessary. There is no prescribed format for presentation of the quantitative information; NFPs have flexibility in how they comply with the requirements. Some NFPs might start with the total amount of the entity's financial assets at the reporting date as the top line, and then deduct amounts that are not available for general expenditures to arrive at the bottom-line measure of availability. This approach is illustrated in Figure NP 2-2, which provides an example of liquidity and availability disclosures combined into a single note.

Figure NP 2-2
Liquidity and availability disclosures (combined format)

Excerpted from Note G in ASC 958-205-55-21

The following reflects Not-for-Profit Entity A's financial assets as of the balance sheet date, reduced by amounts not available for general use because of contractual or donor-imposed restrictions within one year of the balance sheet date. Amounts not available include amounts set aside for long-term investing in the quasi-endowment that could be drawn upon if the governing board approves that action. However, amounts already appropriated from either the donor-restricted endowment or quasi-endowment for general expenditure within one year of the balance sheet date have not been subtracted as unavailable.

Financial assets, at year-end	\$ 234,410
Less those unavailable for general expenditures within one year, due to:	
Contractual or donor-imposed restrictions:	
Restricted by donor with time or purpose restrictions	(11,940)
Subject to appropriation and satisfaction of donor restrictions	(174,700)
Investments held in annuity trust	(4,500)
Board designations:	
Quasi-endowment fund, primarily for long-term investing	(36,600)
Amounts set aside for liquidity reserve	(1,300)
Financial assets available to meet cash needs for general expenditures within one year	<u>\$ 5,370</u>

Not-for-Profit Entity A is substantially supported by restricted contributions. Because a donor's restriction requires resources to be used in a particular manner or in a future period, Not-for-Profit Entity A must maintain sufficient resources to meet those responsibilities to its donors. Thus, financial assets may not be available for general expenditure within one year. As part of Not-for-Profit Entity A's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, Not-for-Profit Entity A invests cash in excess of daily requirements in short-term investments. Occasionally, the board designates a portion of any operating surplus to its liquidity reserve, which was \$1,300 as of June 30, 20X1. There is a fund established by the governing board that may be drawn upon in the event of financial distress or an immediate liquidity need resulting from events outside the typical life cycle of converting financial assets to cash or settling financial liabilities.

In the event of an unanticipated liquidity need, Not-for-Profit Entity A also could draw upon \$10,000 of available lines of credit (as further discussed in Note XX) or its quasi-endowment fund.

An NFP that prepares a classified balance sheet might use an approach that is similar to Figure NP 2-2, but which focuses solely on financial assets classified as current (as the reader will know from the face of the balance sheet that financial assets classified as noncurrent are not available). This approach is illustrated in ASC 958-210-55-8. Other NFPs might choose to display only net amounts of liquid resources that are free of limitations – that is, listing the net amount from each category of financial assets reduced by the amount of limitations on their use, with the total representing the bottom-line measure of financial assets available for general expenditure.

ASC 958-210-55-5 indicates that other display options are possible. For example, ASC 958-210-55-7 illustrates a combined liquidity and availability disclosure that uses a narrative format only, which might be appropriate for an NFP with no limitations on its financial assets.

2.5 Presentation of net assets (equity)

Because NFPs are not owned by investors (see NP 1 for further background), the “equity” section of an NFP’s balance sheet is simply referred to as “net assets” (i.e., the residual of assets less liabilities). As described in ASC 958-205-05-6, it is comprised of two broad classes: net assets without donor restrictions (see NP 2.5.1) and net assets with donor restrictions (see NP 2.5.2).

ASC 958-205-05-6

General-purpose financial statements classify and report net assets in two groups—net assets with donor restrictions and net assets without donor restrictions—based on the existence or absence of donor-imposed restrictions.

At a minimum, ASC 958-205 requires that the amount of net assets with and without donor restrictions and the total of net assets be reported on the face of the balance sheet. As discussed in NP 2.5.1.1 and NP 2.5.2, certain disaggregated information must also be disclosed for each category, either on the face of the balance sheet or in the notes.

Figure NP 2-3 illustrates how an NFP might present this type of detail on the face of the balance sheet.

Figure NP 2-3

Presentation of net asset categories on the face of the balance sheet

Net assets:

With donor restrictions:

Perpetual in nature	\$1,000
Purpose restricted	2,000
Time restricted	<u>5,000</u>
Total net assets with donor restrictions	\$8,000

Without donor restrictions:

Designated by the Board for capital	2,000
Board-designated endowment	2,000
Undesignated	<u>5,000</u>
Total net assets without donor restrictions	<u>\$9,000</u>

Total net assets	<u>\$17,000</u>
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Throughout ASC 958, the categories are captioned *net assets without donor restrictions* and *net assets with donor restrictions*. ASC 958-205 encourages the use of these labels but acknowledges that other captions are possible as long as they correspond with the meanings of the categories. For example, *equity* may be used in lieu of *net assets* (for example, “members’ equity” for a club). The term *unrestricted net assets* should not be used out of concern that it implies that the net assets are not

subject to any restrictions or limitations resulting from laws, regulations, contracts, or governing board designations. ASC 958-210-55-3 indicates that captions such as “other” or “not donor-restricted” may be used with care to distinguish net assets with donor restrictions from net assets without donor restrictions.

For additional information on presentation of net assets, see AAG-NFP 11 and AAG-HCO 9.

2.5.1 *Net assets without donor restrictions*

Net assets without donor restrictions generally includes an entity’s working capital, property, plant, and equipment, and long-term debt. In some respects, it corresponds to the retained earnings reported in a business entity’s balance sheet. Figure NP 2-4 compares typical captions found in the equity section of a business entity’s balance sheet to similar balances in the net assets without donor restrictions component of an NFP’s equity.

Figure NP 2-4

Comparison of equity captions in a business enterprise to net assets without donor restrictions

Business entity		NFP entity
Capital stock	<ul style="list-style-type: none"> □ Capital stock reflects the owner’s legal financial interest in the entity 	<ul style="list-style-type: none"> □ An NFP is not “owned” in the same sense as a business enterprise and thus has no ownership interests to report that are comparable to capital stock □ “Shares” of NFP clubs have different attributes
Additional paid-in capital	<ul style="list-style-type: none"> □ Additional amounts paid-in by investors and shareholders 	<ul style="list-style-type: none"> □ Capital contributed to initially form the entity (for example, capital from a religious sponsor) is subsumed into net assets without donor restrictions □ In separately-issued statements of subsidiaries, net assets without donor restrictions would include equity transfers provided by a parent or sister entity (see “equity transfers” in NP 3)
Retained earnings (deficit)	<ul style="list-style-type: none"> □ The company’s past earnings that have not been distributed to its stockholders □ A portion might be restricted to comply with contractual requirements or voluntary limitations (e.g., board policy decisions) 	<ul style="list-style-type: none"> □ Net assets without donor restrictions includes cumulative surpluses (deficits) since formation, less any distributions of net assets □ Board-designations of net assets must be separately disclosed
Accumulated other comprehensive income (AOCI)	<ul style="list-style-type: none"> □ Aggregation of remaining items of other comprehensive income (OCI) that will be reclassified to net income in future periods 	<ul style="list-style-type: none"> □ For NFPs that report a performance indicator, net assets without donor restrictions inherently carries forward accumulated other comprehensive income amounts that will be reclassified to the performance indicator in future periods □ NFPs are not required to disclose an AOCI balance, but may do so voluntarily

	Business entity	NFP entity
Noncontrolling interests	□ Business entities present NCI as a separate item (where applicable) as part of equity	□ Similar requirements apply to NFP organizations, as discussed in NP 2.5.3
Dividends	□ Distributions of accumulated/current profits to shareholders	□ In separately-issued statements of subsidiaries, decreases in net assets for resources transferred to/from/among its subsidiaries (see “equity transfers” in NP 3) would be treated similar to dividends

Disclosure about the amounts and purpose of one specific subcategory within net assets—governing board designations of net assets—is required, as discussed in NP 2.3.1.3. Other disaggregations may be voluntarily provided, for example:

- The amount of net assets invested in property, plant, and equipment (for example, PP&E less associated financing)
- In the case of clubs, the amount of net assets attributable to certain mandatorily redeemable membership interests
- Amounts that business entities would report as components of accumulated other comprehensive income (AOCI), for example, pension and OPEB actuarial gains/losses and prior service costs not yet recognized in changes in net assets. Displaying the impact on net assets of an individual component is acceptable even if the NFP has other AOCI-like components embedded within its net assets without donor restrictions that it chooses not to separately disclose.

2.5.1.1 Governing board designations of net assets

NFP governing boards sometimes take formal action (through a corporate resolution) to set aside a portion of net assets without donor restrictions for specific purposes, for example:

- long-term investing for total return (a board-designated endowment or “quasi-endowment”)
- replacement of long-lived assets (a capital reserve)
- reserving for specific future expenditures or risk exposures
- unexpected cash flow or liquidity needs (sometimes called an operating reserve, liquidity reserve, or rainy-day fund)

The concept is similar to appropriated retained earnings that might be established by a business entity’s board of directors. In NFP financial reporting, such amounts are referred to as board-designated net assets. The ASC Master Glossary defines board-designated net assets.

ASC Master Glossary

Board-designated net assets: Net assets without donor restrictions subject to self-imposed limits by action of the governing board. Board-designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses. Some governing boards may delegate designation decisions to internal management. Such designations are considered to be included in board-designated net assets.

According to the definition, board-designated net assets would include designations made by internal management in situations when the board has delegated those designation decisions.

ASC 958-210-45-11 requires that information pertaining to amounts and purposes of board-designated net assets be provided on the face of the balance sheet or disclosed in the notes.

ASC 958-210-45-11

Information about self-imposed limits also is useful, including information about voluntary resolutions by the governing board of an entity, such as resolutions to designate a portion of its net assets without donor restrictions to function as an endowment (sometimes called a board-designated endowment fund) or to designate a portion for a specific future expenditure (called board-designated net assets). Information about the amounts and purposes of board designations of net assets without donor restrictions shall be provided in notes to or on the face of financial statements in accordance with paragraph 958-210-50-3.

Figure NP 2-4 in NP 2.5 illustrates the reporting of board-designated net assets on the face of the balance sheet (along with the mandatory total for net assets without donor restriction). See also ASC 958-210-55-3. ASC 958-205-55-21 (Note DD) illustrates disclosure made in notes to the financial statements.

Board-designated net assets might or might not be funded by setting aside specific assets. NP 2.3.1.3 discusses classification and sequencing considerations for specific assets that are set aside.

2.5.2 *Net assets with donor restrictions*

Net assets with donor restrictions is a special component of equity that reflects activity involving donor-restricted contributions and related investment returns that are restricted. These resources can only be used for the purposes established by donors; they cannot be used to purchase goods or services or to settle liabilities that are outside the scope of the stipulations (and thus, are not available to an NFP's creditors). As a donor's restrictions are satisfied, a reclassification is made from the restricted component of equity to the component without donor restrictions.

Figure NP 2-5 illustrates the broad types of donor restrictions.

Figure NP 2-5
Examples of donor-imposed restrictions

Nature of restriction	Examples
Donor-imposed restrictions that require the NFP to maintain the resources in perpetuity	<ul style="list-style-type: none"> □ Contributions and other inflows of assets for which use by the organization is limited by donor-imposed restrictions that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization □ Other asset enhancements or diminutions subject to the same kind of stipulations □ Reclassification from (or to) other classes of net assets as a consequence of donor-imposed restrictions
Donor-imposed restrictions that limit the NFP's use of the resources to later periods of time or for specified purposes	<ul style="list-style-type: none"> □ Contributions and other inflows of assets for which use by the organization is limited by donor-imposed restrictions that either expire by passage of time or can be fulfilled and thus removed by actions of the organization □ Other asset enhancements or diminutions subject to similar stipulations □ Reclassifications to (or from) other classes of net assets as a consequence of donor-imposed restrictions, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those restrictions

ASC 958-210-45-9 requires an NFP to provide information about the nature and amounts of different types of donor-imposed restrictions either by reporting their amounts on the face of the balance sheet or by including relevant details in the notes. See Note B in ASC 958-205-55-21 for an illustration of this disclosure.

The governing board of an NFP has a fiduciary responsibility to spend donor-restricted contributions in accordance with the donor's instructions. This requires maintaining an appropriate composition of financial assets (usually cash and marketable securities) in amounts needed to carry out the donors' instructions. If an NFP does not maintain an appropriate composition of assets (and thus, may appear to have spent the donated funds for purposes other than those specified), disclosure may be required under ASC 958-450-50-3. For additional information, see AAG-NFP 3.173 through AAG-NFP 3.175.

ASC 958-450-50-3

If the noncompliance result from an NFP's failure to maintain an appropriate composition of assets in amounts needed to comply with all donor restrictions, the amounts and circumstances shall be disclosed.

2.5.3 *Controlling and noncontrolling interests*

If an NFP owns less than 100% of a consolidated for-profit subsidiary, the portion owned by others is referred to as the noncontrolling interest. In certain circumstances, noncontrolling interests can also arise in connection with relationships involving not-for-profit subsidiaries (see NP 5.2.5).

ASC 958-810 tailors the general guidance for reporting noncontrolling interests in subsidiaries to the NFP reporting model. ASC 958-810-45-1 states that noncontrolling interests in the equity (net assets) of consolidated subsidiaries should be reported in the consolidated balance sheet as a separate component of the appropriate class of net assets (for example, with donor restrictions or without donor restrictions). That amount should be clearly identified and described (for example, as “noncontrolling ownership interest in subsidiaries”) to distinguish it from the components of net assets of the parent (which includes the parent’s controlling financial interest in its subsidiaries).

Figure NP 2-6 illustrates the presentation of noncontrolling interests in the equity of a partially-owned subsidiary with no donor-restricted net assets.

Figure NP 2-6

Presentation of noncontrolling interests in net assets

Net assets without donor restrictions:		
Parent NFP	\$376,000	
Noncontrolling interests in subsidiaries	<u>94,000</u>	
Total net assets without donor restrictions		\$470,000
Net assets with donor restrictions		<u>250,000</u>
Total net assets		<u>\$720,000</u>

If donor-imposed restrictions on the use of the subsidiary’s net assets exist, the related net assets and noncontrolling interest would be presented in net assets with donor restrictions.

ASC 958-810-55-17 through ASC 958-810-55-25 provides a comprehensive illustration of the presentation of noncontrolling interests.

Chapter 3:

Statement of activities/ statement of operations

3.1 Overview of the statement of activities

In the NFP financial reporting model, the statement of financial performance is referred to as a statement of activities (or, in the case of NFP HCOs, a statement of operations). The NFP reporting requirements are based on the income statement concepts used by business entities, and, in general no more stringent. However, some differences exist in light of NFP-specific characteristics and transactions. For example:

- The NFP statement of activities classifies and reports activity using two broad net asset classifications: *with donor restrictions* and *without donor restrictions*. If an NFP regularly receives significant amounts of contributions and investment income that are donor-restricted, the face of the statement will often display separate columns for the activity in each class.
- With the exception of NFP HCO reporting, the NFP model does not employ the business entity concepts of earnings and other comprehensive income. Thus, the “bottom line” of the statement of activities is the total change in net assets during a period, which is analogous to total comprehensive income for a business enterprise.

This chapter provides an overview of the key elements of the statement, including its format, organization, and contents. The presentation requirements are in ASC 958-205, *Not-for-Profit Entities—Presentation of Financial Statements*, and ASC 958-220, *Not-for-Profit Entities—Income Statement—Reporting Comprehensive Income*. Incremental requirements for NFP HCOs (which limit some of the flexibility available to other NFPs) are in ASC 954-205, *Health Care Entities—Presentation of Financial Statements*, and ASC 954-220, *Health Care Entities—Income Statement—Reporting Comprehensive Income*.

3.2 Core model—statement of activities

The statement of activities provides information about the increase or decrease in an NFP’s net assets during the period. Its purpose is described in ASC 958-220-05-2.

ASC 958-220-05-2

The primary purpose of a statement of activities is to provide relevant information about all of the following items:

- a. The effects of transactions and other events and circumstances that change the amount and nature of net assets.
- b. The relationships of those transactions and other events and circumstances to each other.
- c. How the NFP’s resources are used in providing various programs and services.

ASC 958-205 and ASC 958-220 specify the basic information to be reported in the statement of activities. The guidance permits flexibility in the titles used for the statement, as long as they are appropriately descriptive.

First, NFPs are required to classify revenues, expenses, gains, and losses using two broad classifications of net assets. *Net assets with donor restrictions* is a special component of net assets that reflects activity involving donor-restricted contributions and related investment return that is

restricted. *Net assets without donor restrictions* reports all other activity. In addition, ASC 958-220-45-1 requires that the statement of activities display, at a minimum, the change in net assets and the change in net assets with and without donor restrictions.

ASC 958-220-45-1

A statement of activities provided by a NFP shall focus on the entity as a whole and shall report the following amounts for the period:

- a. The change in net assets
- b. The change in net assets with donor restrictions
- c. The change in net assets without donor restrictions

Revenues are reported as increases in net assets without donor restrictions unless the use of the assets received is limited by donor-imposed restrictions. As a donor's restrictions are satisfied, a reclassification is made from the restricted component of net assets to the component without donor restrictions (see NP 3.4.3). Expenses are reported as decreases in net assets without donor restrictions, with the exception of investment expenses, which must be netted against investment return and reported in the net asset category in which the net investment return is reported. For additional information on reporting expenses, see NP 3.5.

Apart from mandating the reporting of activities by net asset classes and requiring certain basic totals and subtotals, ASC 958-205 does not prescribe the use of any particular format for the statement of activities. To accommodate the requirement to report activities by net asset class, NFPs can use single-column, multi-column, single-page, or multi-page formats as they see fit. ASC 958-205-55-10 through ASC 958-205-55-17 illustrate some (but not all) of the permissible formats, highlighting the baseline totals and subtotals required. While the illustrative statements show items of revenues, gains, and reclassifications first, followed by expenses and losses, ASC 958-205-55-11 explicitly states that those items can be arranged in other ways, and other subtotals may be included.

Within the classes of net assets, NFPs may also choose to classify revenues and expenses in ways that they believe will provide meaningful information to users of their financial statements, such as operating and nonoperating (see NP 3.4.2), expendable and nonexpendable, recurring and nonrecurring, or by operating units. Many NFPs customarily use at least one intermediate subtotal; since the guidance does not limit their use, the subtotals (except for the performance indicator) are often defined differently for each NFP. ASC 958-220-55-5 provides an example that illustrates how items may be sequenced to distinguish between operating and nonoperating activities or to make other distinctions, if desired.

The degree of aggregation and order of presentation of items of revenues and expenses in the statement, although not specified, generally should be similar to those required or permitted for business entities. ASC 958-220-45-14 requires revenues and expenses to be reported gross, except for certain investment expenses that are required to be netted against the related investment return. Gains and losses may be presented on a net basis, similar to business entities.

If discontinued operations are present, their results are reported just above the total change in net assets, preceded by appropriate subtotals (see NP 3.4.). If a newly-issued standard requires that the

effect of an accounting change be reported as a cumulative effect adjustment to the change in net assets of the period, that amount would be displayed in a manner similar to discontinued operations, unless the transition requirements provide otherwise (see NP 3.4.5).

If the NFP has a less-than-wholly-owned subsidiary, and, therefore, must report a noncontrolling interest in the net assets of the subsidiary, it must apportion the consolidated change in net assets between the parent's controlling interest and the noncontrolling interest. This information is typically provided through note disclosure, rather than through display on the face of the statement of activities. For more information, see NP 3.6.

3.3 ***NFP HCOs—statement of operations and changes in net assets***

ASC 954 modifies the core NFP reporting model in ASC 958 to establish a framework regarded as the NFP equivalent of reporting by commercial enterprises. Its use is required for NFP HCOs, but other NFPs can voluntarily apply it if desired. The principal difference from the core NFP model is a requirement to report a defined performance indicator that is the NFP equivalent of net income of a commercial enterprise (or income from continuing operations, if discontinued operations are present). Because of the requirement to report a performance indicator and the desire to more closely parallel business entity reporting, NFP HCOs do not present the statement of activities described in NP 3.2. Instead, they present a *statement of operations* (which includes the performance indicator) and a *statement of changes in net assets*, as required by ASC 954-205-45-1.

ASC 954-205-45-1

The basic financial statements of health care entities consist of a balance sheet, a statement of operations, a statement of changes in equity (or net assets), a statement of cash flows, and notes to the financial statements.

The statement of operations (discussed in NP 3.3.1) focuses on changes in net assets without donor restrictions, and closely resembles a single-statement format *statement of comprehensive income* presented by some business enterprises. The statement of changes in net assets reports changes in net assets both with and without donor restrictions, with summary amounts from the statement of operations reported for the “without donor restrictions” class (similar to the approach described in ASC 958-205-55-10(c) for other NFP entities).

Figure NP 3-1 illustrates the two-statement format for an NFP HCO. Line items in red bold are subtotals required by GAAP.

Figure NP 3-1**Two-statement format for NFP HCO performance reporting**

Subsidiary Hospital, Inc. Statement of Operations	
Revenue	
Net patient service revenue	\$ xxx
Expenses	
Salaries/supplies/benefits	(xxx)
Depreciation	(xxx)
Interest expense	(xxx)
Excess of revenues over expenses	xxx
OCI and other changes	
Effective portion of hedging derivative	xxx
Equity transfer from affiliate	xxx
Net assets released from restriction for PP&E	xxx
Change in net assets without donor restrictions before discontinued operation	xxx
Loss from discontinued operation	(xxx)
Increase in net assets without donor restrictions	xxx

Subsidiary Hospital, Inc. Statement of Changes in Net Assets	
Change in net assets without donor restrictions	
Excess of revenues over expenses	\$ xxx
Effective portion of hedging derivative	xxx
Equity transfer from affiliate	xxx
Net assets released from restriction for PP&E	xxx
Loss from discontinued operations	(xxx)
Increase in net assets without donor restrictions	xxx
Change in donor-restricted net assets	
Contributions	(xxx)
Investment return	(xxx)
Net assets released from restriction for PP&E	(xxx)
Change in beneficial interest in trust	xxx
Decrease in donor-restricted net assets	xxx
Total change in net assets	xxx
Net assets, beginning of year	xxx
Net assets, end of year	xxx

In accordance with ASC 954-220-45-1, an NFP HCO can combine the statement of operations and the statement of changes in net assets into a single statement. To maintain the analogy to business entity reporting and emphasize the inclusion of the performance indicator, a combined statement is referred to as a *statement of operations and changes in net assets*, to differentiate it from a statement of activities prepared under the core model.

ASC 954-220-45-1

For not-for-profit, business-oriented health care entities, the statement of operations may be combined with the statement of changes in equity (net assets).

Some NFP HCOs that choose to present a combined statement use a “two page” format, with a page break inserted after the performance indicator subtotal in order to more closely approximate the presentation of a separate income statement by a business enterprise. When this approach is used, the NFP HCO must ensure that it complies with the requirement of ASC 954-220-45-5 that the performance indicator be reported in a statement that also presents the total changes in net assets without donor restrictions. To accomplish this, the word “continued” should appear at the bottom of the page that reports the performance indicator and in the heading of the second page of the statement. In addition, the performance indicator subtotal cannot be double underscored as if it were a bottom-line measure.

3.3.1 NFP HCO statement of operations

A statement of operations focuses solely on reporting the changes in net assets without donor restrictions that occurred during the reporting period and displays the required performance indicator (earnings measure) that is analogous to income from continuing operations of a business enterprise as required by ASC 954-220-45-5. Below that measure, the statement displays all items that a business

enterprise would report in other comprehensive income, along with other changes in net assets without donor restrictions. In the statement of operations, the performance indicator is simply an intermediate measure, not the bottom line. The bottom line of the statement is *change in net assets without donor restrictions*.

ASC 954-220-45-5

The statement of operations for not-for-profit, business-oriented health care entities shall include a performance indicator. Because of the importance of the performance indicator, it shall be clearly labeled with a descriptive term such as revenues over expenses, revenues and gains over expenses and losses, recognized income, or performance earnings. Not-for-profit, business-oriented health care entities shall report the performance indicator in a statement that also presents the total changes in net assets without donor restrictions. Other changes in net assets may be presented separately or in the same statement.

If desired, an operating/nonoperating distinction can be made above the performance indicator (see NP 3.4.2.)

If discontinued operations are present, their results are reported just above the change in net assets without donor restrictions, preceded by appropriate subtotals (see NP 3.4.4).

If noncontrolling interests are present, there is no requirement to reflect the apportionment of earnings between the parent and the noncontrolling interests on the face of the statement, as would be required for a business entity. Instead, disclosure of the apportionment of the performance indicator and changes in net assets between the controlling and noncontrolling interests is provided through a reconciliation of the beginning and ending balances of net assets, described further in NP 3.6.

3.3.1.1 NFP HCO performance indicator

HCOs are the only NFPs that are required to report an earnings measure. For other NFPs, doing so is permitted but not required. This earnings measure is referred to as the performance indicator.

The performance indicator is a standardized measure defined in the ASC Master Glossary, which is analogous to income from continuing operations of a for-profit entity. It should contain the same elements of income and expense that a business entity would include in income from continuing operations.

Definition from ASC Master Glossary

Performance indicator: A performance indicator reports results of operations. A performance indicator and the income from continuing operations reported by for-profit health care entities generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care entities typically would not receive contributions, and not-for-profit health care entities would not award stock compensation). That is, a performance indicator is analogous to income from continuing operations of a for-profit entity.

The performance indicator must be clearly identified using a descriptive caption such as "excess of revenues over expenses," "revenues and gains over expenses and losses," "recognized income," or "performance earnings." The term "net income" is not appropriate due to differences in the

requirements for reporting discontinued operations and, when explicitly provided for in the transition provisions of newly issued FASB standards, the cumulative effect of changes in accounting principle. Similar to business entities, which generally exclude those items from income from continuing operations, NFP HCOs are required to exclude those items from the performance indicator (see NP 3.4.4 and NP 3.4.5). Business entities include those amounts in net income; NFP HCOs include them in *change in net assets without donor restrictions*.

In accordance with ASC 954-220-45-8, the following changes in net assets without donor restrictions must be excluded from (that is, reported below) the performance indicator:

- Transactions with owners acting in that capacity
- Equity transfers involving other entities that control the reporting entity, are controlled by the reporting entity, or are under common control with the reporting entity
- Contributions of (and assets released from donor restrictions related to) long-lived assets
- Unrealized gains and losses on other than trading debt securities
- Other items that are required to be reported in or reclassified from other comprehensive income by a business entity, such as (a) actuarial or experience gains and losses of pension or OPEB plans, as well as prior service costs or credits and transition assets or obligations for those plans; (b) the gain or loss on derivative instruments designated as and qualifying as cash flow hedging instruments; and (c) foreign currency translation adjustments.

ASC 954-220-50-1 requires note disclosure of the nature and composition of the performance indicator.

3.3.2 NFP HCO statement of changes in net assets

The statement of changes in net assets presents all changes in net assets that occurred during the reporting period disaggregated between the two classes of net assets. It displays the three measures required by ASC 958-220-45-1: the change in donor restricted net assets, the change in net assets without donor restrictions, and the change in net assets for the entity as a whole.

□ *Net assets without donor restrictions*

When the two-statement format is used, the activity reported for the changes in net assets without donor restrictions typically begins with the performance indicator and details all other changes in net assets without donor restrictions that were reported below the performance indicator in the statement of operations.

□ *Net assets with donor restrictions*

The activity reported for the changes in net assets with donor restrictions generally includes donor-restricted contributions, donor-restricted investment return (net of investment expenses), and changes in the value of split-interest agreements. As donor restrictions are satisfied, reclassifications are made from donor-restricted net assets to net assets without donor restrictions (see NP 3.4.3). If the HCO recognized an inherent contribution in connection with a business combination that occurred during the period (see NP 5.5.3.1), any portion that is donor-restricted would be included in this category.

As discussed in NP 3.2, the only expenses that may be included in the activity associated within donor-restricted net assets are investment expenses that have been netted against investment

return. The reporting of certain losses within this class (e.g., impairment losses associated with uncollectible donor-restricted pledges) is, however, permissible.

3.4 *Applicability of certain sub-totals and captions*

As discussed in NP 3.3.1, the statement of operations prepared by an NFP HCO reports a performance indicator (earnings measure) that is analogous to income from continuing operations of a business enterprise. Other NFPs may voluntarily choose to report this measure in a statement of operations.

NFPs that present a performance indicator apply the reporting concepts for other comprehensive income (OCI) in a manner similar to business entities. In income statements of business entities, OCI is a separate category of comprehensive income that is used to report certain gains, losses or other non-owner changes in equity during the period that are not included in net income. Amounts initially reported in OCI typically arise from unrealized remeasurement gains and losses that are reclassified to net income in a subsequent period, generally when realized. See ASC 220-10-45-10A and FSP 4.3 for a list of the items that qualify to be reported in this manner.

An NFP HCO would report items a business entity would classify as OCI in the change in net assets outside of the performance indicator in the period in which they arise and subsequently reclassify them into the performance indicator depending on the nature of the item.

As discussed in NP 2, an NFP HCO's *net assets without donor restrictions* inherently includes the accumulated other comprehensive income amounts that will be reclassified to the performance indicator in future periods. As discussed in ASC 954-815-45-1, NFP HCOs are neither required to separately present a category of net assets called "accumulated other comprehensive income" on the face of the balance sheet nor disclose changes (remeasurements or reclassifications) in these amounts.

Excerpt from ASC 954-815-45-1

The absence of a requirement to report a separate component of equity in the balance sheet of a not-for-profit, business-oriented health care entity shall not preclude those entities from using comprehensive income reporting... Although accumulated other comprehensive income will inherently be carried forward in a not-for-profit health care entity's net assets, there is no compelling need for it to be reported separately in the balance sheet.

3.4.1 *OCI for entities not reporting a performance indicator*

With the exception of NFPs that report a performance indicator (as defined), NFPs are not required to distinguish between the categories of income (i.e., net income and other comprehensive income) in their financial reporting.

For NFPs, the statement of activities reports the total change in net assets during a period, which is analogous to comprehensive income for a business enterprise. Because NFPs are not required to report an earnings measure, they cannot apply the other comprehensive income accounting concepts by reporting certain items outside of an earnings measure in the period in which they occur and subsequently reclassifying them into earnings. This has some practical consequences for financial reporting by NFPs. For example, it precludes most non-healthcare NFPs from using cash flow hedge accounting for derivatives.

In one area of GAAP, the FASB has prescribed special “OCI-like” reporting requirements for NFPs, as illustrated in Figure NP 3-2, which shows the presentation of a separate line item for the “other components” of net periodic benefit cost.

Figure NP 3-2

Display of pension-related amounts in statement of activities with intermediate measure of operations

	Net assets		Total
	Without donor restrictions	With donor restrictions	
Operating:			
Revenues, gains, and other support	\$ 10,000	\$ 5,000	\$ 15,000
Expenses, including pension service cost	7,500		7,500
Increase in net assets from operating activities	2,500		2,500
Nonoperating:			
Other components of net periodic pension Cost	(100)		(100)
Pension-related changes other than net periodic pension cost*	50		50
Increase in net assets	2,450	5,000	7,450
Net assets beginning of year	105,000	52,000	157,000
Net assets end of year	\$107,450	\$57,000	\$164,450

* Amortization of prior service cost and other gains/losses recognized in changes in net assets but not included in net periodic pension cost when they arose

All entities are required to report the service cost component of net periodic benefit cost separate from the other components of net benefit cost (which include amortization of the remeasurement adjustments previously recognized apart from expenses). ASC 958-715-45-3 prohibits NFPs from reporting the “other components of net benefit cost” in the same line as the OCI-type items because that line item is, by definition, classified outside of expenses and the “other components” are expenses. If the “other components” are shown as a separate line item, the caption should appropriately differentiate that line from the OCI-type amounts. If the NFP reports an intermediate measure of operations (which may or may not meet the definition of a performance indicator), ASC 958-715-45-1 imposes a new requirement that the OCI-type amounts be reflected as nonoperating (consistent with the requirement for reporting the other components of net benefit cost). In that circumstance, the annual reclassification out of the OCI-type amounts and into net periodic benefit cost would occur entirely within nonoperating activity.

3.4.2 Operating/nonoperating distinctions

Some NFPs may choose to report an intermediate measure of operations (that is, to classify revenues, expenses, gains and losses reported in net assets without donor restrictions as operating or nonoperating) in the statement of activities or statement of operations. This measure is considered intermediate in relation to the required sub-total of “change in net assets without donor restrictions,” and, according to ASC 958-220-45-10, must be presented in the statement that reports the change in net assets without donor restrictions. For NFP HCOs, this “operating” measure refers to an optional intermediate subtotal that is reported above the required performance indicator.

Excerpt from ASC 958-220-45-10

Because terms such as operating income, operating profit, operating surplus, operating deficit, and results of operations are used with different meanings, if an intermediate measure of operations (for example, excess or deficit of operating revenues over expenses) is reported, it shall be in a financial statement that, at a minimum, reports the change in net assets without donor restrictions for the period.

ASC 958-220-55-5 through ASC 958-220-55-6 provide an example of a statement of activities that distinguishes between operating and nonoperating activities.

Like business entities, an NFP is allowed to self-define an intermediate subtotal that is appropriate for the organization, but ASC 958-220-45-14 requires that there be sufficient clarity (either on the face of the statement or in the notes) about how the organization defines “operations.” In particular, if an NFP reports internal transfers between operating and nonoperating categories, it must clearly and transparently disclose the effects of internal transfers on the intermediate subtotal.

Excerpt from ASC 958-220-45-14

Pursuant to paragraph 958-220-50-1, if an NFP’s use of the term *operations* is not apparent from the details provided on the face of the statement, a note to financial statements shall describe the nature of the reported measure of operations or the items excluded from operations.

Figure NP 3-3 illustrates a footnote disclosure describing operations when not apparent from the face of the statement.

Figure NP 3-3**Disclosure of composition of intermediate measure of operations**

Measure of operations. NFP A’s operating revenues in excess of expenses and transfers include all operating revenues and expenses that are an integral part of its programs and supporting activities, net assets released from donor restrictions to support operating expenditures, and transfers from Board-designated and other nonoperating funds to support current operating activities. The measure of operations includes support for operating activities from both donor-restricted net assets and net assets without donor restrictions designated for long-term investment (the donor-restricted and quasi-endowment) according to NFP A’s spending policy, which is detailed in Note X. The measure of operations excludes investment return in excess of (less than) amounts made available for current support, gains and losses on extinguishment of debt, and changes in fair value of the interest rate swap.

ASC 958-220-55-16 through ASC 958-220-55-19 provide additional information and examples.

Despite the flexibility to self-define a measure of operations in most respects, ASC 958-220-45-11 requires certain items to be included in or excluded from that measure, if it is presented.

ASC 958-220-45-11

Some limitations on an NFP's use of an intermediate measure of operations are imposed by other Subtopics. If a subtotal such as income from operations is presented, it shall include the following amounts:

- a. An impairment loss recognized for a long-lived asset (asset group) to be held and used, pursuant to paragraph 360-10-45-4
- b. Costs associated with an exit or disposal activity that does not involve a discontinued operation, pursuant to paragraph 420-10-45-3
- c. A gain or loss recognized on the sale of a long-lived asset (disposal group) that is not a component of an entity that qualified for discontinued operations treatment, as defined in Subtopic 205-20, and pursuant to paragraph 360-10-45-5

In addition, the subtotal such as income from operations shall exclude the components of net periodic pension cost and net periodic postretirement benefit cost other than the service cost component, pursuant to paragraph 958-715-45-3.

Question NP 3-1 discusses the appropriate presentation of OCI items in an intermediate measure of operations.

Question NP 3-1

Can an NFP that does not report a performance indicator include items in its measure of operations that are treated as OCI items by business enterprises?

PwC response

Yes, with one exception. NFPs that do not report a performance indicator (as defined, see NP 3.3.1.1) have the flexibility to include OCI items in an intermediate measure of operations with the exception of certain OCI items related to pension and OPEB costs, which must be reported outside a measure of operations (consistent with the requirement for reporting the other components of net benefit cost).

3.4.3 Reclassifications between categories of net assets

The ASC Master Glossary defines a "reclassification of net assets" as follows:

Excerpt from ASC Master Glossary

Reclassification of net assets: Simultaneous increase of one class of net assets and decrease of another. A reclassification of net assets usually results from a donor-imposed restriction (donors include other types of contributors, including makers of certain grants) being satisfied or otherwise lapsing.

When the donor's stipulation has been satisfied (e.g., the equipment has been placed in service, the program activities have been carried out, the stipulated time period has elapsed), a reclassification is made from net assets with donor restrictions to net assets without donor restrictions to reflect the expiration of the restriction (see NP 6.7.2).

Reclassifications of net assets are not revenues, expenses, gains, or losses. Rather, they are a special category of transaction unique to NFPs. In accordance with ASC 958-220-45-3, they are reported as a separate line or lines on the face of the statement of activities using a caption such as “net assets released from restriction.” Because releases of restriction are not considered revenue, financial statement captions that include increases of net assets associated with releases of restriction typically refer to those amounts as “support” (for example, *total revenues and support*).

NFP HCOs must tailor their presentation of reclassifications in light of the additional reporting requirements associated with their reporting model. As discussed in NP 3.3, HCOs typically report their activities in two statements: a statement of operations and a statement of changes in net assets. When a donor restriction is satisfied, the decrease in donor-restricted net assets is reflected as a separate line in the statement of changes in net assets, and the increase in net assets without donor restrictions appears as a separate line in the statement of operations. In the statement of operations, the reclassification is reported above the performance indicator unless the restriction pertained to the purchase of long-lived assets (see NP 6.7.3).

For more information regarding reclassifications, see NP 6.7.2

3.4.4 NFP presentation of discontinued operations

NFPs apply the same guidance as business entities with respect to determining whether disposal of a component meets the conditions for reporting as a discontinued operation. See FSP 27 for information on those requirements. ASC 205-20-45-3 describes in which period such component should be presented as discontinued operations.

ASC 205-20-45-3

The statement in which net income of a business entity is reported or the statement of activities of a not-for-profit entity (NFP) for current and prior periods shall report the results of operations of the discontinued operation, including any gain or loss recognized in accordance with paragraph 205-20-45-3C, in the period in which a discontinued operation either has been disposed of or is classified as held for sale.

NFP and business entity reporting models differ with respect to where the effects of discontinued operations are presented. For business entities, discontinued operations are included in net income. Not-for-profit entities must report the results of discontinued operations as a separate component of the change in net assets for the appropriate net asset class (or classes). Display of an appropriately labeled subtotal (for example, “change in net assets before discontinued operations”) prior to the effects of the discontinued operations is required by ASC 958-220-55-6 and ASC 958-220-55-7.

Figure NP 3-4 illustrates the presentation of discontinued operations for an NFP.

Figure NP 3-4

Presentation of discontinued operations in statement of activities

	Net assets	
	Without donor restrictions	With donor restrictions
Change in net assets before discontinued operations	\$XXX,XXX	\$XX,XXX
Discontinued operations (including loss on disposal of \$XX)	XXX	—
Change in net assets	<u>\$XXX,XXX</u>	<u>\$XX,XXX</u>

The NFP-specific presentation requirements for discontinued operations also apply to NFP HCOs that report a performance indicator. The sequencing of discontinued operations is the primary structural difference between the performance indicator for an NFP HCO and net income of a business entity. In an NFP HCO's statement of operations, discontinued operations must be reported below the performance indicator, just prior to the change in net assets. NFP HCOs cannot report discontinued operations in the same manner as a business entity (that is, include discontinued operations within the performance indicator) in order to appear more comparable to their for-profit business entity counterparts.

3.4.5 ***Presentations of cumulative effect of accounting changes***

The cumulative effect of a change in accounting principle associated with issuance of a new standard must be reflected in current period activity, rather than by adjusting the opening balance of net assets. As explained in AAG-HCO 3.22, the effect of these changes would be displayed similar to discontinued operations.

AAG-HCO 3.22

Normally, a FASB Accounting Standards Update (ASU) will provide specific transition requirements. If a newly issued standard requires that the effect of an accounting change be reported as a cumulative-effect adjustment to the change in net assets of the period of the change, rather than by retrospective application, that amount would be displayed similar to discontinued operations, unless the transition requirements provided otherwise.

As discussed in FSP 27.4.2, if a financial reporting period includes both a cumulative effect accounting change and a discontinued operation, the statement of activities should present the discontinued operation prior to reporting the cumulative effect of the change in accounting principle.

3.4.6 ***Accounting changes and error corrections***

Changes in accounting necessitated by a newly-issued FASB standard are subject to the transition provisions of each particular standard. Changes in accounting principle can also be voluntary.

ASC 250-10 requires retrospective application for voluntary changes in accounting principle. Retrospective application requires that the cumulative effect of the change to all prior periods be reported as an adjustment to the opening balance of net assets as of the earliest period presented in the comparative financial statements.

Figure NP 3-5 illustrates the reporting of a voluntary change in accounting principle through retrospective application.

Figure NP 3-5

Retrospective application of a change in accounting principle

Change in net assets	<u>\$ XXX,XXX</u>
Net assets, beginning of year, as originally reported	XXX,XXX
Adjustment for retrospective application of new accounting principle (Note X)	<u>XXX</u>
Net assets, beginning of year, as adjusted	<u>XXX,XXX</u>
Net assets, end of year	<u>\$ XXX,XXX</u>

Prior periods may also be restated due to the need to correct a material error. Figure NP 3-6 illustrates the reporting of the correction of an error.

Figure NP 3-6

Correction of an error

Change in net assets	<u>\$ XXX,XXX</u>
Net assets, beginning of year, as originally reported	XXX,XXX
Restatement (Note X)	<u>XXX</u>
Net assets, beginning of year, as restated	<u>XXX,XXX</u>
Net assets, end of year	<u>\$ XXX,XXX</u>

3.4.7 Board designations, appropriations, and similar actions

Some NFPs that report a self-defined operating measure (see NP 3.4.2) will choose to display the effects of internal board designations, appropriations, and similar actions—hereafter referred to as “internal transfers”—on the face of the statement of activities. Entities that apply this practice are able to increase or decrease the amount of operating income reported in a given year, based on decisions made by their governing boards to spend, or not spend, certain resources during the year.

For example, an NFP might receive a larger-than-normal bequest that the governing board decides not to use in current period operations. An NFP that chooses to report internal transfers on the face of the statement of activities would report a transfer out of operating activity for that amount along with a corresponding transfer into nonoperating activity. In the period that the board decides to use the

funds in operations, the statements would reflect a decrease in nonoperating income and an increase in operating income to “transfer” the resources back into the operating classification. The bottom line “change in net assets” for the period is unaffected, only the income from operations subtotal will change.

Other common situations when internal transfers might be reported are:

- Contributions designated by the board for capital projects
- Investment returns appropriated from a quasi-endowment
- Establishing or adding to a board-designated endowment fund (quasi-endowment, funds functioning as endowment)

NFPs that choose to display internal transfers in the statement of activities are required to clearly and transparently present those transfers, appropriately disaggregated and described by type, so that users of the financial statements can determine their effect on the operating measure. This information can be provided either on the face of the statement of activities or in the notes.

Excerpt from ASC 958-220-45-14

If an NFP presents internal board designations, appropriations, and similar actions on the face of the financial statements, a note to financial statements shall provide an appropriate disaggregation and description by type of these actions if not provided on the face of the financial statements.

ASC 958-220-55-17 illustrates a statement showing internal transfers that are appropriately disaggregated and described by type on the face (that is, each type of transfer appears separately in both the operating and nonoperating section). ASC 958-220-55-18 illustrates a statement when internal transfers are aggregated and reported net in a single line item in the operating and nonoperating sections of the statement. In the latter case, the entity must provide disclosure in the notes to the financial statements of the disaggregated information required by GAAP.

3.4.8 *Equity transfers and equity transactions among affiliates*

There are two special types of related party transactions that are unique to NFPs: equity transfers and equity transactions, as articulated in ASC 958-20-55-2B.

ASC 958-20-55-2B

An equity transaction differs from an equity transfer in that an equity transaction, as described in paragraph 958-20-25-4, involves a financially interrelated party either as a third party in a transfer from an entity to one of its affiliates or as a counterparty in a transfer from an entity to itself. In addition, an equity transaction, unlike an equity transfer, is reciprocal; the NFP or its affiliate named as the beneficiary receives an ongoing economic interest in the assets held by the recipient entity. See paragraph 954-220-45-2 for guidance on how to present equity transfers for not-for-profit, business-oriented health care entities that present a performance indicator.

3.4.8.1 *Equity transfers*

As defined in the ASC Master Glossary, an equity transfer is a nonreciprocal transfer of resources between entities that are members of the same NFP consolidated financial reporting entity. In some

ways, they are the not-for-profit counterpart of transfers of capital that occur between a business entity and its owners (for example, additional paid-in capital or payment of dividends).

Excerpt from ASC Master Glossary

Equity Transfer: An equity transfer is nonreciprocal. An equity transfer is a transaction directly between a transferor and a transferee. Equity transfers are similar to ownership transactions between a for-profit parent and its owned subsidiary (for example, additional paid-in capital or dividends). However, equity transfers can occur only between related not-for-profit entities (NFPs) if one controls the other or both are under common control. An equity transfer embodies no expectation of repayment, nor does the transferor receive anything of immediate economic value (such as a financial interest or ownership).

Because these transfers occur between members of the same financial reporting entity, they eliminate in consolidation. However, when separate financial statements are issued for a subsidiary that makes or receives an equity transfer, the transfer must be displayed.

Equity transfers must be reported as a separate line item (or items) in a statement of activities. In an NFP HCO's statement of operations, that separate line item must be displayed outside of (that is, below) the performance indicator. Flexibility is provided in how these line items can be captioned, as long as the captions are appropriately descriptive (for example, "grant from affiliate"). See ASC 954-220-45-2 for additional guidance on the reporting of equity transfers for NFPs and NFP HCOs.

While these transactions often involve transfers of financial resources, they also can take other forms, such as the transfer of tangible assets. Such transfers are reported at the carrying amount of the underlying asset and do not result in a step-up to fair value. For example, if a nonreciprocal transfer of equipment occurs between affiliates, the recipient would reflect the capital asset at its carryover basis (that is, the value at which it was carried on the books of the transferring entity).

Equity transfers can also take the form of services provided. See NP 7.5.2 for further information about personnel services donated by an affiliated organization.

3.4.8.2 Equity transactions

Equity transactions are reciprocal transfers that occur between NFP affiliates in certain specific circumstances. In accordance with ASC 958-20-45-1 and ASC 958-20-45-2, both the recipient and donor NFP must report affiliate equity transactions as a separate line item. ASC 958-20-25-4 through ASC 958-20-25-7 describe circumstances involving equity transfers with other NFPs that are financially-interrelated (see NP 8).

Excerpt from ASC 958-20-45-1

A recipient entity shall report an equity transaction as a separate line item in its statement of activities. Paragraph 958-20-55-2B describes the difference between an equity transfer and an equity transaction.

ASC 958-20-45-2

A resource provider shall report an equity transaction as a separate line in its statement of activities if it specifies an affiliate as beneficiary. See paragraph 958-20-25-4 for the conditions that determine if a transfer is an equity transaction.

Equity transactions also are used for reporting share transactions between an NFP parent and noncontrolling shareholders. ASC 958-810-55-21(c) states that shares purchased by an NFP parent from noncontrolling shareholders, or shares sold by an NFP parent to noncontrolling shareholders, are reported as equity transactions within net assets without donor restrictions. This reporting is illustrated in ASC 958-810-55-24.

3.5 ***Expenses—presentation and disclosure***

Expenses are outflows or other using up of assets associated with delivering or producing goods, rendering services, or carrying out the NFP's other activities. In a statement of activities or statement of operations, expenses must be reflected as changes in net assets without donor restrictions, except for external and direct internal investment expenses that must be netted against investment returns (see NP 9).

As discussed in AAG-NFP 12.11, expenses that are directly related to specific revenues may be displayed adjacent to those revenues, similar to the manner in which costs of goods sold are reported.

Excerpt from AAG-NFP 12.11

Expenses that are directly related to specific gross revenues may be displayed sequentially with [the related] revenues. For example, gross revenues from special events less the direct costs related to those events, followed by a subtotal, may be reported in a statement of activities.

NFPs are required to provide information about expenses disaggregated by both function and nature, as those terms are defined in the ASC Master Glossary.

ASC Master Glossary

Functional expense classification: A method of grouping expenses according to the purpose for which costs are incurred. The primary functional classifications of a not-for-profit entity are program services and supporting activities.

Natural expense classification: A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, professional services, supplies, interest expense, rent, utilities, and depreciation

Figure NP 3-7 illustrates the functional versus natural classification presentations.

Figure NP 3-7
Expense classification formats

Expenses by natural classification		Expenses by functional classification	
Expenses:		Expenses:	
Salaries and benefits	\$ 15,115	Program A	\$ 13,296
Grants to other organizations	4,750	Program B	8,649
Supplies and travel	3,155	Program C	5,837
Services and professional fees	2,840	Management and general	2,038
Office and occupancy	2,528	Fundraising	2,150
Depreciation	3,200		
Interest	382		
Total expenses	<u>\$ 31,970</u>	Total expenses	<u>\$ 31,970</u>

An NFP has free choice regarding which classification to use for displaying expenses on the face of the statement of activities or statement of operations. Information regarding the other expense classification may be satisfied by the required analysis of program expenses by function and nature, discussed at NP 3.5.2. Some entities with a single program might be able to display both classifications on the face of the statement. Figure NP 3-9 illustrates such an approach.

For NFP HCOs, industry convention is to use natural expense classifications on the face of the statement of operations, consistent with business entity reporting practices. Among other NFPs, practice is mixed.

3.5.1 Reporting expenses by functional classification

The presentation and disclosure requirements for NFPs regarding expenses are more extensive than they are for business entities. Because most NFPs have no single indicator of performance comparable to a business entity's profit, the FASB determined that other indicators of performance (such as information regarding service efforts) were needed in financial statements. Consequently, ASC 958-720-05-4 established a requirement to provide information about expenses by functional classifications, which focus on how an NFP's resources (cash, personnel, materials, etc.) are used in providing its programs or services.

ASC 958-720-05-4

To help donors, creditors, and others in assessing an NFP's service efforts, including the costs of its services and how it uses resources, a statement of activities or notes to financial statements shall provide information about expenses reported by their functional classification such as major classes of program services and supporting activities.

Functional reporting involves grouping expenses according to the purposes for which they were incurred. The primary categories used are program services and supporting activities.

3.5.1.1 *Program services*

Program services involve distribution of the NFP's goods or services to beneficiaries, customers, or members—in other words, carrying out the purpose for which the NFP exists. Some entities will report multiple programs—for example, an academic medical center might report information about programs for student instruction, research, and patient care, among others. Others may have a single program. For financial reporting purposes, NFPs have latitude to define the programs to be displayed and to determine the degree of aggregation used when reporting expenses of programs.

The components of program expenses must be evident from the details provided either on the face of the statement of activities or in the notes.

Excerpt from ASC 958-720-50-1

The financial statements of an not-for-profit entity (NFP) shall disclose the following information:

...

- b. Total program expenses and information about why total program expenses disclosed in the notes do not articulate with the statement of activities. Pursuant to paragraph 958-720-45-5, this disclosure is only required if the components of total program expenses are not evident from the details provided on the face of the statement of activities (for example, if cost of sales is not identified as either program or supporting services).

3.5.1.2 *Supporting activities*

Expenses that are not associated with programs are considered to be supporting activities. Supporting activities generally include:

□ *Fundraising*

Fundraising activities are undertaken to induce potential donors to contribute. They include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.

□ *Membership development*

Membership development expenses include costs associated with member dues, member relations, and soliciting new members. As discussed at NP 12, some NFPs have "members" whose "dues" are tantamount to contributions, because the member receives no significant benefits in exchange for the resources they provide. In those situations, membership development activities might more appropriately be considered fundraising activities. If member dues paid are part-exchange and part-contribution, membership development activities would be "joint activities," the costs of which must be allocated according to a specific framework (see NP 3.5.1.3).

□ *Management and general*

This is the residual classification used for activities that are not directly identifiable with program, fundraising, or membership development functions. Typically, it includes the salaries and expenses of the NFP's executive management and supporting staff, expenses of the governing board, and costs of activities or departments that benefit the overall organization (for example, human resources or accounting). See ASC 958-720-45-2A for types of activities that are considered management and general.

3.5.1.3 Allocation of costs among functions

Some expenses relate directly to a single program or supporting service. Whenever possible, direct identification of specific expenses (also referred to as "assigning" expenses) is the preferable method of charging expenses to functions.

When that is not possible, expenses must be allocated among the functions to which they relate. Situations requiring allocation include:

□ *Specific activities that directly benefit more than one function*

Costs of certain supporting activities carried within management and general should be allocated among the functions that receive direct benefit, while others should remain entirely within the management and general function. Costs of departments that benefit the overall organization should remain entirely within management and general. ASC 958-720-45-2A cites accounting, financial reporting, and human resources as examples of supporting activities for the entire entity that benefit the overall organization. Information technology is cited as an example of costs that are shared by and identifiable with more than one function that should be allocated. Illustrative guidance that clarifies the types of costs that should (and should not) be allocated are provided in paragraphs ASC 958-720-55-171 through ASC 958-720-55-176.

Excerpt from ASC 958-720-45-2A

Certain costs benefit more than one function and, therefore, shall be allocated. For example, information technology generally can be identified as benefitting various functions, such as management and general (for example, accounting and financial reporting and human resources), fundraising, and program delivery. Therefore, information technology costs generally would be allocated among the functions receiving direct benefit.

□ *Joint activities*

If activities that are part of the fundraising function have elements of one or more other functions, they are considered "joint activities" that must be allocated in a particular manner. Guidance on the allocation of costs of joint activities is provided in the *Accounting for Costs of Activities That Include Fundraising* subsections of ASC 958-720 (beginning with ASC 958-720-45-28). ASC 958-720-55-2 includes a flowchart that is useful in determining how to account for joint activities.

- *General management personnel are involved in conducting or supervising program, fundraising, or membership development activities*

If individuals whose compensation and benefits are classified as management and general costs spend a portion of their time directly conducting or supervising program, fundraising, or membership development activities, allocation of a ratable portion of their compensation to those other functions is required by ASC 958-720-45-2A.

Excerpt from ASC 958-720-45-2A

Activities that represent direct conduct or direct supervision of program or other supporting activities require allocation from management and general activities.

Example NP 3-1 illustrates the allocation of the costs of supervisory personnel to various functions.

EXAMPLE NP 3-1

Allocating compensation of the chief financial officer among functions

The CFO at Charitable.org has primary responsibility for (a) accounting and reporting, (b) short-term budgeting and long-term financial planning, (c) information technology, and (d) managing the investment strategy of the endowment. The CFO spends 40% of her time on accounting and reporting (including supervising the accounting for investments); 30% on budgeting and financial reporting; 20% on information technology; and 10% managing the investment strategy.

How should Charitable.org allocate the CFO's salary and benefits among its functions?

Analysis

In this situation, 70% of the CFO's compensation and benefits would relate to conduct or supervision of management and general activities that benefit the overall organization (i.e., accounting and reporting, and budgeting and financial planning). That portion of compensation and benefits would remain within the management and general function. The 20% of time spent directly supervising the information technology department means that 20% of the CFO's compensation and benefit costs should be included in the IT costs that are allocated among the functions that benefit from them. The time spent directly supervising and managing the investment strategy for the endowment qualifies as direct investment expense, so 10% of her compensation and benefit costs would be netted against investment return and thus, would not be displayed as part of expenses (see NP 9 for guidance on direct internal investment expenses netted against investment return). The time spent supervising the accounting for investments is not allocated to investment return; instead, it is part of the accounting function within management and general activities.

Other examples can be found in ASC 958-720-55-171 through ASC 958-720-55-175.

ASC 958-720-50-1(d) requires disclosure of the allocation methods used. AAG-NFP 13.67 through AAG-NFP 13.73 provide additional commentary on allocations and allocation methods.

3.5.2 Analysis of expenses by nature and function

NFPs are required by ASC 958-720-45-15 to provide a statement or schedule detailing how the entity's natural expenses were allocated among its program and support functions in order to demonstrate more clearly how an NFP uses its resources to achieve its mission or objectives.

Excerpt from ASC 958-720-45-15

The relationship between functional classification and natural classification for all expenses shall be presented in an analysis that disaggregates functional expense classifications, such as major classes of program services and supporting activities, by their natural expense classifications, such as salaries, rent, electricity, interest expense, supplies, depreciation, awards and grants to others, and professional fees.

NFPs have flexibility in where they present this information. It can be provided on the face of the financial statements, in the notes, or as a separate basic financial statement. The analysis must include all expenses reported in the statement of activities or statement of operations and is required for all periods presented. If an entity reports expenses on the face of the statement using functional classifications, and those amounts do not reconcile to this analysis, the differences must be explained. This might occur if, for example, cost of sales is displayed apart from other expenses on the face of the statement, in order to present those costs together with the related program revenue.

Figure NP 3-8 illustrates the reporting of expenses by nature and function as a separate schedule.

Figure NP 3-8

Schedule of expenses by nature and function

	Program activities				Supporting activities			Total expenses
	A	B	C	Subtotal	Management and general	Fund-raising	Subtotal	
Expenses and losses:								
Salaries and benefits	\$ 7,400	\$3,900	\$1,725	\$13,025	\$1,130	\$960	\$2,090	\$ 15,115
Grants to other organizations	2,075	750	1,925	4,750				4,750
Supplies and travel	890	1,013	499	2,402	213	540	753	3,155
Services and professional fees	160	1,490	600	2,250	200	390	590	2,840
Office and occupancy	1,160	600	450	2,210	218	100	318	2,528
Depreciation	1,440	800	570	2,810	250	140	390	3,200
Interest	171	96	68	335	27	20	47	382
Total expenses (Note F)	\$13,296	\$8,649	\$5,837	\$27,782	\$2,038	\$2,150	\$4,188	\$ 31,970

Figure NP 3-9 illustrates how the requirements of ASC 958-720-45-15 might be accomplished on the face of a statement of activities.

Figure NP 3-9

Expenses by function and nature on face of statement of activities

Expenses:	
Program:	
Salaries and benefits	\$3,900
Supplies	1,013
Services and professional fees	1,490
Office and occupancy	600
Depreciation	<u>800</u>
Total program	7,803
Management and general:	
Salaries and benefits	1,130
Supplies	213
Services and professional fees	200
Office and occupancy	218
Depreciation	<u>250</u>
Total supporting	<u>2,011</u>
Total expenses	\$ 9,814

Figure NP 3-10 provides a summary of items that frequently raise questions as to whether they should be included or excluded from the analysis.

Figure NP 3-10

Items included in or excluded from the analysis by nature and function (ASC 958-205-45-6)

	Included in analysis	Excluded from analysis
Salaries included in cost of goods sold on face of statement	●	
Facility rental costs of special events reported as direct benefits to donors on face of statement	●	
Any other expenses shown apart from functional expenses on the face of a statement that displays expenses by functional classifications	●	
Non-service component of net periodic benefit cost	●	
Expenses shown as nonoperating activity	●	
External and direct internal investment expenses netted against investment return (see NP 9)		●
Losses (in general)		●
Losses reported in OCI of business entities (see NP 3.4.1)		●

Question NP 3-2 and Question NP 3-3 address common questions related to the analysis.

Question NP 3-2

Can an NFP consider materiality in determining whether to present the analysis of expenses by nature and function?

PwC response

Yes. ASC 105-10-05-6 states that “the provisions of the Codification need not be applied to immaterial items.” This applies to all provisions of the Codification, including disclosure requirements.

Question NP 3-3

An NFP’s statement of activities presents an intermediate measure of operations. Should the components of net periodic benefit cost other than service cost be excluded from the analysis of expenses by nature and function?

PwC response

No. Net periodic benefit cost represents a period expense of the entity, regardless of whether it is displayed as a single amount or subdivided into its various components. The requirement to segregate net periodic benefit costs between operating and nonoperating categories would have no impact on the amounts to be included in the analysis. All expenses reported in the financial statements—including those classified as nonoperating—must be included in the analysis of expense by nature and function.

3.6 ***Noncontrolling interests***

When an NFP owns less than 100% of a consolidated for-profit subsidiary, the other owners are referred to as noncontrolling shareholders. Additionally, in some situations, an NFP HCO may have attributed a portion of the net assets of a consolidated NFP subsidiary to a noncontrolling interest (see NP 5.2.5). ASC 958-810 tailors the general guidance for reporting noncontrolling interests in subsidiaries (ASC 810-10-45-15 through ASC 810-10-45-21) to the NFP reporting model.

Purchases or sales of shares between the NFP parent and the noncontrolling shareholders are considered equity transactions and should be displayed separately. See NP 3.4.8.

ASC 958-810-55-17 through ASC 958-810-55-25 provide a comprehensive example of NFP financial statements that illustrates the presentation and disclosure requirements for noncontrolling interests. With respect to the statement of activities or statement of operations, ASC 958-810-50-4 requires a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest. This is similar to the reconciliation of the beginning and ending balances of net assets attributable to the parent and noncontrolling interest that business entities are required to present pursuant to ASC 810-10-50-1A.

ASC 958-810-50-4

An NFP (parent) that has one or more consolidated subsidiaries with a noncontrolling interest shall provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest either in notes to the consolidated financial statements or on the face of financial statements, if practicable. That schedule shall reconcile beginning and ending balances of the parent's controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists during the reporting period.

Excerpt from ASC 958-810-50-5

The schedule shall, at a minimum, include:

- a. A performance indicator, if the entity is a not-for-profit, business-oriented health care entity
- b. Amounts of discontinued operations
- c. Not used
- d. Changes in ownership interests in a subsidiary, including investments by and distributions to noncontrolling interests acting in their capacity as owners, which shall be reported separate from any revenues, expenses, gains, or losses and outside any measure of operations, if reported
- e. An aggregate amount of all other changes in net assets without donor restrictions and net assets with donor restrictions for the period.

This schedule reconciles beginning and ending balances of the parent's controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists. It is either displayed on the face of the statement or provided in the notes.

Unlike business entities, NFPs are not required to separately present amounts for the parent and the noncontrolling interest on the face of the statement of activities or the statement of operations. Only the rollforward schedule is required. If an NFP HCO wishes to display the performance indicator and the change in net assets without donor restrictions on the face of the statement of operations in a manner similar to a business entity, such a presentation could be modeled on the guidance for business entities that present a single continuous statement of comprehensive income. FSP 4.4.2 provides an example of such reporting by a business entity.

Figure NP 3-11 illustrates this rollforward for an NFP that does not report a performance indicator (and is not reporting discontinued operations or changes in ownership interests).

Figure NP 3-11

Schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest (no performance indicator)

Changes in consolidated net assets without donor restrictions attributable to NFP parent			
	Total	Controlling interest	Noncontrolling interest
Balance, July 1, 20X0	\$400,000	\$320,000	\$80,000
Changes in net assets without donor restrictions	50,000	40,000	10,000
Balance, June 30, 20X1	\$450,000	\$360,000	\$90,000
Changes in net assets without donor restrictions	20,000	16,000	4,000
Balance, June 30, 20X2	<u>\$470,000</u>	<u>\$376,000</u>	<u>\$94,000</u>

Figure NP 3-12 is an example for an NFP HCO that reports a performance indicator derived from ASC 958-910-55-25. No purchases or sales of shares between the parent and noncontrolling shareholders occurred during these periods.

Figure NP 3-12

Schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest (with performance indicator)

Changes in consolidated net assets without donor restrictions attributable to NFP parent			
	Total	Controlling interest	Noncontrolling interest
Balance, July 1, 20X0	\$400,000	\$320,000	\$80,000
Excess of revenues over expenses (from continuing operations)	23,000	18,400	4,600
Discontinued operations, net of tax	(7,000)	(5,600)	(1,400)
Other changes	15,000	12,000	3,000
Changes in net assets without donor restrictions	31,000	24,800	6,200
Balance, June 30, 20X1	\$431,000	\$344,800	\$86,200
Excess of revenues over expenses	29,000	23,200	5,800
Other changes	5,000	4,000	1,000
Changes in net assets without donor restrictions	34,000	27,200	6,800
Balance, June 30, 20X2	<u>\$465,000</u>	<u>\$372,000</u>	<u>\$93,000</u>

Chapter 4:

Statement of cash flows

4.1 *Statement of cash flows—chapter overview*

This chapter provides an overview of the requirements related to the cash flow statement for not-for-profit (NFP) entities, including how certain transactions unique to NFPs should be presented. For a comprehensive discussion of general issues related to preparing a statement of cash flows, see FSP 6.

New guidance

This chapter has been updated for ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash*. ASU 2016-18 provides new presentation and disclosure guidance for amounts generally described as restricted cash and restricted cash equivalents as well as any other cash balances included on the balance sheet. For all NFPs, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. For guidance on cash flow statement presentation prior to ASU 2016-18, see FSP 6.5.

4.2 *Overview of the cash flow statement*

A statement of cash flows explains the change during the period in cash, cash equivalents, and restricted cash. It is required for each period for which a statement of activities is presented.

Both NFPs and business entities prepare their cash flow statements in accordance with ASC 230-10, *Statement of Cash Flows*, using the same classifications and definitions. ASC 230-10 requires that cash receipts and cash payments be classified according to their nature—whether they stem from operating, investing, or financing activities—and provides explicit definitions of operating, investing, and financing cash flows. ASC 230-10 and ASC 958-230, *Not-for-Profit Entities – Statement of Cash Flows*, provide cash flow reporting guidance specific to contribution transactions (see NP 4.5).

Entities can present cash flows from operations using either the direct or indirect method. Although ASC 230 suggests that the direct method is preferable, most entities use the indirect method in which operating cash flows are derived by making adjustments to the total change in net assets (or net income for business entities). Investing and financing activities that affect recognized assets or liabilities but do not result in cash receipts or payments—for example, entering into a financing lease or purchasing fixed assets in exchange for a note payable—are required to be disclosed either on the face of the cash flow statement or in the notes.

4.3 *Cash, cash equivalents, and restricted cash*

The cash flow statement details changes in an entity's cash, cash equivalents, and restricted cash by reconciling the beginning and ending totals of all such amounts for the period. ASC 230-10 does not define restricted cash; instead, it refers to "amounts generally described as" restricted cash or restricted cash equivalents. For general information on what qualifies as cash, cash equivalents, and amounts generally described as restricted cash and restricted cash equivalents, see FSP 6.5.

As discussed in ASC 958-230-55-2, restrictions or constraints on an NFP's ability to withdraw or use cash and cash equivalents can cause those resources to be classified as noncurrent in the balance sheet (or in an unclassified balance sheet, sequenced apart from and below cash and cash equivalents used

in operations). Despite being classified apart from cash and cash equivalents on the balance sheet, our view is that these amounts represent restricted cash or restricted cash equivalents and therefore are subject to inclusion in beginning and ending cash in the statement of cash flows.

ASC 958-230-55-2

Not all assets of NFPs that meet the definition of cash equivalents are cash equivalents for purposes of preparing statements of financial position and cash flows. Restrictions can prevent them from being included as cash equivalents even if they otherwise qualify. For example, short-term highly liquid investments are not cash equivalents if they are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment.

All cash—regardless of its location on the balance sheet and any restrictions placed on its use—must be included in the beginning and ending totals. The beginning and ending totals must also include any short-term, highly-liquid investments that are defined as cash equivalents under an entity’s accounting policy, including those that are subject to restrictions. As discussed in ASC 230-10-45-6, because not all investments that might qualify as cash equivalents under the ASC Master Glossary definition are required to be classified as such, entities must establish and disclose a policy identifying which investments are treated as cash equivalents for financial reporting purposes.

ASC 230-10-45-6

Not all investments that qualify are required to be treated as cash equivalents. An entity shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition of cash equivalents are treated as cash equivalents. For example, an entity having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an entity whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents.

Similar to the example in ASC 230-10-45-6, an NFP with an endowment or investment pool might establish a policy to report as cash equivalents all short-term, highly-liquid investments meeting the definition, except for such instruments that are purchased for its endowment or investment pool. In that case, the short-term, highly-liquid instruments held within the endowment or investment pool are accounted for as investments, rather than as cash equivalents. If the NFP had not made the election, the short-term, highly liquid investments would be considered cash equivalents or restricted cash equivalents and would be included in the beginning and ending totals in the statement of cash flows. See FSP 6.5.2 for further discussion of the accounting policy for defining cash equivalents.

According to ASC 230-10-50-8, when cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are included in more than one line item on the balance sheet, a reconciliation of the totals in the statement of cash flows to the related captions in the balance sheet must be provided either on the face of the statement of cash flows or in the notes to the financial statements. Entities must also disclose the nature of restrictions on their restricted cash and restricted cash equivalent balances, as required by ASC 230-10-50-7 and ASC 958-210-50-3.

4.4 *Cash flows from operating activities*

Cash flows from operating activities is the residual category in the cash flow statement. If a cash inflow (receipt) or outflow (payment) does not result from an investing or financing activity, it is classified as operating.

ASC 230-10 encourages entities to report cash flows from operating activities by showing major classes of operating cash receipts and payments (the direct method) (see NP 4.4.2). Alternatively, entities can use the indirect (or reconciliation) method to determine net cash flow from operating activities (see NP 4.4.1).

As discussed at NP 3.4.2, some NFPs may choose to present a statement of activities in a format that classifies transactions as operating or nonoperating. The definition of “operating activities” as used in the statement of cash flows is not intended to correspond to the definition of “operations” that an entity might use in its statement of activities. If an entity 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. However, “operating activities” as used in the statement of cash flows is prescribed by GAAP. Therefore, NFPs should be mindful of certain types of transactions that must be classified as operating activities under ASC 230 that might be classified differently in the statement of activities. For example:

- Under ASC 230-10, all cash receipts from contributions must be classified within operating activities in the statement of cash flows unless the gifts are donor-restricted for long-term purposes. In the statement of activities, management might choose to classify some contributions as operating and others as nonoperating, or to assign all contributions to one category or the other.
- ASC 230-10 similarly requires that dividends, interest, and other investment income received be classified within operating activities in the statement of cash flows unless those resources are donor-restricted for long-term purposes. In the statement of activities, many NFPs voluntarily apportion net investment return between operating and nonoperating categories using a spending rate.

4.4.1 *Indirect method of determining operating cash flows*

If an NFP chooses to report operating cash flows using the indirect method, ASC 230-10-45-28 requires that the operating section must reconcile from the overall “change in net assets” measure reported in the statement of activities (or, for NFP healthcare organizations (HCOs), in the statement of changes in net assets) to net cash provided by or used in operating activities.

Excerpt from ASC 230-10-45-28

Entities that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 230-10-45-25 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business entity or change in net assets of a not-for-profit entity (NFP) to reconcile it to net cash flow from operating activities (the indirect or reconciliation method).

This requirement applies to all NFPs, including those that are required to report a performance indicator that is equivalent to earnings of a business enterprise, and those who choose to do so voluntarily. Entities cannot elect to use their performance indicator as the starting point of the reconciliation in order to more closely parallel the reporting by business enterprises.

Under the indirect method, the net cash provided by or used in operating activities is determined by adjusting the overall change in net assets to remove the effects of:

- changes during the period in trade receivables and payables;
- changes during the period in inventory, prepaid expenses, or deferred revenue;
- changes during the period in pledges receivable; and
- all other transactions included within the "change in net assets" measure that are either noncash or do not affect net cash provided by or used in operating activities, including:
 - non-cash expenses—for example, depreciation of property plant and equipment, amortization of finite-lived intangibles, or, for NFPs that have adopted the option to amortize goodwill, amortization of goodwill;
 - gains and losses on investments, changes in the fair value of derivatives, undistributed portions of changes in interest in financially interrelated foundations;
 - noncash contributions—for example, "in-kind" contributions and contributions of long-lived assets;
 - the gain or loss on disposal of property and equipment; and
 - inflows from cash contributions and investment income that are donor-restricted for long-term purposes, which must be reclassified into financing activities (see NP 4.5).

All adjustments made to reconcile the change in net assets to the net cash provided by or used in operating activities should be clearly identified as reconciling items. An illustration of an NFP cash flow statement that reports operating cash flows using the indirect method is provided at ASC 958-205-55-20.

4.4.2 *Direct method of determining operating cash flows*

NFPs are encouraged, but not required, to use the direct method of reporting cash flows from operating activities. According to ASC 230-10-45-25, entities that use the direct method should, at a minimum, separately report the following classes of operating receipts and payments:

- Cash received from service recipients
- Other operating cash receipts
- Interest and dividends received (excluding any that are donor-restricted for long-term purposes and thus, are financing activities)

- Cash paid to employees and suppliers
- Interest paid
- Income taxes paid (if material)
- Grants paid
- Miscellaneous receipts/payments

Operating activities would also include all cash receipts from contributions (with or without donor-restrictions) other than those that are donor-restricted for long-term purposes, which are financing activities (see NP 4.5).

Unlike business enterprises, if an NFP uses the direct method to present its cash flow statement, it is not required to present a reconciliation of the change in net assets to net cash flows provided by operating activities in a separate schedule.

An illustration of an NFP cash flow statement prepared using the direct method is provided at ASC 958-205-55-19.

4.5 *Cash flow presentation of contributions*

ASC 230-10-45-14 requires that receipts from contributions and investment returns that are donor restricted for long-term purposes must be reported as financing cash inflows, rather than operating cash flows.

Excerpt from ASC 230-10-45-14

All of the following are cash inflows from financing activities:...

- a. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a donor-restricted endowment fund

When an NFP uses the indirect method, the reconciliation of changes in net assets to net cash flow from operating activities must eliminate receipts from cash contributions and investment returns that are donor restricted for long-term purposes from operating cash flows. Example NP 4-1 illustrates the cash flow presentation of such contributions.

EXAMPLE NP 4-1

Indirect method – contribution restricted for long-term purpose

Performing Arts Center (PAC) receives a cash contribution of \$50,000 that is donor-restricted for upgrading the acoustical system. PAC prepares its cash flow statement using the indirect method. How would this contribution be reflected?

Analysis

Because the gift was donor-restricted for a long-term purpose, PAC cannot reflect the \$50,000 of cash proceeds received as inflows from operating activities. Instead, PAC must reflect those proceeds as a cash inflow from financing activities. In addition, PAC must eliminate the \$50,000 of contribution revenue when reconciling the change in net assets to net cash flows provided by or used in operating activities.

Many contributions that are donor restricted for long-term purposes arise from promises to give (sometimes called “pledges”). As discussed at NP 7.3.2, unconditional promises to give cash are reported as receivables with a corresponding increase in net assets with donor restrictions in the period the promise is received. For purposes of the statement of cash flows, it is important to bear in mind that such transactions only give rise to a cash flow when or as the pledge is collected, not at the time the contribution income is recognized. If a pledge that is donor-restricted for long-term purposes is partially collected during the same year it is made, only the amount actually collected should be reported as a cash inflow (classified as financing due to the long-term purpose restriction), as illustrated in Example NP 4-2.

EXAMPLE NP 4-2**Indirect method – collections on pledge restricted for long-term purpose**

On March 31, Performing Arts Center (PAC) receives a pledge of \$50,000 that is donor restricted for upgrading the acoustical system. The pledge is payable in two installments: \$20,000 is due on June 1 (two months after execution of the gift agreement), and the remaining \$30,000 is due the following March 31 (on the first anniversary of the gift).

PAC has a June 30 year end and prepares its cash flow statement using the indirect method. How would this contribution be reflected in the statement of cash flows for the year the pledge is received?

Analysis

Although the pledge gave rise to contribution income of \$50,000 in the year it was received, the related cash inflows will occur in the periods that the installment payments are collected. Because the donor restrictions relate to a long-term purpose, the payments collected represent cash inflows from financing activities, rather than inflows from operating activities. Therefore, the pledge will generate \$20,000 of financing cash inflows during the current year and \$30,000 of financing cash inflows in the following year.

PAC might choose to present this activity in the statement of cash flows by reflecting the receipt of the pledge and the subsequent collections as separate activities. In that event, PAC would reflect a \$50,000 adjustment in the reconciliation of the change in net assets to cash flows provided by or used in operating activities in order to eliminate the noncash contribution income. PAC would also reflect a financing cash inflow of \$20,000 for the first installment payment collected on the pledge. Thus, the statement of cash flows would display the activity associated with the pledge as follows:

Cash flows from operating activities:

Adjustments to reconcile change in net assets to net cash provided by operating activities:

Noncash contribution received	\$(50,000)
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Cash flows from financing activities:

Proceeds from contributions restricted for long-term purposes	\$ 20,000
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Alternatively, when reconciling the change in net assets to cash flows provided by or used in operating activities, PAC might focus on changes in the balance of the pledge receivable (the operating asset). In that case, PAC would reflect a \$30,000 adjustment to eliminate the net increase in pledges receivable (in effect, eliminating the income associated with the portion of the pledge that remains uncollected). For the portion of the pledge that was collected, PAC would reflect a \$20,000 adjustment to transfer the inflows from the operating to the financing category. Thus, the statement of cash flows would display the activity associated with the pledge as follows:

Cash flows from operating activities:

Adjustments to reconcile change in net assets to net cash provided by operating activities:

Increase in contributions receivable	\$(30,000)
Proceeds from contributions restricted for long-term purposes	(20,000)

Cash flows from financing activities:

Proceeds from contributions restricted for long-term purposes	\$ 20,000
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We view either presentation as acceptable.

4.5.1 Impact of donated investments on the cash flow statement

For tax-planning purposes, some donors will contribute gifts of appreciated securities in lieu of making cash gifts. Subsequent to the gift, the donated investment might be retained by the NFP in its investment portfolio or, as is more often the case, it may be liquidated. If a decision is made to liquidate the investment, the proceeds from converting the investment to cash are classified as inflows from investing activities, as required by ASC 230-10-45-12(b). FSP 6.7.1.3 provides general guidance on the classification of cash flows associated with sales of investments.

However, if the organization has a policy which requires liquidation of donated investments upon receipt, and is able to liquidate the investments “nearly immediately” after receipt, the receipt and liquidation processes are aligned to such an extent that the gift is economically similar to a gift of cash. Because the NFP is not making “investment decisions” in these circumstances, ASC 230-10-45-21A stipulates that the proceeds from the sale of the donated investments would be classified as operating or, if restricted for a long-term purpose, as financing using the same classification framework applied to cash donations.

ASC 230-10-45-21A

Cash receipts resulting from the sale of donated financial assets (for example, donated debt or equity instruments) by NFPs that upon receipt were directed without any NFP-imposed limitations for sale and were converted nearly immediately into cash shall be classified as operating cash flows. If, however, the donor restricted the use of the contributed resource to a long-term purpose of the nature of those described in paragraph 230-10-45-14(c), then those cash receipts meeting all the conditions in this paragraph shall be classified as a financing activity.

The exception applies if both of the following criteria are met:

- The NFP does not decide whether to hold or sell the investments received, but directs them for sale as a matter of policy without any limitations. In applying this exception, the policy must provide no discretion for the NFP. For example, the exception would not apply if an NFP provides specific instructions to a broker to only sell the donated assets at or above a specified price. This would indicate that the NFP is making an investing decision.
- The investments are converted to cash “nearly immediately,” which is generally a matter of days.

Under the exception, proceeds from the sale of the donated investments are classified as operating cash inflows unless the donor restricted the gift for a long-term purpose. If the gift was donor restricted for a long-term purpose, the proceeds are classified as financing inflows, consistent with the discussion in NP 4.5. Note that the exception does not permit the proceeds of liquidation to be reported as proceeds from cash contributions; they must still be identified as proceeds from the sale of investments.

Example NP 4-3 illustrates how the exception impacts reporting in a cash flow statement prepared using the direct method.

EXAMPLE NP 4-3

Direct method — securities donation program

Museum maintains a securities donation program for the convenience of donors who wish to make gifts of appreciated marketable securities. Donors are instructed to send such gifts directly to a special brokerage account that will immediately convert the securities to cash and remit the proceeds to Museum. Museum received the following gifts through this program:

Gifts restricted by donors for endowment	\$ 7,500
Gifts without long-term donor restrictions	<u>5,000</u>
	<u>\$ 12,500</u>

How should Museum classify this activity in a statement of cash flows prepared using the direct method?

Analysis

Acquiring investments by donation is a non-cash investing activity pursuant to ASC 230-10-50-4. However, Museum’s donation program qualifies for the exception described in ASC 230-10-45-21A that allows the proceeds from donated investments that are “nearly immediately” liquidated to be classified as either operating or (if donor-restricted for a long-term purpose) financing cash inflows. Thus, the statement of cash flows would display the activity associated with the donated securities program as follows:

Cash flows from operating activities:

Proceeds from sales of contributed investments	\$5,000
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Cash flows from financing activities:

Proceeds from sales of contributed investments restricted for long-term purposes	\$7,500
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The proceeds from sale of the \$5,000 of securities donated without long-term purpose restrictions would be included in Museum's net cash flows from operations, while the proceeds from sale of the \$7,500 of securities that are restricted for the endowment (a long-term purpose restriction) would be reported as financing cash inflows.

If an NFP chooses to report operating cash flows using the indirect method, its "change in net assets" measure must be adjusted to eliminate the effects of noncash revenues and expenses. Diversity in practice exists regarding reporting a noncash adjustment to eliminate contribution revenues associated with donated investments that convert to cash "nearly immediately." Some NFPs report two adjustments within the reconciliation: (1) a noncash adjustment to eliminate contribution income arising from all donated investments and (2) an adjustment to add the proceeds from sale of securities that convert "nearly immediately" to cash and are classified as operating activity. Other NFPs view donations of these investments as, in essence, equivalent to cash transactions. Therefore, they make no adjustment to eliminate noncash contribution income. These NFPs report a reclassification adjustment to "transfer" the proceeds from sales that are subject to long-term donor-imposed restrictions into financing activities, similar to the adjustments made to transfer cash contributions with long-term donor-restrictions into the financing category.

Example NP 4-4 illustrates the presentation alternatives for donated securities in a cash flow statement prepared using the indirect method.

EXAMPLE NP 4-4

Indirect method – securities donation program

Museum maintains a securities donation program for the convenience of its donors that wish to make gifts of appreciated marketable securities. Donors are instructed to send securities to a special brokerage account set up to immediately convert the securities to cash and remit the proceeds to Museum. Museum received the following gifts through this program:

Gifts restricted by donors for endowment	\$ 7,500
Gifts without long-term donor restrictions	<u>5,000</u>
	<u>\$ 12,500</u>

How would Museum classify this activity in a statement of cash flows prepared under the indirect method?

Analysis

Acquiring investments by donation is a non-cash investing activity pursuant to ASC 230-10-50-4. However, Museum's donation program qualifies for the exception described in ASC 230-10-45-21A that allows the proceeds from donated investments that are "nearly immediately" liquidated to be classified as either operating or (if restricted for a long-term purpose) financing cash inflows. Thus, the proceeds from sale of the \$5,000 of securities donated without long-term purpose restrictions would be included in Museum's net cash flows from operating activities while the proceeds from sale of the \$7,500 of securities that are restricted for the endowment (a long-term purpose restriction) would be reported in financing activities.

If Museum chooses to treat all donated securities as a noncash activity (consistent with ASC 230-10-50-4), the operating activities section would reflect a \$12,500 reduction in the reconciliation of the change in net assets to net cash provided by or used in operating activities to eliminate the income from the noncash gifts, along with a \$5,000 cash increase for the proceeds from the immediate liquidation of the securities donated without long-term purpose restrictions, as follows:

Cash flows from operating activities:

Adjustments to reconcile change in net assets to net cash provided by operating activities:

Noncash contributions of securities	\$(12,500)
Proceeds from sales of contributed investments	\$5,000

Cash flows from financing activities:

Proceeds from sales of contributed investments restricted for long-term purposes	\$ 7,500
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Alternatively, Museum might view donated securities that are converted "nearly immediately" to cash as being, in essence, cash transactions, in which case no adjustment to reduce the change in net assets for the impact of noncash donations is made. Under that approach, Museum would reflect an adjustment in the reconciliation of the change in net assets to net cash provided by or used in operating activities to transfer the proceeds from sales of the \$7,500 in investments that are donor-restricted for the endowment out of operating cash flows and into financing activities, as follows:

Cash flows from operating activities:

Adjustments to reconcile change in net assets to net cash provided by operating activities:

Proceeds from sales of contributed investments restricted for long-term purposes	(\$7,500)
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Cash flows from financing activities:

Proceeds from sales of contributed investments restricted for long-term purposes	\$ 7,500
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4.5.1.1 *Donated investments—noncash investing disclosure*

As mentioned in ASC 958-230-55, separate disclosure of noncash investing activities is required by ASC 230-10-50-3.

Excerpt from ASC 230-10-50-3

Information about all investing and financing activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be disclosed.

In practice, NFPs have approached the disclosure of noncash investing activities in different ways. Some NFPs disclose all donated investments received during the period—a literal application of ASC 230-10-50-4. Other NFPs only disclose donated investments received that were not liquidated in the same period (and thus, did not result in cash receipts during the period). Either approach is acceptable, but once an NFP has adopted a policy regarding disclosure of donated investments, that policy should be applied consistently from period to period.

4.6 *Cash flows classification of various transactions*

See FSP 6 for information on the classification of a number of different common transactions in cash flow statements.

Additionally, Figure NP 4-1 summarizes the classifications of certain cash inflows and outflows that are unique to NFPs and other areas that frequently generate questions. Also see ASC 958-205-55 for an illustration of the cash flow classification of a number of NFP-specific transactions.

Figure NP 4-1

Classification of common NFP transactions

Activity	Inflow	Outflow
Operating	<ul style="list-style-type: none"> <input type="checkbox"/> Cash contributions without donor restrictions <input type="checkbox"/> Cash contributions with donor restrictions other than long-term purposes <input type="checkbox"/> Proceeds collected on pledges that are not restricted for long-term purposes <input type="checkbox"/> Proceeds from sales and maturities of certain securities classified as trading (healthcare organizations (HCOs). See FSP 6.7.1.3 	<ul style="list-style-type: none"> <input type="checkbox"/> Contributions or grants to other NFPs <input type="checkbox"/> Purchases of certain securities classified as trading (HCOs). See FSP 6.7.1.3
Investing	<ul style="list-style-type: none"> <input type="checkbox"/> Proceeds from sale of works of art, historical treasures, and similar assets (whether capitalized or not) 	<ul style="list-style-type: none"> <input type="checkbox"/> Purchase of works of art, historical treasures, and similar

Activity	Inflow	Outflow
	<ul style="list-style-type: none"> □ Proceeds from sales and maturities of certain securities classified as trading (HCOs). See FSP 6.7.1.3 □ Proceeds from sales and maturities of other-than-trading securities (HCOs) 	<ul style="list-style-type: none"> assets (whether capitalized or not) □ Purchases of certain securities classified as trading (HCOs). See FSP 6.7.1.3 □ Purchases of securities classified as other-than-trading (HCOs) □ Cash consideration paid in an acquisition, net of cash acquired. See ASC 958-805-55-69
Financing	<ul style="list-style-type: none"> □ Receipts from contributions that are restricted for purposes of acquiring, constructing, and improving land, buildings, or equipment or other long-lived assets □ Receipts from contributions that are restricted for purposes of creating permanent or term endowments □ Cash received by an NFP trustee in creation of donor-restricted annuity trusts or life income funds □ Receipts from grants that create revolving student loan funds □ Interest income restricted for revolving student loan funds □ Receipts of donor-restricted dividends, interest, or other investment income that must be used to increase permanent or term endowments □ Receipts of investment income on annuity trusts or life income funds that, by agreement with donors, must be held to make payments to beneficiaries (as opposed to benefiting the NFP's interest) □ Proceeds collected on pledges restricted to long-term purposes □ Cash inflows from member purchases of capital shares/stock (clubs) □ Receipts from equity transfer made by affiliate 	<ul style="list-style-type: none"> □ Refunds to donors of gifts that were restricted for long-term purposes □ Payments to beneficiaries under donor-restricted annuity trusts or life income funding agreements □ Refunds of grants that were restricted to creating revolving student loan funds □ Payment of equity transfer to affiliate

Noncash

- Donations of works of art, historical treasures, and similar assets, whether capitalized or not
 - Donated buildings or PP&E
 - Certain donated investments (see NP 4.5.1)
 - Donated services utilized in acquisition or construction of a long-lived asset
 - Noncash assets received and liabilities assumed in an acquisition transaction. See ASC 958-805-55-70
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Chapter 5: Consolidation, mergers, and acquisitions

5.1 Consolidations, mergers and acquisitions—chapter overview

A fundamental difference between NFPs and for-profit businesses is that NFPs lack ownership interests in the traditional sense. Unlike for-profit businesses that can distribute earnings to shareholders, any surpluses earned by an NFP must be reinvested in the organization. This absence of ownership interests means that NFPs have unique considerations with respect to defining the reporting entity (that is, consolidation) and in accounting for business combinations.

NFPs may engage in relationships with other NFPs, a variety of for-profit entities, and/or special purpose entities. Additionally, NFPs may engage in business combinations. While certain aspects of the business combination model are similar to that used by business entities, there are often differences in the way in which NFPs enter into, and effect, such transactions.

This chapter discusses the specialized guidance developed for NFPs in these areas. Refer to PwC's *Business combinations and noncontrolling interests* guide and *Consolidation and equity method of accounting* guide for general information on accounting for business combinations and consolidation.

5.2 The NFP reporting entity

While some NFPs operate as independent legal entities, others carry out their activities in conjunction with one or more related entities. For example, fundraising is often conducted by legally-separate foundations. Universities might have affiliates engaged in investing, real estate management, or healthcare. Health systems are typically comprised of multiple entities that can be either for-profit or not-for-profit. When such relationships have certain characteristics, consolidated financial statements must be prepared that aggregate the related organizations into a single financial reporting entity.

ASC 958-810 and ASC 954-810 provide NFP-specific guidance on consolidation matters, supplementing the general consolidation guidance in ASC 810-10. When evaluating legal control of other entities, NFPs exclusively use a voting-interest model (that is, a model based on voting rights), and therefore disregard the guidance in the variable interest entity subsections of ASC 810-10 (see NP 9). The manner in which the voting interest model is applied differs depending on whether the relationship involves another NFP or a for-profit entity. The approach for evaluating consolidation of other NFPs is discussed at NP 5.2.1; consolidation of ownership interests in for-profit entities is discussed in NP 9, which addresses accounting for investments.

Other topics in this section include:

- Evaluating the consolidation of special-purpose entity lessors (see NP 5.2.3) and other relationships where legal control is not present (see NP 5.2.4)
- Reporting noncontrolling interests (sometimes called minority interests) in for-profit and not-for-profit subsidiaries (see NP 5.2.5)
- Consolidated financial statement presentation matters (see NP 5.2.6)

See AAG-NFP Chapter 3 and AAG-HCO Chapter 12 for additional commentary on consolidation topics.

5.2.1 Evaluating consolidation of other NFPs

ASC 958-810-25-1 through ASC 958-810-25-6 set forth the unique model used for evaluating consolidation in relationships with other NFPs. ASC 954-810-15-2(f) requires NFP HCOs to use this model. The model focuses primarily on whether the reporting NFP has voting control over another NFP's board as evidenced by provisions included in the other NFP's governing documents (articles of incorporation and bylaws). For background information on how NFP corporations are organized and governed, see NP 5.2.1.1.

The glossary in ASC 958-810-20 defines the concept of "control" used in evaluating consolidation.

Excerpt from ASC 958-810-20

Control: The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.

Control that requires consolidation can be evidenced by either:

- Possession of a controlling financial interest which arises through sole corporate membership or ownership of a majority voting interest (which could be direct or indirect)
- Holding a majority voting interest in the board of another NFP through means other than sole corporate membership or ownership, in addition to having an "economic interest" in that entity. The economic interest concept (discussed in NP 5.2.1.3) is used in lieu of the notion of "financial interest" that is present in ownership relationships involving for-profit entities.

If an NFP is controlled by other means (for example, through contract or affiliation agreement) and an economic interest also exists, consolidation is permitted but not required, as discussed in ASC 958-810-25-4. The consolidation requirements are summarized in Figure NP 5-1.

Figure NP 5-1

ASC 958-810's requirements for consolidating other NFPs

Relationship	Requirement	Additional guidance
Reporting NFP is the sole corporate member of another NFP	Consolidate unless control does not rest with the sole corporate member.	If the sole corporate member does not have control, consolidation is prohibited. See NP 5.2.1.2.
Reporting NFP owns, directly or indirectly, a majority voting interest in an NFP	Consolidate unless control does not rest with the majority owner.	If the majority owner does not have control, consolidation is prohibited. See NP 5.2.1.2.
Reporting NFP controls another NFP through having a majority voting interest in its board and has an economic interest in the other NFP	Consolidate unless control does not rest with the holder of the majority voting interest.	If majority voting interest holder does not have control, consolidation is prohibited. See NP 5.2.1.3.

Reporting NFP controls another NFP through means other than sole corporate membership or majority voting interest (e.g., through contract or affiliation agreement) and has an economic interest in the other NFP	If consolidation would be meaningful, it is permitted but not required.	If consolidated statements are not presented, notes to the financial statements should disclose (a) the identification of the other entity and the nature of its relationship with the reporting entity, (b) summarized financial data of the other entity, and (c) the related party disclosures required by ASC 850-10-50. See ASC 958-810-25-4 and ASC 958-810-50-2.
Reporting NFP has control over another NFP or an economic interest in another NFP, but not both	Consolidation is prohibited.	Notes to the financial statements should provide the related party disclosures required by ASC 850-10-50. See ASC 958-810-25-5 and ASC 958-810-50-3.

5.2.1.1 Governance of NFP corporations

NFPs that incorporate under state laws are run by boards of directors, trustees, or regents that have legal authority and ultimate accountability for the actions of the corporation. Like a business corporation, an incorporated NFP must have articles of incorporation (sometimes referred to as a corporate charter or certificate of incorporation) and bylaws.

Unlike a business corporation, a nonprofit corporation does not have owners. However, in some cases, the articles of incorporation or bylaws will provide for a membership structure that resembles the shareholder structure of investor-owned corporations. “Members” of an NFP corporation have significant rights with respect to corporate governance provided under the articles, bylaws, or state law (for example, to vote for directors, or to approve fundamental corporate decisions, such as amending articles and bylaws, acquisitions, or dissolution). Unlike shareholders in business entities, however, they do not obtain financial benefits such as dividend rights or the ability to share in profits.

This type of membership should not be confused with other member relationships unrelated to governance that provide certain benefits, such as admission to exhibits, newsletters, or gift shop discounts, to supporters or donors.

Under some membership structures, an individual or corporation will be named in the articles or bylaws as the single voting member (“sole member”). A sole member’s rights are similar to a sole shareholder of a business corporation. A sole member has the exclusive right to elect and remove directors, enabling it to replace board members who would vote against the sole member’s interests. The sole member structure is often used to establish controlled NFP subsidiaries or to effect a transfer of control in an NFP acquisition (by amending the articles or bylaws of an acquiree to name the acquirer as its sole member).

If an NFP is not legally organized with a membership structure, its board might be independent and self-perpetuating (that is, board members vote for their own replacements). Alternatively, the articles of incorporation or bylaws might provide another entity with the right to appoint some or all of the

NFP's board members ("appointment rights"). The latter approach can be used to establish a controlled NFP subsidiary over which the parent has exclusive board appointment rights or to effect a transfer of control in an NFP acquisition (by amending the articles or bylaws of the acquiree to provide the acquirer with a majority of the appointment rights).

Most states prohibit NFPs from issuing stock. In the few states that allow stock to be issued, the nature of the shares differs from corporate stock in that they do not provide the shareholder with a financial interest in the entity. Instead, they provide holders with a mechanism for exercising voting powers related to election of directors and proposals for fundamental corporate changes (similar to rights of members in a membership structure NFP).

5.2.1.2 NFP controlling financial interests

Under the voting interest model, consolidation generally is appropriate when one entity has a controlling financial interest in another. Typically, the holder of a controlling financial interest in an entity has a unilateral right to make significant financial and operating decisions for that entity. According to ASC 958-810, two situations can give rise to a controlling financial interest in an NFP: sole corporate membership and ownership of a majority voting interest.

As discussed in NP 5.2.1.1, some NFP corporations have a single voting member ("sole member"). If the sole member is a corporate entity, it is referred to as a *sole corporate member*. A sole corporate member generally holds powers equivalent to those of a sole shareholder, such as the ability to appoint and terminate the NFP's board or dissolve the organization. ASC 958-810-45-3A states that a sole corporate member generally would possess a controlling financial interest that requires consolidation, unless control does not rest with the sole corporate member. Question NP 5-1 illustrates some of those situations.

Question NP 5-1

NFP A is the sole corporate member of NFP B. Could there be a situation when NFP A would not be required to consolidate NFP B?

PwC response

Maybe. If NFP B's articles of incorporation designate NFP A as its sole corporate member, consolidation by NFP A is required unless control does not rest with NFP A. For example, if NFP B's articles of incorporation or bylaws provide approval or veto rights to a party other than NFP A that are so restrictive as to call into question whether control rests with NFP A, then consolidation by NFP A may not be appropriate. Additionally, ASC 958-810-25-2 indicates that the presumption of control by the sole corporate member might be overcome when the entity is in legal reorganization or bankruptcy, or when the entity is subject to other legal or contractual limitations that severely restrict the powers that the sole corporate member would otherwise have the ability to exercise.

In the few states that permit issuance of nonprofit stock or shares, ownership of shares provides a mechanism for shareholders to vote on certain corporate matters such as election of directors and fundamental corporate changes. Generally, a majority voting interest exists when a stockholder owns over 50% of a corporation's voting shares. An NFP shareholder that owns more than 50% of the voting shares would be able to veto any decisions made by the board and thus, would have a controlling financial interest that results in consolidation, unless control does not rest with the majority owner.

ASC 958-810-25-2A indicates that actions that require approval by a supermajority vote of the board might overcome the presumption of control by the owner of a majority voting interest.

ASC 958-810-55-4A provides considerations when evaluating control, and indicates that the guidance in ASC 810-10-25-2 through ASC 810-10-25-14 may be helpful in evaluating whether a majority voting interest holder can exercise control.

5.2.1.3 *Majority voting interest coupled with economic interest*

According to ASC 958-810-25-3, consolidation is required if an NFP controls a majority voting interest in the board of another NFP (through means other than those discussed in NP 5.2.1.2) and also has an economic interest in that NFP.

ASC 958-810-25-3

In the case of control of a related but separate NFP through a majority voting interest in the board of the other NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP, consolidation is required, unless control does not rest with the holder of the majority voting interest, in which case consolidation is prohibited. An NFP has a majority voting interest in the board of another entity if it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions). Those individuals are not limited to the NFP's own board members, employees, or officers. For implementation guidance on a majority voting interest in the board of another entity, see paragraph 958-810-55-5.

In this situation, a majority voting interest arises when an NFP's articles of incorporation provide another organization with the right to appoint a majority of its governing board. The "right to appoint" is the key determinant of whether a majority voting interest exists. The meaning of "right to appoint" is explained in ASC 958-810-55-5.

ASC 958-810-55-5

A majority voting interest in the board of another entity... is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of Entity B if Entity A has the ability to appoint three or more of Entity B's board members. If three of Entity A's board members, employees, or officers serve on the board of Entity B but Entity A does not have the ability to require that those members serve on the Entity B board, Entity A does not have a majority voting interest in the board of Entity B.

The evaluation of whether a "majority voting interest" exists is made in relation to the NFP's fully constituted board (including any vacant board positions). For example, if vacancies on the board of Entity B cause Entity A to temporarily possess a majority voting interest in Entity B, that circumstance, in and of itself, would not automatically trigger consolidation by Entity A.

ASC 958-810-25-2A indicates that actions that require approval by a supermajority vote of the board might overcome the presumption of control by the holder of a majority voting interest. ASC 958-810-55-4A provides considerations when evaluating control, and indicates that the guidance in ASC 810-10-25-2 through ASC 810-10-25-14 may be helpful in evaluating whether a majority voting interest holder can exercise control.

With this type of majority voting interest, an economic interest must also exist in order for consolidation to be required. If no economic interest exists, consolidation is prohibited by ASC 958-810-25-5. Economic interest is defined and described in ASC 958-810-20.

Excerpt from ASC 958-810-20

Economic interest: A not-for-profit entity's (NFP's) interest in another entity that exists if any of the following criteria are met:

- a. The other entity holds or utilizes significant resources that must be used for the purposes of the NFP, either directly or indirectly by producing income or providing services.
- b. The NFP is responsible for the liabilities of the other entity.

In addition, the guidance in ASC 958-810-55-6 provides NFP-specific examples of "economic interests."

ASC 958-810-55-6

The following are examples of economic interests:

- a. Other entities solicit funds in the name of and with the expressed or implied approval of the NFP, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the NFP or used at its discretion or direction.
- b. An NFP transfers significant resources to another entity whose resources are held for the benefit of the NFP.
- c. An NFP assigns certain significant functions to another entity.
- d. An NFP provides or is committed to provide funds for another entity or guarantees significant debt of another entity.
- e. An NFP has a right to or a responsibility for the operating results of another entity. Or upon dissolution, an NFP is entitled to the net assets, or is responsible for any deficit, of another entity.

We believe the examples are indicative of situations where a separate organization's activities are an extension of the reporting NFP's activities or where the reporting NFP participates in financial risks and rewards associated with the separate organization.

5.2.2 *Evaluating consolidation of NFP joint ventures*

NFPs may pursue a variety of approaches to combining or coordinating their services, operations, and resources. For example, two or more NFPs might sponsor formation of a new legal entity through which they will collaboratively provide a new service or program or carry out an essential function. Often, such arrangements are informally referred to as "not-for-profit joint ventures."

In evaluating the accounting and financial reporting for participation in such ventures (including potential consolidation), substance must be considered over form. As discussed in NP 1, several NFPs might band together to form an NFP corporation that exists solely to benefit its participants or

members in a manner similar to a cooperative (see Question NP 1-2). Or, they might choose to establish the venture in a stock corporation, partnership, limited partnership, or limited liability company that provides each participant with an equity ownership interest (see Question NP 1-4).

In situations where the venture provides its participants with ownership interests (or the functional equivalent of ownership interests), it would not meet the GAAP definition of an NFP for accounting purposes despite the fact that its purpose is to carry out a nonprofit activity. Therefore, in evaluating whether consolidation of the venture is required, a participant would consider the guidance discussed in NP 9 for equity interests in for-profit business entities, which differs based on the structure of the investment.

If the venture is not conducted in a separate legal entity, it would be accounted for based on the guidance in ASC 808, *Collaborative Arrangements*. ASC 808-10-45-1 states that revenues generated and costs incurred by the participants should be reported in the appropriate line items in each participant's statement of operations pursuant to the guidance in the "Principal versus Agent Considerations" in ASC 606-10-55-36 through ASC 606-10-55-40. A line item such as "collaboration revenue" or "collaborative expenses" would be used to report "sharing" payments made between the venture participants. AAG-NFP 3.141 illustrates this guidance.

5.2.3 Evaluating consolidation of special purpose entities

NFPs may carry out certain activities, such as leasing, through for-profit entities that exist primarily to benefit the NFP (i.e., special purpose entities (SPEs)), but which are not required to be consolidated under the guidance discussed in NP 5.2.2 for equity interests. Often, SPEs are used in an effort to achieve off balance sheet treatment of certain assets and liabilities.

When evaluating SPE leasing entities for consolidation, NFPs apply different requirements than business entities. Business entities utilize the variable interest entity subsections of ASC 810-10, which are not applicable to NFPs. NFPs apply the guidance in ASC 958-810-25-8 through ASC 958-810-25-10, *Not-for-Profit Entities: Consolidation—Special-Purpose Leasing Entities*, which largely predates the variable interest entity guidance. Under that guidance, an NFP lessee must consolidate an SPE lessor if all three of the following conditions exist:

- Substantially all of the SPE's activities involve assets that are to be leased to a single lessee
- The expected substantive residual risks, substantially all the residual rewards of the leased asset(s), and the obligation imposed by the underlying debt of the SPE directly or indirectly reside with the lessee
- The SPE's owner of record has not made an initial substantive residual equity capital investment that is at risk during the entire lease term. This criterion is deemed to be met if the majority owner(s) of the lessor is (are) not an independent third party, regardless of the level of capital investment.

If the SPE's owner made a substantive residual equity capital investment that will be at risk during the entire lease term, the NFP does not have to consolidate the SPE. To qualify as "substantive," an investment must represent an equity interest in legal form, must be subordinate to all debt interests, and must represent the residual equity interest during the entire term of the lease. Further, according to AAG-HCO 12.55 and AAG-NFP 3.105, the AICPA believes that the minimum acceptable investment to qualify as "substantive" would be equal to 3% of the assets owned by the SPE. A greater level of

investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3% is needed.

In some build-to-suit lease transactions, the lease or related construction agreement provides that the SPE will construct, or cause to be constructed, the property that is to be leased. When SPEs are established for both the construction and subsequent lease of the asset, consolidation by the lessee should begin at the beginning of the construction arrangement, rather than at the beginning of the lease term, if the conditions requiring consolidation are met.

See ASC 958-810-55-7 through ASC 958-810-55-16 for additional guidance on applying these requirements.

Consolidation by NFPs of SPEs used in activities other than leasing is not explicitly addressed in the codification. However, during the FASB's deliberations on the SPE leasing guidance for NFPs, they noted that nothing precludes an NFP from applying the SPE leasing guidance by analogy to other SPE situations. We believe that accounting for non-lease transactions by analogy to leasing guidance is a reasonable approach. AAG-HCO 12.59 observes that NFP HCOs typically analogize to the SPE leasing guidance.

5.2.4 *Evaluating other relationships involving potential consolidation*

Figure NP 5-2 highlights other situations that, while occurring less frequently, may lead to potential consolidation and the reference to where specific guidance can be found.

Figure NP 5-2

Consolidation in other situations

Situation	Requirements	Reference
NFP sponsors and provides funding for a research and development arrangement	Apply guidance in ASC 810-30, <i>Research and development arrangements</i>	ASC 810-30-15 AAG-NFP 3.75 ASC 954-810-15-3(e)
Contractual management relationship with a for-profit entity	Apply guidance in the "Consolidation of Entities Controlled by Contract" subsections of ASC 810-10-25 and ASC 810-10-55 to determine whether the arrangement conveys a controlling financial interest. Contractual management relationships with NFP entities would be evaluated under the framework discussed in NP 5.2.1 for relationships with NFP entities.	ASC 810-10-15-3(c) AAG-NFP 3.75 ASC 954-810-15-3(c) ASC 954-810-60-1 AAG-HCO 12.30 through AAG-HCO 12.32

Ongoing standard setting

In September 2017, the FASB issued an exposure draft, *Consolidation (Topic 812): Reorganization*. Among other things, the exposure draft proposes to eliminate the guidance in ASC 810-30 for research and development arrangements. It would also move the guidance in the “Consolidation of Entities Controlled by Contract” subsection of ASC 810 to ASC 958-810 because that guidance applies only to NFPs. As of the publication of this guide, no timeframe has been established for issuance of a final standard.

5.2.5 Reporting noncontrolling interests in subsidiaries

When an NFP consolidates a less-than-wholly-owned subsidiary, the portion owned by others is referred to as the noncontrolling interest (NCI). ASC 958-810 tailors general GAAP guidance for reporting NCIs (contained in ASC 810-10-45-15 through ASC 810-10-45-21) to the NFP reporting model. The presentation of a noncontrolling interest in the equity section of the balance sheet is discussed at NP 2.5.3. Disclosure of the changes in consolidated net assets attributable to the parent and the noncontrolling interest is discussed at NP 3.6.

Under ASC 810-10-45-23, if a parent’s ownership interest in a consolidated subsidiary changes during a reporting period (for example, if a parent purchases additional ownership interests from noncontrolling shareholders, or sells some of its interest to noncontrolling shareholders), that activity is accounted for as an equity transaction.

Excerpt from ASC 810-10-45-23

Changes in a parent’s ownership interest in a subsidiary while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent.

ASC 958-810-55-21 through ASC 958-810-55-22 illustrate how an NFP parent would account for equity transactions. In the statement of activities, equity transactions should be reported separate from revenues, expenses, gains, or losses and outside a measure of operations (if one is reported), according to ASC 958-810-50-5(d). For an NFP HCO, such activity is excluded from the performance indicator, consistent with the requirement for business entities to exclude such amounts from consolidated net income. That display is illustrated in ASC 958-810-55-24.

5.2.5.1 Noncontrolling interests in NFP subsidiaries

The guidance in ASC 958-810 and ASC 954-810 differ with respect to the recognition of noncontrolling interests in other NFPs (such as when an NFP parent has a less-than-complete voting interest in the board of an NFP subsidiary—for example, if the parent controls five of seven board seats, and another NFP controls the other two seats). ASC 954-810-45-3B permits NFP HCOs to recognize a noncontrolling interest if such interest is represented by an economic interest whereby the noncontrolling interest would share in the operating results or residual interest upon dissolution.

ASC 954-810-45-3B

When consolidated financial statements are required or permitted by Section 958-810-25, a noncontrolling interest shall be provided if such interest is represented by an economic interest whereby the noncontrolling interest would share in the operating results or residual interest upon dissolution.

If a noncontrolling interest in the net assets of the consolidated entity is recognized by an NFP HCO, the presentation and disclosure provisions of ASC 958-810 described in NP 5.2.5 should be applied.

For all other NFPs, ASC 958-810-25-6 precludes reporting noncontrolling interests in NFP subsidiaries.

ASC 958-810-25-6

An interest by an NFP in another NFP may be less than a complete interest. For example, an NFP may appoint 80 percent of the board of the other NFP. For NFPs other than those within the scope of Topic 954, if the conditions for consolidation in paragraphs 958-810-25-2, 958-810-25-3, or 958-810-25-4 are met, the basis of that consolidation would not reflect a noncontrolling interest for the portion of the board that the reporting entity does not control, because there is no ownership interest other than the interest of the reporting entity.

5.2.6 *Presentation of consolidated entities in NFP financial statements*

FSP 18 addresses presentation and disclosure matters broadly applicable to consolidated financial statements. It discusses matters such as elimination of intra-entity transactions, differing fiscal periods, and changes in fiscal periods. It also addresses preparation of combined (as opposed to consolidated) financial statements and presentation of nonhomogeneous subsidiaries.

One presentation consideration that is unique to NFPs relates to the display of donor-restricted net assets in consolidated financial statements. When individual NFP financial statements are aggregated in consolidation, the amounts ascribed to components of net assets in the consolidated financial statements might differ from the classifications of net assets reflected in the individual financial statements of the constituent entities.

For example, at an individual entity level, unrestricted gifts from donors can be used for any purposes consistent with the donee's nature and the purposes specified in its articles of incorporation or bylaws. Therefore, those gifts are reported as net assets without donor restrictions in the donee's separate financial statements. But if the donee's financial statements roll up into financial statements of a consolidated entity that has a broader purpose, the donee's "unrestricted" gifts (as well as any unrestricted investment return that has been appropriated for spending from an endowment) and net assets may need to be displayed as donor-restricted to reflect that the resources can only be used for the narrower purposes stipulated by the donors. This concept is discussed in AAG-NFP 3.107 through AAG-NFP 3.109. Note that net assets attributable to a subsidiary entity's exchange transactions (for example, fees or ticket sales) would not need to be similarly segregated in consolidation, as they do not arise from contributions.

In addition to considering legal restrictions imposed by donors, ASC 958-810-50-1 requires that consolidated financial statements disclose any other restrictions imposed by entities outside of the reporting entity on the parent's ability to receive distributions from the subsidiary, or limitations on the NFP parent's ability to use the subsidiary's assets. Similar considerations apply when aggregating net assets of sister corporations in combined financial statements. Example NP 5-1 illustrates the reporting of restrictions on net assets in consolidation.

EXAMPLE NP 5-1

Restrictions on net assets in consolidation

A membership association (Parent) has an educational subsidiary (Subsidiary) whose mission is to provide scholarships. Donors make unrestricted contributions to the educational subsidiary with the intent that the subsidiary use the contributions to support its mission. These gifts are classified as increases in net assets without donor restrictions in the subsidiary's stand-alone financial statements.

At the balance sheet date, the net asset balances for the Parent and the Subsidiary on a standalone basis are as follows:

	Net assets		Total
	Without donor restrictions	With donor restrictions	
Parent	\$3,000	\$800	\$3,800
Subsidiary	600	--	600
	<u>\$3,600</u>	<u>\$800</u>	<u>\$4,400</u>

\$500 of Subsidiary's net assets without donor restrictions is associated with unspent gifts. What amounts should the consolidated financial statements reflect in each of the net asset categories?

Analysis

In addition to the Parent's \$800 in net assets with donor restrictions, the consolidated financial statements should reflect \$500 of Subsidiary's net assets as donor-restricted, because they can only be used to provide scholarships. The presentation would be as follows:

	Net assets		Total
	Without donor restrictions	With donor restrictions	
Consolidated	<u>\$3,100</u>	<u>\$1,300</u>	<u>\$4,400</u>

5.2.7 Specialized industry accounting principles in consolidation

NFPs may encounter recognition and measurement differences when consolidating subsidiaries that follow specialized industry accounting principles. For example, an NFP health care system within the scope of ASC 954 might have an insurance subsidiary whose standalone financial statements are prepared in accordance with ASC 944. ASC 810-10-25-15 provides that the specialized industry principles applied by the subsidiary are typically retained in consolidation, assuming those principles are appropriate at the subsidiary level.

5.3 Overview of not-for-profit combinations

Like business entities, NFPs may engage in business combinations. The NFP combination accounting model (described in ASC 958-805, *Not-for-Profit Entities – Business Combinations*) differs from the model applied by business entities in that it distinguishes a merger of two or more NFPs from an acquisition of another entity. That difference, as well as differences in measurement associated with the acquisition model, are justified by characteristics unique to NFP combination transactions, which are described in NP 5.3.1.

The ASC 958-805 model applies to (a) combinations of two or more NFPs and (b) combinations in which an NFP acquires a for-profit entity. It excludes transactions that are not considered business combinations (e.g., asset acquisitions, transactions involving entities under common control). It also excludes acquisitions by for-profit entities (for example, if an NFP parent makes an acquisition using a for-profit subsidiary), which are accounted for using ASC 805. Figure NP 5-3 summarizes the scope of ASC 958-805.

Figure NP 5-3

Scope of ASC 958-805

In scope	Outside of scope
<input type="checkbox"/> Acquisition of an NFP by another NFP	<input type="checkbox"/> Acquisition of an NFP by a business entity (ASC 805)
<input type="checkbox"/> Acquisition of a for-profit entity by an NFP	<input type="checkbox"/> Reorganization of entities under common control (ASC 805-50) (BCG 6)
<input type="checkbox"/> Merger of NFPs	<input type="checkbox"/> Formation of a joint venture (CG 3)
<input type="checkbox"/> Acquisition by an NFP of a portion of an entity that meets the definition of a “business or nonprofit activity” (NP 5.3.2)	<input type="checkbox"/> Asset acquisitions that do not constitute a “business or nonprofit activity” (ASC 805-50) (PPE 2)

If a transaction is a combination, it must be classified as either a “merger of not-for-profit entities” or an “acquisition by a not-for-profit entity.” These terms are defined in the ASC Master Glossary.

ASC Master Glossary

Merger of NFP entities: A transaction or other event in which the governing bodies of two or more NFPs cede control to those entities to create a new NFP.

Acquisition by an NFP entity: A transaction or other event in which an NFP acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer’s financial statements. When applicable guidance in Topic 805 is applied by an NFP entity, the term *business combination* has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to *acquisitions by NFP entities*.

Ceding of control by all parties to a new entity is the sole definitive criterion for identifying a merger of NFPs. Similarly, one entity obtaining control over another entity is the sole definitive criterion for identifying an acquisition. When making these evaluations, the NFP-specific definition of “control” is used: the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise. See NP 5.2.1.

In some cases, it is clear that a transaction is an acquisition, and the identities of the acquirer and acquiree are evident. In others, it is necessary to go through an evaluation process to determine whether a particular transaction is a merger, an acquisition, or another form of transaction (such as formation of a joint venture). ASC 958-805-55-3 through ASC 958-805-55-8 provide indicators, summarized in Figure NP 5-4, to use in evaluating transaction-specific characteristics, such as the process leading to the combination and the characteristics of the combining and combined entities related to governance, control powers, and financial capacity.

Figure NP 5-4
Distinguishing mergers from acquisitions

Indicators of a merger	Indicators of an acquisition
<input type="checkbox"/> No one party dominates the negotiations and process leading to formation of combined entity	<input type="checkbox"/> One party dominates the process and/or dictates the terms of the transaction
<input type="checkbox"/> Combining entities cease to exist as autonomous entities	<input type="checkbox"/> One organization continues on as the surviving corporation
<input type="checkbox"/> Neither entity dominates the day to day management or governance	<input type="checkbox"/> One entity appoints significantly more of the governing board <input type="checkbox"/> One entity retains significantly more of its key officers
<input type="checkbox"/> New articles, bylaws, operating policies, and practices are created	<input type="checkbox"/> One party retains its bylaws, operating policies, and practices substantially unchanged

As several of the factors used for identifying an acquirer in the acquisition model (ASC 958-805-55-42 through ASC 958-805-55-46) are similar, that guidance may add helpful perspective on distinguishing mergers from acquisitions.

The determination should consider all the facts and circumstances surrounding the transaction, using professional judgment based on the preponderance of evidence. The guidance is built around principles and indicators, rather than “bright line” prescriptive criteria, due to the complex nature of the determinations in some cases. ASC 958-805-55 includes illustrations that demonstrate how the control criteria (that is, ceding control versus obtaining control) and the indicators would be applied in evaluating the nature of various transactions. Example 1 compares the factors that would lead to a merger conclusion (ASC 958-805-55-15 through ASC 958-805-55-16) to those that would lead to a joint venture conclusion (ASC 958-805-55-17 through ASC 958-805-55-19), using assumptions described in ASC 958-805-55-10 through ASC 958-805-55-14. Example 2 (ASC 958-805-55-20 through ASC 958-805-55-31) analyzes a fact pattern that is determined to be an acquisition.

See AAG-NFP chapter 3 and AAG-HCO chapter 12 for additional discussion.

Question NP 5-2 addresses whether there is a rebuttable presumption that a transaction is an acquisition.

Question NP 5-2

Is there a rebuttable presumption that a transaction is an acquisition that must be overcome in order to use merger accounting?

PwC response

No. In the Basis for Conclusions of FAS 164 (the standard that underlies this section of the codification), the Board acknowledged that they considered but ultimately decided not to incorporate a rebuttable presumption in the model. The Board concluded that applying the guidance for distinguishing mergers from acquisitions in a neutral manner would generally produce a better result.

5.3.1 Conceptual differences between NFP and business entity combinations guidance

The motivation for NFPs to enter into business combinations can differ significantly from those of business entities. Combinations of business entities are presumed to involve a bargained exchange—a transaction in which each party sacrifices and receives commensurate value—whereas NFP combinations can be motivated by considerations related to their mission as well as financial considerations. Because NFPs lack the types of ownership interests that business entities have, negotiations generally focus on governance and furthering the mission and programs of the entities for the benefit of the public, not maximizing returns for equity holders.

The focus on mission means that many NFP combinations do not involve an exchange of consideration other than the assumption of an acquiree's liabilities. If cash consideration is paid, it may be unrelated to the fair value of the acquiree, or it may be transferred to an unrelated third party (for example, to establish a charitable foundation). Thus, unlike combinations of businesses, consideration exchanged does not provide evidence of the acquired NFP's fair value. As a result, market data on NFP combinations is limited, and to the extent available, may not accurately reflect fair value of the underlying transactions.

In many NFP combinations, a significant portion of the economics may be akin to a contribution. For example, an NFP's governing board might voluntarily surrender control in order to align itself with a larger or stronger NFP (in essence “contributing” the NFP to the larger or stronger entity). Or, an NFP parent might transfer a subsidiary to another NFP in exchange for an amount of consideration that bears no relationship to the subsidiary's fair value (for example, an amount needed by the parent to fund a retirement obligation).

Despite the differences, the guidance developed for combinations of NFPs (ASC 958-805) is largely based on the guidance applied by business entities (ASC 805) except when departures are justified by characteristics unique to NFP transactions. The principal differences between the accounting models used by NFPs and business entities are highlighted in Figure NP 5-5.

Figure NP 5-5

Conceptual differences between ASC 805 and ASC 958-805

Business entity (ASC 805)	NFP (ASC 958-805)
An acquirer must be designated in every combination.	“True mergers” or “mergers of equals” occur in which none of the combining entities obtain control of the others. Thus, mergers are distinguished from acquisitions and accounted for differently. See NP 5.4.
Transactions involving business entities are deemed to be bargained exchanges.	NFP acquisitions typically do not involve a bargained exchange of equal fair value, although those sometimes occur.
An acquisition is measured using the fair value of the consideration exchanged for control of the acquiree and requires the acquirer to recognize 100% of the fair value of the net assets (“enterprise value”) acquired, which often includes goodwill.	An acquisition is measured using the fair value of individual assets acquired compared to liabilities assumed and consideration, if any (a “net assets” approach), with the residual recognized as either an inherent contribution received or, in a net deficit acquisition, as goodwill. Goodwill is recognized less frequently than in business entity combinations. See NP 5.5.2.
Goodwill represents the excess of the amount paid over the fair value of the acquirer. It is recognized as an asset.	The nature of goodwill recognized by an NFP may differ significantly from goodwill recognized in business entity acquisitions. In certain circumstances, it represents an excess of liabilities assumed over assets acquired; in others, it may be immediately expensed. See NP 5.5.3.2.

5.3.2 Asset acquisition versus acquisition of a business or nonprofit activity

As noted in NP 5.3 some transactions involve the acquisition of a portion of an entity, rather than a complete entity. The term *business* or *nonprofit activity* is used to differentiate such acquisitions that should be accounted for as a business combination from acquisitions of an asset (or a group of assets) that do not qualify as a business combination (and therefore, are accounted for as asset acquisitions under ASC 805-50).

Note about recent standard setting

This section reflects ASU 2017-01, *Business Combinations: Clarifying the Definition of a Business*, which changes the boundary distinguishing acquisitions of a business or nonprofit activity from acquisitions of assets. For NFPs, ASU 2017-01 is effective for annual periods beginning after December 15, 2018 (that is, calendar 2019 and fiscal 2020), and interim periods within the following year. The guidance is applied prospectively as of the beginning of the period of adoption.

The accounting used for an asset acquisition differs significantly from the accounting for a business combination. For example, in a business combination, each asset and liability acquired is measured at fair value and either goodwill or an inherent contribution is recognized, as discussed at NP 5.5. In an

asset acquisition, however, the cost of the acquisition is allocated among the assets acquired on a relative fair value basis, and no goodwill or inherent contribution is recognized. Another difference is that transaction costs are capitalized in an asset acquisition but are expensed in a business combination. See PPE 2 for more information on accounting for asset acquisitions.

ASC 805-10-55-3A through ASC 805-10-55-9 provide guidance on how an entity should evaluate whether it has acquired a business or instead, acquired an asset or group of assets that is akin to an asset acquisition. ASC 958-805-55-40 extends that guidance to include nonprofit activities.

Excerpt from ASC 958-805-55-40

In applying the guidance in paragraphs 805-10-55-3A through 55-9, references to a *business* or *businesses* also refer to a *not-for-profit activity* or *not-for-profit activities*, and references to the three elements of *input*, *process*, and *output* also include outputs that provide or have the ability to provide goods or services to beneficiaries, customers, or members that fulfill the purpose or mission for which an NFP exists.

First, the acquiring entity should evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset (or group of similar identifiable assets), using a screening test described in ASC 805-10-55-5A. ASC 805-10-55-5B provides guidance on what qualifies as a single identifiable asset.

Excerpt from ASC 805-10-55-5A

If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business.

ASC 805-10-55-5B

A single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination. However, for purposes of this evaluation, the following should be considered a single asset:

- a. A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)
- b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

If a transaction qualifies as a single asset (or group of similar assets) under this test, it is not considered a business or nonprofit activity, and is accounted for under the “asset acquisition” subsections of ASC 805-50. Example NP 5-2 illustrates application of the screen.

If the screen does not classify the transaction as an acquisition of a single asset (or group of similar assets), the acquirer would need to analyze the relationships among the inputs, processes, and outputs acquired to determine whether the transaction meets the definition of a business or nonprofit activity, which can be judgmental and complex.

For more information on this analysis, see BCG 1.2.

EXAMPLE NP 5-2

Business combination vs asset acquisition

NFP Health System (“System”) purchases a medical office building. At the acquisition date, the building is fully leased out to tenants, and System becomes a party to all of the existing leases at closing. System also hires the current leasing and other personnel involved with the operations of the property.

Would this transaction be accounted for as a purchase of property (an asset acquisition) or an acquisition of a business or nonprofit activity (a business combination)?

Analysis

To answer this question, System would need to perform a screen test to determine if substantially all of the fair value of the gross assets acquired (the land, building, property improvements, and in-place leases) is concentrated in a single asset or group of similar assets. According to ASC 805-10-55-5B, the building and property improvements are attached to the land and cannot be removed without incurring significant cost, and the in-place lease intangible is combined with the related real estate. Because substantially all of the fair value of the gross assets acquired is concentrated in a single asset (the combined land, building, and lease intangible), the acquisition would not be considered a business or nonprofit activity. Thus, System would account for the acquisition using the “asset acquisition” subsections of ASC 805-50.

If System instead had acquired dissimilar assets in the transaction (for example, a medical office building and a retail facility), the “acquired set” would pass through the screen and further analysis of the inputs, processes, and outputs would be required.

5.3.2.1 **Definition of nonprofit activity**

The term nonprofit activity is used in many areas of GAAP (for example, business combinations, discontinued operations, and asset disposals) and is defined in the ASC master glossary.

ASC Master Glossary

Nonprofit activity: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity’s purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

According to ASC 958-805-55-40, nonprofit activity is the not-for-profit counterpart of the definition of a business.

Excerpt from ASC 958-805-55-40

In addition to the term *business*, this Subtopic also uses the term *nonprofit activity* to differentiate an acquisition of an integrated set of activities and assets that is within its scope from an acquisition of a group of assets that is outside its scope. It builds on the definition of a *business* in defining a *nonprofit activity*; each is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits.

The nature of the benefits provided distinguishes a business activity from a nonprofit activity. For a business activity, the primary focus is on economic benefits, such as revenues, while for a nonprofit activity, benefits are identified in terms of achieving a purpose or mission (which may or may not generate revenues).

5.4 *Merger accounting model*

For accounting purposes, a merger occurs when two or more NFPs join together in their entirety to create a new organization. The governing bodies of the combining entities cede control of their respective entities to a new entity with a newly-formed governing body.

The requirements for merger accounting are set forth in the Merger of Not-for-Profit Entities subsections of ASC 958-805. Merger accounting has no business entity counterpart in ASC 805; it is unique to NFPs.

NP 5.3 discusses the FASB's considerations for distinguishing between a merger and an acquisition. According to ASC 958-805-55-1, the ceding of control by all parties to a new entity is the sole definitive criterion for identifying a merger. In establishing a merger framework within the model, the FASB indicated their expectation that there would be a relatively high hurdle for qualifying to use merger accounting. The evaluation of whether all parties have ceded control must be based on a preponderance of the evidence.

Question NP 5-3 addresses the composition of the new entity's governing board after a merger.

Question NP 5-3

In order for a combination of two NFPs to be considered a merger, must the governing board of the new entity have exactly equal representation from each entity?

PwC response

No. In fact, the FASB provides an example illustrating a combination that is accounted for as a merger in which the initial board of the combined entity has 15 members, with 9 appointed by one entity and 6 appointed by the other (see ASC 958-805-55-9 through ASC 958-805-55-16). The example analyzes the characteristics of the process leading to the combination, the participants in the combination, and the combined entity. Based on the preponderance of the evidence, it concludes that both entities have ceded control to a new entity in a transaction that would be accounted for as a merger.

The guidance for determining whether a combination is a merger is principles based and all relevant facts and circumstances of a particular transaction should be considered. For example, if the bylaws of the combined entity indicate that major decisions require a simple majority vote, and one of the

combining organizations has one more board member than the other, then the entity with the additional board member would always be able to dictate the board's decisions. However, if major decisions require a supermajority vote, an imbalance of board members might be less of a concern. It is important to bear in mind that no single indicator is by itself determinative, and that decisions should be made based on the preponderance of the evidence, using professional judgment.

Question NP 5-4 addresses whether cash consideration impacts the ability to qualify as a merger.

Question NP 5-4

Would a transfer of cash consideration preclude the use of merger accounting?

PwC response

No. Although a merger typically is accomplished without a transfer of cash or other assets to any of the participating entities or any of their owners, members, sponsors, or other designated beneficiaries, we believe the presence or absence of consideration is not a determinative factor in distinguishing a merger from an acquisition.

Question NP 5-5 addresses qualification as a merger when one entity is a subsidiary.

Question NP 5-5

A freestanding hospital is combining with an entity that is a subsidiary of a hospital system. Can merger accounting be applied if one of the combining NFPs is a subsidiary of a larger organization?

PwC response

No. If one of the combining entities continues to be operated as the subsidiary of another entity, then the entities have not come together in their entirety, and a new entity has not been created. In substance, this is an acquisition of the freestanding hospital by the system, using one of its subsidiaries to effect the acquisition.

5.4.1 Accounting requirements under merger model

Mergers are accounted for using the framework described in Figure NP 5-6, known informally as the “carryover method.” The assets and liabilities of the combining entities as of the merger date (the date the combination becomes effective) are combined using their historical amounts, adjusted as necessary to conform the combined entities’ respective accounting policies. Operations of the new entity are reported from the merger date forward, consistent with the FASB’s view that in a merger, a new entity (with no historical operations) emerges from the formerly separate organizations.

Figure NP 5-6
Merger model – accounting framework

Principle	ASC reference
<ul style="list-style-type: none"> □ The NFP resulting from a merger is a new reporting entity, with no activities before the merger date 	ASC 958-805-45-1
<ul style="list-style-type: none"> □ The new NFP's initial reporting period begins with the merger date 	ASC 958-805-45-1
<ul style="list-style-type: none"> □ Balance sheet <ul style="list-style-type: none"> ○ The combined assets, liabilities, and net assets of the merging entities are included in the statement of financial position as of the beginning of that initial reporting period ○ The assets and liabilities are measured at the amounts reported in the financial statements of the merging entities immediately prior to the merger, adjusted as necessary to conform accounting policies; the assets and liabilities are not remeasured to fair value ○ The new NFP does not recognize additional assets or liabilities that GAAP did not require or permit the merging entities to recognize (for example, internally-developed intangible assets, noncapitalized museum collections, conditional contributions receivable) ○ The assets and liabilities carry forward the merging entities' classifications and designations at the merger date, unless an exception applies 	ASC 958-805-25-6 ASC 958-805-45-1 ASC 958-805-30-1 ASC 958-805-25-7 ASC 958-805-25-8 ASC 958-805-25-9
<ul style="list-style-type: none"> □ Statement of activities <ul style="list-style-type: none"> ○ The merger itself is not reported as activity in the new NFP's initial reporting period 	ASC 958-805-45-1

If the merging entities used different accounting policies, those differences must be conformed so that the new entity will have a consistent accounting policy. For example, as discussed at NP 6.7.2.3, GAAP allows NFPs to elect an accounting policy of reporting donor-restricted contributions as unrestricted revenues if the restrictions are satisfied in the same reporting period that the contributions were received. One of the combining entities might have elected this accounting policy, while the other did not. If conforming the accounting policies results in an adjustment to financial statement amounts, those adjustments are reflected in the opening balances (which are the balances carried forward from the financial statements of the merging entities), with disclosure made of the nature and amount of any significant adjustments.

The new NFP must disclose information that enables its financial statement users to evaluate the nature and financial effect of the formation transaction. ASC 958-805-50-1 through ASC 958-805-50-6 identify the required disclosures, including certain required supplemental information (see NP 5.4.2). ASC 958-805-55-32 through ASC 958-805-55-37 illustrate disclosures that describe the merger, significant unrecognized assets (for example, conditional contributions receivable), any significant adjustments necessary to conform accounting policies, and identify the major classes of assets, liabilities, and net assets combined. AAG-NFP chapter 3 and AAG-HCO chapter 12 provide additional discussion.

Question NP 5-6 addresses one of the differences between acquisition and merger accounting.

Question NP 5-6

In a merger, should the opening balance sheet of the new entity recognize assets and liabilities that were not included in the predecessor entities' historical financial statements because they did not meet the GAAP requirements for recognition (for example, internally generated intangible assets)?

PwC response

No. ASC 958-805-25-7 states that the new entity should not recognize additional assets and liabilities that GAAP did not require or permit the combining entities to recognize in their historical financial statements.

Question NP 5-7 addresses whether the merged entity can change the predecessor entities' decisions regarding election of the ASC 825-10 fair value option.

Question NP 5-7

Can the newly merged entity elect or reverse the instrument-by-instrument elections made under the fair value option subsections of ASC 825-10 by the predecessor entities'?

PwC response

No. According to ASC 958-805-30-3, because the carryover method does not reflect a fresh-start measurement, a merger is not an event that permits the election of accounting options that are restricted to the entity's initial acquisition or recognition of an item (or the reversal of a previous election), as is the case with the ASC 825-10 fair value option. Therefore, decisions made by the predecessor entities regarding election of the ASC 825-10 fair value option for particular assets or liabilities carry forward into the financial statements of the new entity. For example, assume that NFP A and NFP B each have an equity method investment. NFP A elected the ASC 825-10 fair value option for subsequent measurement of its investment but NFP B did not. If NFP A and NFP B merge, the new entity cannot reverse NFP A's prior election of the fair value option for its investment that is carried over to the new entity, nor can it elect the fair value option for Hospital B's investment. If NFP A had instead acquired NFP B, NFP A would be permitted to elect the fair value option for the investments obtained from NFP B in connection with its initial recognition of the acquired assets.

5.4.2 Required supplemental information for mergers

ASC 958-805-50-3 through ASC 958-805-50-5 describe pro forma disclosures that must be provided for certain mergers involving a conduit bond obligor with publicly-traded debt. ASC 958-805-55-3 identifies these disclosures as required supplemental information (RSI). Standard setters require the reporting of certain information outside the financial statements as RSI when they believe the information is essential to placing the financial statements in their proper context. RSI differs from other types of supplementary information that might accompany financial statements (for example, consolidating schedules that may be voluntarily provided) in that it is mandated by the FASB, and the FASB has established requirements for how it should be presented. ASC 958-805-55-3 specifies that

the pro forma information should not be disclosed in the notes to the financial statements, but should instead be provided in a separate schedule that accompanies the financial statements and notes.

The pro forma disclosures are required only when the merger date does not coincide with the beginning of the first annual reporting period (and thus, the initial statement of activities or income statement covers a period of less than twelve months). In those situations, the new NFP must disclose what its revenue, change in net assets without donor restrictions, change in net assets with donor restrictions, and (for HCOs only) performance indicator would have been if the merger had occurred at the beginning of the annual reporting period. If the subsequent year's financial statements are comparative, the pro forma disclosure for the year of merger must continue to be reported. If disclosure of the pro forma information is impracticable, the entity must disclose that fact and explain why the disclosure is impracticable.

ASC 958-805-55-38 illustrates this disclosure for an entity that does not report a performance indicator.

5.5 Acquisition accounting model

Most NFP combinations will be accounted for using the acquisition accounting model. Broadly speaking, an acquisition is an event that results in initial inclusion of an NFP, a business entity, or a portion of an entity (discussed in NP 5.3.2) in an NFP parent's consolidated financial statements. For example, if one NFP's articles of incorporation are modified to designate the other as its sole corporate member, or if one NFP's articles of incorporation are modified to give the other entity a majority voting interest in its board (and an economic interest is present), an acquisition has taken place.

The ASC 805 acquisition model applies to acquisitions made by NFPs, with certain adjustments based on differences in the nature of NFP acquisitions. The adjustments based on the differences are found in the "Acquisition by a Not-for-Profit Entity" subsections of ASC 958-805. Figure NP 5-7 summarizes the key differences between the NFP and business entity acquisition methods. In particular, it indicates whether ASC 958-805's guidance supplements the guidance in ASC 805, or is applied in lieu of the guidance in ASC 805.

Figure NP 5-7

Contrasting acquisition accounting in ASC 958-805 and ASC 805

Topic	ASC 958-805: Primary or supplemental	Reference
Identifying the acquirer	Primary. Uses the concepts of control in the NFP consolidation model instead of the guidance in ASC 805-10-25-5.	ASC 958-805-25-15
	Supplemental. If the identity of the acquirer is unclear, NFPs consider factors in ASC 958-805-55-42 through ASC 958-805-55-46 in addition to the factors in ASC 805-10-55.	ASC 958-805-25-16
Identifying the acquisition date	Supplemental. Supplements ASC 805-20 with guidance on acquisitions involving sole corporate memberships.	ASC 958-805-25-17

Topic	ASC 958-805: Primary or supplemental	Reference
Recognizing identifiable assets acquired, liabilities assumed, and noncontrolling interest	Supplemental. Supplements ASC 805-20 with NFP-specific considerations regarding recognition conditions, classifying or designating assets acquired and liabilities assumed, and exceptions to the recognition principle.	ASC 958-805-25-18 through ASC 958-805-25-26
Recognition and measurement of consideration and the residual (goodwill or contribution)	Primary. ASC 805-30's scope excludes NFPs. NFPs do not measure the fair value of the acquiree as a whole. ASC 958-805 requires use of a "net asset" approach to recognize and measure any goodwill or inherent contribution received.	ASC 958-810-25-27 ASC 958-805-30-5
Inherent contribution received (assets acquired exceed liabilities assumed and consideration paid)	Primary. ASC 958-805 views this residual as a contribution received, not a bargain purchase.	ASC 958-805-25-27 ASC 958-805-25-31 ASC 958-805-30-8 through ASC 958-805-30-9
Goodwill (liabilities assumed and consideration paid exceed assets acquired)	Primary. Goodwill arising from certain transactions is expensed immediately.	ASC 958-805-25-27 through ASC 958-805-25-30 ASC 958-805-30-6 through ASC 958-805-30-7
Consideration transferred (including contingent consideration)	Primary. Provides recognition and measurement guidance in lieu of guidance in ASC 805-30. Also addresses the interaction of consideration transfers with releases of donor restrictions	ASC 958-805-25-32 through ASC 958-805-25-36 ASC 958-805-30-10 through ASC 958-805-30-13 ASC 958-805-45-8 through ASC 958-805-45-10
Determining what is part of the transaction	Supplemental. Supplements ASC 805-10-25-1 examples.	ASC 958-805-25-37
Subsequent measurement	Supplemental. Supplements ASC 805-10-35-1 and ASC 805-20-35 with incremental guidance on contingent consideration arrangements and goodwill acquired. ASC 954-805-35 also contains HCO considerations.	ASC 958-805-35

The most significant difference is that the NFP model measures an acquiree based on the fair value of individual assets acquired and liabilities assumed (a "net assets" approach), while the ASC 805 model measures the acquisition using the fair value of the acquiree as a whole ("enterprise value"). As a result, the guidance in ASC 958-805 is applied in lieu of guidance in ASC 805-30.

The NFP acquisition model involves the following steps:

- Identify the acquirer

- Determine the acquisition date
- Recognize and measure the identifiable assets acquired, the liabilities assumed, the consideration transferred (if any), and (if appropriate) any noncontrolling interest in the acquiree
- Recognize and measure inherent contribution income or goodwill as a residual

See AAG-NFP chapter 3 and AAG-HCO chapter 12 for additional discussion.

5.5.1 *Identifying the acquirer*

The concepts of the NFP consolidation model discussed in NP 5.2 are used to identify the acquirer. If the acquirer's identity is unclear, a process similar to that discussed in NP 5.3 for distinguishing a merger from an acquisition is used to designate one. This requires consideration of all facts and circumstances surrounding the transaction, such as whether one of the parties can select (or dictate the process of selecting) a voting majority of the combined organization's governing board or whether the combined entity retains the name and mission of one of the parties. ASC 958-805-55-42 through ASC 958-805-55-46 provide NFP-specific factors to consider, in addition to the general factors in ASC 805-10-55.

5.5.2 *Identifying and measuring assets and liabilities*

The acquiree's fair value is determined by aggregating the fair values of its individual assets and liabilities.

Other than a few specific exceptions, all assets acquired and liabilities assumed are recognized at fair value, including intangible assets that may not have been recognized on the acquiree's balance sheet (e.g., the value of trade names, non-compete agreements, management agreements, curriculum acquired). Several general exceptions to the recognition and measurement principle are described in BCG 2.5. The following are additional exceptions to recognition provided by ASC 958-805:

- An acquirer that has an organizational policy of not capitalizing collections of works of art, historical treasures, and similar items (see NP 10) would not recognize collection items that it acquires as part of an acquisition and adds to its collection. For additional information, see NP 10.3.3.
- Unrecognized conditional promises to give that are acquired as part of an acquisition are not recognized unless the conditions on which they depend are substantially met as of the acquisition date.
- No value is ascribed to the acquiree's donor relationships (i.e., the information the acquiree has about its donors, and the donors' ability to make direct contact with the acquiree). Unlike acquired customer relationships (which are recognized and valued separately), the FASB concluded that the benefit did not outweigh the cost of estimating the fair value of donor relationships. Instead, the value of these relationships are subsumed into goodwill.

The fair value of each recognized asset and liability is determined based on the principles of the framework described in ASC 820. BCG 2 and BCG 4 and FV 7 discuss relevant considerations related to measurement.

Private company alternative

In ASU 2019-06, the FASB extended to NFPs certain private company alternatives that simplify the accounting for intangible assets acquired in a business combination. Under the alternative, an NFP acquirer can make an accounting policy election to not recognize and measure: (a) customer-related intangibles (unless they are capable of being sold or licensed independent from the other assets of the acquired business) and (b) noncompetition agreements. These alternatives are described more fully in BC 4.7. An NFP that elects the accounting alternative for intangibles must also adopt the accounting alternative to amortize goodwill, discussed at NP 10.4.3.1. The provisions became eligible for adoption by NFPs upon issuance of the ASU in May 2019.

5.5.3 *Measuring goodwill or inherent contribution*

The aggregate fair value of the identifiable assets acquired is compared to the aggregate fair value of (a) liabilities assumed, (b) consideration transferred, if any, and (c) any noncontrolling interest (NCI) held by outside parties. The residual is recognized as either an inherent contribution or goodwill.

The guidance used by NFPs for this step differs significantly from the guidance used by business entities. As a result, NFPs are excluded from the scope of ASC 805-30 by ASC 805-30-15-2 and apply only the NFP-specific guidance in ASC 958-805.

ASC 805-30-15-2

The guidance in this Subtopic does not apply to not-for-profit entities. NFPs apply the guidance in Subtopic 958-805 for measuring goodwill acquired, a contribution received, and consideration transferred.

5.5.3.1 *Inherent contribution in an acquisition*

If the fair value of identifiable assets acquired is greater than the fair value of liabilities assumed, consideration transferred, and NCI, the acquirer recognizes the residual as an inherent contribution received. Note that if an acquiree has significant property, plant, and equipment (and in particular, land), it is likely that the requirement to measure real estate at fair value will result in an inherent contribution even if the historical net assets of the acquiree reflected a net deficit.

An inherent contribution that arises in a combination is different than the contributions discussed in NP 6 through NP 8, and must be reported in the statement of activities in a separate line item that is appropriately captioned—for example, “excess of assets acquired over liabilities assumed in donation of Entity X,” “contribution received in donation of Entity X,” or “excess of fair value of net assets acquired over consideration paid in acquisition of Entity X.” This is discussed at ASC 958-805-45-5.

The inherent contribution received increases the acquirer’s donor-restricted net assets, net assets without donor restrictions, or some combination of those categories. ASC 958-805-45-6 addresses considerations for classifying a portion as donor restricted.

Excerpt from ASC 958-805-45-6

An NFP acquirer shall classify the inherent contribution received...on the basis of the donor restrictions imposed on the related net assets. In classifying those net assets, an acquirer shall do both of the following:

- a. Include restrictions imposed on the net assets of the acquiree by a donor before the acquisition and those imposed by the donor of the business or nonprofit activity acquired, if any, in accordance with Section 958-605-45.
- b. Report donor-restricted contributions as donor-restricted support even if the restrictions are met in the same reporting period in which the acquisition occurs. That is, the acquirer shall not apply the reporting exception in paragraph 958-605-45-4 to net assets with donor restrictions acquired in an acquisition.

According to ASC 958-805-45-6(a), a donor-restricted portion of an inherent contribution could arise in two ways:

- If the acquired entity has donor-restricted net assets, the acquirer must classify a corresponding portion of the inherent contribution as donor restricted. In obtaining the acquiree's assets and liabilities, the acquirer assumes fiduciary responsibilities to the acquiree's donors. ASC 958-805-55-62 through ASC 958-805-55-66 illustrate this requirement.
- If the acquiree was donated by another entity (for example, a subsidiary donated by its parent), the donating entity might impose restrictions on how the acquirer must use the acquiree's net assets without donor restrictions. For example, as a condition of an acquisition, the donor might require the acquirer to use \$2 million of net assets without donor restrictions to invest in upgraded fixed assets for the acquiree. This requirement would impose a donor restriction on \$2 million of the inherent contribution. ASC 958-805-55-67 illustrates this requirement.

If an acquirer has an accounting policy of reporting as unrestricted those restricted contributions for which the conditions are met in the same reporting period that the contribution was received (as discussed in NP 6.7.2.3), it cannot apply that policy to the donor-restricted portion of an inherent contribution arising from an acquisition. The donor-restricted portion of an inherent contribution in an acquisition must always be reported as restricted support, as required by ASC 958-805-45-6(b).

The portion of an inherent contribution that is not donor restricted would increase the acquirer's net assets without donor restrictions. If the acquirer is an HCO within the scope of ASC 954, any unrestricted portion of the contribution must be presented within the performance indicator (above the line) in the statement of operations, as required by ASC 954-805-45-2.

5.5.3.2 Goodwill in an NFP acquisition

If the fair value of liabilities assumed, consideration transferred, and NCI exceeds the fair value of identifiable assets acquired, the acquirer would recognize goodwill or an immediate charge to income (in essence, like a contribution made). The choice is not voluntary, but must be based on how the acquiree's operations are expected to be funded within the combined organization.

If the acquiree will be predominantly supported by contributions and investment income, the excess is immediately expensed (as if the acquirer had made a contribution in taking on the acquired entity). According to ASC 958-805-45-4, this amount is reported as a separate line item in the statement of activities with an appropriate descriptive caption—for example, “excess of liabilities assumed over assets acquired in acquisition of Entity X” or “excess of consideration paid over net assets acquired in acquisition of Entity X.” NFP HCOs must report the expense within the performance indicator (above the line), as required by ASC 954-805-45-1.

For purposes of this evaluation, “predominantly supported” means that contributions and returns on investment are expected to be significantly more than the total of all other sources of revenues. The FASB considered but rejected a threshold of “primarily supported” (which generally connotes more than half), determining that a higher threshold was needed.

If the acquiree’s operations are not expected to be predominantly contribution supported, the acquired net deficit represents goodwill that is reported as an asset in the balance sheet.

For additional discussion of goodwill acquired in NFP transactions, see NP 10.4.3.

5.5.4 Consideration transferred in an acquisition

Consideration transferred in an NFP acquisition effectively serves to reduce the amount of inherent contribution recognized (or, although less common, to increase the amount of goodwill recognized or expensed in an acquisition of a net deficit).

Consideration transferred can take different forms, as noted in ASC 958-805-25-32.

Excerpt from ASC 958-805-25-32

An NFP acquirer might transfer consideration to the former owner of the acquiree or to a designee of the former owner. Examples of potential forms of consideration include any of the following:

- a. Cash
- b. Other assets
- c. A business or a nonprofit activity of the acquirer
- d. Contingent consideration.

Often, NFP acquisitions do not involve an exchange of consideration other than the assumption of an acquiree’s liabilities. If consideration is paid, it might be unrelated to the fair value of the acquiree. Further, in some transactions, consideration is paid to a party other than a seller. For example, consideration might be transferred to an independent NFP foundation established in connection with the transaction. A transfer of assets to an unrelated third party as a requirement of a combination is accounted for as consideration transferred in accordance with ASC 958-805-25-33 unless the acquirer retains control over the transferred assets. For discussion of situations in which an acquirer retains control, see NP 5.5.5.2. Question NP 5-8 illustrates these concepts.

ASC 958-805-25-33

An asset transferred by an NFP acquirer to an unrelated third party as a required condition of an acquisition shall be accounted for as consideration transferred for the acquiree unless the NFP acquirer retains control over the transferred assets.

Question NP 5-8

Community Hospital agreed to be acquired by NFP Health System in a transaction that is an inherent contribution. At closing, NFP Health System was required to transfer \$5 million to establish and fund a foundation with a mission of supporting initiatives to benefit the health and welfare of the community. The new foundation is unrelated to either NFP Health System or Community Hospital, and is governed by an independent board. The transferred funds can be used for any purpose that is consistent with the foundation's mission.

Does the \$5 million transferred at closing represent consideration paid by Health System?

PwC response

Yes. A transfer of assets to an independent third-party that is made as a requirement of an acquisition is accounted for as consideration transferred, unless the acquirer retains control over the assets (or over the economic benefits they represent). NFP Health System neither controls the foundation nor retains control over the transferred assets, as the foundation's independent board can use the resources for any purpose that is consistent with its mission. Accordingly, the transfer represents consideration that serves to reduce the amount of inherent contribution that otherwise would be recognized by NFP Health System in the acquisition accounting.

If instead, the acquisition agreement had stipulated that the assets transferred could only be used to fund future capital improvements at Community Hospital, the \$5 million would not represent consideration transferred, because System would retain control over the future economic benefits of the transferred assets post-acquisition.

Consideration transferred is measured at its acquisition-date fair value in accordance with ASC 958-805-30-10. Sometimes the assets transferred will be noncash assets whose fair value at the acquisition date differs from their carrying value. In those situations, ASC 958-805-25-34 requires a gain or loss to be recognized for the difference. This gain or loss on remeasurement is not part of the acquisition accounting (that is, it is not included in the calculation of the inherent contribution or goodwill recognized). Instead, those gains or losses are reported as current period activity in the statement of activities. Consistent with the requirement for business entities to include remeasurement gains or losses in earnings, an NFP HCO would include these gains or losses in its performance indicator.

ASC 958-805-30-10

The consideration transferred in an acquisition by an NFP shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer and the liabilities incurred by the acquirer.

Excerpt from ASC 958-805-25-34

The consideration transferred may include assets or liabilities of the NFP acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, nonmonetary assets or a business of the acquirer). If so, the NFP acquirer shall recognize the resulting gains or losses, if any, in the statement of activities.

ASC 958-805 also addresses the presentation in the statement of cash flows of cash consideration paid. Generally, such cash outflows are netted against any cash acquired from the acquiree and classified as an investing activity, according to ASC 958-805-45-11. Special considerations apply to cash payments associated with contingent consideration; these are discussed in ASC 958-805-45-11 through ASC 958-805-45-12.

Excerpt from ASC 958-805-45-11

An NFP acquirer shall report the entire amount of any net cash flow related to an acquisition (cash paid as consideration, if any, less acquired cash of the acquiree) in the statement of cash flows as an investing activity. Example 7 (see paragraphs 958-805-55-68 through 55-70) illustrates this requirement.

5.5.4.1 Contingent consideration

The parties to an NFP acquisition might agree to a contingent consideration arrangement. Under these arrangements, if specified future events occur or conditions are met, the acquirer has an obligation to make additional payments (or in some cases, has a right to the return of consideration previously paid). The ASC 958-805 accounting framework for contingent consideration is generally consistent with the requirements applied by business entities, as described in BCG 6.2.4. However, because NFPs do not have ownership interests like those of business entities, contingent consideration paid in NFP acquisitions would never take the form of equity interests that would be accounted for within equity (net assets).

ASC 958-805-30-13 provides guidance on the initial measurement of contingent consideration, and ASC 958-805-35-1 through ASC 958-805-35-4 provide guidance on the subsequent measurement. Changes in the fair value of contingent consideration are reported in the statement of activities. An NFP HCO generally reports those changes within the performance indicator (see ASC 954-805-35-1 for additional information).

5.5.4.2 Consideration transferred triggers net asset reclassifications

ASC 958-805-45-8 requires that when an acquirer transfers assets that qualify as consideration, it must consider whether that outlay will satisfy a restriction on its donor-restricted net assets and therefore, trigger a change in its own net asset classifications.

ASC 958-805-45-8

An NFP acquirer that transfers assets as consideration for an acquired nonprofit activity or business shall assess whether that transaction satisfies a donor-imposed restriction [see paragraph 958-805-45-9] or otherwise results in a change in its net asset classifications (see paragraph 958-805-45-10).

For example, if the acquirer has net assets that are restricted for acquisition of long-lived assets and the acquiree has long-lived assets of the type needed or used by the acquirer, it is possible that the act of transferring consideration could satisfy some or all of those donor-imposed restrictions, as illustrated in Example NP 5-3.

EXAMPLE NP 5-3**Consideration transferred satisfies a donor restriction on the acquirer's net assets**

NFP A pays consideration of \$800 to acquire NFP B. At the acquisition date, the fair value of NFP B's assets and liabilities are as follows:

Land, buildings, and equipment	\$1,000
Noncapital assets	200
Liabilities	<u>(400)</u>
Net assets acquired	<u>\$ 800</u>

NFP A's own donor-restricted net assets include \$2,000 that is restricted for unspecified capital purposes.

Would NFP A's \$800 outlay to acquire NFP B satisfy any of the restrictions on its net assets that are donor-restricted for capital purposes?

Analysis

This situation would require the exercise of judgment. Most of the acquisition's value is concentrated in the acquiree's PP&E. Assuming that NFP B's long-lived assets are consistent with the types of long-lived assets used in (and needed for) NFP A's operations, it might be reasonable to conclude that NFP A's \$800 outlay to acquire NFP B would satisfy the restriction with respect to \$800 of its \$2,000 of net assets restricted for acquisition of capital assets. In that case, NFP A's statement of activities would reflect a reclassification from donor-restricted net assets to net assets without donor restrictions in the amount of \$800 in acquisition accounting.

In the situation illustrated in Example NP 5-3, the NFP acquirer has flexibility in how it reports the expiration of the restriction (the reclassification—the simultaneous increase in one class of net assets and decrease of another) in the statement of activities. That reclassification can be displayed separately or aggregated together with the NFP's other expirations of donor-imposed restrictions.

In other cases, transferring consideration could result in imposition of additional donor-restrictions on the acquirer's own net assets. For example, if an acquirer transfers unrestricted resources in exchange for an acquiree's donor-restricted resources, the acquirer has (in effect) replaced a portion of its own net assets without donor restrictions with donor-restricted net assets of the acquiree. In that situation, the acquirer would need to adjust its net asset classifications to reflect the shift associated with the

assumption of fiduciary responsibility to the acquiree's original donors. This is illustrated in Example NP 5-4.

EXAMPLE NP 5-4

Consideration transferred imposes additional donor restrictions on acquirer's net assets

NFP C entered into an agreement to acquire the assets and liabilities of Charity D in exchange for payment of consideration of \$80. At the acquisition date, Charity D's balance sheet consisted entirely of unspent donor-restricted gifts with fair values totaling \$100. The acquisition was part-exchange and part-contribution, with NFP C recognizing an inherent contribution of \$20.

During the same reporting period, NFP C received \$450 of contributions (\$200 of which were donor-restricted) and satisfied \$150 of donor restrictions. For ease of illustration, NFP C's expenses for the period are disregarded.

How would NFP C's statement of activities reflect its assumption of fiduciary responsibilities to the acquired entity's donors?

Analysis

To recognize the fiduciary responsibilities associated with the donor-restricted assets acquired by contribution, NFP C would report the inherent contribution of \$20 as an increase in donor-restricted net assets. For the assets that were purchased, NFP C would report a reclassification that simultaneously increases net assets with donor restrictions and reduces net assets without donor restrictions by \$80. In effect, NFP C exchanged \$80 of net assets without donor restrictions for donor-restricted net assets of the acquiree. The \$80 reclassification, along with expiration of any restrictions on the related net assets during the year of the acquisition, would be reported separate from the reclassifications associated with NFP C's own donor-restricted contribution activity during the period.

NFP C's statement of activities would display these transactions as follows:

	Net assets	
	Without donor restrictions	With donor restrictions
Contributions from donors	\$ 250	\$ 200
Net assets released from restriction	150	(150)
Acquisition of Charity D:		
Consideration paid for donor-restricted assets	(80)	80
Expiration of restrictions associated with purchased assets	65	(65)
Excess of net assets acquired over consideration paid (inherent contribution)	--	20
Change in net assets	<u>\$ 385</u>	<u>\$ 85</u>

In the statement of activities of the reporting period that includes the acquisition, ASC 958-805-45-10 provides specific requirements for displaying the reclassifications associated with the purchased donor-restricted assets. Unlike Example NP 5-3, these reclassifications cannot be aggregated with reclassifications associated with the acquirer's own contribution transactions. The reclassification associated with the purchase must be reported in a separate line item. Any reclassifications associated with expirations of restrictions on the purchased assets must similarly be segregated and separately displayed.

ASC 958-805-45-10

If transferring consideration results in changes in net asset classifications other than those described in [paragraph 958-805-45-9], an NFP acquirer shall report those changes separately from both any other reclassification of net assets and any expiration of those restrictions during the period in which the acquisition occurs. For example, an acquirer that transfers as consideration its assets with no associated donor restrictions and acquires assets from the acquiree that have associated donor restrictions shall recognize a reclassification of net assets in its statement of activities.

5.5.5 Other transfers required as a condition of an acquisition

An acquisition transaction might require asset transfers whose nature differs from the transfers of consideration discussed in NP 5.5.4. The impact of these transfers on the acquisition accounting (if any) varies based on the circumstances surrounding the transfer.

5.5.5.1 Assets transferred to acquirer by unrelated third party

As a condition of an acquisition that involves a transfer of control without an exchange of consideration, an unrelated third party might be required to transfer assets to an acquirer. In such cases, the acquirer will need to determine whether that transfer is a separate transaction that occurs concurrently with the acquisition, or if instead it should be included in the acquisition accounting.

NFPs apply the same rules for making that assessment as do business entities (ASC 805-20-25-3 and ASC 805-10-25-20 through ASC 805-10-25-23). While the guidance in ASC 805-10 focuses on transactions involving an exchange of consideration, ASC 958-805-25-19 indicates that the concepts would apply equally to nonexchange transactions – for example, an acquisition that represents an inherent contribution, or a nonexchange transfer to induce the acquirer to enter into the transaction.

ASC 805-20-25-3

In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 805-10-25-20 through 25-23 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable GAAP.

ASC 958-805-25-19

When considering whether an identifiable asset or liability assumed qualifies for recognition as part of applying the acquisition method as described in paragraph 805-20-25-3, an identifiable asset or liability also qualifies if it is part of what was contributed in an acquisition that includes an inherent contribution.

The analysis focuses on identifying which party (the acquirer or the acquiree) the concurrent transaction was intended to benefit. A transaction entered into primarily for the economic benefit of the acquiree is likely to be part of the combination accounting. A transaction entered into primarily for the benefit of the acquirer or the combined entity is likely to be a separate transaction that should be accounted for in accordance with its nature and the applicable GAAP. ASC 805-10-55-18 provides factors to consider. Example NP 5-5 illustrates these concepts.

EXAMPLE NP 5-5**Acquisition-related transfer from unrelated third party**

The board of financially troubled Local Hospital is in discussions with a potential acquirer, Health System. The parties believe that the fair value of Local Hospital's assets at the proposed acquisition date will exceed the fair value of its liabilities by \$5 million.

To induce Health System to enter into the transaction, Community Foundation offers to transfer \$20 million for the support of Local Hospital to Health System at the closing of the transaction. Community Foundation's purpose is to support initiatives that benefit the health and welfare of the community and its citizens.

If Health System agrees to the acquisition, would it account for the \$20 million transfer from Community Foundation as a separate contribution, or would it include the transfer in the acquisition accounting?

Analysis

In evaluating the transfer under the guidance in ASC 805-20-25-3 and ASC 805-10-25-20 through ASC 805-10-25-23, it is likely that Health System would conclude that the transaction was arranged primarily to achieve economic benefits favorable to Local Hospital. While Health System also benefits from the transfer, the impetus for Community Foundation's offer was to ensure Local Hospital's ongoing viability for the benefit of the community's citizens.

In that case, because the transferred assets would primarily benefit the acquiree, they would be included in acquisition accounting. As a result, Health System would recognize an inherent contribution of \$25 million (\$20 million from Community Foundation plus \$5 million in Local Hospital fair value of net assets) in connection with the acquisition. This accounting outcome is the same as if Community Foundation had made a \$20 million contribution to Local Hospital prior to the acquisition.

If instead, Health System had concluded that the transaction was primarily for its own benefit (or the benefit of the combined entity), the \$20 million transfer would represent a separate transaction accounted for under ASC 958-605, rather than ASC 958-805. Health System would separately

recognize \$20 million of contribution revenue associated with the transfer from Community Foundation, along with \$5 million of inherent contribution in connection with the acquisition.

ASC 805-10-25-21 provides examples of separate transactions that should not be included in acquisition accounting. ASC 958-805-25-37 provides an additional example of a separate transaction that might occur in conjunction with an acquisition by a not-for-profit entity.

ASC 958-805-25-37

In addition to the examples in paragraph 805-10-25-21, a payment by a former owner of an acquired business that is unrelated to the acquiree, such as a contribution to fund activities of the acquirer or its affiliates that are unrelated to those of the acquiree, is an example of a separate transaction that is not to be included in applying the acquisition method. Those contributions made shall be accounted for in accordance with the guidance in Subtopic 720-25.

5.5.5.2 Acquirer retains control of economic benefits transferred

In some transactions, instead of paying consideration to a former owner or to an independent foundation, the acquirer makes certain financial commitments to the acquiree as a condition of the acquisition (for example, to fund capital improvements at the acquiree). At closing, the acquirer might transfer the committed resources to the acquiree, a foundation controlled by the acquiree, or to an outside third party.

When assets that are required to be transferred in connection with an acquisition (or the economic benefits associated with the assets) will remain within the consolidated entity after the acquisition (for example, because the assets were transferred to the acquiree rather than to its former owners), the acquirer retains control of the economic benefits. Similarly, if the asset transfer is revocable, repayable, or refundable, or if the transferred resources are not irrevocably committed for the acquiree's use, the acquirer (by virtue of its control over the acquiree) has the ability to reclaim the resources at will and thus, retains control. These examples are codified in ASC 958-805-25-35.

ASC 958-805-25-35

Examples of asset transfers in which control over the future economic benefits of the transferred assets is retained by the acquirer include all of the following:

- a. The assets are transferred to the acquiree rather than to its former owners or are otherwise transferred to a recipient that is controlled by the acquirer. By virtue of its control over the recipient, the acquiring entity has the ability to revoke the transfer or to direct the use of the assets to itself or an affiliate.
- b. The asset transfer is otherwise revocable, repayable, or refundable.
- c. The assets are transferred with the stipulation that they be used on behalf of, or for the benefit of, the acquiree, the acquirer, the consolidated entity, or their affiliates. Example 3 (see paragraphs 958-805-55-55 through 55-56) illustrates an asset transfer in which the NFP acquirer retains control over the future economic benefits after the acquisition.

Question NP 5-9 and Question NP 5-10 illustrate two fact patterns in which an acquirer retains control of the economic benefits associated with an acquisition-related transfer.

Question NP 5-9

NFP Health System wishes to acquire Community Hospital. As a condition of agreeing to the transaction, Community Hospital's board negotiates a financial commitment of \$5 million from NFP Health System to fund improvements of Community Hospital's facilities. The purpose of this commitment is to help ensure that Community Hospital will have the wherewithal to be maintained and operated in a manner that benefits the community after the local board surrenders control. NFP Health System will transfer the \$5 million to Community Hospital at closing.

Does the \$5 million transfer at closing represent consideration paid by NFP Health System?

PwC response

No. In this situation, the transferred assets will remain within the consolidated entity after the transaction closes (by virtue of NFP Health System's control of Community Hospital post-acquisition). The transfer is not consideration paid and does not impact the amount of inherent contribution or goodwill recognized in the acquisition accounting. In substance, this is a nonreciprocal transfer of funds from a parent to a controlled subsidiary. NFP Health System would credit cash and debit equity transfer for \$5 million, and Community Hospital would reflect a corresponding entity.

Question NP 5-10

Community Hospital agreed to be acquired by NFP Health System in a transaction that is an inherent contribution. At closing, NFP Health System was required to transfer \$5 million to establish and fund a foundation with a mission of supporting initiatives to benefit the health and welfare of the community. The new foundation is unrelated to either NFP Health System or Community Hospital, and is governed by an independent board.

According to the acquisition agreement, the foundation must use the transferred resources to fund future capital improvements at Community Hospital. The purpose of this stipulation is to help ensure that Community Hospital will have the wherewithal to be maintained and operated in a manner that benefits the community after the local board surrenders control.

Does the \$5 million transferred at closing represent consideration paid by NFP Health System?

PwC response

No. Although the assets were transferred to an independent foundation established in connection with the acquisition, the combined entity nonetheless retains the economic benefit of those assets due to the stipulation that they can only be used to fund future capital improvements at Community Hospital. The substance of the transfer is that NFP Health System exchanged one asset for another (that is, it replaced the transferred resources with a beneficial interest in assets held by the foundation).

Thus, the asset transfer does not represent consideration paid, and would not impact the amount of inherent contribution or goodwill recognized in the acquisition accounting. Subsequent to closing, NFP Health System would likely transfer the beneficial interest to Community Hospital through an equity transfer.

As detailed in ASC 958-805-30-12, when the acquirer retains control over noncash assets transferred (or economic benefits associated with noncash assets transferred) whose fair value at the acquisition date differs from their carrying value, the assets are not revalued to fair value in connection with the transfer, as they would have been if the transfers were deemed to be consideration. In these transfers, the difference between fair value and carrying value is not recognized.

ASC 958-805-30-12

An NFP acquirer that retains control over the transferred assets as described in paragraphs 958-805-25-33 through 25-34 shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date.

Excerpt from ASC 958-805-25-34

Sometimes the transferred assets or liabilities remain within the combined entity after the acquisition, and the acquirer therefore retains control of them. An NFP acquirer that retains control over the transferred assets shall not recognize a gain or loss in the statement of activities on assets or liabilities it controls both before and after the acquisition.

5.5.6 *Recognizing and measuring noncontrolling interests*

An NFP may acquire less than 100% of the equity of an acquiree (for example, purchase or receive a contribution of a majority ownership in the equity of a business entity). In that situation, the portion that is owned by others is referred to as the noncontrolling interest (NCI). A not-for-profit entity also might acquire an NFP that had previously recognized an NCI through an acquisition. The ASC 958-805 acquisition model requires an NFP to measure any NCI in the acquiree at its fair value at the acquisition date. For example, if NFP A acquires 80% of Company B, the 20% NCI in Company B would be recognized in the accounting for the business combination and measured at its fair value. See BCG 6 for a detailed discussion of recognizing and measuring an NCI.

If an NFP acquires another NFP by virtue of obtaining a less-than-complete voting interest in that NFP's board (for example, if it acquires the right to appoint five of seven board members, with another NFP appointing the other two), recognition of a noncontrolling interest is precluded, except in certain specific situations involving NFP HCOs (see NP 5.2.5.1). Presentation and disclosure of noncontrolling interests by an NFP parent is discussed at NP 2.5.3 and NP 3.6.

5.5.7 *Pushdown accounting*

As discussed at NP 5.5.2, an acquirer initially measures the assets and liabilities acquired based on their fair values. Pushdown accounting refers to the “push down” of the acquirer's (parent's) acquisition date fair value basis in the assets and liabilities of the acquired entity to the acquired entity's standalone financial statements.

Pushdown accounting is optional and can be elected any time there is a change in control event involving an entity. Once made, however, the election is irrevocable, and the entity cannot go back and undo pushdown accounting for a particular transaction. If an acquired entity will continue to issue standalone financial statements, the entity should consider whether to apply pushdown accounting.

The question of whether to apply pushdown accounting might arise if, for example, the acquired entity continues to have debt outstanding that is subject to a continuing disclosure covenant and therefore

must continue to file standalone financial statements on the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) website. The entity should consider whether it is more informative for the bondholders to see information presented consistent with the entity's historical basis of assets and liabilities, or if information pertaining to the new basis is more informative.

5.5.7.1 *Application of pushdown accounting (“black line” reporting)*

From the acquired entity's reporting perspective, the election of pushdown accounting represents the termination of the old accounting entity (referred to as the predecessor entity) and the creation of a new accounting entity (the successor entity). If the acquisition date does not correspond with the beginning or end of a reporting period, the acquired entity's statement of activities (or statements of operations and changes in net assets) for the period that includes the acquisition must report the activity attributable to the predecessor entity and the activity attributable to the successor entity in separate columns. For example, if an entity is acquired nine months into its fiscal year, the activity for the first nine months of the year would be reported in a column labelled “predecessor entity” and the activity for the remaining three months would be reported in a column labelled “successor entity.” The columns are separated by a black line to indicate that a change in basis has occurred (hence the term “black line reporting”). The statement of cash flows would be reported in a similar manner.

5.5.7.2 *Pushdown accounting disclosures and supplemental schedules*

Footnote disclosures related to pre- and post-pushdown periods should not be combined. ASC 805-50-50-6 requires that disclosure notify the reader that the reporting entity's results of operations and cash flows after the transaction are not comparable with those prior to the acquisition as a result of pushdown accounting, and therefore have been segregated within the financial statements. For additional information on pushdown accounting, see FSP 17.6.

If the parent company's statements include a supplemental consolidating schedule for the statement of activities or statement of operations, the information presented in the acquiree's column should only include activity from the acquisition date forward (which will correspond to the activity that will be reported in the “successor entity” column of the push-down statements). Any contribution income or goodwill “expense” associated with acquisition accounting would be reported in the parent's column.

Chapter 6:

Contributions received and made—the basics

6.1 Chapter overview—contributions

Not-for-profit organizations receive and make contributions in different forms. Most often, they are made by transferring assets (e.g., cash, investments, land, buildings, materials and supplies), providing utilities or other services, or allowing the use of facilities. Unconditional promises to give or provide any of those items in the future are also contributions, as is the forgiveness of a liability.

Because the contribution accounting model under ASC 958 is symmetrical for contributors and recipients—that is, the same recognition and measurement rules are applied by donors and donees—the discussion in this chapter applies equally to revenue recognition by recipients and expense recognition by donors. The primary sources of authoritative guidance for contribution transactions are

- ASC 958-605, *Not-for-Profit Entities: Revenue Recognition—Contributions*
- ASC 720-25, *Other Expenses: Contributions Made*
- ASC 958-720, *Not-for-Profit Entities: Other Expenses*

Chapter 5 of AAG-NFP and Chapter 11 of AAG-HCO also provide useful context and commentary.

This chapter discusses how to distinguish contributions from other types of nonexchange transactions and provides an overview of the basic rules for recognition of contribution revenue and contribution expense. NP 7 focuses on more specialized recognition and measurement considerations related to promises to give, noncash donations, donated services, and bequests. NP 8 discusses contributions received indirectly through another party (such as a split interest agreement or an institutional fund-raising foundation), and NP 12 discusses transactions that are part exchange and part contribution.

While this chapter uses terminology commonly associated with gift transactions (i.e., “donor” and “donee”), the concepts discussed apply equally to grants that are accounted for using the contribution accounting model. The commentary in this chapter would apply to any non-exchange gift, grant, donation, or similar transaction that meets the defining characteristics of a contribution in NP 6.2. Depending on a grant’s characteristics, it might be accounted for using the contribution accounting model, or it might be accounted for as an exchange transaction. NP 12 discusses the framework for distinguishing between exchange and non-exchange transactions.

6.2 Distinguishing characteristics of contributions

For accounting purposes, a contribution is defined in the ASC Master Glossary.

Excerpt from ASC Master Glossary

Contribution

An unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner. Those characteristics distinguish contributions from a) exchange transactions, which are reciprocal transfers in which each party receives and sacrifices approximately commensurate value; b) investments by owners and distributions to owners, which are nonreciprocal transfers between an entity and its owners; and from c) other nonreciprocal transfers, such as impositions of taxes or legal judgments, fines, and thefts, which are not voluntary transfers.

In a contribution transaction, the resource provider often receives value indirectly by providing a societal benefit although that benefit is not considered to be of commensurate value. In an exchange transaction, the potential public benefits are secondary to the potential direct benefits to the resource provider.

The essential elements of the definition are:

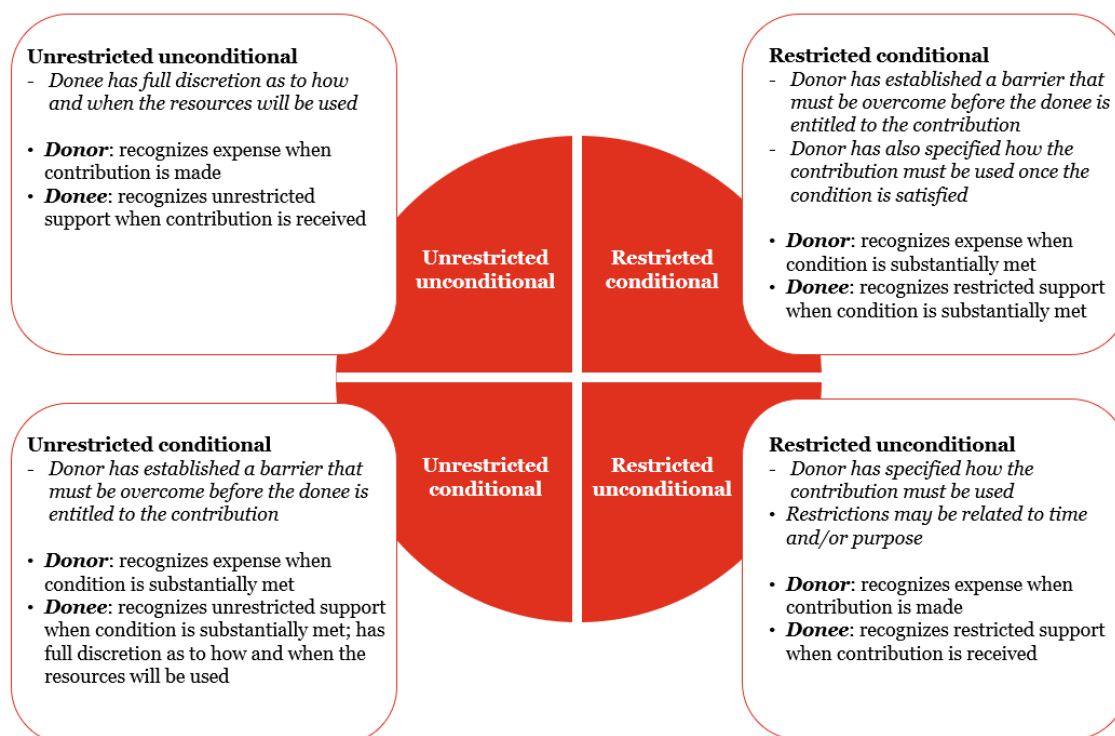
- The transfer is nonreciprocal or non-exchange; that is, the resource provider makes a “one way” transfer of assets or services to the recipient, with nothing expected in return. This characteristic distinguishes a contribution from a reciprocal (or exchange) transaction, in which an exchange of commensurate value takes place between the parties. Considerations when distinguishing a nonreciprocal transfer from an exchange transaction are discussed in NP 12.
- The transfer is voluntarily made by the donor. This characteristic distinguishes contributions from nonreciprocal transfers that are imposed by taxes, fines, penalties, court judgments, or theft.
- The resource provider is not acting as an owner or potential owner. This distinguishes contributions from nonreciprocal transfers of a capital nature, such as equity transfers. An equity transfer is a nonreciprocal transfer of resources between two not-for-profits that are members of the same financial reporting entity. In some ways, equity transfers function as the not-for-profit counterpart of transfers of capital that occur between a business entity and its owners (for example, additional paid-in capital or payment of dividends). See NP 3.4.8.1 for discussion of equity transfers. For similar reasons, some transfers made in connection with or in contemplation of an acquisition of an NFP are not contributions. See NP 5 for a discussion of consolidation and combinations.

6.3 *Summary of accounting for various contribution types*

The chart in Figure NP 6-1 summarizes the four basic classifications of contributions, along with the accounting required by the donor and the donee.

Figure NP 6-1

Summary of accounting considerations for contributions received and made



6.4 The basic accounting for contributions

The basic rules in accounting for contributions are summarized below.

- **A contribution involves a donor, a donee, and a simultaneous transfer of benefit.**

The donor or “resource provider” is the party that transfers the economic benefit. The donee or “resource recipient” is the party that receives those benefits. The transfer is recognized simultaneously by both parties (making this a “symmetrical” model) under ASC 958-605-25-2.

Excerpt from ASC 958-605-25-2

A contribution made and a corresponding contribution received generally are recognized by both the donor and the donee at the same time, that is, when made or received, respectively, or if conditional, when the barrier is overcome.

The donor might be a government agency, an individual, a corporation, a corporate foundation, or a not-for-profit grant-making foundation. The benefits transferred can be cash, noncash assets, services, promises to give financial resources or noncash assets in the future, or cancellation of liabilities.

- **Contributions are recognized in the period that the simultaneous transfer of benefit occurs.**

In accordance with ASC 958-605-25-2 (donee) and ASC 720-25-25-1 (donor), at that time, the recipient recognizes contribution revenue (an increase in its net assets) and the donor recognizes contribution expense. Note that if the contribution involves a promise to give, the transfer of benefit occurs in the period the promise is made (and accepted), not when the actual transfer of resources occurs. Exceptions related to the recognition of contributed collections and donated services are discussed in NP 7.

Excerpt from ASC 958-605-25-2

Contributions received shall be recognized as revenues or gains in the period received and as assets, decreases of liabilities, or expenses depending on the form of the benefits received.

Excerpt from ASC 720-25-25-1

Contributions made shall be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given.

- **Contributions are measured at fair value by both donor and donee.**

The fair value of the asset transferred or liability cancelled is the relevant measurement basis for contributions received (ASC 958-605-30-2) or made (ASC 720-25-30-1). Fair value measurement is required regardless of the nature of the contribution (e.g., services, noncash assets such as real estate or securities, a promise to give). AAG-NFP chapter 5 and its appendix contain extensive interpretive commentary on fair value measurement issues related to contributions. For an in-depth discussion of the principles of fair value measurement, see PwC's *Fair value measurements* guide.

Excerpt from ASC 958-605-30-2

Contributions received shall be measured at their fair values.

ASC 720-25-30-1

Contributions made shall be measured at the fair values of the assets given or, if made in the form of a settlement or cancellation of a donee's liabilities, at the fair value of the liabilities cancelled.

- **Donor-imposed conditions result in deferral of revenue and expense recognition.**

Conditions are barriers or hurdles established by the donor (including other types of contributors, such as makers of certain grants) that must be overcome before the recipient is entitled to the assets transferred or promised. Until that occurs, no gift has been received or made; instead, the gift is contingent. The contribution becomes unconditional (and is recognized by both parties) in the period that the donee substantially meets the condition or conditions associated with the grant. See NP 6.6 for further discussion.

□ **Donor-imposed restrictions on the use of gifts affect financial statement presentation, not recognition.**

A donor may direct how and when a recipient will use their gift. Those instructions create legal restrictions that govern the use of the funds by the recipient. Donor-imposed restrictions do not affect the donee's ability to recognize the gift. Instead, they affect how the gift is reported in the donee's statement of activities (i.e., as an increase in net assets with donor restrictions or net assets without donor restrictions). See NP 6.7 for further discussion of the presentation implications for donees. The imposition of restrictions does not impact the donor's reporting.

Question NP 6-1 addresses the timing of recognizing a grant payable.

Question NP 6-1

On December 31, Foundation's board votes to award \$1 million of grants. The award recipients will be determined at a later date. Should Foundation accrue \$1 million of grant expense/grants payable on December 31?

PwC response

No. ASC 958-605-25-2 states that a contribution made and a corresponding contribution received generally are recognized by the donor and donee at the same time—that is, when the nonreciprocal transfer of economic benefit occurs. Because the Foundation has not yet determined or notified the donees, no transfer of benefit has yet occurred.

Question NP 6-2 addresses donor/donee alignment.

Question NP 6-2

The contribution accounting model requires symmetrical accounting between a resource provider and a resource recipient. Must the parties communicate with each other to agree on the accounting for the transaction?

PwC response

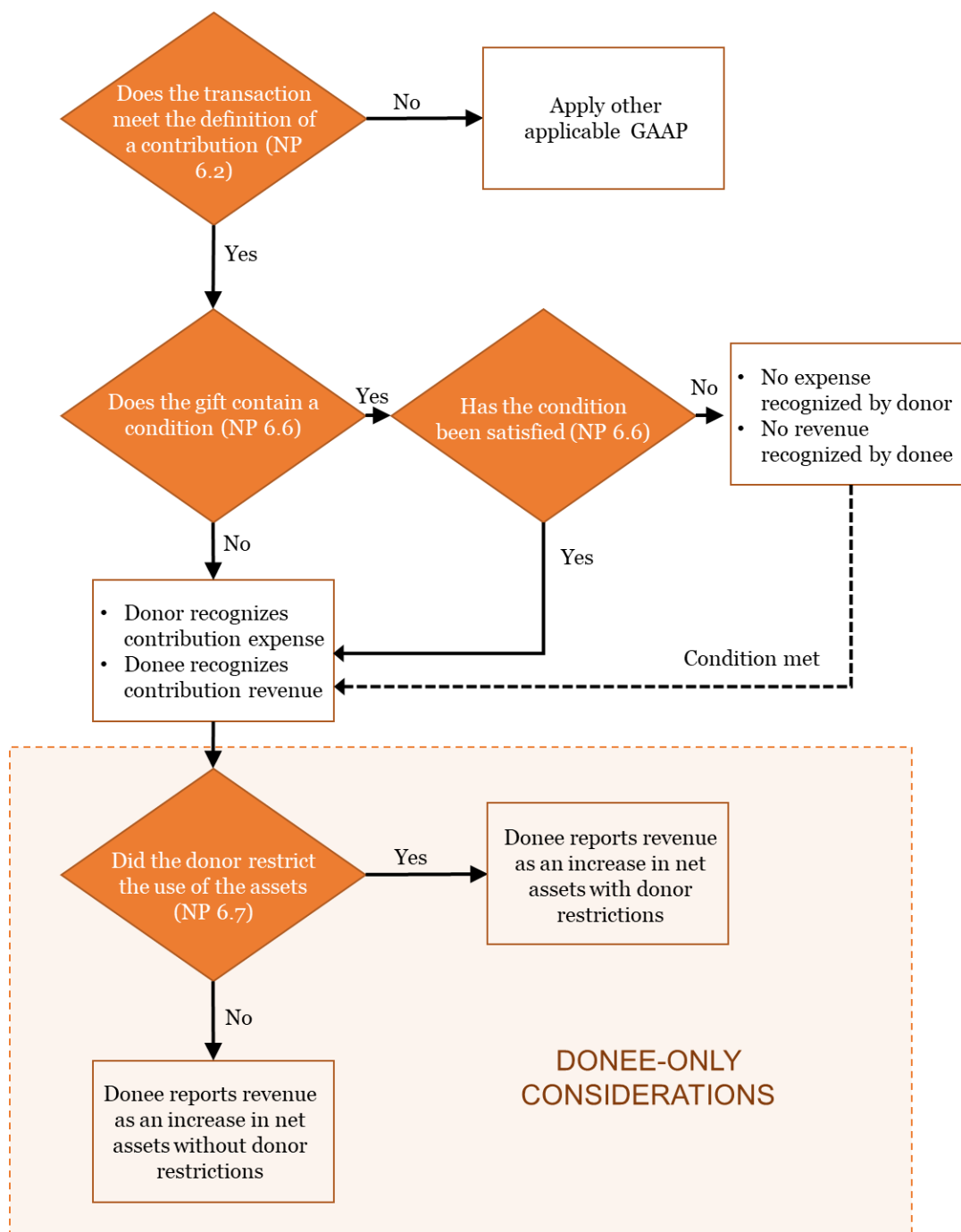
No. GAAP provides the same guidance and recognition principles for both donors and donees to apply in making key accounting determinations, such as classification of transactions as exchange or nonexchange and conditional or unconditional. And, other than the requirement for both parties to have a mutual understanding of the terms of a contribution, GAAP does not require the parties to communicate the specific accounting conclusions reached. Specifically, a grantor can and should apply its own judgment regarding the timing of satisfaction by grantees of the barriers it imposed on the grant (discussed in NP 6.6.1); the grantor is not required to obtain information from the grantee confirming that a barrier has been met.

6.5 Steps in a contribution transaction

Figure NP 6-2 provides an overview of the steps associated with recognition of a contribution by the donor or donee.

Figure NP 6-2

Decision framework for recognizing contributions



6.6 *Conditions on contributions*

Once a transaction is determined to be a contribution, the next step is to determine whether that contribution is conditional or unconditional. The presence or absence of a condition affects the timing of revenue recognition by the recipient and expense recognition by the donor. Unconditional contributions are recognized immediately. However, under ASC 958-605-25-11, if a contribution contains a condition, neither revenue nor expense can be recognized until the condition is satisfied (at which time the contribution becomes unconditional).

Excerpt from ASC 958-605-25-11

Conditional promises to give, which contain donor-imposed conditions that represent a barrier that must be overcome as well as a right of release from obligation, shall be recognized when the condition or conditions on which they depend are substantially met, that is, when the conditional promise becomes unconditional.

A donor-imposed condition is described in ASC 958-605-25-5A. It involves a barrier or hurdle stipulated in the grant award or gift agreement that must be overcome in order for the donee to be entitled to the resources. If the donee fails to overcome the barrier, the donor is released from its obligation to transfer the resources (or, if the donor transferred the resources in advance, the donor has the right to demand their return/is entitled to a return of the transferred assets).

ASC 958-605-25-5A

A donor-imposed condition must have both:

- a. One or more barriers that must be overcome before a recipient is entitled to the assets transferred or promised
- b. A right of return to the contributor for assets transferred (or for a reduction, settlement, or cancellation of liabilities) or a right of release of the promisor from its obligation to transfer assets (or reduce, settle, or cancel liabilities).

A condition that impacts revenue or expense recognition for financial reporting purposes embodies both a barrier that the recipient must overcome (described further in NP 6.6.1) and a right of return of assets or release for the donor if the barrier is not overcome (discussed in NP 6.6.2). If either characteristic is missing (for example, if the agreement contains a right of return but does not specify a barrier), the contribution is unconditional.

A simple example of a conditional contribution is a “challenge grant,” where a donor agrees to make a gift upon the donee’s achievement of a specified level of fundraising (the challenge) set by the donor.

Example NP 6-1 illustrates a challenge grant involving a promise to transfer assets in the future.

EXAMPLE NP 6-1

Challenge grant – funds are promised

Foundation promises to give \$100,000 to City Opera if the City Opera raises at least \$100,000 from other donors before the end of its fiscal year.

At what point would City Opera and the Foundation record the promise to give?

Analysis

As the gift is contingently promised. City Opera does not have a right to the resources, and Foundation does not have an obligation to transfer the resources, unless the opera raises \$100,000 by the deadline. The requirement to raise the \$100,000 is the “barrier” in the agreement. If City Opera is successful (and thus, the barrier is overcome), the gift becomes unconditional, and Foundation is obligated to transfer the resources. When that occurs, City Opera would recognize a contribution receivable and contribution revenue of \$100,000, and Foundation would recognize a corresponding contribution payable and contribution expense. If City Opera is unable to raise \$100,000 (and cannot overcome the barrier), Foundation is released from its promise to transfer the resources.

Example NP 6-2 illustrates the accounting for a challenge grant when the donor transfers resources in advance.

EXAMPLE NP 6-2

Challenge grant – funds are advanced

Foundation agrees to give \$100,000 to City Opera if the City Opera raises at least \$100,000 on its own before the end of its fiscal year. At the time the agreement is executed, Foundation advances \$50,000 to City Opera. If City Opera fails to raise the other funds, the \$50,000 will have to be returned to Foundation.

How should City Opera and the Foundation record the advance?

Analysis

When the funds are transferred, City Opera would recognize cash and a refundable advance (a liability) and Foundation would recognize a reduction in cash and a receivable from City Opera. If City Opera ultimately achieves the \$100,000 fundraising goal, City Opera would derecognize the refundable advance, recognize the additional \$50,000 due from Foundation as a receivable and recognize \$100,000 of contribution revenue. Similarly, Foundation would derecognize the receivable for the refundable advance, recognize an additional payable to City Opera for \$50,000 and recognize \$100,000 of contribution expense. The following are the journal entries:

City Opera (donee)		Foundation (donor)	
Dr. Cash	\$50,000	Dr. Refundable advance	\$50,000
Cr. Refundable advance	50,000	Cr. Cash	50,000
<i>To record funds advanced by donor</i>		<i>To record funds advanced to donee</i>	
Dr. Refundable advance	\$50,000	Dr. Contribution expense	\$100,000
Dr. Contribution receivable	50,000	Cr. Refundable advance	50,000
Cr. Contribution revenue	100,000	Cr. Contribution payable	50,000
<i>To recognize contribution revenue upon meeting condition</i>		<i>To recognize contribution expense—donee met condition</i>	

In some cases, a gift might be partly conditional and partly unconditional. Example NP 6-3 illustrates the accounting in such situations.

EXAMPLE NP 6-3

Contribution is partly conditional

Donor executes a gift agreement with Hospital to provide \$10 million for construction of a new wing. \$5 million is paid when the agreement is signed, with no identifiable barriers to entitlement. The remainder will be due upon completion of construction, when the certificate of occupancy is granted.

When would Hospital recognize the revenue associated with this gift?

Analysis

Hospital would bifurcate the \$10 million gift. The \$5 million received at signing is unconditional and would be recognized as contribution revenue in the period that the gift instrument was executed.

The remaining \$5 million is a conditional promise to give. The donor has stipulated a barrier (completion of construction and obtaining the certificate of occupancy) which must be overcome in order for Hospital to be entitled to the remaining funds.

Hospital would recognize the remaining \$5 million of contribution revenue in the period when the barrier is overcome.

6.6.1 What is a contribution “barrier”?

A barrier is a stipulation in an agreement that must be overcome (either through a recipient’s own performance or by other means) in order for the recipient to be entitled to funds received or promised.

Barriers are absolute thresholds for donors and donees to assess whether a contribution should be recognized. They are not subject to a probability or likelihood assessment. Barriers are objective and binary – an entity will either meet the barrier (and thus, be entitled to the resources) or it will not. Thus, the stipulation needs to be specific enough to allow both parties to identify the condition or conditions that must be satisfied and to be able to determine when they have been satisfied.

Requirements must be substantive to impose a barrier; trivial stipulations (such as certain reporting requirements discussed at NP 6.6.1.3) do not establish barriers.

In practice, grant agreements often contain an array of stipulations ranging from project objectives intended to serve as desirable outcomes or goals to strive for, to requests for information to facilitate the grant maker's learning and evaluation process. This broad spectrum of requirements can complicate or obscure the process of identifying stipulations that are intended to serve as barriers to revenue or expense recognition for financial reporting purposes. GAAP provides a table of indicators in ASC 958-605-25-5D to assist donors and donees in evaluating whether stipulations included in gift and grant agreements would be considered substantive barriers to entitlement for accounting purposes. They include:

- Does the agreement require the entity to achieve performance levels or goals that are measurable in terms of specified outputs, outcomes, or levels of service? (see NP 6.6.1.1)
- Does the agreement stipulate that a specific external event must occur in order for the entity to be entitled to the resources? (see NP 6.6.1.1)
- Does the agreement require that the recipient perform the activity in a specific manner (and thus, limits its discretion)? (see NP 6.6.1.2)
- Are reporting or administrative requirements directly related to achieving the grant or gift's purpose (rather than compliance-oriented)? (see NP 6.6.1.3)

Entities must exercise judgment when considering the indicators in the light of the individual facts and circumstances of the arrangement. The indicators are intended to be assessed collectively. While some indicators may be more significant, no single one is determinative, as indicated in ASC 958-605-25-5D.

Question NP 6-3 addresses the consideration of likelihood when evaluating a barrier.

Question NP 6-3

Shelter is evaluating a new grant received. According to the grant agreement, Shelter must provide 10,000 meals to the homeless during the one-year grant period (a measurable barrier) in order to be entitled to the grant funds. This averages roughly 200 meals per week. Because Shelter consistently provides an average of 500 meals each week, its management views meeting the barrier of 10,000 meals in a year as perfunctory. Can Shelter consider the likelihood of achieving the barrier when initially classifying the grant as conditional or unconditional?

PwC response

No. Neither the likelihood that a barrier will be met nor the resource provider's intent to enforce a right of return may be considered in evaluating whether an agreement is conditional. Shelter must initially classify the grant as conditional and thus, would delay recognizing revenue until it overcomes the barrier of providing the 10,000 meals during the performance period.

Question NP 6-4 addresses "satisfactory progress" provisions.

Question NP 6-4

NFP receives a grant from Foundation. The grant agreement states that Foundation may terminate any or all payments if, in its sole discretion, it determines that NFP fails to make satisfactory progress toward the grant's purpose. Does this provision constitute a barrier?

PwC response

Not likely. Standard terms of grant agreements often include “satisfactory progress clauses” as protective language giving the donor or grantor the right to decide to cancel the agreement if the project takes a turn that the funding entity does not like.

A barrier should be objectively determinable by both parties, both as to the specific condition that must be satisfied and the point at which satisfaction will have occurred. A typical “satisfactory progress clause” would meet neither characteristic, as the decision on the part of the Foundation would be based entirely on subjective considerations. While all facts and circumstances would need to be considered, this particular provision, in and of itself, would not appear to establish a clear, objectively determinable hurdle for NFP. Assuming no other barriers are present in the agreement, NFP would recognize the grant as an unconditional contribution. If the provision is exercised, NFP would report a reversal of contribution revenue in that period.

Similar considerations would apply to evaluating “right to rescind” provisions in agreements, when the donor or grantor, in its sole discretion and for any reason, reserves the right to terminate the agreement with appropriate notice.

6.6.1.1 Measurable barriers

Some barriers involve either quantitative metrics that must be accomplished or specified events that must occur in order for a recipient to be entitled to the assets received or promised (see Figure NP 6-3). For example, a resource provider might stipulate that a recipient must achieve performance levels or goals that are measurable in terms of specified outputs, outcomes, or levels of service. Alternatively, a resource provider may state that a gift or grant will be made only if a certain event occurs. In either case, an unambiguous threshold for entitlement is established that will clearly indicate (to both resource provider and resource recipient) whether the threshold has been met and if so, when that occurred.

Some conditions involve a series of barriers that must be overcome, called “milestones.” Milestones are checkpoints established at intervals throughout a grant project that serve as unambiguous indicators of progress (e.g., a recipient must achieve specific levels of services or accomplish identified tasks within specified time intervals). Milestones are also considered performance-related barriers, and gifts or grants involving milestones become unconditional in stages as each milestone is met (ASC 958-605-55-21).

Figure NP 6-3 summarizes the various types of measurable barriers.

Figure NP 6-3

Examples of measurable barriers

Type	To be entitled to the funds...	Examples
Performance-related	<input type="checkbox"/> A specific level of service must be provided	<input type="checkbox"/> NFP must provide 1,000 meals per week
	<input type="checkbox"/> A specific output or outcome must be obtained	<input type="checkbox"/> NFP's efforts must lower high-school drop-out rate for specified area to 10%
	<input type="checkbox"/> Specified milestones must be achieved	<input type="checkbox"/> NFP must train 2,000 veterans during each quarter of the calendar year
External event	<input type="checkbox"/> A specified matching ratio or amount must be achieved	<input type="checkbox"/> NFP must raise additional \$100,000
	<input type="checkbox"/> A specified external event must occur	<input type="checkbox"/> Donor company's stock price reaches a specified level

ASC 958-605-55-17D provides a number of other examples of measurable barriers.

Question NP 6-5 addresses whether a grant provision qualifies as a barrier.

Question NP 6-5

Foundation awards a grant to Social Services Organization stating that the organization's activities "must be directed toward a goal of lowering the high-school dropout rate in a specified area to 10% or less." Would this provision constitute a measurable performance barrier?

PwC response

No. It's important to distinguish between metrics that establish requirements versus those that are goals to strive for. "Best efforts" metrics do not establish barriers. General requirements in an agreement often may be intended to serve merely as guidelines, rather than being intended to impose a barrier that must be overcome.

The metric described in this fact pattern was likely included as an objective toward advancing the goals of the grant, rather than a barrier upon which the organization's entitlement to funds depends.

6.6.1.2 Award stipulations that limit discretion in how the activity is conducted

Some awards give the recipient broad discretion to conduct the funded activity in any way it sees fit within the parameters of a specified budget. Others, however, require the recipient to perform the grant-funded activity in a specific manner, as described in ASC 958-605-55-17E. The "limited discretion" indicator in ASC 958-605-25-5D focuses on identifying situations when a recipient's entitlement to resources is conditioned upon performing the funded activity according to instructions stipulated by the resource provider. If the recipient fails to comply with those specifications, it is not entitled to the resources.

Excerpt from ASC 958-605-25-5D

Examples of limited discretion could include a requirement to follow specific guidelines about incurring qualifying expenses, a requirement to hire specific individuals as part of the workforce conducting the activity (such as the hiring of specified employees or an identified professor at a university), and a specific protocol that must be adhered to.

A common example of “limited discretion” is a requirement to carry out the activities funded by a Federal grant in accordance with cost principles issued by the Federal government’s Office of Management and Budget. Those requirements are aimed at ensuring that taxpayers’ money (the source of most federal grant funding) is used prudently and in a manner that also achieves certain federal policy objectives. For example, entities with grants subject to the cost principles:

- are required to use competitive sealed bids or competitive proposals when making certain types of purchases;
- cannot purchase materials or services from organizations that are debarred or suspended from Federal assistance programs, or utilize the services of individuals that are debarred or suspended;
- must use local businesses and contract with small, minority, and/or women-owned businesses to the maximum extent feasible when purchasing materials and supplies; and
- must use US air carriers for foreign travel, to the extent that service by such carriers is available.

Often, these awards are cost-reimbursement grants — that is, the entity will only be entitled to reimbursement for expenditures made in compliance with the guidelines. Annual audits performed under Government Auditing Standards issued by the Government Accountability Office (referred to as the “Yellow Book”) ensure compliance with these requirements.

Because the entity’s discretion in how it carries out the activity is pervasively constrained by these requirements, and the entity is not entitled to the funding unless it complies, these awards are deemed to contain a barrier. However, assuming no other barriers exist, and the organization has reasonable controls in place to ensure compliance with the Federal cost principles, the barrier can be considered to have been met (and contribution revenue recognized) as the qualifying expenditures are made. If, ultimately, the expenditures are deemed not to comply with the cost principles, the recipient must repay the government and recognize negative contribution revenue.

Another example might be a research grant containing a “key person” provision. This type of provision states that if a principal investigator (researcher), project director, or other specified key project team member leaves the funded project for another organization, the unexpended proceeds from the research award follow that individual to their new organization. These provisions are commonly included in situations when an award is made based upon the qualifications of a particular individual.

Example NP 6-4 describes the application of this guidance to a research grant that is conditional due to the requirement that the research be led by a specified individual.

EXAMPLE NP 6-4

Key person provision in grant agreement – grant is cancelled if principal investigator leaves

Foundation awards a research grant to University. Foundation's selection of University was based largely on the qualifications of Dr. Jane Doe, the principal investigator (PI) named in University's grant application.

The grant agreement stipulates that the research funding is conditioned upon Dr. Doe serving as the PI, and that transfer of the award to another PI is not permitted. If Dr. Doe moves to another organization during the grant term, unexpended grant funds will transfer to Dr. Doe's new employer. If Dr. Doe does not continue the research at another nonprofit organization, or if the project is terminated for any reason, the award will be cancelled and unused funds must be returned.

Does this stipulation in the agreement limit University's discretion in how it conducts the research?

Analysis

Yes. University is not entitled to the funds if Dr. Doe moves to another institution during the award period. The award is not transferrable to another PI employed by University, limiting University's discretion in how the research is conducted and by whom.

Thus, this stipulation in the grant agreement would create a barrier that must be overcome. In this arrangement, University would overcome the barrier as funds are expended under the direction of Dr. Doe.

Example NP 6-5 describes the application of the guidance to a research grant that provides the resource provider with the ability to cancel if a specific individual (key person) leaves the recipient organization.

EXAMPLE NP 6-5

Key person provision in grant agreement – funder reserves right to cancel if PI leaves

Foundation awards a research grant to University. Foundation's selection of University was based largely on the qualifications of Dr. Jane Doe, the principal investigator (PI) named in University's grant application.

The grant agreement stipulates that Dr. Doe must serve as the PI for the research. If Dr. Doe moves to another organization during the Award period, Foundation reserves its right to transfer unexpended grant funds to Dr. Doe's new employer. Does this stipulation in the agreement limit University's discretion in how it conducts the research?

Analysis

Probably not. In this fact pattern, Foundation "reserves the right" to decide to cancel the agreement if the PI moves, which is subjective and discretionary on the part of the Foundation rather than an objective performance criterion.

Although all facts and circumstances would need to be considered, because the key person provision in this situation does not establish a clear, objectively determinable hurdle that University must overcome in order to be entitled to the funds, it would likely not constitute a barrier.

6.6.1.3 *Reporting and administrative stipulations*

Most grant agreements require some level of reporting to the grantor regarding what was achieved by or learned from the grant-funded project. Most will also specify administrative requirements with which the recipient must comply, for example:

- a requirement to file a report at the conclusion of the grant explaining to the grantor how the resources were spent;
- a requirement to have an audit of the grantee's spending of the grant funds conducted after the funds are exhausted; or
- a stipulation that an annual report be provided by the donee to receive subsequent annual payments on a multi-year promise.

Often, these requirements are geared towards providing the grantor with information useful in evaluating whether the funds were used in accordance with the terms of the agreement. Historically, there was diversity in practice in evaluating whether a routine reporting requirement constituted a condition that should preclude recognition of revenue and expense. However, in ASU 2018-08, the FASB clarified that these types of routine administrative stipulations are not considered barriers that affect the timing of recognition of contribution revenue or expense. ASC 958-605-25-5D now states that a stipulation in an agreement that is unrelated to the purpose for which the grant or gift was made (for example, administrative tasks or trivial stipulations) is not indicative of a barrier.

Excerpt from ASC 958-605-25-5D

A stipulation that is unrelated to the purpose of the agreement (for example, administrative tasks and trivial stipulations) is not indicative of a barrier. Administrative and trivial stipulations could include routine reporting such as a requirement to provide (a) an annual report or (b) a report that summarizes the recipient's performance to demonstrate the underlying actions that were taken to meet the barrier(s) specified in the agreement.

However, if a reporting or administrative requirement relates directly to achieving a grant or gift's purpose, that requirement might constitute a barrier.

6.6.1.4 *Ambiguous stipulations*

In some agreements, it may be difficult for the donee to determine whether a condition is present because the donor's requirements are ambiguous. The lack of specificity referred to in ASC 958-605-25-5E might indicate that no barrier exists because no condition would be sufficiently specific or measurable. In some cases, the ambiguous clauses may relate to satisfactory progress clauses or "right to rescind" clauses, (discussed in the response to Question NP 6-4 in NP 6.6.1), which are generally not considered barriers. In other cases, however, it may be more difficult to conclude that a barrier does not exist.

ASC 958-605-25-5E

Determining whether a contribution is conditional can be difficult if it contains donor stipulations that do not clearly state whether both:

- a. One or more barriers exist
- b. The right to receive or retain payment or delivery of the promised assets depends on meeting those barriers.

In cases of ambiguous donor stipulations, a contribution containing stipulations that are not clearly unconditional shall be presumed to be a conditional contribution.

If the donor's stipulations in the gift are ambiguous, and the donee is unable to resolve the ambiguity by reviewing the facts and circumstances surrounding the gift or by communicating with the donor, the gift is presumed to be conditional (i.e., subject to satisfaction of the condition prior to recognition as revenue).

6.6.2 *Right of return (or release from obligation)*

The second characteristic of a conditional contribution in ASC 958-605-25-5A is that if the recipient does not overcome the barrier, the donor or grantor is released from its obligation to transfer the promised resources (or if assets were advanced, has a right to demand their return).

The right of return or release must be determinable from the gift or grant agreement (or another document linked to the agreement, such as a grant making organization's standard terms and conditions). The presence of both a barrier and a right of return or release from obligation to fund indicates that a recipient is not entitled to the transferred assets or a future transfer of assets until it has overcome the barriers in the agreement.

The specific phrase "right of return" or "release from obligation" does not have to appear in the agreement; however, the right (or release) should be stated sufficiently clearly to be able to support a reasonable conclusion about when a recipient would be entitled to the assets. For example, a grant agreement that requires adherence to the US Federal Office of Management and Budget (OMB) Circular compliance rules when expending grant funds means that the recipient must pay back funds spent inappropriately and must return any unspent funds advanced. In this situation, the "right of return" is evidenced by inclusion of the reference to the OMB rules.

The standard wording used in many grant agreements includes "right of return" language for protective reasons, regardless of whether any barriers are stipulated. The mere inclusion in a grant agreement of "right of return" language is not, by itself, sufficient to make a contribution conditional.

Example NP 6-6 illustrates a situation when a "right of return" clause does not cause a grant to be conditional.

EXAMPLE NP 6-6

Right of return clause without a barrier

Foundation awards University \$5M to conduct basic research in astronomy. The grant agreement stipulates that University must file a report with Foundation at the conclusion of the grant that explains how the assets were spent, and also must provide an auditor's report as to compliance with the terms of the grant. If University is not able to complete the project funded by the grant, University must return the funds to Foundation.

Is this agreement conditional or unconditional?

Analysis

This agreement is unconditional. The requirements to file a report and obtain an audit are compliance requirements that would not be considered barriers. The inclusion of the “right of return” language in the event that University decides to terminate the project is not, by itself, sufficient to make the grant conditional. For a condition to exist, the right of return must be linked to a specified barrier to entitlement.

6.7 Donor-imposed restrictions

Some contributions can be used by the recipient for any purpose. Others—referred to as *donor-restricted contributions*—must be used for specific purposes or in specific time periods that are prescribed by the donor.

In order to apply the decision-making framework in Figure NP 6-2 (in NP 6.5), it is important to understand how donor-imposed restrictions differ from the donor-imposed conditions (discussed in NP 6.5). Conditions dictate what a recipient must achieve or accomplish in order to initially recognize a grant or contribution (that is, to be entitled to the resources). As described in ASC 958-605-25-2A, after the grant or contribution has been recognized, restrictions, if any, stipulate how or when the donated resources must be used.

ASC 958-605-25-2A

After a contribution has been deemed not to contain a **donor-imposed condition** (see paragraphs ASC 958-605-25-5A through ASC 958-605-25-5F), an entity shall consider whether the contribution includes a **donor-imposed restriction**, which includes the consideration about how broad or narrow the purpose of the agreement is and whether the resources can be used only after a specified date.

As discussed in NP 2, the net assets (equity) of an NFP consist of a restricted component and an unrestricted component. Revenue from donor-restricted contributions increases the restricted component, called net assets with donor-restrictions (see Example NP 6-7 in NP 6.7.1). This special component of net assets reflects resources that can only be used for purposes established by a donor. Those resources cannot be used to purchase goods or services or to settle liabilities that are outside the scope of the stipulations (and thus, are generally not available to the donee’s creditors).

6.7.1 What is a donor restriction?

Donor-imposed restrictions are defined in the ASC Master Glossary. They are legally binding on an organization that accepts a restricted gift. Management has a fiduciary obligation to ensure that the resources are used as directed by the donor, and state attorneys general have regulatory and enforcement powers to ensure that donors’ wishes are followed.

Definition from the ASC Master Glossary**Donor-imposed restriction**

A donor stipulation that specifies a use for a contributed asset that is more specific than broad limits resulting from the following:

- a. The nature of the not-for-profit entity (NFP)
- b. The environment in which it operates
- c. The purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association.

Some donors impose restrictions that are temporary in nature, for example, stipulating that resources be used after a specified date, for particular programs or services, or to acquire buildings or equipment. Other donors impose restrictions that are perpetual in nature, for example, stipulating that resources must be maintained in perpetuity. Laws may extend those limits to investment returns from those resources and to other enhancements (diminishments) of those resources. Thus, those laws extend donor-imposed restrictions.

For accounting purposes, a donor-imposed restriction is a stipulation in a gift agreement that limits the use of contributed resources in a manner that is narrower than the limitation imposed by the recipient's overall mission or purpose. For example, if a hospital receives a gift that is donor-restricted to caring for patients, that gift is regarded as unrestricted, because the hospital's mission is to provide patient care. However, a gift designated for care of babies in the neonatal intensive care unit would be donor-restricted, because the specified use is narrower than the hospital's mission.

Some donor-imposed restrictions last forever; they cannot be removed by actions of the organization or the passage of time. For example, a painting might be donated to a museum with the stipulation that it be added to the museum's permanent collection. Or a donor might stipulate that a gift can never be spent, but instead must be invested in perpetuity to create an ongoing stream of investment return to support the entity's activities (an endowment, discussed further in NP 10).

Other donor-restrictions limit the resource's use to a specific purpose (for example, supporting a particular program activity or acquiring a capital asset) or to a future time period (for example, a gift for use in next year's operations of a fixed term endowment which must be invested for five years before being spent). Once the stipulation is satisfied, the restriction expires. Purpose restrictions are satisfied when the donee spends the funds for the indicated purpose; time restrictions are satisfied by the passage of time.

As described in ASC 958-605-45-4, while most donor-imposed restrictions will be explicitly stated, some are implied (see AAG-NFP 5.76 to AAG-NFP 5.77).

Excerpt from ASC 958-605-45-4

A restriction on an NFP's use of the assets contributed results either from a donor's explicit stipulation or from circumstances surrounding the receipt of the contribution that make clear the donor's implicit restriction on use.

The following are examples of circumstances in which a time or purpose restriction would be implied on a gift:

- If circumstances surrounding a gift make it clear that a donor implicitly restricted the use of the gift (e.g., gifts received in response to a specific appeal), the gift has an implied purpose restriction. For example, use of the resources is restricted if the gifts are received in a fund-raising campaign declared to be for a specific purpose—for example, to improve or construct capital assets.
- Promises to give that have payments due in future periods have an implied time restriction, unless the donor explicitly states that the gift is to support current-period activities or other circumstances make that clear. Such restrictions generally expire when the payments on those promises become due, which may be earlier than when the promised payments are received. For additional information on lapsing of implicit time restrictions, see AICPA TQA Section 6140.03 to AICPA TQA Section 6140.04 and AAG-NFP 11.37 to AAG NFP 11.45.
- If a donor makes a gift through an intermediary organization, and the third-party donee is unable to influence the timing of the distribution of the contributed resources from the intermediary, a time restriction is implied (see NP 8.5.2.1).
- Typically, state endowment laws specify that unless a gift instrument indicates otherwise, the assets in an endowment fund (see NP 10) are donor-restricted until they are “appropriated for expenditure.” These statutory requirements impose an implied time restriction on an endowment’s income and capital appreciation.

Example NP 6-7 illustrates the presentation of net assets with donor restrictions and without donor restrictions when a donor-restricted gift is received and when the restrictions are released.

EXAMPLE NP 6-7

Displaying donor-restricted contributions and releases of restrictions

Donor gives \$10,000 to Museum to help defray the costs of a new exhibition. At the date of the gift, Museum’s financial statements reflect an increase in the donor-restricted component of net assets (net assets with donor restrictions). During the same period, Museum incurred \$12,000 of costs associated with installing the new exhibition. Because the purpose restriction has been satisfied, the resources are reclassified to the unrestricted component of net assets (net assets without donor restrictions), so that the resources are associated with the expenses they are intended to fund.

How would the donor restriction be displayed in Museum’s statement of activities?

Analysis

Museum would reflect the following in its statement of activities:

	<i>Net assets</i>	
	Without donor restrictions	With donor restrictions
Contribution revenue	\$ --	\$ 10,000
Net assets released from restriction	10,000	(10,000)
Total contributions and support	10,000	--
Expenses of new exhibition	(12,000)	--

6.7.2 *Expiration of restrictions*

Restricted contributions are generally reported as increases in net assets with donor restrictions when received. Under ASC 958-205-45-9, when the donor's stipulation has been satisfied (e.g., the equipment has been placed in service, the program activities have been carried out, the stipulated time period has elapsed), a reclassification is made from net assets with donor restrictions to net assets without donor restrictions to reflect the expiration of the restriction (see Example NP 6-7 in NP 6.7.1).

ASC 958-205-45-9

An NFP shall recognize the expiration of a donor-imposed restriction on a contribution in the period in which the restriction expires. A restriction expires when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both. If two or more donor-imposed restrictions that are temporary in nature are imposed on a contribution, the effect of the expiration of those restrictions shall be recognized in the period in which the last remaining restriction has expired.

Reporting the expiration of restrictions allows expenses to be associated with the gifts that are intended to support them. This is another unique aspect of the NFP financial reporting model, as discussed in NP 3.

The general rules for reporting expirations of restrictions, or “reclassifications,” are:

- They are recognized in the period the restriction expires.
- They simultaneously increase the unrestricted component of net assets while decreasing the donor-restricted component.
- They are reported separately from revenues and expenses.

Reclassifications are not revenues, expenses, gains or losses; instead, they are a special category of transaction unique to NFPs (ASC 958-605-45-7). They are reported as a separate line or lines on the face of the statement of activities using a caption such as “net assets released from restriction.” Because releases of restriction are not considered revenue, financial statement subtotals that include increases of net assets associated with releases of restriction typically refer to those amounts as “support” (for example, “Total revenues and support”).

Health care organizations must tailor the presentation of reclassifications in light of the additional reporting requirements associated with their reporting model. As discussed in NP 3, health care entities typically report their activities in two statements: a statement of operations and a statement of changes in net assets. When the restriction is satisfied, the decrease in donor-restricted net assets is reflected as a separate line in the statement of changes in net assets, and the increase in net assets without donor restrictions appears as a separate line in the statement of operations. In the statement of operations, the reclassification is reported above the performance indicator unless the restriction pertained to the purchase of long-lived assets (see NP 6.7.3).

Specific guidance is provided on reporting reclassifications in the following situations:

- When two or more sources of restricted net assets are available (NP 6.7.2.1)
- When both restricted and unrestricted net assets are available (NP 6.7.2.2)
- When donor-restricted contributions are received and used in the same period (NP 6.7.2.3)
- When two or more restrictions are imposed on a single gift (NP 6.7.2.4)
- Expiration of restrictions on gifts to acquire long-lived assets (NP 6.7.3)

Additional interpretive guidance is provided in AAG-NFP 11.30 to AAG-NFP 11.52.

6.7.2.1 *Two or more sources of restricted net assets available*

If two or more sources of restricted net assets are available that could satisfy a donor's restriction, management can choose which source of restricted net assets to decrease when the reclassification is recognized or can allocate the expiration among the sources.

Example NP 6-8 illustrates the application of management's discretion as to which source of restricted net assets to decrease.

EXAMPLE NP 6-8

Expenditure could satisfy two different donor restrictions

A hospital purchases a \$5,000 crib for its neonatal intensive care unit (NICU). At the time, the hospital had donor-restricted resources of \$10,000 that were restricted for the NICU, and another \$10,000 that were restricted for capital needs.

Which source of restricted net assets should the hospital release as a result of the purchase of the crib?

Analysis

Because the purchase of the NICU crib would satisfy donor restrictions associated with either category (i.e., NICU restriction because the crib was for the NICU or the capital needs restriction because the crib is a capital asset), management could choose to release net assets from restriction from either category or could allocate the release between them.

6.7.2.2 *Restricted and unrestricted net assets are available*

As implied by ASC 958-205-45-11, when expenses are incurred that would satisfy a donor restriction, the restriction must be released, regardless of whether the donated resources were actually spent. This requirement, informally referred to as the "first dollar" or "deemed spent" rule, precludes management from controlling the timing of releases of restrictions by choosing when to consider specific donor-restricted funds as having been spent. According to the rule, when expenses are incurred that satisfy the donor's restriction, the donor's purpose has been carried out regardless of whether the restricted net assets were used to make the purchase.

ASC 958-205-45-11

If an expense is incurred for a purpose for which both net assets without donor restrictions and net assets with donor restrictions are available, a donor-imposed restriction is fulfilled to the extent of the expense incurred unless the expense is for a purpose that is directly attributable to another specific external source of revenue. For example, an expense does not fulfill an existing donor restriction if that expense is incurred for a purpose that is directly attributable to and reimbursed by a sponsored exchange agreement or a conditional award from a government agency, private foundation, or others. Explicit time restrictions, such as those discussed in paragraph 958-205-45-10, and implied time restrictions, such as those discussed in paragraph 958-605-45-5, make net assets unavailable to support expenses until the time restrictions have expired.

The restricted net assets must be available for spending before expenses can be incurred that would satisfy a donor's purpose restriction. If they are subject to time restrictions (explicit or implicit), then as a general rule, they are not available to support expenses until the time restrictions have expired. See NP 7.3.2.3 for further discussion of the expiration of time restrictions.

Note that the first dollar rule does not dictate the timing of when management must actually expend various sources of funds. It exists solely to determine (for financial reporting purposes) the point at which donor-restricted net assets are deemed to be released to net assets without donor restriction.

Example NP 6-9 illustrates the application of the first dollar rule.

EXAMPLE NP 6-9**Donor-restricted resources not used**

A hospital purchases a \$5,000 crib for its neonatal intensive care unit (NICU) using board-designated (unrestricted) assets. At the time, the hospital had donor gifts of \$10,000 that were restricted for the NICU, and another \$10,000 that were donor-restricted for capital needs.

From which source (board-designated or donor-restricted) should the hospital release net assets from restriction for the purchase of the crib?

Analysis

For financial reporting purposes, the crib's purchase triggers a \$5,000 reclassification from restricted net assets to net assets without donor restrictions, even though the hospital opted not to fund the purchase from contributed resources.

The hospital cannot avoid recognizing the reclassification simply because it chooses to use unrestricted resources for the expenditure.

The first dollar rule provides an exception for expenditures associated with earning revenue under a sponsored exchange agreement or when the entity will be entitled to promised resources under a conditional grant or promise to give—i.e., the expense is for a purpose that is directly attributable to another specific external source of revenue. If an expenditure is incurred pursuant to the performance of a sponsored exchange agreement (where typically the recognition of revenue is based on reimbursement of attributable costs), or the expenditure is incurred in furtherance of satisfying a

condition related to a conditional grant or promise to give, the expenditure cannot also be attributed to another restricted contribution. AAG-NFP 11.33 through AAG-NFP 11.36 provide additional interpretive guidance in these circumstances.

Example NP 6-10 provides an example of applying this guidance in the context of a conditional grant.

EXAMPLE NP 6-10

Conditional grant is available

University's school of computer science and engineering (CSE) conducts research on robotics. For the year ended June 30, 20x2, University received donor gifts of \$200,000 that are restricted for the robotics research program. It also has \$100,000 available from an endowment that supports the CSE department and \$100,000 from a federal cost-reimbursement (conditional) grant of \$100,000 from the National Science Foundation for general robotics research. Expenditures associated with the robotics program during the year ended June 30, 20x2 were \$250,000.

How much should the University reclassify from donor-restricted net assets in the period?

Analysis

When determining the amount of reclassification to report in its 20X2 financial statements, University is permitted to allocate up to (and seek reimbursement for) \$100,000 of the expenditures to the National Science Foundation cost-reimbursement grant, triggering income from the grant. This is because the expenditure is directly attributable to another specific external source of external revenue. The remaining \$150,000 would satisfy either the donor-imposed restrictions on the current year gifts restricted for robotics research or the endowment restricted for the CSE department. For internal record-keeping purposes, University could allocate the expiration to one or the other of the purpose restrictions or could allocate it between them. It might choose to use the more narrowly-restricted gifts for robotics first, but it is not required to do so.

Alternatively, University could choose to attribute all of the expenses to the donor-restricted sources, which would result in a reclassification of \$250,000. In making that determination, University might consider how soon the federal cost-reimbursement grant ends and whether it is likely that other expenses meeting the grant terms would be incurred before the grant's end date, to avoid the possibility of losing the grant resources permanently. If the University chooses to attribute all of the expenses to the donor-restricted sources, it cannot also submit the expenses for reimbursement under the federal grant.

6.7.2.3 Restricted contributions received and used during the same period

An NFP might satisfy a donor's restriction in the same reporting period as the gift was received. Based on the general rules discussed in NP 6.7, the financial statements for that period would reflect an increase in restricted net assets for the restricted contribution received, along with a reclassification to net assets without donor restrictions reflecting the gift's use for the intended purpose, as illustrated in Example NP 6-7 (in NP 6.7.1). However, ASC 958-605-45-4 allows entities to elect an accounting policy of reporting contributions whose restrictions are met in the same reporting period as unrestricted revenues.

Excerpt from ASC 958-605-45-4

Donor-restricted contributions whose restrictions are met in the same reporting period may be reported as support within net assets without donor restrictions provided that an NFP has a similar policy for reporting investment gains and income, reports consistently from period to period, and discloses its accounting policy.

This election is often referred to as “simultaneous release.” An entity that makes this election would simply report those gifts as unrestricted, instead of the separate steps of increasing restricted net assets and then reporting the expiration as separate transaction. If such a policy is adopted, the NFP must have a similar policy for reporting donor-restricted investment return that is utilized in the same reporting period in which it is earned. An NFP that adopts such a policy must also disclose it in the notes to the financial statements and apply it consistently from period to period.

Example NP 6-11 illustrates the application of the accounting policy election for reporting the release of restrictions in the same period as the support is received.

EXAMPLE NP 6-11**Simultaneous release election – purchase of PP&E**

A hospital wishes to acquire a commercial building adjacent to its campus to house its Administrative Services division. The cost is \$500,000. A donor makes a contribution that is restricted for use in purchasing the building. The donor’s contribution effectively underwrites the purchase of the building, which the hospital completes in the same period as the donor’s contribution was received.

How should the hospital record the contribution and release from restriction within net assets?

Analysis

If the hospital does not have a policy of reporting contributions whose restrictions are met in the same period as unrestricted, the contributions would be reported as an increase in donor-restricted net assets in the statement of changes in net assets, and the expiration of the restriction would be reported as an increase in unrestricted net assets in the statement of operations, reported below the performance indicator as illustrated in Example NP 6-7 (in NP 6.7.1).

If the hospital has elected the policy to report contributions whose restrictions are met in the same period as unrestricted, the contributions effectively “bypass” the statement of changes in net assets. Instead, they are reported in the statement of operations, reported below the performance indicator. Under the “simultaneous release” option, if the donor restriction and condition are satisfied simultaneously, the entity reports the contribution income as unrestricted, bypassing the separate steps of increasing restricted net assets and then reporting the expiration as a separate transaction.

The table below illustrates the difference in the two approaches.

	<i>Default presentation</i>		<i>Simultaneous release election</i>	
	Net assets		Net assets	
	Without restrictions	Donor-restricted	Without restrictions	Donor-restricted
Revenues	\$ 10,000		\$ 10,000	
Expenses	9,500		9,500	
Excess of revenues over expenses	500		500	
Contributions received for PP&E	–	\$ 250	250	
Net assets released from restriction used to acquire PP&E	250	(250)	–	–
Change in net assets	\$ 750	\$ –	\$ 750	\$ –

ASU 2018-08 expanded the “simultaneous release” election to provide an additional election specifically for donor-restricted conditional contributions. After adoption of the ASU, many transactions previously reported as exchange transactions (e.g., federally-sponsored awards) are reported as restricted conditional contributions. This creates a significant increase in both the amount of donor-restricted contributions, and, in turn, the amounts of net assets reported as released from restriction. Entities can make an election that is specific to donor-restricted conditional contributions, without having to adopt a similar policy for unconditional contributions and investment income.

Example NP 6-12 provides an example of applying the expanded policy election to conditional contributions.

EXAMPLE NP 6-12

Simultaneous release election for restricted conditional contributions

University incurred expenses related to federal awards of \$300 million during the period. University determined that all of the expenses were qualifying expenditures; therefore, both the condition and related donor-restrictions were met in the same period. University also received \$80 million of unconditional, donor-restricted contributions, and released net assets from restriction of \$50 million during the year relating to those gifts. The University has not elected a policy to report unconditional restricted contributions received and used in the same period as unrestricted gifts.

How should University report the release from restriction of its federal awards and donor-restricted contributions for the period?

Analysis

University would report \$300 million of federal awards as contribution revenue (see NP 12 for further discussion of the impact of ASU 2018-08 on federally funded awards). For those grants, expending the funds causes two events to occur simultaneously: the recognition of donor-restricted contribution (because the condition is satisfied) and the release of the restriction (because the purpose restriction is satisfied).

Electing the ASU's new simultaneous release option would permit University to report the income from those grants as unrestricted, bypassing the extra steps of increasing restricted net assets and then reporting a reclassification between net assets with restrictions and net assets without restrictions. It would be permitted to adopt that policy for all of its conditional donor-restricted contributions (including federal grants which now meet this definition) without altering the accounting historically used for its unconditional donor-restricted contributions. The financial reporting implications with and without the policy election would be as follows:

	<i>Default presentation (no simultaneous release election)</i>		<i>Simultaneous release election (for conditional contributions only)</i>	
	Net assets		Net assets	
	Without restrictions	Donor- restricted	Without restrictions	Donor- restricted
Tuition revenues	\$ 100,000		\$ 100,000	
Grants and contracts		\$ 300,000	300,000	
Contributions		80,000		\$ 80,000
Net assets released from restriction	350,000	(350,000)	50,000	(50,000)
Total revenues and support	<u>\$ 450,000</u>	<u>\$ 30,000</u>	<u>\$ 450,000</u>	<u>\$ 30,000</u>

Note that University's total revenues and support will remain the same either way. As such, the decision as to whether to adopt the election will largely depend on whether management believes the "gross" presentation of net assets released from restrictions is more useful to its financial statement users.

6.7.2.4 Two or more restrictions on a single gift

Pursuant to ASC 958-205-45-9, if a contribution has two or more restrictions, the reclassification from net assets with donor restrictions to net assets without donor restrictions is reported in the period in which the last remaining restriction expires. Generally speaking, if one of the restrictions is a time restriction (which limits the funds to use in a particular time period, or after a particular date), that restriction must be satisfied first. In other words, the purpose restriction cannot be satisfied until the funds are made available for spending. This is illustrated in Example NP 6-13.

EXAMPLE NP 6-13

Gift with both time and purpose restrictions

On January 1 20X1, Private School received a \$100,000 promise to give that was donor-restricted to support the athletics program. The promise was payable in full on December 31, 20X1. The donor did not specify that the funds were for use in a particular time period. Expenses incurred for the athletics program in 20X1 were \$200,000.

Should Private School report a reclassification associated with the satisfaction of the donor's restrictions in its financial statements for the period ended December 31, 20X1?

Analysis

Private School should not report a reclassification in its financial statements for 20X1. In making this determination, it must consider the interaction of two rules previously discussed: the implied time restriction associated with promises to give (discussed in NP 6.7.1), and the first dollar rule (discussed in NP 6.7.2.2). The gift received contains both an implied time restriction and a purpose restriction. The time restriction expires on December 31, 20X1. The purpose restriction (support of the athletics program) expires when Private School has incurred \$100,000 of expenses that meet the donor's stipulation.

However, the purpose restriction can only be satisfied by expenditures made *after* the time restriction expires, according to ASC 958-205-45-11. In other words, the donor's resources must be available for spending before they can be used for the stipulated purpose. Therefore, even though Private School spent in excess of the \$100,000 gift amount during 20X1, the resources were not available until December 31, 20X1, presumably after the expenditures were made.

If Private School incurs at least \$100,000 of athletics program expenses in 20X2, it would report the reclassification in its 20X2 financial statements, which is the period in which the last restriction expires (ASC 958-225-45-9).

Specific exceptions apply to this general rule. For example, ASC 958-205-45-10A indicates that the implied time restriction on multi-year pledges for construction purposes, should be released when the related constructed capital asset is placed in service, even if the pledges are not yet due and payable.

ASC 958-205-45-10A

In determining when the last of two or more donor-imposed restrictions that are temporary in nature has expired, explicit donor stipulations generally carry more weight than implied restrictions. For example, assume in Year 1 that an entity receives an unconditional promise to give that is payable in two equal installments in Years 2 and 3 with an explicit donor stipulation that its gift is to cover purchases of new equipment for the new School of Chemistry, which is expected to be completed in Year 3. That gift would have a purpose restriction (to be used to acquire new equipment to be housed in the new building), and because the unconditional promise is payable in Years 2 and 3, an entity generally would imply a time restriction (see paragraph [958-605-45-5](#)). If, however, the building was completed early and opened in Year 2 and all of the needed equipment was purchased in Year 2 and exceeded the promised amount, absent an explicit stipulation to the contrary, it would be reasonable to conclude that those purchases fulfilled the donor restriction on the promised gift. The restriction for the purchase of the equipment expires when the equipment is placed in service in accordance with paragraph [958-205-45-12](#). In addition, a reclassification of net assets would be reported to reflect the decrease in net assets with donor restrictions and the increase in net assets without donor restrictions in Year 2.

According to ASC 958-205-45-10A, if evidence suggests that it is reasonable to conclude that a donor-restriction has been met, an implied time restriction should not override that evidence.

Additionally, if a donor makes a gift through an intermediary organization and the third-party donee implies a time restriction because it is unable to influence the timing of the distribution of those resources from the intermediary, the resources are nonetheless available to support expenditures prior

to the expiration of the implied time restriction, according to footnote 18 of TQA 6140.18 and footnote 11 of TQA 6400.41. For additional information, see NP 8.5.2.1.

6.7.3 *Contributions to acquire long-lived assets*

Donors often contribute towards the purchase, construction, or acquisition of capital assets. If a donor provides explicit instructions on how long the asset must be used, the gift has both a time and a purpose restriction, and the time restriction expires over the stipulated time period. If no time restriction exists, the purpose restriction expires when the capital asset is placed in service as per ASC 958-205-45-12. At that time, the NFP reclassifies the gift amount from net assets with donor restrictions to net assets without donor restrictions.

ASC 958-205-45-12

Unless donor stipulations limit the use of the assets for a period of time or for a particular purpose, donor restrictions on long-lived assets, if any, or cash to acquire or construct long-lived assets are considered to have expired when the assets are placed in service.

A health care entity would report the reclassification from net assets with restrictions to net assets without restrictions below the performance indicator in the statement of operations as “net assets released from restriction,” unless the HCO has elected a simultaneous release policy for restrictions satisfied in the same period as the gift was received (see Example NP 6-12).

Special rules apply to reporting these contributions in the balance sheet. If the balance sheet is unclassified, assets that are restricted by donors for acquisition of long-lived assets (such as cash or contributions receivable) are not included in “cash and cash equivalents” or other “contributions receivable.” Instead, they are reported in a separate section, such as “assets restricted to investment in property and equipment,” and are sequenced near the “property and equipment” section or caption. In a classified balance sheet, the assets would be classified as noncurrent. For further discussion, see discussion of “assets whose use is limited” in NP 2.3.

Refer to NP 7 for a discussion of gifts of tangible long-lived assets and other noncash donations.

Question NP 6-6 addresses when to release restrictions on a donation is restricted to the construction of a long-lived asset.

Question NP 6-6

When a donor contributes to a capital campaign for the construction of a long-lived asset, may the restriction be considered released as the NFP makes construction-related expenditures?

PwC response

In rare situations, a donor's gift instrument might be worded in such a specific manner that the NFP would need to consider whether the purpose restriction is satisfied when construction expenditures are made. However, most capital campaigns and campaigns to solicit funds for construction or renovation of a structure would be expected to be covered under the general rule in ASC 958-205-45-12, which requires that the restriction be released when the asset is placed in service.

***Chapter 7:
Contributions received and
made – noncash
gifts/promises to give—
updated April 2022***

7.1 Overview—noncash gifts/promises to give

NP 6 covers the basic principles of accounting for contributions received and made. As defined in the Master Glossary, a contribution is a transfer of cash or other assets from a donor to a donee. This chapter expands on considerations related to contributions of “other assets,” such as securities, land, buildings, use of facilities or utilities, materials and supplies, intangible assets, services, and unconditional promises to give those items in the future.

For the most part, accounting for these gift transactions uses the basic principles discussed in NP 6 for cash contributions. That is, the gifts generally are recognized when the transfer of benefit occurs and are measured at fair value by donor and donee. However, their noncash nature gives rise to some special accounting considerations.

The chapter is divided into the following topics:

- Overview of the measurement framework for noncash gifts
- Unconditional promises to give cash
- Gifts of noncash assets
- Contributed services of individuals
- Other contributed services and use of facilities
- Financial reporting considerations

This chapter generally does not apply to transactions that appear similar to contributions but which do not meet the definition of a contribution because they occur between entities that are affiliates (and thus, generally are members of the same financial reporting entity). However, this chapter does discuss donated personnel services received from an affiliate in NP 7.5.2. Transactions between affiliates (including donated personnel services) are considered equity transfers, the presentation of which is discussed in NP 3.4.8.

7.2 Overview of the measurement framework for noncash gifts

Contributions are measured at fair value by both donor and donee. When a gift involves noncash assets, services, promises to give, or other noncash benefits, measurement becomes a significant consideration. ASC 820, *Fair Value Measurement*, provides authoritative guidance on determining fair value. A high-level overview of the fair value measurement framework is provided here; specific considerations related to different types of contributions are discussed in the sections that follow.

According to ASC 820, fair value is the price that would be received in a hypothetical sale of an asset or transfer of a liability between a willing buyer and a willing seller (the “market participants”) on the measurement date. The ease or difficulty in determining the fair value of an asset using the ASC 820 framework depends on the nature of the asset and whether markets exist for its purchase and sale. For example, the fair value of marketable equity securities that trade publicly on a stock exchange can be

easily determined. However, determining the fair value of promises to give, which are financial assets for which no market exists, is more complicated.

For additional information on the fair value measurement framework, see PwC's *Global Guide to Fair Value Measurement* (FV). In addition, AAG-NFP chapter 5 and its appendix, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*, contain extensive discussions on the application of ASC 820 to contributions.

7.3 Unconditional promises to give cash

Sometimes a donor will make a binding promise to provide resources to an NFP at a future date. In such cases, benefits transfer from the donor to the donee when the promise is made, not when the promised resources are ultimately transferred.

Guidance on the unique recognition and measurement considerations associated with these gifts is located in the following ASC Topics:

Donors (makers of promises)	Donees (recipients of promises)
<ul style="list-style-type: none"> □ ASC 720-25, <i>Other Expenses: Contributions Made</i> □ ASC 958-720, <i>Not-for-Profit Entities: Other Expenses</i> □ ASC 958-405, <i>Not-for-Profit Entities: Liabilities</i> 	<ul style="list-style-type: none"> □ ASC 958-605, <i>Not-for-Profit Entities: Revenue Recognition</i> (“Contributions received” subsections) □ ASC 958-310, <i>Not-for-Profit Entities: Receivables</i>

Chapter 5 of the AAG-NFP contains extensive commentary, discussion, and examples applicable to recipients of promises. AAG-NFP 10.91 through AAG-NFP 10.95 and AAG-NFP 13.28 through AAG-NFP 13.33 contain similar discussions related to makers of promises.

7.3.1 What is a promise to give?

An unconditional promise to give is an agreement to contribute cash or other assets to another entity that contains no barriers or hurdles that the donee must overcome to be entitled to the resources (i.e., conditions). Its fulfillment depends only on the passage of time or the donee's demand for performance.

Definitions from ASC Master Glossary

Promise to give: A written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be either conditional or unconditional.

Unconditional promise to give: A promise to give that depends only on passage of time or demand by the promisee for performance.

ASC 958-605-25-8 through ASC 958-605-25-10 provide the recognition principles for unconditional promises to give. These principles address the various elements of a promise to give, including considerations for distinguishing between intentions to give and promises to give (NP 7.3.1.1) and the evidence required to indicate a promise has been made (NP 7.3.1.2).

7.3.1.1 *Elements of a promise to give—rights and obligations/enforceability*

In order for a promise to give to be recognized, it must contain rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. For accounting purposes, unambiguous promises to give do not require a determination as to whether they are legally enforceable.

Promises to give are generally legally enforceable, but this determination may require judgment if the donor communication is ambiguous. In part, this is due to the fact that laws governing the legal enforceability of pledges vary by state and may rest on whether there was consideration exchanged (such as the naming of a building or recognition in the annual fundraising report) or whether the NFP relied on the promise under the theory of promissory estoppel or detrimental reliance. In BC 97 to FAS 116, *Accounting for Contributions Received and Made* (the original FASB Statement underpinning ASC 958-605), the FASB articulated that donors/promisors may have equitable or constructive obligations to pay, even though the promise lacks legal sanction.

Distinguishing between an intention and a promise to give

An intention to give does not contain enforceable rights and obligations, and, therefore, is not a promise to give; however, distinguishing between an intention and a promise can require significant judgment. ASC 958-605-25-9 states that a communication that does not indicate clearly whether it is a promise can be considered an unconditional promise only if it indicates an unconditional intention to give that is legally enforceable. That is, a lack of clarity in the donor documentation as to whether it is a promise requires a determination as to legal enforceability. This could be the case, for example, when a potential donor articulates an amount and intended purpose of a donation but also states that the agreement is not legally binding. We believe that all of the facts and circumstances—the nature of the solicitation to the donor, discussions with the donor prior to the agreement, publicity about the donor action (e.g., a press release issued by the NFP and/or the donor announcing the pledge), or actions taken by the NFP in reliance on the donor commitment (if any)—should be considered when determining whether there has been a promise to give that warrants recognition for accounting purposes.

ASC 958-605-25-9 also states that legal enforceability refers to the availability of legal remedies, not merely the recipient entity's intent (or lack thereof) to use them. Assertions by an NFP that it would not enforce a promise does not preclude recognition of that promise as a contribution; the only question is whether the legal remedy to enforce the promise exists.

Some NFPs receive communications from donors that indicate an intention to give, rather than a promise to give. For example, some “pledge cards” that allow individuals to indicate an amount they hope to be able to give to a faith-based organization during a specified period might be non-binding. Because they are not binding commitments, intentions to give are not considered promises to give and do not give rise to either a contribution receivable (for the recipient) or contribution payable (for the maker).

7.3.1.2 *Elements of a promise to give—documentation*

Another element for recognition of promises to give is documentation. ASC 958-605-55-18 through ASC 958-605-55-19 state that a promise can be written or oral; however, verifiable documentation supporting the promise must exist. Written documentation in the form of a signed binding pledge card or other written correspondence would typically provide sufficient evidence of a promise. If a promise is made orally, a recording of a telephone or other conversation, or a written log of promises made orally that are verifiable would generally suffice.

7.3.2 *Donee's accounting for promises to give cash*

Under ASC 958-310-25-1, unconditional promises are reported as receivables and as contribution income in the period the promise is received and measured at fair value on the date the promise was made. If the initial gift was a conditional promise, fair value is measured on the date the condition is met (that is, when the promise becomes unconditional).

ASC 958-310-25-1

An unconditional promise to give shall be recognized as revenue or gain in the period received and as an asset in accordance with paragraphs 958-605-25-7 through 25-15.

7.3.2.1 *Promises due in less than one year*

ASC 958-310-35-3 indicates that a promise that will be collected within one year can be measured at its net realizable value, because that amount represents a reasonable estimate of fair value. That means that the donee should assess whether the contribution is reasonably assured of collection, and only recognizes the amount that it estimates will be collected, less direct costs of collection, if any. If the promise is still outstanding at the end of the fiscal year, net realizable value would be updated to reflect any changes, if necessary.

7.3.2.2 *Promises due in more than one year*

The present value of the future cash flows (an “income approach” under ASC 820) is the valuation technique typically used when measuring the fair value of a contribution due more than one year from the date of the promise. AAG-NFP 5.181 indicates that no market exists for promises to give cash. Because no observable market exists, the donee must make suppositions about the assumptions market participants would use in deciding what to pay for the right to receive the cash flows inherent in the promise.

In developing expectations related to future cash flows, ASC 958-605-30-4 states that the NFP would consider factors associated with the receivable's collectability (such as the donor's creditworthiness, the NFP's past collection experience, and the NFP's policies concerning the enforcement of promises to give), as well as the possibility that the donor could make payments at times other than the scheduled dates.

The future cash flows are discounted to reflect the time value of money. The assumptions used in selecting a discount rate should be consistent with the assumptions inherent in the cash flows. For example, if probability-weighted cash flows are used, a discount rate that reflects uncertainty in expectations about future defaults should not be used, because the cash flows already reflect

assumptions about the uncertainty of future defaults. Under ASC 958-605-30-5, unless an NFP has elected the fair value option, the discount rate is established when the unconditional promise to give is initially recognized and not revised subsequently.

ASC 958-605-30-5

The discount rate shall be determined at the time the unconditional promise to give is initially recognized and shall not be revised subsequently unless the entity has elected to measure the promise to give at fair value in conformity with the Fair Value Option Subsections of Subtopic 825-10.

Example NP 7-1 is derived from ASC 958-605-55-22 and illustrates the use of a present value technique for initial recognition and measurement of unconditional promises to give cash that are expected to be collected after more than one year.

EXAMPLE NP 7-1

Initial recognition of unconditional promises to give cash

An NFP receives a promise of a gift of \$100 to be paid in five years. The anticipated future cash flows from the promise are \$70, and the present value of the future cash flows is \$50. How should the NFP record the contribution receivable and revenue using a present value technique to measure fair value?

Analysis

The NFP would record the following entry:

Dr. Contribution receivable	\$70	
Cr. Contribution revenue – donor-restricted		\$50
Cr. Discount on contribution receivable		\$20

Note that because expectations related to collectability are considered in initial measurement, the amount initially recognized for the contribution receivable is less than the gross amount promised.

Subsequent to initial recognition, contributions receivable are reported at amortized cost, unless the NFP has elected subsequent fair value measurement of the receivable under ASC 825-10 (refer to NP 7.3.4). According to AAG-NFP 5.193, this is similar to accounting for trade receivables due in one year or more. If the expectation of uncollectibility of the cash flows increases (and thus, the NFP believes the expected future cash flows will be lower than initially estimated), it would establish an allowance for uncollectible receivables. Note that the allowance for uncollectible contributions receivable only includes amounts determined to be uncollectible after initial recognition; it does not include the amounts that were determined to be uncollectible in the initial measurement process as stated in ASC 958-310-50-2. Downward revisions in the initial expectation of collectability are reported as a loss or an expense (bad debt) corresponding to the appropriate net asset class. According to ASC 958-310-45-3, because expenses may only be reported in net assets without donor restriction, uncollectible amounts should be reported as losses if they are decreases in net assets with donor restriction. Since most contributions receivable are donor-restricted because of the implied time restriction (see NP 6.7.1), revisions in the initial expectation of collectibility of contributions receivable should be reported as losses rather than expenses.

Unless the NFP has elected subsequent fair value measurement under ASC 825-10, the discount computed at initial recognition is not revised to reflect market conditions at each measurement date. Instead, it is amortized over the receivable's scheduled term, typically using the interest method, as described in ASC 835-30-35-2, although AAG-NFP 5.195 indicates that other methods could also be used if the results are not materially different. ASC 958-310-35-6 requires the increase in the receivable due to the interest amortization to be reported as additional contribution income (rather than as interest income). The increase in the carrying amount of the receivable increases the net asset class in which the promise was originally reported.

7.3.2.3 *Implied time restrictions on promises to give cash*

Contribution revenue arising from unconditional promises to give with payments due in future years will normally increase donor-restricted net assets, even if the donor imposes no explicit time or purpose restrictions. By agreeing to a future payment date (or a schedule of future payment dates), donors implicitly indicate that the gift is to support activities of the period in which payment is scheduled. Therefore, as discussed in NP 6.7.1, a time restriction is implicit in all promises to give with payments due in future periods, unless the donor explicitly states that the gift is to support current activities or other circumstances clearly point to that intent. AAG-NFP 5.95 and AAG-NFP 5.96 provide examples of when a time restriction is not implied on promises to give.

The implied time restriction (or a portion of the implied time restriction) expires as the future payment or payments come due. If there are no other time or purpose restrictions, a reclassification from net assets with donor restrictions to net assets without donor restrictions is made when the implied time restriction expires. If other donor restrictions have been imposed (for example, the gift must be used for a specific purpose), the reclassification is reported in the period in which the last remaining restriction expires, as discussed at NP 6.7.2.4 and in Example NP 6-13.

Promises that are due within the same reporting period that they are made have no implicit time restriction. The associated contribution revenue is reported as an increase in net assets without donor restrictions unless other time or purpose restrictions are imposed by the donor.

7.3.3 *Donor's accounting for promises to give cash*

ASC 720-25-25-1 requires that the donor report unconditional promises as contributions payable and as contribution expense in the period the promise is made, measured as described in ASC 720-25-30-1.

ASC 720-25-25-1

Contributions made shall be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given. For example, gifts of items from inventory held for sale are recognized as decreases of inventory and contribution expenses, and unconditional promises to give cash are recognized as payables and contribution expenses.

ASC 720-25-30-1

Contributions made shall be measured at the fair values of the assets given or, if made in the form of a settlement or cancellation of a donee's liabilities, at the fair value of the liabilities cancelled.

As noted in NP 7.3.2, no market exists for unconditional promises to give cash. Therefore, the approach discussed for fair value measurement of the receivable (i.e., the present value of future cash flows) is typically applied to determine the fair value of the contribution payable. Similarly, promises that are expected to be paid in less than one year can be measured using net settlement value (the counterpart to net realizable value).

If a present value measurement technique is used, a multi-year promise to give would be initially measured at its discounted value (i.e., an amount less than the notional amount of the pledge). The discount rate determined at the time the promise is initially recognized should not be revised unless the promise is subsequently remeasured at fair value pursuant to the fair value option (discussed at NP 7.3.4). The interest method is used to amortize the discount. Similar to the donee's accounting, the increase in the liability due to amortization of the interest is reported as additional contribution expense (rather than as interest expense) and included in the same functional expense classification in which the promise was originally reported.

Question NP 7-2 distinguishes promises to give from other gifts of contractual rights to receive cash.

Question NP 7-2

An NFP received a gift of a paid-up cash value life insurance policy in which the NFP was given ownership of the policy and named as sole beneficiary. The policy will pay \$1 million to the NFP upon the death of the donor. Is this a promise to give \$1 million in cash to the NFP upon the death of the donor (i.e., a death-contingent pledge)?

PwC response

This would not be considered a promise to give cash to the NFP in a future period. Rather, the NFP has received a noncash gift of an insurance contract (i.e., a financial asset). The NFP would recognize the financial asset at its fair value on the date of the gift (which is likely to be the cash surrender value).

7.3.4 *Electing the fair value option for unconditional promises to give cash*

For contributions receivable or payable that meet the definition of a financial instrument (such as promises to give cash or other financial assets), donors and donees can elect to subsequently measure them at fair value pursuant to the fair value option under ASC 825-10. This election must be made at the point of initial recognition and is irrevocable for the life of the asset or liability. If fair value is determined using a discounted cash flow valuation technique, the entity would update the estimated cash flows and the discount rate assumptions to reflect current market conditions at each measurement date, pursuant to the guidance in ASC 958-310-35-1, and all of the changes would be reflected together as an adjustment to fair value. For further information on use of the fair value option for financial instruments, see FV 6.

7.3.5 *Presentation and disclosure of promises to give cash*

In the donee's balance sheet, contributions receivable that are reported at amortized cost are displayed net of any unamortized discount and the allowance for uncollectible promises. The discount should be separately disclosed on the face of the balance sheet or in the notes to the financial statements, pursuant to ASC 958-310-45-1. In the donee's statement of activities, losses (or expenses) associated with uncollectible pledges should not be netted against contribution revenue unless contribution revenues are considered peripheral and incidental activity, as discussed in AICPA Technical Questions

and Answers (TQA) 6140.09, *Reporting Bad Debt Losses*. Per ASC 958-310-50-1, notes to the recipient's financial statements should disclose:

- a schedule of contributions receivable showing the total amount receivable within one year, in one to five years, and in more than five years, and
- the amount of the allowance for uncollectible promises receivable arising from subsequent decreases due to changes in the quantity or nature of assets expected to be received.

NFP donors such as foundations must provide a schedule of unconditional promises to give that shows the total amount separated into amounts payable in each of the next five years, the aggregate amount due in more than five years, and the unamortized discount for unconditional promises to give reported using a present value technique, in accordance with ASC 958-405-50. ASC 450-20-50, which provides guidance for disclosure of loss contingencies, should be followed to evaluate whether conditional promises made should be disclosed.

See ASC 958-310-50-3 for the disclosures required for unconditional promises when the fair value option has been elected.

7.4 *Gifts of noncash assets*

Some noncash gifts represent goods and services needed to carry out a donee's programs that would otherwise have to be purchased if not provided by donation. Other noncash gifts are given with the intention that they be sold to generate resources for use in carrying out the donee's mission. As used in this section, *noncash assets* include financial assets (for example, gifts of equity instruments and securities/financial instruments) as well as nonfinancial assets. Gifts of noncash nonfinancial assets are commonly referred to as gifts in kind, or GIK, and can take a variety of forms, such as property, equipment, medical supplies, food, clothing, and household items.

In some situations, it can be challenging to determine whether a transfer of noncash assets is a contribution received by the recipient NFP, or whether the recipient NFP is acting as an agent in transferring the assets to the ultimate donee organization. This section discusses situations when noncash assets are a contribution to the recipient NFP. NP 8 discusses situations when the recipient NFP is acting as an agent.

Chapter 5 of AAG-NFP provides information on reporting and measuring a variety of noncash gifts, including gifts in kind; contributions of fund-raising materials, informational materials, advertising, and media time or space; below market interest rate loans; and bargain purchases.

7.4.1 *Recognizing donated noncash assets*

The guidance for recognizing contributions of noncash assets is generally the same as for cash contributions, with a few exceptions. These exceptions include gifts of noncash assets that have no intrinsic value to the recipient (see NP 7.4.1.1) and gifts of works of art or historical treasures that meet certain conditions (see NP 7.4.1.2).

When the donee recognizes contribution revenue, the corresponding entry depends on the form of the noncash asset received. A donated security would be reported as an increase in investments. Donation of an intangible (such as intellectual property) would be recognized as an intangible asset. Donation of an item of inventory or a fixed asset that is capitalizable by the donee under its accounting policies

would be reflected as an increase in inventory or of fixed assets. Donation of an item that is not capitalizable (for example, office supplies) results in an increase in expense.

7.4.1.1 *Donated noncash assets with uncertain (or no) value*

Unlike cash (which always has value), some donated noncash assets may not provide value to a donee. Chapter 4 of Concepts Statement 8 indicates that an essential characteristic of an asset is “economic benefit,” which is the capacity to provide services or benefits to the entities that use them. Significant uncertainty about whether a donated asset has value (or economic benefit) to the donee may indicate that an item received or given should not be recognized as a contribution. ASC 958-605-25-3 indicates that contributed tangible property should be “worth accepting” and ASC 958-605-30-11 indicates that gifts in kind should be able to be “used or sold” as a prerequisite to recognition.

Excerpt from ASC 958-605-25-5

Contributed tangible property worth accepting generally possesses the common characteristic of all assets—future economic benefit or service potential. The future economic benefit or service potential of a tangible item usually can be obtained by exchanging it for cash or by using it to produce goods or services.

Excerpt from ASC 958-605-30-11

Gifts in kind that can be used or sold shall be measured at fair value.

For example, if the donated assets cannot either be used internally by the donee in carrying out its activities or sold to generate financial resources, the donation has no value to that entity. Similarly, an item accepted solely to be saved for its potential future use in scientific or educational research that has uncertain value (or perhaps no value) or has highly restricted alternative uses would not be recognized. Examples of those items include contributions of flora, fauna, photographs, and objects that are identified with historic persons, places, or events. In theory, the donor of such items would not recognize contribution expense for such items but would simply write off the asset (if recognized) and report a loss on disposal. However, because the notion of value is subjective, different conclusions might be reached by the donor and donee.

7.4.1.2 *Exception for donated collection items*

By nature, donations of works of art, historical treasures, or similar assets are considered donations of long-lived assets. However, if such items will be added to the collection of a donee with a policy of non-capitalization, pursuant to ASC 958-605-25-19, no contribution revenue would be recognized. See NP 10 for accounting for collections.

Irrespective of the donee’s policy, the donor would report the gift in the same manner as a gift of a long-lived asset, unless the item is from a donor’s non-capitalized collection. In that event, the donor would not recognize contribution expense but instead, would provide the disclosures required by ASC 958-360-50-6.

7.4.2 *Measuring donations of noncash assets*

Donees measure contributions of noncash assets received at the fair value of the asset received, and donors measure them at the fair value of the asset given up. In theory, fair value for donor and donee

would be the same, but no requirement exists for the donor and donee to agree on a fair value to be used. Some specific considerations related to applying the ASC 820 fair value model to donated noncash items are discussed at NP 7.4.2.1. As described in NP 7.4.2.2, ASC 958-605-25-20 modifies the initial contribution date fair value for measurement of gifts of items donated for sale in charity auctions.

7.4.2.1 Applying the ASC 820 model to donations of noncash assets

Some donations of noncash assets are relatively easy to measure using the ASC 820 model, such as donations of marketable securities, automobiles, or real estate. But for many nonfinancial assets (for example, food, supplies, used clothing and household items, intangible assets, and pharmaceuticals), valuation is more difficult due to a lack of readily available observable inputs. The fact that valuation of those gifts can be challenging does not eliminate the need to make a good faith estimate. As discussed in NP 7.4.1.1, the only exception to recognition at fair value for an NFP is a significant uncertainty regarding the existence of value.

ASC 820 broadly addresses the measurement of both financial and nonfinancial assets. The application of ASC 820 to financial assets (such as investments) differs from the application to nonfinancial assets (such as fixed assets, intangibles, and inventory or supplies). Although as noted below, ASC 958-605-30-11 and ASC 958-605-30-9 contain additional considerations for inputs to valuation of GIKs by NFP entities, the fundamental principle is to record GIKs at fair value in accordance with ASC 820. Also, ASU 2020-07, *Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, added incremental disclosures regarding the fair value measurement of contributed nonfinancial assets for NFPs, specifically related to the valuation techniques used, related inputs, and the principal or most advantageous market. See NP 7.4.6 for further discussion of these disclosure requirements.

Excerpt from ASC 958-605-30-11

In determining fair value, entities should consider the quality and quantity of the gifts, as well as any applicable discounts that would have been received by the entity, including discounts based on that quantity if the assets had been acquired in exchange transactions.

ASC 958-605-30-9

Inputs for measuring fair value of contributed inventory items may be obtained from published catalogs, vendors, independent appraisals, and other sources. If methods such as estimates, averages, or computational approximations, such as average value per pound or subsequent sales, can reduce the cost of measuring the fair value of inventory, use of those methods is appropriate, provided the methods are applied consistently, and the results of applying those methods are reasonably expected not to be materially different from the results of a detailed measurement of the fair value of contributed inventory.

The following considerations may be helpful when estimating the fair values of contributions of nonfinancial assets:

- **Identifying market participants.** Market participants are entities who would transact for the goods and are able to buy the product at its market price. Because of the nature of GIK, a hypothetical market participant scenario may need to be developed. Depending on the nature of the goods, these might include other NFPs, governmental agencies, or for-profit entities.

- **Base utility value.** Certain GIK items may not have a readily identifiable market, but typically, they have some base level of utility that is marketable. NFPs should consider that base utility when estimating fair value.
- **Inputs to valuation techniques.** After the principal market is identified, NFPs must identify a source for exit prices in that market. When a GIK item differs from a similar item observed in a marketplace transaction, the NFP should consider whether an adjustment to the pricing input is needed. In doing so, entities should consider the quality and quantity of the donated assets, as well as any applicable discounts that would have been received by the entity (including discounts based on that quantity if the assets had been acquired in exchange transactions). For example:
 - If GIK items are donated in wholesale quantities but only retail values are readily available to use as inputs to fair value, then a wholesale discount generally would be applied.
 - If the GIK items have earlier expiration dates than those of products typically sold in the marketplace, or if technological advances have made the GIK less desirable than similar items in the marketplace, a valuation discount should be applied. For example, a product with 25% of its shelf life remaining would have a lower fair value than the same product with significant shelf life remaining.
- **Impact of restrictions on valuation.** Measurement must take into account the characteristics of the asset (for example, its condition or expected collectability) as well as any restrictions on its transferability. GIK use is often subject to donor restrictions and sometimes legal restrictions. NFPs need to differentiate restrictions that are characteristics of the donated assets (and, thus, would transfer to market participants) from donor-imposed restrictions that are specific to the donee (which would not transfer to market participants). Restrictions that transfer to market participants should be considered when determining the asset's value. For example:
 - A land conservation easement (which is recorded like a deed and is binding upon future owners of the property) would be considered by a hypothetical buyer in pricing the asset and may affect the land's value.
 - Pharmaceuticals sourced in foreign countries that do not meet US Food and Drug Administration standards cannot be sold in the US. That restriction on sales would need to be considered in valuing donated pharmaceuticals, as it would also apply to market participants.

Restrictions on an asset's use that are specific to the donee do not affect the asset's fair value, because a hypothetical buyer's use of the asset would not be affected by them. This includes purpose or time restrictions imposed by a donor. If those restrictions are specific to the entity to whom the asset is donated (and thus, would not transfer to a market participant), fair value measurement would not be affected. Those restrictions should be reflected in the donee's classification of net assets, not in the measurement of fair value. For example:

- A manufacturer might donate excess inventory (such as pharmaceuticals, clothing, toys, etc.) with the stipulation that the donee cannot sell the assets (that is, the NFP can only use them in carrying out its programs). Because that restriction would not transfer to a market participant, it would not be considered in pricing the asset.

- A donor might specify that the donee use the items in its work in a stipulated geographic area (for example, a specific country). Because that restriction would not transfer to a market participant, it would not be considered in pricing the asset.

Example NP 7-2 illustrates a restriction that would not impact measurement of the donated land.

EXAMPLE NP 7-2

Restriction on use of donated asset does not impact measurement

A donor contributes land currently used as a playground to an NFP neighborhood association. The donor specifies that the land must continue to be used by the association as a playground in perpetuity; however, the association is not restricted from selling the land. Upon review of relevant legal and other documentation, the association determines that if it sold the land, the fiduciary responsibility imposed by the donor's restriction would not transfer to market participants.

Would the donor's restriction impact the fair value of the land/contribution recognized by the association?

Analysis

No. The donor restriction requiring the land to be used as a playground applies only to the association and would not transfer to market participants. Without the restriction on the use of the land by the association, the land could be used as a site for residential development. Therefore, the fair value of the land would be the higher of its fair value used as a playground or its fair value as a site for residential development.

Example NP 7-3 illustrates a restriction that would impact measurement of the donated land and is derived from ASC 820-10-55-54.

EXAMPLE NP 7-3

Restriction on use of donated asset that impacts measurement

A donor contributes land currently used as a playground to an NFP neighborhood association. The donated parcel of land is subject to an easement allowing a utility to run power lines across it. By regulatory authority, the easement is permanently associated with the specific parcel of land.

Would this restriction be considered in determining the fair value of the donated land?

Analysis

The easement would need to be considered in measuring the fair value of the land. Because it is specific to that parcel of land (i.e., the easement is a characteristic of the asset), it would transfer with the land to any market participant. Therefore, the fair value measurement of the land would need to consider the effect of the easement, regardless of whether the highest and best use is as a playground or as a site for residential development.

7.4.2.2 *Measurement exception for items donated for charity auctions*

A donee might receive donations of items to be sold in fundraising events such as charity auctions. In those cases, the amount recognized as contribution revenue should be the amount received when the item is ultimately sold. Typically, this would involve a two-step process. When the item is initially received from the donor, it would be reported as a contribution measured at its fair value. When the item is subsequently sold, the difference between fair value and the amount ultimately received is recognized as additional contribution income (if the item sells for more than the fair value) or as a reduction in contribution income (if it sells for less than fair value). The net effect is that the recognized contribution amount represents the amount received at auction for the gift. AAG-NFP 5.151 provides an example of this accounting.

7.4.3 *Donor's recognition and measurement of gifts of noncash assets*

The requirement to recognize contribution expense at the fair value of the asset given up has unique accounting consequences for a donor. Normally, accounting for disposition of an asset by other than sale would involve derecognizing the asset and recognizing a corresponding amount of loss on disposal for the carrying value. However, ASC 720-25-25-2 requires that if the fair value of a contributed asset differs from its carrying amount, the donor must recognize a gain or loss upon disposition.

ASC 720-25-25-2

If the fair value of an asset transferred differs from its carrying amount, a gain or loss shall be recognized on the disposition of the asset (see paragraphs 845-10-30-1 through 30-2).

As a general rule, the recognition and measurement of a noncash contribution of assets by a donor generally results in the same economic outcome as if the donor had made a cash gift to the donee, which the donee in turn used to purchase the good from the donor. Example NP 7-4 illustrates this concept.

EXAMPLE NP 7-4

Accounting by donor and donee for contribution of used medical equipment

As a result of a natural disaster, Clinic lost much of its diagnostic equipment. In response to appeals for assistance, Hospital (an unrelated entity) donated a piece of used diagnostic equipment. The donated equipment was fully functional and in use by Hospital at the time of the gift. Hospital's carrying value for the equipment was \$100,000 and its fair value was \$300,000.

How would Hospital and Clinic report this transaction?

Analysis

Hospital would report the donation of the equipment in accordance with the provisions of ASC 720 and ASC 958-720. Thus, contribution expense would be reported based on the fair value of the contribution made. Hospital would reflect an entry to remove the donated asset and recognize contribution expense along with a gain on the disposition, as follows:

Dr. Contribution expense	\$300,000
Cr. PP&E	\$100,000
Cr. Gain on disposition of PP&E	\$200,000

To record gift of used equipment to Clinic with fair value of \$300,000 and carrying amount of \$100,000.

Recording the gift in this manner is economically similar to the result if Hospital had instead made a cash donation of \$300,000 to enable Clinic to purchase the equipment from Hospital. In that event, Hospital's entries would have been:

Dr. Contribution expense	\$300,000
Cr. Cash	\$300,000

To record cash gift to Clinic.

Dr. Cash	\$300,000
Cr. PP&E	\$100,000
Cr. Gain on disposition of PP&E	\$200,000

To record sale of PP&E to Clinic.

Clinic would record the contribution received in accordance with the provisions of ASC 958-605, as follows:

Dr. PP&E	\$300,000
Cr. Contribution revenue	\$300,000

To record contribution of PP&E from Hospital.

The contribution revenue increases net assets without donor restrictions, and in accordance with ASC 954-220-45-8(d) would be reported below the performance indicator in Clinic's statement of operations.

7.4.4 Measuring promises to give noncash assets at a future date

Sometimes a donor will unconditionally promise to donate a noncash asset in the future. For example, an individual might enter into an agreement to transfer a parcel of land in four years, or a company might promise to give 1,000 shares of its stock in four years. As is the case with promises to give cash, such gifts are reported at fair value as contribution revenue in the period the promise is made, even though the promised asset will not be transferred until a future date. There are uncertainties in these gifts related to potential changes in value of the underlying asset between the time it is promised and the time it is actually transferred, as well as the potential that the donor may not follow through on their promise. Fair value measurement takes those uncertainties into consideration.

As with promises to give cash, expectations related to collectibility (i.e., the performance of the donor in transferring the assets) as well as changes in the value of what will be received are contemplated when initially measuring the fair value of the contribution. If a present value technique is used, fair value of the contribution would be based on the present value of the projected fair value of the underlying noncash items on the date it is to be transferred. That is, the future fair value of the item should be discounted to reflect the timing and uncertainty of the item's future delivery, using an appropriate discount rate. In cases when the future fair value of the underlying asset is difficult to determine, ASC 958-605-30-8 allows the fair value of the promise to be based on the fair value of the underlying asset at the date of initial recognition. If that approach is used, the fair value of the promise is not discounted for the time value of money.

The value of the promised noncash asset might change between the date the promise is made and the date the asset is transferred. If the underlying asset is a financial instrument with a readily determinable fair value, both increases and decreases in fair value are recognized. For other types of promised assets, subsequent measurement of the contribution receivable will depend on (1) whether the contribution receivable for the noncash asset is eligible for the fair value option under ASC 825-10 and (2) if eligible, whether the entity elects the fair value option.

ASC 825-10-15-4 states that an entity may elect the fair value option for recognized financial assets. To meet the definition of a financial asset, the contribution receivable must ultimately result in cash or an ownership interest in another entity. Therefore, many contributions of noncash assets will not be eligible for the ASC 825 fair value option. For example, unconditional promises to give services, fixed assets, or the use of fixed assets (e.g., a “free” lease) are neither rights to receive cash nor readily convertible to cash, nor do they represent an ownership interest in another entity. See FV 5.4 for more information about the scope and application of the fair value option.

If the contribution receivable for a noncash asset other than a financial instrument with a readily determinable fair value is eligible for the ASC 825 fair value option, and the entity has elected the fair value option, both increases and decreases in the value of the contribution receivable are recognized in contribution revenue in the period that the value changes pursuant to ASC 958-310-35-11. If the contribution receivable is not eligible for the ASC 825 fair value option, or if it is eligible but the entity does not elect the ASC 825 fair value option, then in accordance with ASC 958-310-35-12 and ASC 958-310-35-13, decreases in value are recognized in contribution revenue in the period in which those decreases occur, but subsequent increases prior to receipt are not recognized. ASC 958-310-55-1 provides an illustration of the accounting for various types of promised assets and the reasons for the change in value (i.e., due to the collectibility of the receivable or changes in the fair value of the underlying asset) for assets for which the ASC 825 fair value option is not applied.

Regardless of the type of underlying asset or whether the ASC 825 fair value option is elected (if eligible), changes in value are reported in contribution revenue in the periods in which they occur and are reported in the net asset class in which the contribution was originally reported or in the net asset class in which the net assets are represented.

7.4.5 *Liquidation of noncash gifts in the statement of cash flows*

Obtaining an asset by gift is an example of a noncash transaction. Because such transactions do not involve cash receipts or payments, they are excluded from the body of the statement of cash flows and, instead, disclosed either in narrative form in the notes to the financial statements or reported on the face of the statement of cash flows as a supplemental disclosure. If the NFP uses the indirect method

of reporting cash flows, noncash contributions would be reflected as part of the reconciliation of the change in net assets to net cash from operations.

If the noncash gift will be converted to cash by the NFP, the receipt of the gift (a noncash transaction) and the conversion of the assets into cash (a cash transaction) must be reported separately. For example, if an NFP received a donation of real estate that will not be used in the entity's operations, the NFP's subsequent sale of the real estate for cash would be reported as proceeds from sale of investment property (i.e., an investing cash inflow). Proceeds from the sale of donated collection items also would be investing cash inflows.

Special considerations apply to reporting certain contributed investments that are converted to cash immediately or nearly immediately. These are discussed at NP 4.5.1.

7.4.6 Presentation and disclosure of gifts of nonfinancial assets

ASU 2020-07, *Presentation and Disclosure by Not-for-Profit Entities for Contributed Nonfinancial Assets*, prescribes new presentation and disclosure requirements designed to provide greater transparency regarding the valuation of contributed nonfinancial assets. The provisions are required in financial statements for annual periods beginning after June 15, 2021 and interim periods within annual periods beginning after June 15, 2022. The ASU requires separate presentation of the amount of contributed nonfinancial assets in a separate line item in the statement of activities and additional disclosures, as articulated below.

Nonfinancial assets are any assets that are not financial assets (such as cash or investment securities), and include land, buildings, use of facilities or utilities, materials and supplies, intangible assets, or services. In addition to the disclosures described in this section, NP 7.5.1.5 describes incremental disclosures for contributions of volunteer services.

ASC 958-205-45-36 states that contributed nonfinancial assets should be presented as a separate line item in the statement of activities, apart from contributions of cash and other financial assets. NFP HCOs may be required to present contributions of nonfinancial assets in both the statement of operations (including above and below the performance indicator) and the statement of changes in net assets, depending on the nature of the contributions received. ASC 954-220-45-8 requires contributions of long-lived assets to be excluded from the NFP HCO performance indicator. Therefore, if an NFP HCO receives contributions of nonfinancial long-lived assets as well as contributions of other nonfinancial assets, the NFP HCO could be required to present two separate line items for contributed nonfinancial assets (i.e., one above and one below the performance indicator). In addition, if the NFP HCO receives contributions of restricted nonfinancial assets, they would be presented in the statement of changes in net assets.

Excerpt from ASC 958-605-50-1A

For each category of contributed nonfinancial assets, an NFP also shall disclose the following:

Qualitative information about whether contributed nonfinancial assets were either monetized or utilized during the reporting period. If utilized, a description of the programs or other activities in which those assets were used shall be disclosed.

The NFP's policy (if any) about monetizing rather than utilizing contributed nonfinancial assets.

A description of any donor-imposed restrictions associated with the contributed nonfinancial assets.

A description of the valuation techniques and inputs used to arrive at a fair value measure in accordance with paragraph 820-10-50-2(bbb)(1), at initial recognition.

The principal market (or most advantageous market) used to arrive at a fair value measure if it is a market in which the recipient NFP is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial assets.

An NFP is required to disclose in the notes to financial statements a disaggregation by category of the amount of contributed nonfinancial assets recognized within the statement of activities that depicts the type of contributed nonfinancial assets, and additional information about each category, in accordance with ASC 958-605-50-1A.

As part of the disaggregation disclosures, ASC 958-605-50-1A requires disclosure of the principal market (or most advantageous market) used to arrive at fair value if the NFP is prohibited by a donor-imposed restriction from selling or using the contributed nonfinancial assets. This disclosure is unique to NFP entities and is not a standard disclosure element under ASC 820. This disclosure was added by ASU 2020-07 because donor restrictions on the use or distribution of an asset, while binding on the NFP, are not an inherent characteristic of the asset and thus are not taken into consideration for valuation purposes, as discussed in NP 7.4.2.1. An NFP must consider the highest and best use concept when determining the fair value of nonfinancial assets, which takes into account a market participant's ability to generate economic benefits by using an asset in a way that is physically possible, legally permissible, and financially feasible, as discussed in FV 1.5.

Example NP 7-5 is derived from ASU 2020-07 and includes an example in tabular form of disclosures that would meet the requirements of ASC 958-605-50-1A.

EXAMPLE NP 7-5

Disclosure of gifts of nonfinancial assets in tabular format

NFP received the following nonfinancial assets reflected within the statement of activities:

Category of donation	Revenue recognized in 20X3	Revenue recognized in 20X2	Utilization in programs/activities	Donor restrictions	Fair value techniques and inputs
Vehicle	\$12,000	\$8,465	N/A – Monetized	No donor restrictions	Donated vehicles are valued based on the actual cash proceeds received upon sale of the vehicle, as it is NFP's policy to sell all vehicles upon receipt.
Pharmaceuticals	\$51,432	\$38,416	Global AIDS	Restricted to use in Africa	AIDS medication donated for the use of treatment exclusively within Africa, was valued

Category of donation	Revenue recognized in 20X3	Revenue recognized in 20X2	Utilization in programs/ activities	Donor restrictions	Fair value techniques and inputs
					using the Federal Upper Limit based on the weighted average of the most recently reported monthly Average Manufacturer Prices (AMP) that approximate the wholesale price of the respective medication within the United States (the most advantageous market).
Pharmaceuticals	\$16,445	\$2,340	International Health Services in Ghana	No donor restrictions	The majority of this category consists of malaria prevention pharmaceuticals. FDA restrictions prohibit the use of this medication within the United States. As such, the pharmaceuticals were valued using reliable third-party wholesale prices in markets in which the products are approved for sale.
Software licenses	\$123,250	\$0	All Programs / Activities, primarily payroll and marketing	No donor restrictions	NFP estimated the fair value of the respective software licenses by obtaining the selling price of these licenses to entities of similar size and complexity.

Example NP 7-6 is derived from ASU 2020-07 and includes an example in paragraph form of disclosures that meet the requirements of ASC 958-605-50-1A.

EXAMPLE NP 7-6**Disclosure of gifts of nonfinancial assets in paragraph format**

NFP received the following noncash assets reflected within the statement of activities:

Category of donation	Revenue recognized in 20X3	Revenue recognized in 20X2
Vehicle	\$12,000	\$8,465
Pharmaceuticals – Donor restricted	\$51,432	\$38,416
Pharmaceuticals	\$16,445	\$2,340
Software license	\$123,250	\$0

NFP recognized nonfinancial assets of vehicles, pharmaceuticals, and intellectual property. Unless otherwise noted, no donor restrictions exist for contributed nonfinancial assets.

NFP's policy is to sell all vehicles upon receipt. Donated vehicles are valued based on the actual cash proceeds received from the sale of the vehicle.

Pharmaceuticals valued at \$51,432 and \$38,416 for fiscal year 20X3 and 20X2, respectively, were restricted by donors to use outside the United States; NFP primarily uses these contributed assets in its global AIDS operations in Africa. These pharmaceuticals were valued using the Federal Upper Limit based on the weighted average of the most recently reported monthly Average Manufacturer Prices (AMP) that approximate the wholesale price of the respective medication within the United States (the most advantageous market).

Pharmaceuticals valued at \$16,445 and \$2,340 for fiscal year 20X3 and 20X2, respectively, were not restricted for use by donors; NFP primarily uses these contributed assets in its malaria prevention operations in Ghana. These pharmaceuticals are not legally permitted to be used within the United States per FDA restrictions. As such, the pharmaceuticals were valued using reliable third-party quotes of the cost from Ghanaian pharmacies and/or distributors to estimate the fair value.

Donated software licenses are utilized to assist with payroll and marketing initiatives. NFP estimated the fair value of the respective software licenses by obtaining the average selling price of the software licenses by comparison to the selling price of these licenses to entities of similar size and complexity.

7.5 Services provided by employees of affiliates or volunteers

Labor is essential for carrying out any nonprofit or business activity. Many NFPs accomplish their missions using a mix of paid staff and unpaid volunteers. Sometimes a portion of an NFP's services or functions might be performed by employees of an affiliated entity, with no expectation on the part of the affiliate that it will be reimbursed for the labor costs. To appropriately capture the expenses associated with carrying out an NFP's mission, financial statements must appropriately recognize the value and contribution of services provided by individuals or affiliates at no charge to the NFP.

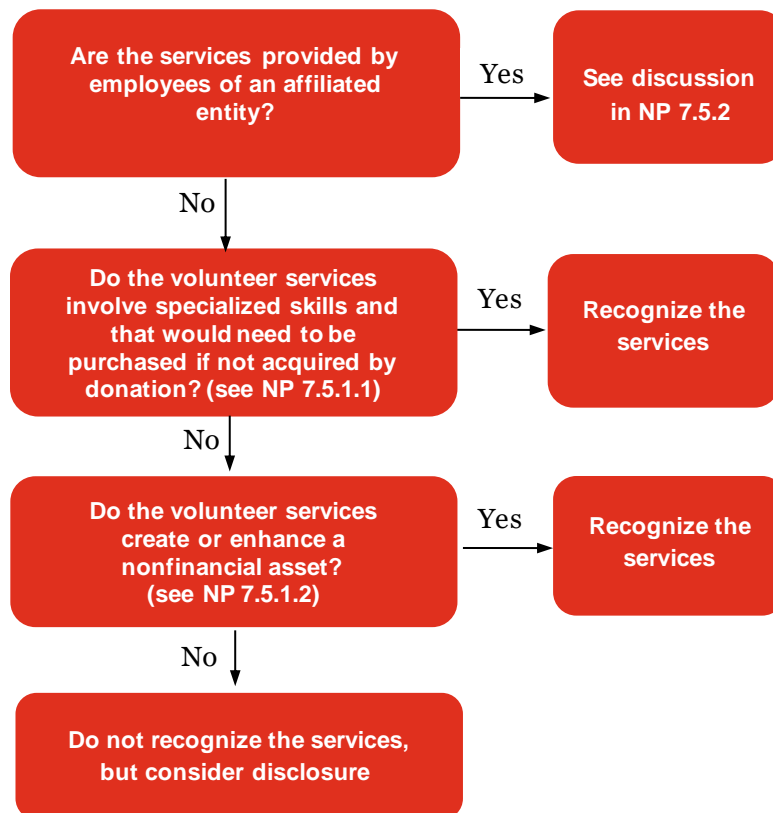
Recognition and measurement principles for volunteer labor are grounded in the contribution accounting model. Recognition and measurement of services provided by affiliates (defined as entities

that are controlled by, under common control with, or a parent of the reporting NFP) are intercompany transactions, not resources arising from parties external to the organization. Those services, discussed in NP 7.5.2, are a form of equity transfer and outside the scope of the contribution guidance.

Figure NP 7-1 provides an overview of the decisions associated with recognition of services provided by volunteers or employees of affiliates.

Figure NP 7-1

Decision framework for recognition of uncompensated labor



7.5.1 *Services provided by volunteers*

Many individuals perform services on behalf of a charity or spend time doing charitable work. However, only those that meet certain criteria are recognized by the recipient NFP for financial reporting purposes. In developing the recognition criteria, the FASB stated that its intent was to limit recognition to only those services that will provide information to users that is clearly relevant, clearly measurable, and obtainable at a cost that does not exceed the benefits of the information provided. Specifically, ASC 958-605-25-16 requires donated services to be recognized if they either:

- create or enhance nonfinancial assets (like construction services), discussed at NP 7.5.1.2 or
- require specialized skills that would usually need to be purchased if they were not donated (like legal counsel, accounting services, or medical services), discussed at NP 7.5.1.1.

Excerpt from ASC 958-605-25-16

Contributions of services shall be recognized if the services meet any of the following criteria:

- a. They create or enhance nonfinancial assets.
- b. They require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Services requiring specialized skills are provided by accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftsmen.

See examples 7 through 11 in ASC 958-605-55-52 through ASC 958-605-55-65 for illustrations of how the criteria are applied to different types of contributed services. Example NP 7-7 illustrates the differences in how the criteria are applied.

EXAMPLE NP 7-7

Applying the criteria for recognizing volunteer services

Fred, an attorney, is a strong supporter of a faith-based NFP organization in his community. Fred volunteers his time in several ways.

- Fred serves on the NFP's board of trustees. In that role, he provides perspectives on general business matters, such as opportunities and risks and potential ethical, moral, and legal concerns.
- When the NFP was engaged in a legal dispute over its property boundaries, Fred provided pro bono legal representation in handling the matter.
- Fred is a knowledgeable do-it-yourselfer who often performs minor repairs and maintenance tasks for the NFP, such as fixing leaking faucets or replacing light fixtures.
- When the NFP embarked on a project to enlarge its fellowship hall, Fred was part of the volunteer labor force that assisted the contractor with building the addition.

Which of Fred's activities would be recognized as contributed services in the NFP's financial statements?

Analysis

- Fred's service on the board of trustees would not qualify for recognition in the financial statements, because that role does not require his specialized skills as a lawyer. Example 9 in ASC 958-605-55-60 discusses considerations related to recognizing services of board members.
- Fred's legal services in the boundary dispute would be included in the financial statements, as the NFP would otherwise have had to engage an attorney if one had not been available (i.e., it required Fred's specialized skills).
- Fred's time spent performing repairs and maintenance would not be recognized, even though those services would need to be purchased if Fred did not perform them. As an amateur handyman, Fred does not possess the specialized skills of a licensed electrician or plumber. In

addition, routine repairs and maintenance do not enhance the NFP's facilities, they merely maintain their existing service potential.

Fred's services as part of the volunteer labor force that assisted in the construction of the new fellowship hall would be recognized because they enhance a nonfinancial asset (the fellowship hall) even though the services do not involve a specialized skill.

7.5.1.1 *The volunteer services involve specialized skills*

This criterion has two elements, both of which must be met for recognition to occur. The first is that the services must involve specialized skills provided by individuals possessing those skills—for example, skills that require a license or certification and are not possessed by the public at large. ASC 958-605-25-16(b) lists accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, and teachers as examples of the professionals whose services would be recognized. In practice, this designation is often extended to any skills that require a license or certification and that are not possessed by the general public. According to ASC 958-605-55-28, an individual who receives some training in a particular field does not necessarily possess a specialized skill. For example, if a volunteer receives some training from an NFP to learn how to help other people learn to read, that volunteer does not possess the specialized skills that a reading teacher possesses.

The second element of this criterion is whether, if the volunteer services were not available, similar services would need to be purchased by the NFP. In some cases, this determination is straightforward, but in others it requires judgment based on the facts and circumstances. For example:

- A telemarketing company contributes services of its personnel for use by a college in its annual telephone fund-raising campaign that has previously been staffed by unpaid student volunteers. The college would not recognize the contributed services because it would not need to purchase the services if they were not provided by donation.
- An architect contributes her time to draw plans to be submitted to the local zoning board to obtain the necessary approvals for an animal shelter to build a new facility. The animal shelter would recognize the contributed services because the architect possesses specialized skills and the animal shelter otherwise would have had to purchase those services in order to obtain the zoning approvals.

7.5.1.2 *The volunteer services create or enhance a nonfinancial asset*

Donated services that create or enhance a nonfinancial asset (for example, construction of a building) should be recognized regardless of whether they involve specialized skills. In those situations, the value of the services (including the value of unskilled labor) is a component of the asset's cost basis. Question NP 7-3 addresses this principle.

Question NP 7-3

NFP constructed a new facility using labor contributed by a local construction company. Should NFP recognize contribution revenue for all the labor contributed by the construction company, or only for the skilled labor?

PwC response

NFP would recognize all of the labor contributed because those services were used to create a nonfinancial asset (criterion (a) in ASC 958-605-25-16). While many of the services contributed would also require specialized skills that would typically need to be purchased if not provided by donation, as long as criteria (a) is met, additional criteria do not need to be considered.

7.5.1.3 Measuring donated volunteer services

When donated volunteer services meet the criteria to be recognized, the donee NFP recognizes contribution revenue when the services are performed. Because the receipt and use of the services is simultaneous, the contribution revenue increases net assets without donor restrictions.

If the services create or enhance a nonfinancial asset (see NP 7.5.1.2), the corresponding entry would be to an applicable asset account. ASC 958-605-30-10 states that those contributions should be measured at fair value by reference to either the fair value of the services received or the fair value of the asset or of the asset enhancement resulting from the services. Example NP 7-8 illustrates application of the guidance for services that create or enhance a nonfinancial asset.

EXAMPLE NP 7-8**Contribution of services to construct a building**

NFP constructed a new facility using labor contributed by a local construction company. NFP purchases the necessary materials, architectural services, permits, and remaining items required at a total cost of \$400,000. An independent appraisal of the completed building (exclusive of land) obtained for insurance purposes estimated the fair value at \$725,000. How would NFP record the contributed labor?

Analysis

NFP could use one of two possible approaches for determining the value of the contributed labor. NFP might derive the value of the contributed labor indirectly by subtracting the capitalizable out-of-pocket costs (\$400,000) from the fair value of the asset created (\$725,000). Under that approach, NFP would record the following entry:

Dr. PP&E	\$725,000	
Cr. Contribution revenue		\$325,000
Cr. Cash	\$400,000	

To record facility constructed with combination of purchased materials and contributed services.

Alternatively, NFP could measure the contribution directly based on the fair value of the services received by obtaining an estimate from the construction company, if that amount was more readily available. In that case, the basis recognized for the building would have been the \$400,000 of capitalizable out-of-pocket costs plus the directly-determined amount of contributed labor.

If instead, the services are specialized skills that would otherwise need to be purchased and are immediately consumed in the NFP's operations (see NP 7.5.1.1), the corresponding entry would be to

expense. Those contributions (and the corresponding compensation expense) are required to be measured based on the fair value of the services received.

According to ASC 958-605-30-10, the fair value of contributed services should represent an amount the organization would have been charged for the individual's services in similar circumstances, even if the NFP would not otherwise be able to afford to purchase the services (for example, if the organization receives contributed services from professionals with high standard hourly billing rates). However, if an individual's services to nonprofit organizations typically are discounted, any contributed services should be valued based on those discounted rates.

Example NP 7-9 illustrates application of the guidance to contributed services that meet the "specialized skills" criterion and was derived from ASC-958-605-55-52.

EXAMPLE NP 7-9

Contribution of teaching services

University's faculty consists of both compensated faculty members and uncompensated faculty members who are associated with religious orders. The performance of the uncompensated faculty members is evaluated in the same manner as the performance of the compensated faculty members, and both are expected to meet the University's standards. University concludes that the services provided by the uncompensated faculty members are specialized skills that meet the criteria in ASC 958-605-25-16(b) and that similar services from compensated faculty would have cost \$2,500,000, which includes salary and benefits. How would University record the contributed services?

Analysis

The contributed services should be recorded at an amount the University would have been charged for the individuals' services in similar circumstances. University would record the following entry to reflect the contributed services:

Dr. Compensation and benefits expense	\$2,500,000
Cr. Contribution revenue	\$2,500,000

To record donated teaching services from uncompensated religious personnel.

If uncompensated faculty are paid a nominal stipend to help defray certain of their out-of-pocket expenses, the contribution received would be measured at the fair value of the services received less the amount of the nominal stipend paid.

7.5.1.4 **Promises to give volunteer services in the future**

Most promises to give personal services are inherently conditioned on the future availability of the promisor. For example, an attorney who promises to provide free legal services for three years might subsequently become incapacitated (and thus, be incapable of fulfilling the promise). Therefore, such contributions generally are recognized when or as the condition is fulfilled (that is, when the services are provided). However, the facts and circumstances of the promise should be considered. If the promise does not depend on the availability of a specific individual—for example, a promise of free

legal services from a large law firm with many attorneys—the contribution would likely be recognizable in advance of when the services are actually performed (see NP 7.4.4).

7.5.1.5 *Disclosure of contributed volunteer services*

When an NFP relies significantly on volunteer services, users of its financial statements need information about those services in order to understand the entity's operations. Contributed services are also considered contributed nonfinancial assets and NFP entities are subject to the presentation and disclosure requirements described in NP 7.4.6. In addition, all entities (both NFPs and business entities) are required by ASC 958-605-50-1B to disclose the activities or programs in which they utilized services of volunteers, the nature and extent of those services, and the amount of contribution revenue recognized in connection with those services (if any). Entities are encouraged to disclose the fair value of services for which revenue was not recognized, if practicable.

ASC 958-605-50-1B

An entity (NFPs and business entities) that receives contributed services shall describe the programs or activities for which those services were used, including the nature and extent of contributed services received for the period and the amount recognized as revenues for the period. Entities are encouraged to disclose the fair value of contributed services received but not recognized as revenues if that is practicable. The nature and extent of contributed services received can be described by nonmonetary information, such as the number and trends of donated hours received or service outputs provided by volunteer efforts, or other monetary information, such as the dollar amount of contributions raised by volunteers. Disclosure of contributed services is required regardless of whether the services received are recognized as revenue in the financial statements.

7.5.2 *Donated personnel services received from an affiliate*

NFPs may operate under arrangements in which some or all its program or administrative activities are carried out by employees of a closely-related entity. For example, a company or financial institution might establish a controlled NFP foundation to manage its charitable giving program, or a university may form a related NFP to manage its fundraising and development activities. Often, such an NFP will not hire its own employees, but instead will utilize employees of the sponsor, who donates the employees' services to the NFP without an expectation of reimbursement. What it means to provide services without charge is described in ASC 958-720-05-7.

This guidance applies only to personnel-related services; it does not extend to other types of services that might be subsidized or provided without charge by an affiliate.

If the sponsor and NFP are affiliates, as defined in the ASC Master Glossary, nonreciprocal transfers between them do not meet the definition of a contribution. As a result, any donated personnel services are outside the scope of the rules for contributed services discussed in NP 7.5.1. Instead, guidance for recognizing, measuring, and reporting them is provided in the "Services Received from Personnel of an Affiliate" subsections of ASC 958-605 and in ASC 958-720. This guidance applies only to separately-issued financial statements of the NFP that receives the services; it does not establish reporting standards for the affiliate that provides the services (which could be either a for-profit or NFP entity).

ASC Master Glossary**Affiliate**

A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

ASC 958-720-05-7

The Services Received from Personnel of an Affiliate Subsections provide guidance for reporting services received by a not-for-profit entity (NFP) from personnel of an affiliate that directly benefit the recipient NFP and for which the affiliate does not charge the recipient NFP. Charging the recipient NFP means requiring payment from the recipient NFP at least for the approximate amount of the direct personnel costs (for example, compensation and any payroll-related fringe benefits) incurred by the affiliate in providing a service to the recipient NFP or the approximate fair value of that service.

The focus of the guidance is on services provided for the NFP's direct benefit—that is, costs associated with services that would be performed by employees that otherwise would need to be directly engaged by the NFP. It includes services performed for and under the direction of the receiving NFP's own personnel (if any) as well as allocations of shared services costs. Question NP 7-4 addresses the scope of this guidance.

Question NP 7-4

Is there a difference between being financially interrelated with another entity (as defined in ASC 958-20) and being an affiliate of another entity for purposes of applying the guidance for “Services Received from Personnel of an Affiliate”?

PwC response

Yes. The threshold for entities to be financially interrelated is lower than the threshold for entities to be considered affiliates, and entities can be considered financially interrelated but not be affiliates. The guidance for “Services Received from Personnel of an Affiliate” only applies to affiliate relationships (see NP 8.4.1). Otherwise, the general rules for recognition of contributed services that are described in ASC 958-605 and NP 7.5.1 would apply.

7.5.2.1 *Measurement of personnel services donated by an affiliate*

In most cases, recognized services would be measured based on the affiliate's cost, which presumably would be readily available. While the components of cost depend on the specific nature and type of services provided, it would include, at a minimum, the direct personnel costs (for example, compensation and any payroll-related fringe benefits) incurred by the affiliate in providing the services. However, if using cost would significantly overstate or understate the value of the services received, the recipient may elect to report the services based on the fair value of what it would normally pay if required to purchase the services, as described by ASC 958-720-30-3. The option to use fair value instead of the affiliate's cost was provided to address concerns that the guidance might produce distorted results in a situation when a highly-compensated employee regularly provides routine services to an NFP affiliate—for example, if the CFO of a large corporation performs bookkeeping services for the corporation's charitable foundation. In these unusual situations, the allocated cost of the individual's compensation might far exceed the amount the NFP would normally

pay for the services. In the original basis for conclusions related to this guidance, the FASB observed that such situations are expected to be uncommon.

Question NP 7-5 and Question NP 7-6 illustrate two potential scenarios.

Question NP 7-5

If the NFP is charged (or allocated through an intercompany account) an amount that is at least the approximate amount of direct personnel costs of the services provided, should they record any adjustments to record the amount at fair value?

PwC response

No. In those situations, the recipient NFP's financial statements already reflect the costs of the services performed by the affiliate on its behalf. Unless the NFP believes the amounts charged or allocated significantly overstate or understate the value received, recording the amounts at fair value is not required, since this is a transaction between affiliates.

Question NP 7-6

If an NFP is charged (or allocated through an intercompany account) an amount that is lower than the cost or fair value of the services provided, should the NFP record any adjustments to record the amount at fair value?

PwC response

Neither ASC 958-605-25-17 nor the “Services Received from Personnel of an Affiliate” subsections of ASC 958-720 explicitly address such situations. Except for the situations described in ASC 958-720-30-3 when the amount charged is significantly understated, we believe that the incremental difference between the affiliate's cost and the amount charged should be recognized, measured, and presented in the manner specified by this guidance.

7.5.2.2 Presentation of personnel services donated by an affiliate

When services are donated by an affiliate, the recipient NFP's statements would reflect an increase in net assets (for the donation) along with a corresponding amount of personnel expense or an increase in an asset (for example, when the personnel are involved in the construction of a fixed asset) based on the nature of the work performed. According to ASC 958-220-45-21, the increase in net assets is considered an equity transfer (as defined in the ASC Master Glossary); it is not reported as contribution revenue. Although an equity transfer typically describes a transaction between NFP affiliates, in this instance, we believe that equity transfer reporting should also be used when a for-profit entity provides the services. This is based on ASC 958-220-45-21, which states that personnel services donated by “any other affiliate” should be reported as equity transfers. If the recipient is a health care entity, the equity transfer is excluded from (reported below) the performance indicator. See NP 3.4.8 for additional discussion of equity transfers.

ASC 958-220-45-21

The increase in net assets associated with services received from personnel of an affiliate that directly benefit the recipient not-for-profit (NFP) and for which the affiliate does not charge the recipient NFP shall be reported as an equity transfer, regardless of whether those services are received from personnel of an NFP affiliate or any other affiliate. The corresponding decrease in net assets or the creation or enhancement of an asset resulting from the use of services received from personnel of an affiliate shall be presented similar to how other such expenses or assets are presented. Paragraphs 954-220-45-2 through 45-3 provide additional guidance for not-for-profit, business-oriented health care entities.

ASC Master Glossary**Equity transfer**

An equity transfer is nonreciprocal. An equity transfer is a transaction directly between a transferor and a transferee. Equity transfers are similar to ownership transactions between a for-profit parent and its owned subsidiary (for example, additional paid-in capital or dividends). However, equity transfers can occur only between related not-for-profit entities (NFPs) if one controls the other or both are under common control. An equity transfer embodies no expectation of repayment, nor does the transferor receive anything of immediate economic value (such as a financial interest or ownership).

Because equity transfers are not contributions, they are not subject to the disclosure requirements for contributions received in ASC 958-605-50. However, entities should consider the appropriate related party disclosures, including a description of the transaction and any other information deemed necessary to understanding the effects of the transaction on the financial statements.

Example NP 7-10 illustrates the recognition, measurement, and presentation considerations for personnel services donated by an affiliate.

EXAMPLE NP 7-10**Personnel provided by a NFP to its charitable foundation**

Foundation is a grant-making entity that administers NFP's charitable giving program. Foundation's articles of incorporation indicate that NFP is its sole corporate member. Foundation has no employees of its own; all its activities are carried out by NFP employees. NFP estimates that \$100,000 of its employee salary and benefit costs are attributable to time spent on Foundation activities. Those costs are in line with amounts that Foundation would have to pay for the services if the services were not provided by NFP employees.

How would Foundation reflect the salary and benefit costs of the donated personnel services in its separately-issued financial statements?

Analysis

When preparing stand-alone financial statements, Foundation would first need to consider whether NFP is an affiliate (as defined in the ASC master glossary). Based on the definition of "control" used in evaluating relationships between donors and intermediaries that facilitate contributions on their behalf (refer to NP 5), Foundation is controlled (by virtue of the sole corporate member relationship) and thus, NFP would be an affiliate.

A recipient not-for-profit (in this example, Foundation) must recognize all services provided by personnel of an affiliate for its direct benefit. Therefore, Foundation would record the following entry to reflect the donated personnel services provided by NFP, based on the costs incurred by NFP:

Dr.	Compensation and benefits expense	\$100,000	
Cr.	Donated services received from affiliate		\$100,000

To record administrative services performed by NFP personnel.

The donated services represent an equity transfer received by Foundation. In the separately issued financial statements, they would be displayed as a separate line within changes in net assets without donor restrictions.

7.6 Other contributed services and use of facilities

An NFP might receive other contributions for use in carrying out its programs that are not related to the NFP's workforce, supplies, or costs of sales. An NFP might receive the use of space or might give another NFP the use of space (i.e., provide the free use of facilities to other NFPs). An NFP might also receive utilities free of charge or at reduced rates.

These arrangements are regarded as a form of donated noncash assets (similar to the situations discussed in NP 7.4). Example NP 7-11 illustrate the application of these principles to gifts of utilities and is derived from ASC 958-605-55-43.

EXAMPLE NP 7-11

Month-to-month contribution of utilities

Foundation receives a contribution of electric utilities from Utility. The electricity is given on a continuous basis subject to the donor's cancellation (that is, Utility could cancel the arrangement at any time). Utility would normally charge a consumer \$400 for the amount of electricity used by Foundation during the month of May.

How should Foundation account for this contribution?

Analysis

Because this is a month-to-month arrangement that Utility could discontinue at its discretion, the contribution would be recorded on a monthly basis. Foundation would record the following entry for the month of May:

Dr.	Utilities expense	\$400	
Cr.	Contribution revenue		\$400

Foundation would recognize the fair value of the contributed electricity as both contribution revenue and expense in the period it is received and used, estimating fair value using rates normally charged to a consumer of similar usage requirements. Because the services are received and used simultaneously, the contribution revenue would increase net assets without donor restrictions.

Unconditional promises to provide the use of space or facilities can be one of an NFP's more difficult accounting challenges, especially as it relates to the determination of the appropriate fair value of the contribution at inception of the arrangement as well as the continuing accounting during the term, and presentation on the balance sheet and statement of activities. This is particularly relevant if the arrangement contains lease payments that are below market. In that case, the actual cash lease payments (even if below market) should be accounted for as a lease under ASC 842, and the difference between those lease payments and the fair market rents for the property should be accounted for as a contribution under ASC 958-605. For an arrangement when no consideration is paid by the NFP, even though it may be similar to a lease, the arrangement does not meet the definition of a lease under ASC 842 and should be accounted for entirely as a contribution. While ASC 958-605-55-24 notes the similarity of such arrangements to leases, it prescribes a not-for-profit-specific accounting model for such unconditional promises to give the use of long-lived assets for which the donor retains title.

ASC 958-605-55-24

Unconditional promises to give the use of long-lived assets (such as a building or other facilities) for a specified number of periods in which the donor retains legal title to the long-lived asset may be received in connection with leases or may be similar to leases but have no lease payments. For example, an NFP may use facilities under a lease agreement that calls for lease payments at amounts below the fair rental value of the property. In circumstances in which an NFP receives an unconditional promise to give for a specified number of periods, the promise should be reported as revenue and as a contribution receivable for the difference between the fair rental value of the property and the stated amount of the lease payments. In other words, if a donor promises that the NFP can use a facility for 10 years, the NFP has received a multiyear promise to give and should report the fair value of that promise as a contribution with a **donor-imposed restriction** in Year 1. Amounts reported as contributions shall not exceed the fair value of the long-lived asset at the time the NFP receives the unconditional promise to give. The contribution receivable may be described in the financial statements based on the item whose use is being contributed, such as a building, rather than as contributions receivable.

One of the key elements of the guidance is that the fair value of the contribution cannot exceed the fair value of the underlying long-lived asset. As noted in AAG-NFP 5.164, the comparison of fair value should be measured at the date of the unconditional promise to give. NFPs should also separate other potential elements of the contribution from the fair value of the underlying asset (such as a commitment to pay executory costs or environmental remediation).

The AICPA whitepaper "Leasing Activity for Not-for-Profit Entities under ASU 2016-02" summarizes the key aspects of ASU 2016-02 (codified in ASC 842) and also includes three examples, with journal entries, for a contribution of fully-donated space (which is also illustrated in Example NP 7-12), a below-market lease that meets the criteria as a financing lease, and a below-market lease that meets the criteria of an operating lease.

ASC 958-605-55-24 also notes that the contribution receivable may be described in the donee's financial statements based on the nature of the item being contributed, such as a building, rather than as contributions receivable. For below-market leases, we also believe the contribution receivable could be combined with the right-of-use asset, with proper disclosure.

Example NP 7-12 illustrates the accounting for free use of space and is derived from ASC 958-605-55-46.

EXAMPLE NP 7-12**Promise to contribute use of office space**

Charity receives the use of 10,000 square feet of prime office space from Local Business for free. Local Business has unconditionally promised the use of the space, rent free, for five years. Annual rents for comparable office space in the area is \$15 per square foot and is projected to remain stable for the next five years.

How should Charity account for this arrangement?

Analysis

Charity has received a multiyear promise to give and should report the fair value of that promise as a contribution that increases net assets with donor-imposed restrictions on day 1 (at the time of the gift). The donor-imposed restriction is an implicit time restriction on the use of the space over the next five years.

The value of the annual rent for each of the five years is \$150,000 (10,000 x \$15) or \$750,000 over the five years. After considering appropriate performance risk and discount rate assumptions, the fair value is determined to be \$715,000. The entry to initially record the promise to give would be:

Dr. Contribution receivable	\$750,000	
Cr. Discount on contribution receivable		\$35,000
Cr. Contribution revenue—restricted		\$715,000

The discount rate determined at the time the promise is initially recognized would not be revised. The interest method would be used to amortize the discount. Charity would report the amortization as additional contribution revenue that increases net assets with donor restrictions.. The entries to record this activity in the first year of the arrangement would be:

Dr. Rent expense	\$150,000	
Cr. Contribution receivable		\$150,000

To reflect annual rent expense

Dr. Discount on contribution receivable	\$7,000	
Cr. Contribution revenue – restricted		\$7,000

To reflect amortization of discount

Dr. Net assets released from restriction (Donor-restricted net assets)	\$150,000	
Cr. Net assets released from restriction (Net assets without donor restrictions)		\$150,000

To reflect expiration of implied time restriction

Chapter 8: Contributions through intermediaries and split- interest agreements

8.1 Overview of contributions through intermediaries

Sometimes a donor will contribute to an NFP through an intermediary. An intermediary might be a community foundation, a fund-raising foundation established to support a specific NFP, a federated fund-raising organization such as United Way, a bank (in the capacity of a trustee) or an entirely unrelated NFP, to name but a few of the possibilities. This chapter discusses the accounting and reporting for those transactions. Throughout this discussion, the term *intermediary* is used in a generic sense to describe an organization that acts as a go-between in facilitating certain transactions. This usage is broader than the definition of *intermediary* in the ASC Master Glossary, which is intended to highlight subtle differences between *intermediaries* and *agents*.

Contribution transactions involving intermediaries raise questions as to whether the intermediary or the ultimate NFP recipient should recognize contribution revenue. This chapter describes a special overlay to the contribution accounting model discussed in NP 6 and NP 7 to provide a framework for addressing these situations. See NP 8.3 for guidance on identifying contribution transactions that are within the scope of that special framework, and NP 8.4 through NP 8.6 for a description of the accounting requirements for intermediary organizations and the ultimate recipient NFPs under various circumstances.

Some transactions through intermediaries involve gift arrangements known as split-interest agreements, whereby a third-party invests and administers donated assets, the benefits of which are shared among NFPs, or between NFPs and other beneficiaries. Other split-interest agreements are invested and administered by the arrangement's charitable beneficiary. Split-interest arrangements are discussed in NP 8.7.

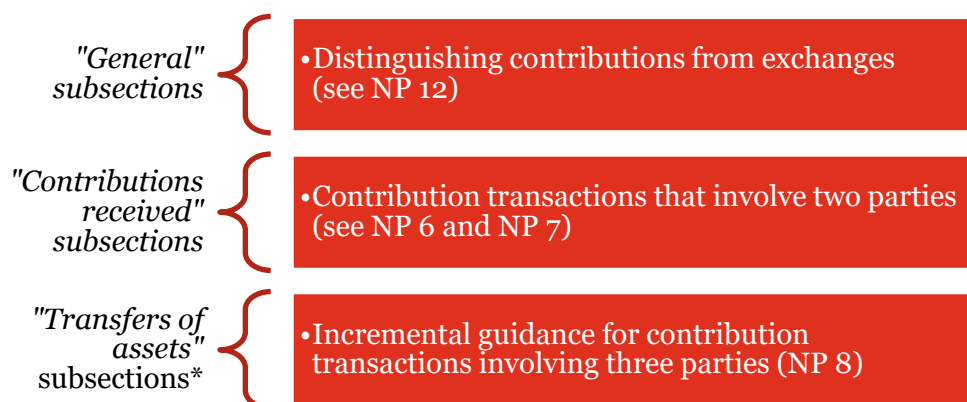
8.2 Contributions made through intermediaries

The incremental (overlay) revenue recognition guidance for intermediary, or "three-party," contributions that involve a donor, an intermediary, and a third-party donee (recipient or beneficiary) is found in subsections of ASC 958-605, titled *Transfers of Assets to a Not-for-Profit Entity or Charitable Trust That Raises or Holds Contributions for Others* (referred to as the "Transfers of Assets" subsections). That guidance is incremental to the general revenue recognition guidance for contributions in the *Contributions Received* subsections of ASC 958-605, discussed in NP 6 and NP 7.

Figure NP 8-1 displays ASC 958-605's three subsections and the subject matter covered by each.

Figure NP 8-1

Road map of ASC 958-605, Revenue recognition—contributions



*Transfers of assets to a not-for-profit entity or charitable trust that raises or holds contributions for others

The incremental guidance in the "Transfers of Assets" subsections (along with companion guidance in ASC 958-20, *Financially-Interrelated Entities*) establishes an accounting framework that (a) addresses whether the recipient entity or the third-party donee should report contribution revenue and (b) requires the third-party donee to report its rights to resources held by the intermediary as an asset. The framework's key principles are:

- If the intermediary has discretion in determining how the transferred assets should be distributed, the transaction is outside the framework. The intermediary has received a contribution from the donor that should be accounted for under the "Contributions Received" subsections of ASC 958-605.
- If the intermediary has little or no discretion in determining how the assets transferred will be distributed:
 - The intermediary acts as a conduit for passing the gift from the donor to the intended donee, and the third-party donee reports the contribution revenue.
 - An exception is provided if the intermediary and third-party donee are *financially interrelated organizations*. In those situations, the intermediary recognizes contribution revenue, and the third-party donee recognizes an interest in the intermediary's net assets. See NP 8.5.2 for the meaning of "financially interrelated" and the rationale underlying this accounting.

8.3 *Evaluating whether a transaction involves a third-party donee*

The existence of a third-party donee (the specified beneficiary or the ultimate beneficiary of the resources) is what distinguishes “three-party” contribution transactions from conventional two-party contribution transactions that involve a direct transfer of resources between a donor and a donee.

As a general rule, if a donor provides resources to an intermediary and identifies a third-party donee as the beneficiary (as described in ASC 958-605-55-78), the special framework is applied unless the intermediary possesses special rights known as *variance power* (discussed at NP 8.3.2.1).

Excerpt from ASC 958-605-55-78

A donor may specify the beneficiary by name, by stating that all entities that meet a set of donor-defined criteria are beneficiaries, or by actions surrounding the transfer that make clear the identity of the beneficiary, such as by responding to a request from a recipient entity that exists to raise assets for the beneficiary.

In some cases, evaluating whether a transaction involves a third-party donee (and thus, should be accounted for using the three-party framework) is straightforward, but often it is not. For example, in some situations when fundraising is conducted by a foundation on behalf of specified organizations, the existence of a third-party donee is implied, rather than explicitly stated (see NP 8.3.1). In other cases, a contribution transaction that initially appears to involve three parties might, upon closer scrutiny, only involve a donor and a donee (see NP 8.3.2).

Example NP 8-1 illustrates the importance of correctly evaluating whether a transaction involves a third-party donee.

EXAMPLE NP 8-1

Evaluating whether a third-party donee has been specified

University Foundation’s articles of incorporation state that it exists solely to solicit donations and to hold and manage such assets for the exclusive benefit of University.

Donor contributes \$1,000 to University Foundation. Does this contribution transaction involve two parties (donor and donee) or three parties (donor, intermediary, and third-party donee)?

Analysis

While the transaction might initially appear to be a gift to University Foundation, in substance it involves three parties. Because the foundation exists solely to support University, all contributions made to University Foundation implicitly involve a specified beneficiary (third-party donee). Foundation has no discretion in determining where the contributed funds should go. Under the three-party framework described in the “Transfers of Assets” subsections of ASC 958-605, University must recognize its rights to the resources held on its behalf by University Foundation. The party that should recognize contribution revenue (University or University Foundation) will be determined based on whether the financially-interrelated fundraising relationship described in ASC 958-30 exists (see NP 8.4.1).

If the transaction is mistakenly assessed as a “two-party” contribution with University Foundation as the donee (and thus, only the guidance in the “Contributions Received” subsections of ASC 958-605 is applied), University Foundation might recognize contribution revenue to which it is not entitled. Furthermore, University’s assets and net assets would be understated, because University would not reflect its rights to the resources held by University Foundation.

8.3.1 Foundations that support several beneficiaries

When a foundation’s fundraising exclusively benefits a single entity (as established through the purpose stated in its articles of incorporation and bylaws), all the contributions it receives will have an implied beneficiary, as illustrated in Example NP 8-1.

Some foundations raise funds on behalf of several named beneficiaries. The supported beneficiaries might be a group of affiliates (for example, subsidiaries of a common parent), or they might be unrelated entities. Either way, if the foundation receives a gift that is donor-designated for one of the beneficiaries, the gift is accounted for using the three-party framework. If the foundation receives a gift that is *not* designated for one of the beneficiaries, then the foundation itself is the donee. However, sometimes a foundation that bears the name of a single beneficiary will be established to serve a broader purpose. In those situations, a third-party donee should not be implied, which is illustrated in Example NP 8-2.

EXAMPLE NP 8-2

Institutional foundation with broader purpose

The articles of incorporation for Hospital Foundation state that it was established to solicit donations and to hold and manage such assets to support the work of Hospital and to address broader health-related issues in the community served by Hospital.

Hospital’s website solicits donations. Prospective donors are informed that fundraising is handled by Hospital Foundation, with a hyperlink provided to the online giving section of Hospital Foundation’s website.

Hospital Foundation uses the three-party model to account for online contributions received from donors who either explicitly stipulate that their gift is to benefit Hospital or who access Hospital Foundation’s online giving area via the donation hyperlink.

Prospective donors can also access Hospital Foundation’s website directly, and its home page clearly indicates its broader purpose. During a reporting period, \$5,000 of contributions received by Hospital Foundation had no stipulations (implicit or explicit) related to Hospital. Do those contributions involve two parties (donor and donee) or three parties (donor, intermediary, and third-party donee)?

Analysis

The \$5,000 of online contributions are two-party contributions in which the Foundation is the donee.

Unless Hospital is explicitly specified as the intended beneficiary or the contribution originated from the hyperlink on Hospital’s website, Hospital has no rights to contributions raised through Hospital Foundation’s website. Even though Foundation bears Hospital’s name, contributions received by Hospital Foundation are not implicitly deemed to be for the benefit of Hospital. Hospital Foundation

has the discretion to choose to support any cause or entity that falls within its broader mission (for example, a community health fair, blood drive, or vaccination campaign), which is clearly stated on its homepage.

Foundations may enter into arrangements whereby gifts without donor restriction must be divided among the beneficiaries according to a prescribed formula. Such a formula might be specified in the articles of incorporation or bylaws of the foundation, or in an inter-entity agreement among the foundation and its benefited organizations. In those cases, the foundation does not have discretion to determine how the funds should be distributed, and, therefore, the foundation's beneficiaries are implied third-party donees.

Example NP 8-3 illustrates a fact pattern when undesigned gifts have implied third-party donees (beneficiaries) resulting from a formula arrangement, and the beneficiaries are unrelated entities.

EXAMPLE NP 8-3

Foundation supports two specific organizations – formula is used

Arts Foundation's articles of incorporation state that it was organized to solicit donations and to hold and manage donated assets for the benefit of two independent NFPs: Civic Ballet and Community Theater. An agreement among the three organizations states that gifts that are not donor designated for a specific organization will be split equally between Civic Ballet and Community Theater.

Donor makes a gift of \$5,000 to Arts Foundation that is not designated for either Civic Ballet or Community Theater. Does that transaction involve two parties (donor and donee) or three parties (donor, intermediary, and third-party donee)?

Analysis

On its surface, this transaction appears to involve only two parties (Donor and Arts Foundation). However, because the inter-entity agreement specifies that undesigned contributions will be split equally between Civic Ballet and Community Theater, beneficiaries are implicit in every undesigned contribution. Therefore, the transaction would be accounted for using the three-party contribution framework.

If the inter-entity agreement did not exist, the transaction would only involve two parties. Even though Arts Foundation must ultimately distribute the gift to one or both of its supported organizations, Arts Foundation would have the ability to choose how to distribute the funds. An illustration involving a foundation that raises funds for a group of affiliates can be found in Example 2 in ASC 958-20-55-8 through ASC 958-20-55-13.

8.3.2 Gifts when potential third-party donees are disregarded

Some transactions that might appear to specify a third-party donee might not actually have one for accounting purposes. In those cases, the guidance for typical two-party contributions would apply. This might occur in the case of gifts that provide variance power to the intermediary and gifts made to donor-advised funds, as described in the following sections.

8.3.2.1 *Gifts that involve variance power*

If a donor specifies a third-party donee but grants the intermediary variance power, then the intermediary has the legal power to redirect the donated assets to a different beneficiary. An intermediary that possesses variance power can recognize contribution revenue, because it has discretion on how the assets are distributed and the named beneficiary has no recognizable rights for accounting purposes. In these situations, the two-party contribution model applies.

Variance power is a legal concept and defined in the ASC Master Glossary. As used in ASC 958-605-25-25, the focus is on two aspects: unilateral power and an explicit grant of the right. Unilateral power means that the recipient organization can override the donor's instructions without approval from the donor, specified beneficiary, or any other interested party. For variance power to be operational, the donor must explicitly grant it to the intermediary as stated in ASC 958-605-25-28.

ASC Master Glossary definition

Variance power: The unilateral power to redirect the use of the transferred assets to another beneficiary. A donor explicitly grants variance power if the recipient entity's unilateral power to redirect the use of the assets is explicitly referred to in the instrument transferring the assets. Unilateral power means that the recipient entity can override the donor's instructions without approval from the donor, specified beneficiary, or any other interested party.

ASC 958-605-25-25

A recipient entity that is directed by a donor to distribute the transferred assets, the return on investment of those assets, or both to a specified unaffiliated beneficiary acts as a donee rather than an agent, trustee, or intermediary, if the donor explicitly grants the recipient entity variance power—that is, the unilateral power to redirect the use of the transferred assets to another beneficiary.

Excerpt from ASC 958-605-25-28

A specified beneficiary shall recognize its rights to the assets (financial or nonfinancial) held by a recipient entity as an asset unless the recipient entity is explicitly granted variance power.

According to the definition, the grant of variance power must be explicitly referred to in the gift agreement. In practice, the variance power might be mentioned in the gift agreement and explained in a separate gift policy document or the intermediary's formation documents (articles of incorporation/bylaws or trust agreement).

Example NP 8-4 illustrates how variance power functions in a gift agreement.

EXAMPLE NP 8-4

Variance power granted to a federated fund-raising organization

An individual contributes \$1,000 to Federated Fundraising Organization (FFO) through a workplace campaign and designates that their gift should go to Community Food Bank. FFO's campaign literature and donor form state that even if donors specify a particular beneficiary, FFO's allocation committee has the authority to redirect their gift if the committee perceives greater need elsewhere in the community.

How many parties are there to this contribution?

Analysis

By agreeing to contribute under the stipulated terms, donor explicitly grants variance power to FFO. Thus, this would be a two-party contribution transaction between the donor and FFO. FFO would account for the contribution based on the “contributions received” subsections in ASC 958-605. If FFO subsequently grants \$1,000 to Community Food Bank, it would be accounted for as a separate transaction in which FFO is the donor and Community Food Bank is the donee.

If the campaign materials did not contain a variance power statement (i.e., the variance power was not explicit), FFO would have no ability to override the donor’s designated beneficiary and would be required to pass those gifts on to Community Food Bank. Under that scenario, donor’s gift would be accounted for using the “three-party” transaction framework.

8.3.2.2 Intermediaries that require donors to grant variance power

Variance power can be granted in any gift agreement involving any type of NFP. However, for certain types of intermediary organizations, possession of variance power is an inherent operating characteristic. That is, these organizations require donors to grant variance power in connection with gifts.

- *Community foundations.* By design, a community foundation’s governing body must possess the power to modify donor-imposed restrictions if, in the board’s judgment and discretion, the restrictions become unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community. By incorporating variance power into gift agreements, the foundation avoids inefficiencies associated with long-lived giving vehicles (charitable trusts, endowments, or similar perpetual gifts) in which outdated donor restrictions might require the use of resources for purposes that are no longer sensible, practical, or efficient (for example, the care of individuals with diseases that have been eradicated).
- *“American friends of...” charities.* These are NFPs formed to support a specific foreign entity. Under IRS rules, charities that make grants to foreign entities are prohibited from serving as a conduit to enable the free flow of funds from American donors to foreign causes. Strict IRS regulations relate to both the letter and the spirit of the law as to how domestic NFPs may raise and transfer funds to foreign entities. For example, in order for contributions raised in support of a project of a foreign entity to be deductible by the donors, the sponsoring charity must have approved the project as being in furtherance of its own exempt purposes, and its board must have full control of the donated funds and discretion as to their use (which is typically achieved through a grant of variance power).

Example NP 8-5 illustrates the use of variance power in a gift made to a community foundation.

EXAMPLE NP 8-5

Donor grants variance power to a community foundation

The governing board of Local Zoo wishes to create and build a donor-restricted endowment. It signs an agreement with Community Foundation establishing The Local Zoo Endowment as a fund to be held and managed by Community Foundation. Local Zoo will solicit endowment gifts for the fund. The

resulting assets will be owned, held, and invested by Community Foundation, with distributions made to Local Zoo annually based on Community Foundation’s spending policy. The agreement contains a “variance power” provision stating that the Local Zoo Endowment fund will be operated subject to Community Foundation’s governing documents and policies, which include the granting of variance power in connection with gifts made to the endowment.

When soliciting gifts for the endowment fund, Local Zoo’s campaign materials (including the donor response cards) inform prospective donors that the endowment will be owned, held, and invested by Community Foundation. Donors also are notified that, in giving to the endowment, they will be granting Community Foundation variance power to redirect their donations if Local Zoo ceases to exist or to function in a manner that is consistent with the needs of the community.

How should Local Zoo and Community Foundation account for gifts received in response to Local Zoo’s endowment campaign?

Analysis

Gifts made to the Local Zoo Endowment fund would be accounted for as gifts to Community Foundation, not gifts to Local Zoo. This is because donors explicitly grant variance power by using donor-response cards clearly stating that the gifts are subject to Community Foundation’s unilateral power to redirect the resources to another beneficiary.

Community Foundation would recognize the fair value of gifts received for by the Local Zoo Endowment fund as contribution revenue. Local Zoo would be precluded from recognizing any rights to the endowment assets. Instead, it would recognize contribution income when Community Foundation makes distributions to Local Zoo.

8.3.2.3 Gifts to donor-advised funds

A donor-advised fund is a separately-identified fund or account over which a donor expects to have advisory privileges over the distribution or investment of the assets, but which is owned or controlled by a sponsoring charity (the “charitable sponsor”). The donor funds the account by making irrevocable, tax-deductible contributions to the charitable sponsor, and advises the sponsor how they would like the funds to be spent (for example, to benefit a specific charity). However, that advice is not legally binding on the charitable sponsor and, therefore, functions merely as a recommendation to the sponsor. Typically, although the charitable sponsor will act based on that advice, it has no legal obligation to do so.

Because the donor’s recommendation of a donee is only advisory in nature, a gift to a donor-advised fund is recognized as contribution revenue by the charitable sponsor. It is not accounted for under the three-party contribution framework. If the charitable sponsor subsequently chooses to make a grant based on the donor’s recommendation, this would be a separate transaction between the charitable sponsor as donor and the recommended charity as donee.

8.4 Framework for three-party contribution transactions

The framework for reporting three-party contribution transactions provides incremental guidance on whether the intermediary or the third-party donee should report the contribution revenue. In

addition, it requires third-party donees to recognize an asset representing their rights to the resources held by the intermediary, as described in ASC 958-605-25-28.

ASC 958-605-25-28

A specified beneficiary shall recognize its rights to the assets (financial or nonfinancial) held by a recipient entity as an asset unless the recipient entity is explicitly granted variance power (see paragraph 958-605-25-25). Those rights are any one of the following:

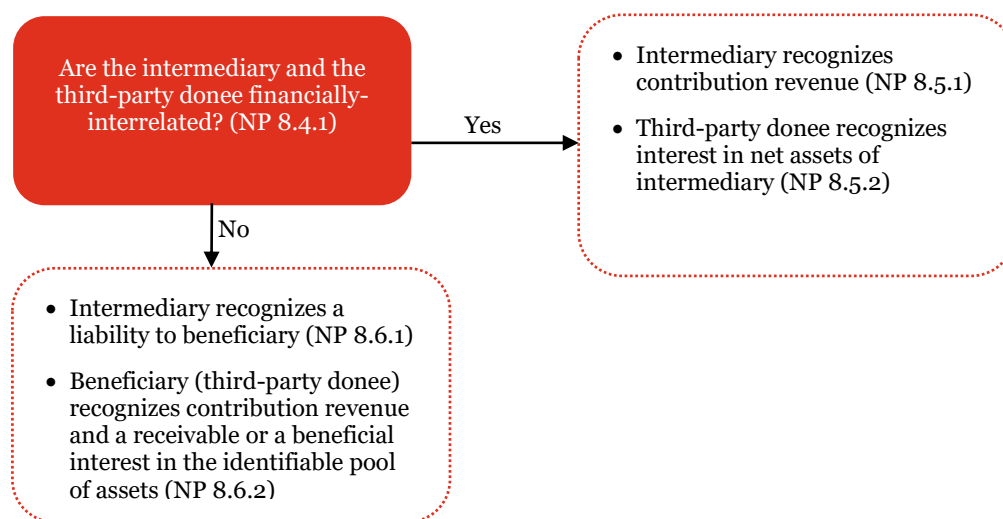
- a. An interest in the net assets of the recipient entity (see paragraph 958-605-25-32)
- b. A beneficial interest
- c. A receivable

In these transactions, the threshold determination is whether the intermediary and the third-party donee have a financially-interrelated fundraising relationship. The guidance for performing that analysis is provided by ASC 958-20, *Financially-interrelated entities*.

Figure NP 8-2 depicts this decision process associated with this analysis.

Figure NP 8-2

Decision framework – accounting for three-party contribution transactions



If the intermediary and the third-party donee are not financially interrelated, the intermediary acts as an agent in transferring the contribution between donor and donee. In that case, the intermediary recognizes a liability to the third-party donee, and the third-party donee recognizes a beneficial interest in the specific assets along with contribution revenue.

If the organizations are financially interrelated, the intermediary's role differs from that of an agent. In that case, the intermediary recognizes the contribution revenue, and the third-party donee recognizes an interest in the intermediary's net assets.

8.4.1 *Identifying “financially-interrelated” relationships*

As described in ASC 958-20-25-1, a financially interrelated relationship typically exists when a foundation is established to raise funds for a specific entity or entities.

Excerpt from ASC 958-20-25-1

A foundation that exists to raise, hold, and invest assets for the specified beneficiary or for a group of affiliates of which the specified beneficiary is a member generally is financially interrelated with the not-for-profit entity or entities it supports.

Often, such organizations share a collective mission, which is to further the services provided by the supported entity.

In a standard agency relationship involving fundraising (discussed at NP 8.6), the intermediary typically has an unavoidable obligation to transfer the assets raised to the third-party donee. In a financially-interrelated relationship, a foundation might have discretion to choose to transfer the assets to the donee, invest them on behalf of the donee, or spend them for a purpose that benefits the donee. Because it has this discretion, it is entitled to recognize the contribution revenue for gifts raised on behalf of the third-party donee.

The framework also requires the third-party donee to recognize an asset representing its rights to the resources held by the intermediary. According to the FASB’s original basis for conclusions for this guidance, the rationale is that, when the parties are financially-interrelated, the nature of the third-party donee’s asset is essentially equivalent to an investor’s residual interest in an investee over which the investor has significant influence. Thus, the third-party donee’s rights are residual rights in net assets of the foundation, rather than rights to specific assets held by the foundation.

The qualifications for financial-interrelationship are modeled on concepts associated with the equity method of accounting in ASC 323. The required characteristics in ASC 958-20-15-2 are an ability to influence operating and financial decisions (NP 8.4.1.1), coupled with an ongoing economic interest in net assets (NP 8.4.1.2). Both characteristics must be present.

Excerpt from ASC 958-20-15-2

A recipient entity and a specified beneficiary are financially interrelated entities if the relationship between them has both of the following characteristics:

- a. One entity has the ability to influence the operating and financial decisions of the other.
- b. One entity has an ongoing economic interest in the net assets of the other.

8.4.1.1 *Ability to influence operating and financial decisions*

In ASC 323, ownership by an investor of 20% or more of an investee’s voting stock leads to a presumption that the investor can exercise significant influence. The four types of relationships listed in ASC 958-20-15-2(a) serve a similar purpose. The existence of any of them establishes a presumption that one of the entities in the fundraising relationship has the ability to influence the operating and financial decisions of the other.

Excerpt from ASC 958-20-15-2(a)

...the ability to influence the operating and financial decisions of the other [entity]...may be demonstrated in several ways, including the following:

1. The entities are *affiliates*.
2. One entity has considerable representation on the governing board of the other entity.
3. The charter or bylaws of one entity limit its activities to those that are beneficial to the other entity.
4. An agreement between the entities allows one entity to actively participate in policymaking processes of the other, such as setting organizational priorities, budgets, and management compensation.

As used in this guidance, “affiliate” refers to a party that controls, is controlled by, or is under common control with the entity (i.e., the ASC Master Glossary definition of affiliate).

8.4.1.2 Ongoing economic interest in net assets

This characteristic is defined in the ASC Master Glossary.

ASC Master Glossary

Ongoing economic interest in the net assets of another: A residual right to another not-for-profit entity's (NFP's) net assets that results from an ongoing relationship. The value of those rights increases or decreases as a result of the investment, fundraising, operating, and other activities of the other entity.

According to the definition, one organization's rights to the assets held by the other must be a residual right, and the relationship between them must be ongoing. Typically, the nature of the economic interest will be such that the third-party donee will have rights to resources (net assets) held by the foundation, but the opposite scenario could also exist. Either scenario would qualify as an ongoing economic interest for purposes of the financially interrelated assessment.

- *Residual right*—instead of having rights to specific assets held by an intermediary (as would be the case in a traditional agency relationship), the third-party donee's rights to the assets held by the foundation are residual. This means that its rights to assets are similar to those of a holder of common stock in a corporation. Upon dissolution of the foundation, the donee would have rights to assets only after the foundation's liabilities were paid in full (meaning that the donee's rights are subordinate to the rights of creditors). It also means that the value of those rights increases or decreases as a result of the foundation's activities.
- *Ongoing*—the fundraising relationship does not arise from a one-time special event or from events that occur during a limited time period; rather, it continues over time.

Note that the “ongoing economic interest in net assets” described here differs from the concept of “economic interest” used in evaluating consolidation (see NP 5). “Economic interest” is broader and

potentially more event-driven – for example, it could refer to an obligation of one NFP to pay another NFP's liabilities upon dissolution. See AAG-NFP 5.32 for additional information.

8.4.1.3 Examples of how to evaluate financial interrelationship

Example NP 8-6 illustrates the analysis of financial interrelationship for a foundation established to raise funds for a single entity.

EXAMPLE NP 8-6

Evaluating financial interrelationship – foundation with a single beneficiary

University Foundation's (Foundation's) articles of incorporation state that it was established solely to solicit donations and to hold and manage such assets for the exclusive benefit of University. Do University and Foundation have a financially-interrelated fundraising relationship?

Analysis

Yes, the relationship between them meets both criteria for financial interrelationship.

- Because University Foundation's articles of incorporation limit its activities to those that are beneficial to University, University is deemed to have the ability to influence Foundation's operating and financial decisions (ASC 958-20-15-2(a)(3)).
- The articles of incorporation limit Foundation's activities to those that benefit University, so the relationship between them is ongoing. Because University is the sole beneficiary of all of Foundation's activities, the results of all of Foundation's activities accrue to the benefit of University. Thus, University has an ongoing economic interest in Foundation's net assets.

Example NP 8-7 illustrates the analysis for a foundation established to raise funds for two independent NFPs.

EXAMPLE NP 8-7

Evaluating financial interrelationship – foundation with two beneficiaries

Arts Foundation's articles of incorporation state that it was organized to raise funds to solicit donations and to hold and manage such assets for the benefit of two independent NFPs: Civic Ballet and Community Theater. Arts Foundation is not controlled by either organization.

At the time Arts Foundation was established, the three organizations entered into an agreement outlining certain aspects of how Arts Foundation would be operated. Among other things, the agreement stated that:

- representatives from the three organizations would meet annually to determine Arts Foundation's campaign priorities for the next year and agree on its operating budget,

- gifts not designated by donors for either Civic Ballet or Community Theater would be split equally between Civic Ballet and Community Theater, and
- Civic Ballet and Community Theater would bear equal responsibility for covering Arts Foundation's operating costs.

Do Civic Ballet and Arts Foundation have a financially-interrelated fundraising relationship?

Analysis

Yes, the relationship meets both criteria for financial interrelationship.

- Because the inter-entity agreement allows Civic Ballet to participate in decisions such as setting campaign priorities for Arts Foundation and establishing its budget, Civic Ballet is deemed to have the ability to influence Arts Foundation's operating and financial decisions (ASC 958-20-15-2(a)(4)).
- Because Arts Foundation's articles of incorporation limit its activities to those that benefit the two beneficiaries, the relationship between the Arts Foundation and Civic Ballet is ongoing. Because the inter-entity agreement establishes how the supported entities will share the revenues and expenses of Arts Foundation, Civic Ballet's rights to resources raised increases or decreases as a result of Arts Foundation's activities. Therefore, Civic Ballet has an ongoing economic interest in Arts Foundation's net assets.

Community Theater also would have a financially-interrelated fundraising relationship with Arts Foundation, for the same reasons.

ASC 958-20-55-3 through ASC 958-20-55-17 provide additional examples, including an example when the foundation and beneficiaries are affiliates.

8.5 Accounting requirements—parties are financially-interrelated

When a foundation (or any type of charitable organization) and a third-party donee—are in a financially-interrelated fundraising relationship, the foundation recognizes contribution revenue (an increase in its net assets) for contributions it receives on behalf of the third-party donee. The recognition principles used are those described in NP 6 and NP 7 for two-party contribution transactions.

Classification of the increase in net assets as donor-restricted or unrestricted is discussed at NP 8.5.1.

When the foundation distributes resources (or obligates itself to transfer the funds), it reduces its assets (or recognizes a liability) and recognizes an expense unless the third-party donee is an affiliate. In the latter situation, the distribution is reported as an equity transfer, as discussed in AICPA TQA 6140.19 and NP 3.4.8.

Distributions that are expenses should be reported by their functional expense classifications. If the distribution (regardless of whether it is an equity transfer or an expense) fulfills the purpose

restriction of the donor contribution, the expiration of the restriction is recognized as a release from restriction on the foundation's statement of changes in net assets.

AAG-NFP 13.129 through AAG-NFP 13.131 provides additional commentary on distributions.

8.5.1 *Classification in the statement of net assets of the foundation*

The foundation's classification of net assets associated with gifts for financially-interrelated beneficiaries depends on whether the foundation supports a single beneficiary or more than one beneficiary.

☐ Single beneficiary

A foundation with a single beneficiary puts itself in the shoes of the beneficiary and classifies the contribution revenue as the beneficiary would have done if it had received the contributions directly from the donor. Therefore, contribution revenue arising from gifts that are subject to donor-imposed time or purpose restrictions with which the beneficiary must comply (for example, a gift that is restricted for the purchase of equipment by the beneficiary) would increase the foundation's donor-restricted net assets. Otherwise, the contributions received would increase the foundation's net assets without donor restrictions.

☐ More than one beneficiary

If a foundation has more than one beneficiary, revenue arising from gifts received on behalf of a specific beneficiary increases donor-restricted net assets because the foundation must use the contribution for the benefit of that entity (see AICPA TQA 6140.16). Gifts that are not donor-designated for a specific beneficiary are considered gifts to the foundation itself. If those gifts are subject to time or purpose restrictions with which the foundation must comply, they increase donor-restricted net assets; otherwise, they increase net assets without donor restrictions. ASC 958-20-55-9 through ASC 958-20-55-10 illustrate this accounting for a foundation that supports a group of affiliates.

8.5.2 *Financially interrelated—accounting by third-party donees*

A third-party donee's rights to the assets held by a financially-interrelated foundation are residual rights; that is, they increase or decrease as a result of the foundation's investing, fundraising, operating, and other activities. Therefore, a third-party donee recognizes its rights by reflecting an asset that represents its interest in the foundation's net assets (rather than recognizing an interest in specific assets held on its behalf by the foundation).

Periodically, the third-party donee must adjust that interest for its share of any change in the foundation's net assets during a reporting period. In a statement of activities, this is reported as a single line item using a caption such as "increase (decrease) in interest in net assets of foundation." As described in ASC 958-20-25-2, this is similar to the share of the earnings or losses of an investee reported by an investor in common stock of a business enterprise under the equity method. For an NFP HCO or other NFP that reports a performance indicator, the portion of any increase that relates to net assets without donor restrictions generally is reported as a single line item in the performance indicator sub-total in the statement of operations, while the portion that increases net assets with donor restrictions is reported as a single line item below the performance indicator within the statement of changes in net assets.

Excerpt from ASC 958-20-25-2

If a beneficiary and a recipient entity are financially interrelated entities, the beneficiary shall recognize its interest in the net assets of the recipient entity. Recognizing an interest in the net assets of the recipient entity and adjusting that interest for a share of the change in net assets of the recipient entity is similar to the equity method, which is described in Subtopic 323-10.

The third-party donee's share of the change in the foundation's net assets must be reported as a change in the appropriate class or classes of net assets. In some situations, the entire change will relate to the beneficiary's net assets with donor restrictions. In others, the beneficiary will need to apportion the change between changes in net assets without donor restrictions and changes in net assets with donor restrictions. The appropriate classification varies based on whether the foundation's separate legal existence creates an implied time restriction on the beneficiary's net assets (see NP 8.5.2.1), and on whether the foundation supports a single beneficiary or more than one beneficiary (see NP 8.5.2.2 and NP 8.5.2.3).

Helpful nonauthoritative guidance on classification matters can be found in a series of AICPA TQAs titled *Classification of a Beneficiary's Interest in the Net Assets of a Financially-Interrelated Fund-Raising Foundation in the Beneficiary's Financial Statements*. For NFP HCOs and other NFPs that report a performance indicator, the relevant TQAs can be found in TQA Section 6400.35 through 6400.43. For all other NFPs, see TQA Section 6140.13 through 6140.18.

When the third-party donee receives distributions from the foundation (or the foundation obligates itself to transfer the resources), it recognizes the assets received or promised, and decreases its interest in the net assets of the foundation. This is discussed in NP 8.5.2.4.

8.5.2.1 Classification—implied time restriction on donee's interest

In evaluating the net asset classification of its share of the net assets of the financially-interrelated foundation, the donee needs to consider whether its access to the contributed resources is impacted by the fact that they are held by a separate legal entity. In other words, because distributions of those resources by the foundation will occur in future periods, the beneficiary may need to imply a time restriction on any net assets held by the foundation.

The key consideration is the third-party donee's ability (or inability) to influence the timing and amount of the distributions it will receive from the foundation. If the donee controls the foundation, or if it otherwise has such a close working relationship with the foundation that it can, in essence, access the foundation's assets at will, it would not be appropriate to imply a time restriction. Otherwise, a time restriction should be implied in addition to any other donor-imposed restrictions that may exist. For more information on implied time restrictions, see TQAs 6400.36 -.37 (for NFP HCOs) and TQAs 6140.14 -.15 (for all other NFPs).

If the foundation and the third-party donee are affiliates (and thus, are part of the same reporting entity), the donee should consider the specific facts and circumstances when determining whether a time restriction should be implied (see TQA 6400.38 for facts and circumstances that might be considered). As previously noted, a beneficiary that has legal control of its foundation would be able to access at will any assets held by the foundation. However, if the foundation and the beneficiary are commonly controlled, the beneficiary may or may not have that ability, depending on the facts and circumstances.

An implied time restriction arising from these circumstances differs in certain respects from an implied time restriction that exists because a promise to give is due in a future period. As discussed in NP 6.7.2.4, if both purpose and time restrictions exist with respect to a gift, time restrictions (including implied time restrictions associated with promises to give that are due in future periods) normally must be met before expenditures can be made that would satisfy the purpose restriction, and thus result in a reclassification of net assets from donor restricted to unrestricted. However, net assets that are subject to implied time restrictions because the beneficiary cannot determine the timing and amount of distributions from the foundation can be considered available to support expenditures made before the expiration of the implied time restriction (see footnote 13 of TQA 6140.18 and footnote 11 of TQA 6400.41). The key consideration is whether the donor's purpose restriction was specific to that particular expenditure. If the foundation has no choice but to distribute the funds based on the expenditure by the donee that met the donor restriction, the implied time restriction is considered met.

8.5.2.2 *Classification—donee is foundation's sole beneficiary*

The net asset classification of the share in net assets of a financially-interrelated foundation is also impacted by whether the donee is the foundation's sole beneficiary or the foundation has multiple beneficiaries.

If the third-party donee is the foundation's sole beneficiary and no time restriction is implied (i.e., the third-party donee can influence the timing of distributions from the foundation), the share of net assets in the foundation is apportioned between "change in donor-restricted net assets" and "change in net assets without donor restrictions" in a manner that mirrors the classification of the activities in the foundation's statement of activities for the period. In other words, the impact on net assets will be the same as if the donee had received the contributions directly from the donor.

If a time restriction is implied, contributions to the foundation would increase the third-party donee's donor-restricted net assets.

Example NP 8-8 illustrates these considerations.

EXAMPLE NP 8-8

Impact of implied time restrictions on sole beneficiary that reports performance indicator

Hospital Foundation's articles of incorporation state that it exists solely to solicit donations and to hold and manage such assets for the exclusive benefit of Hospital. As a result, the organizations are financially interrelated. During the reporting period, Foundation had the following activity:

Contribution revenue	\$50,000	(\$30,000 donor-restricted; \$20,000 unrestricted)
Investment income	7,000	(\$4,000 donor-restricted; \$3,000 unrestricted)
Administrative expenses	(5,000)	
Change in net assets	\$52,000	

How would this activity impact the net assets reported in Hospital's financial statements?

Analysis

Hospital's classification of the change in its interest in Hospital Foundation's net assets depends in part on whether Hospital can influence the timing and amount of distributions it receives from Hospital Foundation.

If the organizations have such a close working relationship that Hospital can, in essence, access at will the assets held for it by Hospital Foundation, no time restrictions should be implied. In that case, in the apportionment of the change in its share of Hospital Foundation's net assets between donor-restricted and unrestricted activity, Hospital would mirror the classification of those activities used in Hospital Foundation's financial statements, as follows:

Dr. Interest in net assets of Foundation	\$52,000	
Cr. Increase in interest (net assets with donor restrictions)		\$34,000
Cr. Increase in interest (net assets w/o donor restrictions)		\$18,000

Because Hospital reports a performance indicator, the portion that increases net assets without donor restrictions would be included in its performance indicator in its statement of operations. The portion that increases net assets with donor restrictions would be excluded from the performance indicator and reported in its statement of changes in net assets.

On the other hand, if Hospital cannot influence the timing and amount of distributions it receives from Hospital Foundation, it must imply a time restriction on the change in its interest in Hospital Foundation's net assets. In that scenario, the entirety of the change in interest in net assets would increase Hospital's donor-restricted net assets, as follows:

Dr. Interest in net assets of Foundation	\$52,000	
Cr. Increase in interest (net assets with donor restrictions)		\$52,000

Thus, the entire change would also be excluded from Hospital's performance indicator and would only be reported in Hospital's statement of changes in net assets.

The implied time restriction would be released when Hospital Foundation distributes the resources to Hospital (or notifies Hospital of its plans to distribute those resources).

8.5.2.3 ***Classification—foundation has multiple beneficiaries***

In contrast to the situations in NP 8.5.2.2, a foundation that is financially interrelated with more than one beneficiary might receive gifts that are not designated for any particular beneficiary. In those situations, a beneficiary recognizes only the share of the foundation's net assets arising from gifts that are specified for their benefit.

As discussed in NP 8.5.1, gifts that have a specified beneficiary are classified as donor-restricted net assets by the foundation. From the perspective of the beneficiary, however, if these gifts have no other donor-imposed (i.e., time or purpose) restrictions, they increase the beneficiary's net assets without donor restrictions, if no implied time restriction exists. If an implied time restriction exists, the resources held by the foundation will increase the beneficiary's donor-restricted net assets until they are distributed.

Figure NP 8-3 compares how the presence or absence of implied time restrictions affect the net asset classification of the interest in net assets of the foundation for beneficiaries that share a single fund-raising foundation.

Figure NP 8-3

Beneficiaries net asset classification—shared foundation

Foundation's net asset classifications		Specified beneficiaries' net asset classifications	
		No implied time restriction	Implied time restriction
Gifts received on behalf of a specified beneficiary (with donor-imposed time/purpose restrictions)	Donor restricted	Donor restricted	Donor restricted
Gifts received on behalf of a specified beneficiary (no time/purpose restrictions)	Donor restricted	Without donor restrictions	Donor restricted
Gifts that will be divided among beneficiaries based on formula arrangement (no time/purpose restriction)	Without donor restrictions	Without donor restrictions	Donor restricted
Gifts that will be distributed to beneficiaries at discretion of foundation (no time/purpose restrictions)	Without donor restrictions	Not recognized by beneficiaries as they have no present rights to these resources	
Gifts that will be distributed to beneficiaries at discretion of foundation (with donor-imposed time/purpose restrictions)	Donor restricted		

Example NP 8-9 illustrates the accounting and reporting considerations for multiple beneficiaries that share a common fundraising foundation.

EXAMPLE NP 8-9

Beneficiary accounting when financially-interrelated foundation is shared

The articles of incorporation of City Cultural Foundation (CCF) state that it is organized to solicit donations and to hold and manage such assets for the benefit of City Opera and Metropolitan Symphony. CCF and City Opera are financially-interrelated organizations, as are CCF and Metropolitan Symphony. City Opera and Metropolitan Symphony are unrelated.

Donor A contributes \$1,000 to CCF for City Opera with no other restrictions on its use. Donor B contributes \$5,000 to CCF without donor restrictions and without designating a recipient. How would CCF, City Opera, and Metropolitan Symphony each account for this activity in their financial statements?

*Analysis*City Cultural Foundation

CCF would recognize the contributions as follows:

Dr. Cash	\$6,000	
Cr. Contribution revenue (donor-restricted)		\$1,000
Cr. Contributions revenue (unrestricted)		\$5,000

The gift from Donor A involves an explicitly-identified donee and thus, is a three-party transaction. Because CCF and City Opera are financially-interrelated, CCF would report contribution revenue of \$1,000 that increases net assets with donor restrictions (as it can only be used for City Opera).

Donor B did not specify a beneficiary for the \$5,000 gift and therefore the gift is outside of the three-party transaction framework. (As a result, the financial-interrelationship of CCF with City Opera and Metropolitan Symphony is irrelevant with respect to the accounting for that gift.) This is a two-party transaction in which CCF is the donee. CCF can choose to allocate this gift to one of the entities or divide it between them, as it wishes. Therefore, CCF would reflect \$5,000 of contribution revenue that increases net assets without donor restrictions.

City Opera

Because Donor A specified that the gift be used for the benefit of City Opera, City Opera would include in its net assets its share of the net assets of CCF resulting from the gift received from Donor A.

Although the gift would be included in CCF's donor-restricted net assets, the resources have no explicit donor-imposed restrictions from City Opera's perspective and thus, might appear to be an increase in City Opera's net assets without donor restrictions. However, because the resources are held by CCF, City Opera must consider whether an implied time restriction exists.

If City Opera has such a close working relationship with CCF that it can, in essence, access at will the resources held for it by CCF, no time restriction should be implied. In that case, the gift would increase City Opera's net assets without donor restrictions, as follows:

Dr. Interest in net assets of CCF	\$1,000	
Cr. Increase in interest (net assets without donor-restrictions)		\$1,000

On the other hand, if City Opera cannot influence the timing and amount of distributions it receives from CCF, it must imply a time restriction on all of CCF's net assets held for its benefit. In that case, the gift would increase City Opera's donor-restricted net assets, as follows:

Dr. Interest in net assets of CCF	\$1,000	
Cr. Increase in interest (donor-restricted net assets)		\$1,000

The implied time restriction would be released when CCF distributes the resources to City Opera (or notifies City Opera of its plans to distribute those resources).

Because Donor B's gift did not specify a beneficiary, City Opera has no rights to it. Therefore, City Opera would make no entry with respect to Donor B's gift.

Metropolitan Symphony

Metropolitan Symphony would make no entries, as it has no claim on either gift.

TQA 6014.16 also illustrates a fact pattern involving beneficiaries that share a foundation.

As can be seen from the table in Figure NP 8-3, a beneficiary would not normally reflect an interest in net assets that belong to the foundation itself. However, if the foundation's articles of incorporation or an agreement between the foundation and the beneficiaries state that that undesignated gifts must be divided among the beneficiaries according to a prescribed formula, each beneficiary would also reflect an interest in its share of the foundation's own net assets, computed in accordance with that agreement or formula. In these situations, the need for an implied time restriction is also considered.

Example NP 8-10 illustrates the consideration by beneficiaries of undesignated gifts that will be shared based on a formula.

EXAMPLE NP 8-10

Beneficiaries entitled to undesignated contributions based on a formula

Arts Foundation's articles of incorporation state that it was organized to solicit donations and to hold and manage such assets for the benefit of two independent NFPs: Civic Ballet and Community Theater. Arts Foundation is not controlled by either of the supported organizations. Arts Foundation and Civic Ballet are financially-interrelated organizations, as are Arts Foundation and Community Theater. An agreement among the three organizations states that gifts not designated by donors for either Civic Ballet or Community Theater must be split equally between them.

Donor makes a gift of \$5,000 to Arts Foundation that is not designated for either Civic Ballet or Community Theater and has no other donor-imposed restrictions. How would Arts Foundation and Civic Ballet reflect this gift?

Analysis

Arts Foundation would recognize contribution revenue of \$5,000 that increases net assets without donor restrictions. Because the inter-entity agreement specifies that gifts without donor restrictions should be split equally between Civic Ballet and Community Theater, each beneficiary would recognize their rights to \$2,500 of Arts Foundation's net assets arising from the gift.

As the donor imposed no restrictions on the gift, the gift would initially appear to be an increase in Civic Ballet's net assets without donor restrictions. However, because the resources are held by Arts Foundation, Civic Ballet must consider whether an implied time restriction exists.

If Civic Ballet determines that a time restriction should be implied, the gift would increase its net assets with donor restrictions, as follows:

Dr. Interest in net assets of Arts Foundation	\$2,500	
Cr. Increase in interest (donor-restricted net assets)		\$2,500

If no implied time restriction exists, the gift would increase Civic Ballet's net assets without donor restrictions, as follows:

Dr. Interest in net assets of Arts Foundation	\$2,500	
Cr. Increase in interest (net assets without donor restrictions)		\$2,500

8.5.2.4 *Distributions from a financially-interrelated foundation*

When a third-party donee receives a distribution from a foundation (or the foundation obligates itself to transfer the resources) from the net assets of the foundation that relate to its interest, the accounting is similar to that used by an equity method investor for distributions received from the investee. The third-party donee would recognize the assets received or receivable and decreases its interest in the net assets of the foundation. This accounting is applied by the beneficiary regardless of whether the foundation accounted for the distribution as an equity transfer (for common control situations) or as expense (see NP 8.5.1).

If the third-party donee has implied a time restriction on its net assets associated with the interest in the foundation (discussed at NP 8.5.2.1), the time restriction on the portion of net assets attributable to the distribution will expire at the time of the distribution, triggering a release of that restriction (see TQA 6140.15 and TQA 6400.37).

Example NP 8-11 illustrates the accounting by the foundation and the beneficiary when funds are distributed by the foundation.

EXAMPLE NP 8-11

Distribution from foundation to sole beneficiary

University Foundation's articles of incorporation state that it exists solely to solicit donations and to hold and manage such assets for the exclusive benefit of University. The organizations are financially interrelated. University does not control University Foundation.

University Foundation distributes \$35,000 of cash to University. \$30,000 relates to net assets with donor restrictions and \$5,000 relates to net assets without donor restrictions. How would University Foundation and University each account for the distribution?

Analysis

University Foundation would reduce its assets and recognize an expense for the distributions, as described in NP 8.5.1. In addition, a \$30,000 reclassification from net assets with donor-restrictions to net assets without donor restrictions would be made in connection with the restricted resources transferred. University would decrease its interest in the net assets of the University Foundation for the \$35,000 distribution received. The journal entries would be as follows:

University		University Foundation	
Dr. Cash	\$35,000	Dr. Distribution to University	\$35,000
Cr. Interest in University		Cr. Cash	\$35,000
Foundation's net assets	\$35,000	<i>To record distribution to University</i>	
<i>To record distribution received from Foundation</i>			
		Dr. Donor-restricted net assets	\$30,000
		Cr. Net assets without donor	
		restrictions	\$30,000
		<i>To record release of donor restrictions</i>	

If University had implied a time restriction on its interest in the net assets without donor restrictions held at University Foundation, it would also make the following reclassification entry to reflect the release of the implied time restriction:

University	
Dr. Donor-restricted net assets	\$35,000
Cr. Net assets without donor	\$35,000
restrictions	
<i>To reflect the release of the implied time restriction due to receipt of distribution</i>	

If the third-party donee is not the foundation's sole beneficiary, a portion of the foundation's net assets will be attributable to the third-party donee, a portion will be attributable to other financially-interrelated beneficiaries, and the remainder will belong to the foundation. If the third-party donee receives a distribution from resources that belong to the foundation, it reports that distribution in its statement of activities or statement of operations as contribution revenue recognized in accordance with the Contributions Received subsections of ASC 958-605, rather than as a decrease in its interest in the net assets of the foundation. This is illustrated in Example NP 8-12.

EXAMPLE NP 8-12

Distribution from shared foundation

The articles of incorporation of City Cultural Foundation (CCF) state that it is organized to solicit donations and to hold and manage such assets for the benefit of City Opera and Metropolitan Symphony. CCF and City Opera are financially-interrelated organizations, as are CCF and Metropolitan Symphony. CCF is not controlled by either organization.

CCF distributes \$35,000 to City Opera. The distribution consists of \$30,000 of funds raised that were donor-designated for City Opera and \$5,000 of resources from CCF's undesignated net assets. How would CCF and City Opera each reflect these distributions?

Analysis

CCF would reduce its assets and recognize an expense for the distribution, as described in NP 8.5.1. In addition, a \$30,000 reclassification from net assets with donor restrictions to net assets without donor

restrictions would be made in connection with the restricted resources transferred that were donor-designated for City Opera.

City Opera would decrease its interest in the net assets of the foundation for the \$30,000 portion of the distribution relating to gifts that were donor designated for City Opera and reflect contribution revenue for the \$5,000 portion of the distribution that came from CCF's own funds.

The journal entries would be as follows:

City Opera		City Cultural Foundation	
Dr. Cash	\$35,000	Dr. Distributions	\$35,000
Cr. Interest in net assets of CCF	\$30,000	Cr. Cash	\$35,000
Cr. Contribution revenue	\$5,000	<i>To record distribution to City Opera</i>	
<i>To record distribution received from CCF</i>		Dr. Donor-restricted net assets	\$30,000
		Cr. Net assets w/o donor restrictions	\$30,000
		<i>To reflect the release of the restriction from the distribution of donor-restricted resources</i>	

If City Opera had implied a time restriction on its interest in the net assets without donor restrictions held at CCF, it would also make the following reclassification entry to reflect the release of the implied time restriction on the \$30,000 portion of the distribution:

City Opera	
Dr. Donor-restricted net assets	\$30,000
Cr. Net assets without donor restrictions	\$30,000
<i>To reflect the release of the implied time restriction related to distribution received</i>	

8.6 Accounting requirements—parties are not financially interrelated

In a three-party contribution transaction where the organizations are not financially interrelated, the intermediary acts as an agent in transferring the resources from the donor to the third-party donee. In the “Transfers of Assets” subsections of ASC 958-605, “agency” is not used in its strict legal sense (that is, to describe a principal-agent relationship). Instead, it describes a relationship in which the intermediary is acting as an agent for both the donor and the third-party donee.

ASC 958-605-20

Agency transaction: A type of exchange transaction in which the reporting entity acts as an agent, trustee, or intermediary for another party that may be a donor or donee.

Agent: An entity that acts for and on behalf of another. Although the term agency has a legal definition, the term is used broadly to encompass not only legal agency, but also the relationships described in Topic 958. A recipient entity acts as an agent for and on behalf of a donor if it receives assets from the donor and agrees to use those assets on behalf of or transfer those assets, the return on investment of those assets, or both to a specified beneficiary. A recipient entity acts as an agent for and on behalf of a beneficiary if it agrees to solicit assets from potential donors specifically for the beneficiary's use and to distribute those assets to the beneficiary. A recipient entity also acts as an agent if a beneficiary can compel the recipient entity to make distributions to it or on its behalf.

8.6.1 *Not financially interrelated—accounting by the intermediary*

When an intermediary receives cash or financial assets from a donor in an agency transaction, it does not recognize contribution revenue. Instead, the intermediary recognizes a liability to deliver the resources to the third-party donee (which will recognize the contribution revenue).

Excerpt from ASC 958-605-25-23

If an intermediary receives cash or other financial assets, it shall recognize its liability to the specified beneficiary concurrent with its recognition of the assets received from the donor. If an intermediary receives nonfinancial assets, it is permitted, but not required, to recognize its liability and those assets provided that the intermediary reports consistently from period to period and discloses its accounting policy.

If the donor imposes restrictions on the use of the assets, those restrictions do not impact the intermediary's net asset accounting because the intermediary will record an offsetting asset and a liability. Both the liability and the assets are measured based on the fair value of the assets received. Once delivered to the third-party donee, the assets and liabilities are derecognized.

For contributed resources that are nonfinancial assets (such as gifts in kind), the intermediary establishes an accounting policy of either recognition of the asset and liability (gross) or nonrecognition (net). The selected approach must be applied consistently and disclosed in the notes.

8.6.1.1 *Presentation of activity in intermediary's financial statements*

For most NFPs, cash inflows and outflows associated with ongoing major or central operations generally arise from transactions related to the change in net assets. However, cash contributions received in agency transactions, while inflows from core operating activities, are not revenue. Similarly, distributions made to third-party donees in agency transactions, while operating in nature, are outflows that are not expenses. Because intermediaries in agency transactions do not reflect revenues and expenses in the statement of activities, financial statement users may have difficulty understanding the magnitude of the intermediary's agency (often fundraising) operations. ASC 958-605-45-10 therefore provides additional presentation alternatives that may address these challenges.

Excerpt from ASC 958-605-45-10

To the extent that an NFP's activities include raising and distributing cash, the total amounts raised and distributed may be evident from a statement of cash flows prepared using the direct method for

reporting operating cash flows. In addition, generally accepted accounting principles (GAAP) do not preclude entities from providing supplementary information or additional disclosures. An NFP may provide a schedule reflecting fundraising efforts or campaign accomplishments or may disclose total amounts raised on the statement of activities, provided that amounts raised in an agent, trustee, or intermediary capacity are not shown as revenues.

The additional presentation alternatives mentioned in ASC 958-605-45-10 can be further described as follows:

- *Focus on the cash flow statement.* Cash flows associated with agency fundraising transactions are operating activities. The magnitude of amounts raised and distributed will be most evident under the direct method, under which major categories of operating cash receipts and payments are presented at their gross amounts (see NP 4.4.2). AAG-NFP 3.49 notes that organizations might consider placing this statement before the balance sheet, for emphasis.

If the cash flow statement is presented using the indirect method, inflows and outflows from agency transactions can be reported either gross or net pursuant to ASC 958-230-55-4. That is, when reconciling from the overall “change in net assets” measure reported in the statement of activities to net cash provided by or used in operating activities, an intermediary might show an adjustment for the amounts raised for third parties separate from an adjustment for amounts remitted to third parties. Alternatively, an entity might reflect a single adjustment reflecting the net amounts raised.

- *Provide additional disclosure within the statement of activities.* While an intermediary cannot display amounts raised for and remitted to third-party donees as if they were “revenues” and “expenses,” ASC 958-220-55-10 provides illustrations of how such amounts might appropriately be displayed in a statement of activities.
- *Provide supplementary information.* Supplementary information refers to information presented outside the basic financial statements and notes that further amplifies or explains the activity or items presented in the statements and notes but is not required by GAAP. For example, an intermediary could provide a supplemental schedule of fundraising efforts or campaign accomplishments in material accompanying the financial statements.

In the balance sheet, if the intermediary chooses to group assets and liabilities by net asset classes, the assets and liabilities attributable to agency transactions would be included in the “net assets without donor restrictions” class (ASC 958-605-25-23).

8.6.2 Not financially interrelated—accounting by third-party donee

ASC 958-605-25-28 through ASC 958-605-25-30 provide guidance for recognition of an agency transaction by the third-party donee (beneficiary).

When an intermediary has received cash or financial assets on behalf of a donee, the donee recognizes an asset (for its rights to the assets held by the intermediary) along with contribution revenue. The asset recognized is either a receivable or a beneficial interest, depending on the nature of the gift.

8.6.2.1 *Gift to intermediary recorded by third-party donee as receivable*

If the third-party donee has the right to receive the transferred assets, it recognizes contribution revenue and a contribution receivable using the guidance for recognition and measurement of unconditional promises to give discussed at NP 7.3. Contribution revenue arising from unconditional promises to give with payments due in future years will normally increase donor-restricted net assets, even if the donor imposes no explicit time or purpose restrictions. This is due to the requirements surrounding the imposition of implied time restrictions on promises to give (see NP 7.3.2.2). Promises that are due within the same reporting period that the gift is made are not subject to implied time restrictions.

Example NP 8-13 illustrates the accounting when an intermediary receives cash or financial assets from a donor in an agency transaction.

EXAMPLE NP 8-13

Agency gift transaction—donee recognizes a receivable

Individual makes a one-time gift of \$1,000 to Federated Fundraising Organization (FFO) through a workplace campaign. Individual designates his gift to Community Food Bank to support its food recovery program. FFO and Community Food Bank are independent organizations and are not financially interrelated. Individual does not grant variance power to FFO. FFO's policy is to distribute designated gifts within 90 days.

How would the gift initially be accounted for by FFO and Community Food Bank?

Analysis

FFO does not have the ability (through variance power) to override Individual's designation of a third-party donee; thus, both entities would account for the gift using the three-party contribution framework. Because FFO and Community Food Bank do not have a financially-interrelated fundraising relationship, this gift is an agency transaction.

FFO would recognize \$1,000 of assets along with a liability to Community Food Bank. Community Food Bank would recognize \$1,000 of contribution revenue and a receivable from FFO. The gift would increase Community Food Bank's net assets with donor restrictions due to the donor-imposed purpose restriction (to use the resources for the food recovery program). Because the funds will be transferred in less than one year, Community Food Bank would not also need to imply a time restriction on the net assets.

8.6.2.2 *Third-party donee recognizes a beneficial interest*

If the donee has unconditional rights to some or all the cash flows generated by an identifiable pool of assets held by the intermediary, it recognizes a beneficial interest. A common example is a gift transaction in which a donor transfers assets to an independent third party (such as a charitable trust for which a bank, trust company, NFP foundation, or private individual acts as trustee) under the terms of a split-interest agreement or perpetual trust. The trustee will invest and administer the contributed assets for the term of the trust (a fixed period, the lifespan of a specified individual, or in perpetuity) and make periodic distributions.

In such arrangements, the third-party donee's rights are to the cash flows associated with the distributions that will be made from the trust, rather than to the underlying assets in the trust. Thus, the donee's asset is the irrevocable right to a portion of the stream of cash flows (in a split-interest agreement) or to the entire stream of cash flows (in a perpetual trust).

In a split-interest agreement, the assets contributed to the trust will be shared between the third-party donee and other (usually non-charitable) beneficiaries in an arrangement with a specified term. The third-party donee will have either the right to distributions during the agreement's term (the lead interest) or the right to the assets remaining at the end of the agreement's term (a remainder interest). Ultimately, all the contributed assets together with the associated investment return will be distributed among the beneficiaries, after which the trust terminates. For more information on various structures used for split interest gifts, see NP 8.7.

In perpetual trusts, the assets are invested in perpetuity for the benefit of one or more charitable beneficiaries. In contrast to a split-interest agreement (see NP 8.7), the distributions from a perpetual trust never end. The third-party donee has the irrevocable right to receive distributions from the income earned on the trust assets in perpetuity, but never receives the assets held in trust.

Beneficial interest—recognition and measurement

If the intermediary has variance power to redirect the benefits to another entity, or if the third-party donee's rights to the benefits are conditional, the donee would not recognize a beneficial interest until its rights to distributions become unconditional. Otherwise, when the third-party donee is notified of the trust's existence, the arrangement should be recognized as donor-restricted contribution revenue and, in accordance with ASC 958-605-30-14, as a beneficial interest measured at fair value.

In some cases, a third-party donee may have reliable evidence that a beneficial interest exists but, after making reasonable efforts, is unable to obtain the information that would be necessary to measure that interest (for example, the amount of assets held by the trust; the payout rate or amount; the ages of all life beneficiaries). According to AAG-NFP 6.22 and 6.23, best practice in those situations is to recognize the beneficial interest in the first year in which the needed information becomes available. Prior to that time, the donee should not report an asset, but instead disclose the known facts and circumstances pertaining to each potentially material beneficial interest or in the aggregate for individually immaterial interests that are material collectively. If the NFP made (and continued to make) reasonable efforts to obtain the necessary information, the initial recognition of the interest would not be reflected as a prior period adjustment to correct an error pursuant to ASC 250, *Accounting Changes and Error Corrections*.

In a split-interest agreement, the asset and contribution revenue initially recorded represents the donee's entitlement to either the lead interest payments or the remainder interest payment, as appropriate. If fair value is measured using a present value approach, the discount rate would be based on the estimated life expectancy of the non-charitable beneficiary. For a perpetual trust, fair value generally can be measured using the fair value of the assets contributed to the trust, unless facts and circumstances indicate that the fair value of the beneficial interest differs from the fair value of the assets contributed to the trust.

At each reporting date, the donee would remeasure its beneficial interest at fair value using the same technique that it used upon initial measurement, as discussed at ASC 958-30-35-2 and ASC 958-605-35-3. Fair value measurement is addressed by ASC 820. Paragraphs 71 through 80 of the AICPA white paper, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*, (see [Appendix](#)

A of chapter 6 of AAG-NFP) provides a comprehensive discussion of fair value measurement considerations for beneficial interests in both split-interest and perpetual trusts.

Beneficial interest—presentation

In the statement of activities, the changes in the fair value of the beneficial interest are recognized as *change in the value of split-interest agreements* (or something similar) and are reported as an increase or decrease in donor-restricted net assets. According to ASC 958-30-45-7, contribution revenue and changes in the value of split-interest agreements should be presented as a separate line item in a statement of activities or the related notes. The codification is silent with respect to presentation considerations for similar activity of perpetual trusts.

Distributions from perpetual trusts and split-interest agreements are accounted for differently. Distributions from split-interest agreement trusts are reported as a reduction in the beneficial interest (ASC 958-30-35-10). Reclassifications from net assets with donor restrictions to net assets without donor restrictions are reported as distributions are received (due to release of the time restriction), unless the distributions are otherwise further restricted by the donor. Annual distributions from a perpetual trust are reported as investment income that increases net assets with or without donor restrictions, depending on whether the donor imposed any time or purpose restrictions (ASC 958-605-35-3).

Example NP 8-14 illustrates the guidance for accounting for measurement of a beneficial interest associated with a split-interest agreement.

EXAMPLE NP 8-14

Agency gift transaction—donee recognizes a beneficial interest

Donor transfers \$100,000 to Trust Company Bank (Trustee) to establish a charitable remainder annuity trust irrevocably designating Museum as the charitable remainder beneficiary (third-party donee). The terms of the agreement require Trustee to invest the trust assets and pay \$5,000 each year to Donor's spouse (the annuitant) for the remainder of the annuitant's life. Upon death of the annuitant, the trust will terminate, and Trust Company Bank will transfer all remaining assets (the remainder interest) to Museum. Donor imposes no restrictions on Museum's use of the assets.

How would Museum account for this gift?

Analysis

In this arrangement, the intermediary (Trustee) would maintain control of the contributed assets throughout the life of the trust established by Donor. Because Trustee does not have the ability to override Donor's designation of a charitable beneficiary (third-party donee), the three-party contribution framework is used. Because Trustee and Museum are not financially interrelated, this gift would be an agency transaction.

Because Museum is the beneficiary of a split-interest agreement held by a third party and has an unconditional right to receive a portion of the specified cash flows (the remainder interest) from the assets held pursuant to that agreement, Museum would recognize an asset (a beneficial interest) and contribution revenue representing its entitlement to the remainder interest. The contribution revenue and beneficial interest asset would be measured at fair value. Because Museum will not receive its

interest until the trust expires in the future, a time restriction exists, and the contribution revenue would increase donor-restricted net assets.

At each reporting period, Museum would remeasure the fair value of the beneficial interest (using the same valuation technique that it used to measure the asset initially). Museum would recognize the changes in fair value as “change in value of split-interest agreement” (or something similar), which would increase or decrease net assets with donor restrictions. When the trust terminates, the assets remaining in the trust are distributed to Museum. Museum would recognize the fair value of the assets distributed, decrease its beneficial interest, and increase donor-restricted net assets for any difference (as “change in value of split-interest agreements.”) Because Donor imposed no restriction on Museum’s use of the assets, a reclassification from net assets with donor restrictions to net assets without donor restrictions would be made when the distribution is received.

Question NP 8-1 addresses the timing of release of restrictions on a charitable remainder trust.

Question NP 8-1

If an NFP holds the remainder interest in a charitable trust administered by a third party, does the time restriction on the net assets expire (1) upon termination of the lead interest, at which point the trust is effectively dissolved; or (2) when the trust’s remaining assets are actually distributed to the NFP?

PwC response

Assuming no other time or purpose restrictions exist, we believe the time restriction would expire when the lead interest terminates. At that point, the third party is obligated to distribute the remaining resources in accordance with the donor’s instructions.

8.6.3 Administrative fees charged by intermediary

An intermediary in an agency transaction might charge the donee an administrative fee to cover the cost associated with raising the gifts. Those fees usually are withheld from the gift proceeds that are transferred to the donee. In those situations, the donee should report the gross amount of the gift as contribution revenue and should recognize fundraising expense for the administrative fee withheld, as illustrated in an example provided at ASC 958-605-55-84 through ASC 958-605-55-87. Additional information can be found in TQAs 6140.21 and 6140.22 and AAG-NFP 5.21.

8.7 Split-interest agreements

Split-interest agreements are charitable giving arrangements in which NFPs receive benefits that are shared with other (usually noncharitable) beneficiaries. NP 8.6.2.2 addresses split-interest agreements when the assets are held by a third party and thus subject to the three-party framework. A split-interest agreement is defined in the ASC Master Glossary.

ASC Master Glossary

Split-interest agreement: An agreement in which a donor enters into a trust or other arrangement under which a not-for-profit entity (NFP) receives benefits that are shared with other beneficiaries. A typical split-interest agreement has the following two components:

- a. A lead interest
- b. A remainder interest.

The accounting requirements for the recognition, measurement, and presentation of split-interest agreements are provided in ASC 958-30, *Split interest agreements*. ASC 958-30-55-30 provides an illustration of journal entries for accounting for the following types of split-interest agreements:

- Charitable lead trusts
- Charitable remainder trusts
- Charitable gift annuities
- Pooled (life) income funds

8.7.1 General characteristics of split-interest agreements

In a typical split-interest agreement, a donor makes a gift by transferring assets to either a third-party (for example, an intermediary NFP or bank trust department) or directly to the NFP (depending on the type of agreement). The donated assets are invested and administered for the term of the arrangement (e.g., a fixed period, the lifespan of a specified individual, or in perpetuity) and periodic distributions are made in accordance with the donor's request.

The time period covered by the agreement typically is expressed either as a specific number of years or as the remaining life of an individual or individuals designated by the donor. Based on the donor's instructions in the trust instrument, the NFP may ultimately have unrestricted use of the resources to which it is ultimately entitled from the trust, or the donor may place time or purpose restrictions on their use.

Arrangements structured as charitable gift annuities (NP 8.7.3) and pooled (life) income funds (NP 8.7.4) are administered directly by the NFP charitable beneficiaries. Charitable lead and remainder trusts can be administered by either the NFP beneficiary or an independent third-party.

In charitable lead or charitable remainder trust arrangements, the NFP beneficiary will have either the right to distributions during the agreement's term (the lead interest) or the right to the assets remaining at the end of the agreement's term (a remainder interest). Ultimately, all the contributed assets together with the associated investment return will be "split" among the beneficiaries, after which the trust terminates. The accounting requirements depend primarily on the nature of the NFP's interest (lead or remainder) and on whether the NFP or an independent third party serves as trustee.

If the split-interest assets are held by a third party, the arrangement is considered a three-party contribution transaction, the general accounting considerations for which are discussed at NP 8.6.2. If the NFP will hold the assets and administer the trust, see NP 8.7.2.

8.7.2 Lead and remainder trust arrangements

Generally, an NFP recognizes contribution revenue and the related assets and liabilities when an irrevocable split-interest agreement naming it trustee or fiscal agent is executed.

When split-interest trusts are irrevocable and the donor has not retained the right to substitute another charitable beneficiary, the NFP has an unconditional right to the benefits represented by the charitable portion of the trust, which will be reported as contribution revenue by the NFP.

The portion representing contribution revenue for the NFP depends on whether the NFP holds the lead interest (the right to distributions during the agreement's term) or the remainder interest (the right to the assets remaining at the end of the agreement's term).

- *Charitable lead trust.* In a charitable lead trust arrangement, the NFP will have the rights to the trust's distributions during the agreement's term. Upon termination of the trust (typically upon the death of the donor), the remainder of the trust assets returns to the donor or is distributed to (usually) noncharitable beneficiaries designated by the donor. Examples include charitable lead annuity trusts (CLATs) and charitable lead unitrusts (CLUTs)
- *Charitable remainder trust.* In a charitable remainder trust, the NFP will have the right to the assets remaining in the trust at the end of the agreement's term (i.e., once the payment of the lead interest ceases). Examples include charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). Some CRUTs limit the annual payout to the lesser of the stated percentage of or the actual income earned.

8.7.2.1 NFP is the trustee—accounting at inception

When the NFP holds the assets and administers the trust, its balance sheet reflects the trust assets along with the trust's liability for the obligation to make future payments to the other beneficiary (or beneficiaries) (see NP 8.6.2.2 for circumstances where the NFP does not hold the assets). The obligation to make payments is limited by the amount of assets in the trust. If the assets in the trust are exhausted, the trust terminates, and the NFP has no further responsibility. Thus, the liability is considered a liability of the trust, not a general obligation of the NFP.

At initial recognition, the difference between the fair value of the assets received and the fair value of the liability to the other beneficiaries is recognized as donor-restricted contribution revenue. That liability might relate to the lead interest (if the other beneficiary has the right to periodic payments from the trust assets during the term of the agreement), or it might pertain to a single payment representing the remainder interest (if the other beneficiary has the right to the assets remaining at the end of the agreement's term).

Appendix A of chapter 6 of AAG-NFP contains excerpts from an AICPA white paper, *Measurement of Fair Value for Certain Transactions of Not-for-Profit Entities*, that are relevant to measurement of split-interest agreements. Paragraphs 67 through 102 of that white paper address the application of ASC 820-10-35 in determining the fair value of contribution revenue and the obligation to other beneficiaries under split-interest agreements. If present value techniques are used to measure fair value, the liability is generally measured at the present value of the future payments to be made to the other beneficiaries. Any present value technique for measuring the fair value of the contribution or payments to be made to other beneficiaries must consider the estimated return on the invested assets during the expected term of the agreement, the contractual payment obligations under the agreement, and a discount rate commensurate with the risks involved.

The contribution portion of the agreement may be subject to explicit donor-imposed restrictions relating to time or purpose. In addition, the contribution is usually subject to an implied time restriction.

The obligations for certain split-interest arrangements will contain embedded derivatives. Identifying those situations and the accounting applied in them is discussed at NP 8.7.2.3.

8.7.2.2 NFP is trustee—subsequent accounting

At each reporting date, trust assets are remeasured based on the guidance discussed in NP 9 for investment accounting.

Distributions to the lead beneficiary (either the NFP itself in a lead trust or to the other beneficiary, if a remainder trust) are made in accordance with the terms indicated by the donor (for example, based on a fixed annuity amount or a percentage of the fair value of the trust assets). If the NFP holds the lead interest, it reflects the periodic reduction of trust assets associated with the distributions along with corresponding increases in assets that belong to the NFP. Reclassifications from net assets with donor restrictions to net assets without donor restrictions are made in connection with each distribution (assuming the donor imposed no other time or purpose restrictions). If the non-charitable beneficiary holds the lead interest, the distribution from trust assets also will reduce the liability to the other beneficiary.

The NFP does not reflect the trust's investment return in its statement of activities because it possesses an undivided interest (i.e., non-exclusive claim) in the assets, which is shared among all beneficiaries. Thus, investment return (including the change in fair value of the trust assets) is reported as an increase or decrease in the obligation to other beneficiaries. The liability to the other beneficiary(ies) is remeasured at the same time as the assets, resulting in a net adjustment.

In accordance with ASC 958-30-35-6, the NFP has two choices for remeasuring the liability. It can elect the fair value option pursuant to ASC 825-10-25 (and thus, remeasure the obligation at fair value). If that is done, the NFP would use the same fair value measurement technique that was used at inception. If fair value is based on the present value of payments to be made, the NFP updates all the assumptions, including the discount rate, to reflect current market conditions. Alternatively, the NFP can amortize the discount associated with the obligation (in a remainder trust) or contribution (in a lead trust) and adjust for changes in life expectancies (if payments are life dependent); in this case, the discount rate is not revised after initial recognition. The changes resulting from remeasuring the liability are reflected in the statement of activities as *change in value of split-interest agreements*, which increases or decreases donor-restricted net assets.

According to AAG NPO 6.35, the preferred approach is to remeasure the liability at fair value.

When the lead interest terminates (typically upon the death of the non-charitable beneficiary), the assets in the trust are distributed to the remainder interest beneficiary, the asset and liability accounts are closed (i.e., the trust terminates), and any difference between those balances is recognized as a change in the value of split-interest agreements in the net assets with donor restrictions class. If the NFP holds the remainder interest, a reclassification from net assets with donor restrictions to net assets without donor restrictions would be made upon the distribution from the trust, if no other donor-imposed time or purpose restrictions on use of the assets exists.

8.7.2.3 Derivatives embedded in split-interest liabilities

As discussed in NP 8.7.2.2, when an NFP charitable beneficiary also serves as trustee for a lead or remainder split-interest agreement, the NFP's balance sheet reflects trust assets along with a liability for the obligation to make future payments to the other beneficiary (or beneficiaries). That liability

might relate to the lead interest (if the other beneficiary has the right to periodic payments from the trust assets during the term of the agreement), or it might be a single payment representing the remainder interest (if the other beneficiary has the right to the assets remaining at the end of the agreement's term).

If the amount of the NFP's obligation is directly affected by changes in the value of the assets in the trust (as explained in NP 8.7.2.4), the liability contains an embedded derivative that may need to be accounted for separately. In those circumstances, the obligation would be considered a hybrid instrument under ASC 815-15, *Embedded derivatives*, consisting of a "debt host contract" and the embedded derivative, as described in ASC 958-30-35-7. The embedded derivative must be measured at fair value as required by ASC 815-10-30-1 (for initial measurement) and ASC 815-10-35-1 (for subsequent measurement). In order to accomplish that, it may be necessary to separate the embedded derivative from the host contract.

Excerpt from ASC 958-30-35-7

The debt host contract is the liability for the payment to the beneficiary that would be required if the fair value of the trust assets does not change over the specified period. The embedded derivative represents the liability (or contra-liability) for the increase (or decrease) in the payments to the beneficiary due to changes in the fair value of the trust assets over the specified period.

8.7.2.4 Arrangements that contain embedded derivatives

If the NFP's obligation is to make a single payment to the other beneficiary for the assets remaining at the end of the agreement's term (as in a CLAT or CLUT), the liability amount will always be affected by the performance of the investments over the trust's term. Because the obligation is directly affected by changes in the value of the assets in the trust, all remainder interest obligations contain an embedded derivative.

On the other hand, if the NFP's obligation is to make periodic payments to the lead beneficiary during the term of the agreement, the payment amounts will either be fixed (as in a CRAT) or variable (as in a CRUT). When the lead beneficiary is entitled to a fixed annuity payment throughout the agreement's term, the amount of the NFP's liability is unaffected by changes in the value of the trust assets. Therefore, no embedded derivative is present in a CRAT. However, if the payment amounts are based on a percentage of the fair value of the trust assets on a given date (and thus, can vary from period to period), the amount of the NFP's liability is directly affected by changes in the value of the trust assets. In a CLUT, therefore, the NFP's obligation will contain an embedded derivative.

8.7.2.5 Accounting for embedded derivatives

Embedded derivatives must be bifurcated from the debt host liability and accounted for separately unless either:

- The term of the split-interest agreement is based on the remaining life of an individual or individuals designated by the donor (see NP 8.7.1). In that situation, because the requirement to make payments ceases upon the death of the individual (in a charitable remainder trust) or the requirement to make a payment is activated upon the death of the individual (in a charitable lead trust), the arrangement is considered "life contingent." Life-contingent contracts are outside the scope of ASC 815 and thus are not subject to the requirement to separately identify any derivative

that might be embedded within the obligation (see ASC 958-30-25-8). The scope exception for life-contingent arrangements is described in ASC 815-10-15-52 through ASC 815-10-15-57.

- The derivative's risks and characteristics are "clearly and closely related" to those of the "host," which would be unlikely in light of the nature of these arrangements. DH 4.3.1 provides information on evaluating whether risks and characteristics are clearly and closely related.

If an arrangement containing an embedded derivative does not qualify for the life-contingent exception, most NFPs will elect to report the entire amount of the obligation to the other beneficiary at fair value, rather than separately accounting for the host contract and the embedded derivative. The NFP could make the election pursuant to a fair value option for hybrid instruments described in ASC 815-15-25-4, or based on the general fair value option for financial instruments described in ASC 825-10.

ASC 958-30-55-6 through ASC 958-30-55-20 provide eight examples (identified as Cases A through H) illustrating and explaining the analyses for potential embedded derivatives under various split-interest agreement structures. The conclusions for each type of arrangement are summarized in Figure NP 8-4.

Figure NP 8-4

Accounting for embedded derivatives in various split-interest structures

Nature of NPO's obligation	Nature of payments to lead beneficiary	Term of agreement		
		Life contingent	Period certain	Period certain and life contingent
Payment of remainder interest	Either fixed or variable (CLAT or CLUT)	□ Separate accounting not required (Case G)	□ Bifurcate or elect fair value option (Case F)	□ Generally, separate accounting not required (Case H)
Periodic payments to lead interest	Fixed (CRAT)	□ N/A -- no derivative exists (Case A)	□ N/A -- no derivative exists (Case A)	□ Separate accounting not required (Case D)
	Variable (CRUT)	□ Separate accounting not required (Case C)	□ Bifurcate or elect fair value option (Case B)	□ Bifurcate or elect fair value option (Case E)

See AAG-NFP 6.36 through AAG-NFP 6.37 for additional information on accounting for embedded derivatives.

8.7.2.6 Practical considerations when evaluating embedded derivatives

Before undertaking an analysis for a specific split-interest agreement, an NFP should consider whether any of the following circumstances apply to that arrangement. If so, the NFP does not need to assess whether the arrangement contains an embedded derivative.

- *The NFP has made an election to measure the obligation to make future payments to the other beneficiary subsequent to inception using the fair value option described in ASC 825-10.* As discussed in NP 8.7.2.2, this is the approach recommended by AAG-NFP 6.35 for subsequent measurement of all split-interest agreements. If this election has been made, any embedded derivative that might be present in the arrangement is already reported at fair value, so there would be no need to separately identify and account for it.
- *The term of the split interest agreement is based on the remaining life of an individual or individuals designated by the donor.* As discussed in NP 8.7.2.5, the obligation to the other beneficiary in this type of agreement is considered “life contingent” and thus is not subject to the requirement to separately identify any derivative that might be embedded within it.
- *The agreement is structured as a charitable remainder annuity trust (CRAT).* Under a CRAT, the NFP’s obligation is to make fixed annuity payments throughout the agreement’s term to the other beneficiary. Regardless of whether the term is period certain or life contingent, the amount of the NFP’s obligation is unaffected by changes in the value of the trust’s assets and thus, no embedded derivative exists. Although the analysis is slightly different if the arrangement’s term is based on the longer of the beneficiary’s remaining life or a specified period (and thus is both period-certain and life contingent), there is no need to evaluate the arrangement for an embedded derivative.

8.7.3 Charitable gift annuity

A charitable gift annuity is an arrangement between a donor and an NFP in which the donor contributes assets directly to the NFP in exchange for a promise by the NFP to pay a fixed amount for a specified period to the donor, or to individuals or organizations designated by the donor. The agreements are like charitable remainder annuity trusts, except that no trust exists, the assets received are held as general assets of the NFP, and the annuity liability is a general obligation of the NFP.

Figure NP 8-5 highlights the financial reporting differences between trust and non-trust charitable remainder arrangements.

Figure NP 8-5

Comparison of charitable remainder trusts to charitable gift annuities

Charitable remainder trust	Charitable gift annuity
□ The assets transferred by the donor belong to the trust	□ The assets transferred by the donor immediately become part of the general assets of the NFP
□ “Lead” and “remainder” interests in the trust are calculated	□ “Lead” and “remainder” interests are not created
□ The liability to the noncharitable beneficiary is an obligation of the trust that will be satisfied solely from trust assets (that is, it is limited to the assets in the trust)	□ The annuity liability is a general obligation of the NFP

Unless either (a) the donor has imposed purpose or time restrictions on the gift, or (b) the gift agreement or laws and regulations require the assets received by the NFP to be invested until the

income beneficiary's death, the contribution portion of a charitable gift annuity increases net assets without donor restrictions.

Actuarial changes in the annuity liability are recognized as changes in the value of split-interest agreements and classified consistent with the classification used when the contribution income was recognized initially.

State laws may require establishment of annuity reserves or other limitations on the NFP, such as limitations on the way some resources are invested. If so, those matters need to be disclosed in the notes to the financial statements.

Some NFPs voluntarily set aside additional reserves for unexpected actuarial losses. These may be presented as a separate component of board-designated net assets on the face of the statement of financial position (see NP 2) or disclosed in the notes.

8.7.4 Pooled life income fund

Some NFPs form, invest, and manage pooled (or life) income funds. These funds are divided into units, and contributions of many donors' life income gifts are pooled and invested as a group. Donors are assigned a specific number of units based on the proportion of the fair value of their contributions to the total fair value of the pooled income fund on the date of the donor's entry to the pooled fund. The donor (or another designated beneficiary) holds a life interest in the income earned (as defined under the arrangement) on those units. Upon the donor's death, the value of these assigned units reverts to the NFP. The accounting for pooled (life) income funds is an exception to the general rule that when the NFP has control over the assets, the contribution revenue is the residual amount, i.e., the difference between the liability to the other beneficiaries and the fair value of the assets received. Thus, in these arrangements, the "split" between benefits for the NFP and benefits for the noncharitable beneficiaries is accomplished differently.

When the assets are received from the donor, the NFP increases assets of the pooled (life) income fund and credits both donor-restricted contribution revenue (a calculated amount) and deferred revenue (the residual amount). Contribution revenue is calculated as the fair value of assets to be received, discounted for the time period until the donor's death. The deferred revenue is the residual resulting from subtracting contribution revenue from the assets received. The deferred revenue represents the time value of money, or the amount of the discount.

Until the donor's death, the donor (or the donor's designated beneficiary or beneficiaries) is paid the actual income (as defined under the arrangement) earned on the donor's assigned units in the pool. Subsequent to initial recognition, earnings on the assets are offset with liability to the beneficiary(ies). Those earnings and the periodic disbursements to the beneficiary are reported as increases and decreases in the liability to the beneficiary. The amortization of deferred revenue is reported in the statement of activities as *change in value of split-interest agreements*. Upon the death of the income beneficiary, the unamortized deferred revenue is also recognized as *change in value of split-interest agreements*.

8.7.5 Revocable charitable gifts

ASC 958-30-25-2 addresses the accounting for a gift agreement that is not irrevocable.

ASC 958-30-25-2

Revocable split-interest agreements shall be accounted for as intentions to give. Assets received by a not-for-profit entity (NFP) acting as a trustee under a revocable split-interest agreement shall be recognized when received as assets and as a refundable advance. If those assets are investments, they shall be recognized in conformity with Section 958-320-25, 958-321-25, or 958-325-25, as appropriate. Contribution revenue for the assets received shall be recognized when the agreement becomes irrevocable or when the assets are distributed to the NFP for its unconditional use, whichever comes first.

8.7.6 *Split-interest agreements presentation and disclosure*

According to ASC 958-30-45-7, contribution revenue and changes in the value of split-interest agreements should be presented as a separate line item in a statement of activities or the related notes.

Assets and liabilities recognized under split-interest agreements, if material, should be presented separate from other assets and liabilities in the balance sheet or disclosed in the notes (see ASC 958-30-45-6).

8.7.7 *Special types of split-interest remainder trusts*

ASC 958-30 and AAG-NFP chapter 6 contain in-depth discussions of two widely used forms of remainder trusts: charitable remainder annuity trusts and charitable remainder unitrusts. However, there are many varieties of remainder trusts which are not discussed in either authoritative GAAP or the AICPA guide. When nonstandard forms of trusts are encountered, the underlying concepts in ASC 958-30 should be applied based on the facts and circumstances of the specific arrangement.

8.7.7.1 *Net Income Remainder Trust (NIRT)*

In a NIRT, the actual income of the trust is paid to the lead beneficiary. The calculations associated with computing the beneficial interest in a NIRT are like those for CRATs and CRUTs, except that the expected payout amount used in the cash flow projections will be based on the income expected to be generated by the trust assets (as contrasted to a CRAT's fixed payment amount or a CRUT's percentage of asset values). A key consideration with NIRTs is how the trust agreement defines "income." If "income" includes all dividends, interest, rents, and net capital appreciation, the amount of cash available to be distributed to the charity when the lead interest terminates will be the amount originally contributed to the trust. If "income" is more narrowly defined to include only dividends, interest, and rents, the net capital appreciation accrues to the NFP's interest, and the estimated rate of return (growth factor) must be factored into the calculations in estimating the fair value of the remainder interest the charity will ultimately receive.

8.7.7.2 *Net Income Principal Invasion Remainder Trust (NIPIRT)*

Like a NIRT, a NIPIRT pays the income earned by the trust to the lead beneficiary; however, in addition, the trustee (at his or her discretion) can also make principal distributions to the lead beneficiary. In substance, this is a split-interest agreement where the trustee has variance power (see NP 8.6). Because the trustee has the discretion to potentially distribute all the trust assets to the lead beneficiary, the charity does not have an unconditional right to cash flows from the trust. In accordance with ASC 958-30-25-18, NIPIRTs should be accounted for similar to conditional promises

to give; that is, we believe no asset or contribution revenue should be recorded until the lead interest terminates and the amount of remainder interest becomes known.

Excerpt from ASC 958-30-25-18

However, if the trustee or fiscal agent has variance power to redirect the benefits to another entity or if the NFP's rights to the benefits are conditional, the NFP shall not recognize its potential for future distributions from the split-interest agreement until the NFP has an unconditional right to receive benefits under the agreement.

8.7.7.3 *Limited Net Income Principal Invasion Remainder Trust*

A limited NIPIRT similarly pays the lead beneficiary the earnings of the trust; however, the trustee's discretionary authority to invade principal is limited to a specified maximum annual amount. Under a limited NIPIRT, a portion of the remainder interest will be contingent on the extent to which the trustee makes (or does not make) distributions from principal. However, it is possible for the NFP to estimate the maximum principal invasion (and thus, the minimum value of the remainder interest) based on the maximum annual distribution amount and the expected lifespan of the noncharitable beneficiary. The NFP's right to receive the minimum value of the remainder interest is unconditional; thus, a beneficial interest in a limited NIPIRT should initially be recorded based on the minimum value of the remainder interest at the time the NFP is notified of the trust's existence. Subsequently, the value of the split-interest should be adjusted based on the pattern of actual principal distributions (if any) that are made by the trustee.

8.7.7.4 *"Lead-and-Remainder" Trust*

Under this type of trust, the NFP is the beneficiary of both the lead and the remainder interests. In essence, this is a term endowment held by a third party. The NFP receives the income earned from the trust assets during the life of the trust; when the trust term expires, the NFP receives the remaining assets. The most accurate valuation technique to use in recording a beneficial interest in this type of trust is a present value technique that discounts the stream of estimated annual payments and eventual distribution of the remainder interest.

Chapter 9:

Accounting for investments

9.1 Overview—accounting for investments

This chapter discusses the guidance used by NFPs in accounting for investments in for-profit entities, including equity securities, as well as investments in debt securities and nonfinancial assets. This guidance differs significantly in certain respects from the model applied by business entities, particularly with respect to investments in equity instruments. The primary differences arise from legacy guidance carried forward from AICPA audit and accounting guides for various subtypes of NFPs.

GAAP contains three models for NFP investment accounting:

- investments by NFP HCOs (which closely resembles the accounting used by business entities)
- investments in entities that are a component of a non-HCO NFP's operations ("operating investments")
- investments entered into by a non-HCO NFP to generate investment return ("portfolio investments")

A unique feature of the model for portfolio investments is an option to measure all investments in the portfolio at fair value, which, among other things, provides exceptions to consolidation of certain investments that are not available to business entities.

Some NFPs enter into specialized investments with their constituents as part of their charitable mission (for example, certain social investments). For information on accounting for these investments (sometimes referred to as "programmatic investments"), see chapter 8 of the AAG-NFP.

This chapter explains the NFP investment accounting models and highlights differences from the general investment accounting guidance applied by business entities. It also discusses the Uniform Prudent Management of Institutional Funds Act (UPMIFA)—a model rule that underpins key accounting considerations related to donor-restricted endowments.

Recent standard setting

Many of the historic differences in accounting for noncontrolling equity investments (between NFPs and business entities, as well as among different types of NFPs) were eliminated by issuance of ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. LI 1.3 provides a high-level overview of the ASU's amendments affecting investment accounting. Detailed guidance regarding the standard is contained throughout the PwC *Loans and investments* guide.

The ASU eliminates use of the cost method of accounting for investments and replaces it with an expanded use of fair value measurement. For NFPs that avail themselves of the portfolio-wide fair value measurement option in connection with total return investing of endowment funds, a new measurement alternative is available which, if elected, can be used to simplify fair value measurement of certain hard-to-measure investments.

For NFPs (including conduit bond obligors), ASU 2016-01 was effective for annual reporting periods beginning after December 15, 2018 and interim periods beginning after December 15, 2019. See LI 13.3 for information on transition provisions.

This chapter incorporates the guidance in ASU 2016-01. In areas where ASU 2016-01 resulted in significant changes, a description of the legacy accounting guidance is also provided. Those areas are indicated by section headings that include an “A.” For example, NP 9.2.3A discusses the accounting requirements for alternative investments prior to an entity’s adoption of ASU 2016-01, while NP 9.2.3 discusses the accounting requirements for those investments in accordance with ASU 2016-01.

9.2 *Principal sources of NFP-specific GAAP*

ASC 958 contains extensive NFP-specific guidance on accounting for investments. In certain respects, this guidance differs significantly from the guidance applied by most business entities. This is due in part to NFPs’ use of a single, voting interest model for assessing consolidation of related entities (i.e., NFPs are not subject to the variable interest entity guidance in ASC 810), and due partly to specialized guidance developed for donor-restricted endowment funds (i.e., donor gifts that require investment in perpetuity).

This section provides brief summaries of the investment accounting subsections within ASC 958-810 and ASC 954-810.

9.2.1 *Consolidation and equity method for equity interests*

ASC 810-10, *Consolidation*, describes two models used to evaluate relationships for consolidation: the voting interest entity (VOE) model and the variable interest entity (VIE) model. The variable interest entity model is described in the VIE subsections of ASC 810-10, and the voting interest model is described in the “general” subsections.

NFPs apply only the voting-interest model (that is, a model based on voting rights) and, therefore, disregard the guidance in the VIE subsections of ASC 810-10 (see CG 2.1.2.1). In addition, significant adjustments are required when applying the VOE guidance in the general subsections of ASC 810-10 to NFPs, summarized as follows:

- For business entities, the VOE model described in the general subsections of ASC 810-10 applies only if the VIE model cannot be applied. Said differently, when evaluating consolidation, business entities first consider whether the variable interest model applies and if it does not, they apply the voting interest model. NFPs, on the other hand, disregard any provisions that reference the need to first consider the VIE model.
- NFPs evaluate consolidation of limited partnerships using NFP-specific requirements in ASC 958-810, rather than the VOE guidance in the general subsections of ASC 810-10. Therefore, NFPs apply the guidance in the general subsections of ASC 810-10 only when evaluating potential consolidation of entities *other than* limited partnerships. References to limited partnerships in the general subsections of ASC 810-10 generally are disregarded, with limited exceptions described in NP 9.8.

These NFP-specific variations of the consolidation guidance are housed in incremental guidance in ASC 958-810, *Not-for-profit entities—consolidation*, and ASC 954-810, *Health care entities—consolidation*. The nucleus of this guidance is ASC 958-810-15-4 (and for NFP HCOs, ASC 954-810-15-3) and a companion flow chart in ASC 958-810-55-4, which directs NFPs to appropriate sections of the codification that address consolidation and application of the equity method in various ownership scenarios.

ASC 958-810 also contains an NFP-specific option for electing fair value measurement of certain investments that is widely applied by NFPs other than NFP HCOs, which are not permitted to apply it. This option, often referred to as the *portfolio-wide fair value option*, facilitates the reporting and administration of investment portfolios for which a total-return investing strategy is used. NP 9.3 explains the portfolio-wide fair value option and the types of investments that are within its scope.

9.2.2 *Investments in equity interests*

ASC 321, *Investments – equity securities*, addresses the accounting and reporting for ownership interests in other entities that are not required to be consolidated or reported using the equity method. Equity interests that are not securities (such as investments in partnerships, unincorporated joint ventures, and limited liability companies) are also within its scope and are accounted for as if they were equity securities. The accounting requirements are described in NP 9.7.3.

ASC 958-321, *Not-for-profit entities – equity securities*, provides incremental NFP-specific guidance regarding:

- equity interests acquired by gift,
- reporting measurement changes under NFP financial reporting requirements, and
- equity interests held in an agency capacity.

9.2.3 *Other investments*

ASC 958-325 and ASC 954-325 provide guidance on accounting for investments in nonfinancial assets such as real estate, oil and gas interests, or intangible assets when those assets are acquired for purposes of earning investment return. They do not apply to similar assets acquired in connection with carrying out the NFP's activities, such as financing receivables, programmatic loans (as described in chapter 8 of AAG-NFP) or real estate held within PP&E.

For NFP HCOs, ASC 954-325-35-1 requires subsequent reporting of investments in nonfinancial assets at amortized cost subject to impairment considerations for PP&E, consistent with those in ASC 360-10, *Property, plant, and equipment*.

For NFPs other than HCOs, measurement of nonfinancial investments that GAAP does not require to be measured at fair value is based on the portfolio-wide accounting policy selected for reporting investments, as explained in NP 9.3. The method selected (carrying value or fair value) must be consistently applied to all alternative investments within a portfolio. ASC 958-325 carries forward guidance from legacy AICPA guidance for different subsets of NFPs, with applicable amendments by subsequent FASB standards.

Figure NP 9-1 summarizes the guidance for various subsets of NFPs.

Figure NP 9-1

ASC 958-325-35 subsequent measurement guidance for investments in nonfinancial assets

NFP subset	ASC 958-325 paragraphs	Portfolio-wide measurement options		Impairment evaluation guidance for cost-based option
Higher education institution	35-1 – 35-2	Fair value	Cost ¹	ASC 958-325-35-1(a)
Voluntary health and welfare entities	35-3 – 35-5	Fair value	Cost	ASC 958-325-35-5
Other NFPs	35-6 – 35-7	Fair value	Lower of cost or fair value	ASC 958-325-35-7

¹ Investments in wasting assets are usually reported net of an allowance for depreciation or depletion.

9.2.4 Debt securities

NFPs apply guidance in ASC 958-320, *Not-for-profit entities—investments—debt securities*, instead of the guidance in ASC 320. ASC 958-320 addresses the accounting and reporting for all investments in debt securities held by NFPs. The scope and definitions are consistent with the guidance for business entities in ASC 320; however, significant differences from the ASC 320 model include:

- NFPs (other than HCOs) are not required to classify debt securities into categories (i.e., trading, available-for-sale, held-to-maturity), and
- all debt securities are carried at fair value; NFPs cannot use amortized cost.

For NFP HCOs, incremental guidance in ASC 954-320 tailors the guidance in ASC 958-320 to describe how debt securities would be classified using “trading” and “other than trading” (i.e., available-for-sale) categories. Other NFPs that desire to more closely parallel business entity reporting may voluntarily classify debt securities into categories using the NFP HCO classification parameters.

NFP HCOs (and other NFPs that voluntarily classify debt securities into categories) should look to ASC 320-10-15-4 for guidance on evaluating impairment.

ASC 320-10-15-4

Paragraphs 320-10-35-17 through 35-34 provide guidance on identifying and accounting for impairment of certain securities and identify the scope application of that guidance to not-for-profit entities (NFPs). No other part of this Topic applies to NFPs. Subtopic 958-320 establishes standards for investments in debt securities by NFPs.

9.2A *Principal sources of industry-specific GAAP (prior to adoption of ASU 2016-01)*

ASC 958 contains extensive NFP-specific guidance on accounting for investments. In certain respects, this guidance differs significantly from the guidance applied by most business entities. This is due in part to an NFP's use of a single, voting interest model for assessing consolidation of related entities (i.e., NFPs are not subject to the variable interest entity guidance in ASC 810), and due partly to specialized guidance developed for donor-restricted endowment funds (i.e., donor gifts that require investment in perpetuity).

This section provides brief summaries of the investment accounting subsections contained within ASC 958-810 and ASC 954-810.

9.2.1A *Consolidation and equity method*

ASC 810-10, *Consolidation*, describes two models used to evaluate relationships for consolidation: the voting interest entity (VOE) model and the variable interest entity (VIE) model. The variable interest entity model is described in the VIE subsections of ASC 810-10, and the voting interest model is described in the “general” subsections.

NFPs apply only the voting interest model (that is, a model based on voting rights), and, therefore, disregard the guidance in the VIE subsection of 810-10 (see CG 2.1.2.1). In addition, significant adjustments are required when applying the VOE guidance in the general subsections of ASC 810-10 to NFPs, summarized as follows:

- For business entities, the VOE model described in the general subsections of ASC 810-10 apply only if the VIE model cannot be applied. Said differently, when evaluating consolidation, business entities first consider whether the variable interest model applies and only if it does not, do they apply the voting interest model. NFPs, on the other hand, disregard any provisions that reference the need to first consider the VIE model.
- NFPs evaluate consolidation of limited partnerships using NFP-specific requirements in ASC 958-810, rather than the VOE guidance in the general subsections of ASC 810-10. Therefore, NFPs apply the guidance in the general subsections of ASC 810-10 only when evaluating potential consolidation of entities *other than* limited partnerships. References to limited partnerships in the general subsections of ASC 810-10 generally are disregarded, with limited exceptions (identified in NP 9.8).

The NFP-specific variations of the consolidation guidance are housed in incremental guidance in ASC 958-810, *Not-for-profit entities—consolidation*, and ASC 954-810, *Health care entities—consolidation*. The nucleus of this guidance is ASC 958-810-15-4 (and for NFP HCOs, ASC 954-810-15-3) and a companion flow chart in ASC 958-810-55-4, which directs NFPs to appropriate sections of the codification that address consolidation and application of the equity method in various ownership scenarios.

9.2.2A *Equity securities with readily determinable fair value and debt securities*

ASC 958-320, *Not-for-profit entities—Investments—debt and equity securities*, addresses the accounting and reporting for (1) investments in equity securities with readily determinable fair value

that either (a) do not result in consolidation or (b) are not reported using the equity method, and (2) all investments in debt securities. NFPs apply this guidance instead of the guidance in ASC 320. The scope and definitions are consistent with those of ASC 320 prior to the effective date of ASU 2016-01. Significant differences from the ASC 320 model include:

- NFPs (other than HCOs) are not required to classify these securities into categories (i.e., trading, available-for-sale).
- All securities are carried at fair value.

For NFP HCOs, incremental guidance in ASC 954-320 tailors the guidance in ASC 958-320 to more closely resemble the business entity reporting model in ASC 320. NFP HCOs must classify their securities using “trading” and “other-than-trading” (i.e., available-for-sale) categories so that investment gains, losses, and impairments are included in or excluded from the performance indicator in the same manner as those items would be included in or excluded from net income of a business entity. Because of the overarching requirement in ASC 958-320 to carry all securities at fair value, use of the held-to-maturity classification (which permits measurement of debt securities using an amortized cost basis for business entities) is not permitted for NFPs or HCOs. For securities classified as other than trading, changes in fair value are reported below the performance indicator (consistent with the reporting of such items in other comprehensive income by business entities). ASC 954-320-55 illustrates the accounting and reporting considerations for other-than-trading securities. Other NFPs desiring to more closely parallel business entity reporting may voluntarily classify securities into categories using the NFP HCO classification parameters.

Neither ASC 958 nor ASC 954 provide guidance on evaluating impairment of securities carried at other than fair value; thus, NFP HCOs (and other NFPs that voluntarily classify securities into categories) look to ASC 320-10 for that guidance, as required by ASC 320-10-15-4 and ASC 954-320-35-1.

ASC 320-10-15-4

Paragraphs 320-10-35-17 through 35-34 provide guidance on identifying and accounting for impairment of certain securities and identify the scope application of that guidance to not-for-profit entities (NFPs). No other part of this Topic applies to NFPs. Subtopic 958-320 establishes standards for investments in debt and equity securities by NFPs.

9.2.3A Other investments

ASC 958-325, *Not-for-profit entities—Investments—other*, provides incremental industry-specific guidance for NFPs (other than NFP HCOs) on accounting for certain investments entered into for purposes of generating investment return. This includes investments in equity instruments that do not have readily determinable fair values and are not consolidated or accounted for using the equity method, mortgage notes that are not debt securities, interests in venture capital funds, partnership interests, oil and gas interests, and real estate.

This specialized guidance is incremental to the guidance in ASC 325, *Investments—other*, which all NFPs apply when accounting for “cost method” investments made in carrying out the NFP’s mission-based activities, such as investments in operating joint ventures.

The specialized guidance in ASC 958-325 facilitates the reporting and administration of investment portfolios for which a total-return investing strategy is used, such as endowment portfolios. It requires NFPs to make an accounting policy choice between accounting for “alternative investments” based on either their fair values or their carrying values. The method selected must be consistently applied to all alternative investments within a portfolio. The requirement to value all alternative investments using the same measurement basis effectively establishes a portfolio-wide fair value option for NFPs other than HCOs (discussed further at NP 9.3), which is widely applied.

The measurement guidance differs slightly among subsets of NFPs. ASC 958-325 carries forward legacy AICPA accounting guidance for various subsets of NFPs for alternative investments, amended as necessary by subsequent FASB standards.

Figure NP 9-1A summarizes the accounting models for the various NFP subsets.

Figure NP 9-1A

ASC 958-325-35 subsequent measurement guidance

NFP subset	ASC 958-325 paras.	Portfolio-wide measurement options		Impairment evaluation guidance for cost-based option	
				Equity interests	Other assets
Higher education institution	35-1 – 35-2	Fair value	Cost ¹	ASC 958-325-35-8 through ASC 958-325-35-13	ASC 958-325-35-1(a)
Voluntary health and welfare entities	35-3 – 35-5	Fair value	Cost	ASC 958-325-35-8 through ASC 958-325-35-13	ASC 958-325-35-5
Other NFPs (excluding HCOs)	35-6 – 35-7	Fair value	Lower of cost or fair value	ASC 958-325-35-8 through ASC 958-325-35-13	ASC 958-325-35-7

¹ According to ASC 958-325-35-2, investments in wasting assets are usually reported net of an allowance for depreciation or depletion

ASC 954-325, *Health care entities—other*, requires NFP HCOs to report investments in assets that are not financial instruments using amortized cost.

9.3 Fair value measurement options

NFPs can make accounting policy elections to measure certain investments at fair value when a different measurement basis otherwise is required by GAAP. For example, the “Fair Value Option” subsections of ASC 825-10 can be elected in order to measure certain investments at fair value as an alternative to applying the equity method (or cost method, prior to adoption of ASU 2016-01). All NFPs are eligible to use this instrument-by-instrument option, which is further discussed in FV 5.

In addition, NFPs (except for NFP HCOs within the scope of ASC 954) can use an NFP-specific option that applies to portfolios of investments, rather than to individual investments. If that election is made for a portfolio, all eligible investments within it for which a measurement basis other than fair value would be required are reported at fair value. Often referred to as the *portfolio-wide fair value option* (PWFVO), it facilitates the reporting and administration of investment portfolios for which a total-return investing strategy is used (for example, endowment portfolios).

The PWFVO's scope is limited to investments entered into for purposes of earning investment return. It cannot be applied to investments entered into in connection with carrying out the NFP's operating activities (for example, participation in joint ventures). The election is "all or nothing" with respect to a portfolio; an NFP cannot choose to report some of the eligible investments within the portfolio at fair value while excluding others.

Figure NP 9-2 contrasts the PWFVO to the ASC 825-10 general fair value option (FVO).

Figure NP 9-2

Comparison of NFP portfolio-wide fair value option to ASC 825-10 fair value option

NFP PWFVO (ASC 958)	General FVO (ASC 825-10)
<input type="checkbox"/> Cannot be applied by NFP HCOs	<input type="checkbox"/> Can be applied by all NFPs
<input type="checkbox"/> Can only be applied to investments that are part of a portfolio held to generate investment return	<input type="checkbox"/> Can be applied to any investment that is a financial asset
<input type="checkbox"/> Cannot be used to measure interests in investees that are part of the NFP's operating activities (e.g., interests in joint ventures)	
<input type="checkbox"/> Can be applied to investments in nonfinancial assets (e.g., real estate)	<input type="checkbox"/> Limited to investments that are financial assets
<input type="checkbox"/> Can be applied to interests in limited partnerships that otherwise would require consolidation	<input type="checkbox"/> Cannot be applied to any investment that would otherwise require consolidation
<input type="checkbox"/> Cannot be applied to any other form of controlling investment	
<input type="checkbox"/> Applies to all eligible investments within a portfolio – no "cherry-picking"	<input type="checkbox"/> Instrument-by-instrument election
<input type="checkbox"/> Accounting policy decision that may be changed, subject to the guidance in ASC 250, <i>Accounting Changes</i> , concerning preferability	<input type="checkbox"/> Election is irrevocable

For more information on specific accounting implications of the PWFVO, see NP 9.3.1.

9.3.1 *Investments eligible for the portfolio-wide fair value option*

The portfolio-wide fair value option is described in ASC 958-810-15-4(e). The following types of investments are eligible for fair value measurement under the portfolio-wide option:

- All limited partnership interests (i.e., both general partner and limited partner interests) for which consolidation or application of the equity method would otherwise be required
- Noncontrolling equity interests in entities other than limited partnerships for which application of the equity method would otherwise be required. Controlling financial interests in entities other than limited partnerships must be consolidated.
- Nonfinancial investments such as real estate (see ASC 958-325-15-2)

For all other equity interests, measurement at fair value is required by ASC 321 and thus, the fair value option is not needed.

9.3.1A *Investments eligible for the portfolio-wide fair value option (prior to adoption of ASU 2016-01)*

Prior to the effective date of ASU 2016-01, the portfolio-wide option is established by an accounting policy choice described in NP 9.2.3A.

The following types of investments are eligible for fair value measurement under the portfolio-wide option:

- All limited partnership interests (that is, both general partner and limited partner interests) for which consolidation or application of the equity method would otherwise be required
- Noncontrolling equity interests in entities other than limited partnerships for which application of the equity method would otherwise be required. (Controlling financial interests in entities other than limited partnerships must be consolidated.)
- Equity interests without readily determinable fair values that are not accounted for under the equity method or required to be consolidated (that is, equity interests within the scope of ASC 958-325, *Other investments*)
- Nonfinancial investments such as real estate (see ASC 958-325-15-2)

9.4 *Investments in debt securities*

A debt security is an investment that represents a creditor relationship with the issuer. The Master Glossary includes a list of items that are and are not debt securities. However, neither list is all inclusive. While the legal classification of the security can be a factor in determining whether the security meets the accounting definition, the definition in ASC 320 is based on the Uniform Commercial Code at the time the guidance was developed more than 20 years ago, and may not be consistent with the legal definition of a security today. For more information on the definition of a security and on the types of instruments covered by this definition, see LI 3.2.2. When accounting for these investments, NFPs apply the guidance in ASC 958-320 rather than ASC 320.

ASC 958-320-30-1 describes the initial and subsequent measurement of debt securities.

Excerpt from ASC 958-320-30-1

A debt security shall be initially measured at its acquisition cost...if it is purchased. It shall be initially measured at fair value if it is received as a contribution or through an agency transaction.

Excerpt from ASC 958-320-35-1

All investments in debt securities shall be measured at fair value in the statement of financial position.

Under ASU 2016-01, acquisition cost excludes brokerage and other transaction fees; prior to adoption of the ASU, brokerage and other transaction fees are included in initial measurement.

Subsequent to initial recognition, debt securities are measured at fair value in accordance with ASC 820 at each reporting date. Changes in fair value are reflected in the appropriate category of net assets (i.e., with or without donor restrictions). See NP 9.11 for additional information on reporting of investment return.

For NFP HCOs, incremental guidance in ASC 954-320 tailors the guidance in ASC 958-320 to more closely resemble the business entity reporting model in ASC 320. NFP HCOs must classify their debt securities as “trading” or “available for sale” (or “other than trading”); gains, losses, and impairments are included in or excluded from the performance indicator based on those designations in the same manner as those items would be included in or excluded from net income of a business entity. Because of the overarching requirement in ASC 958-320 to carry all debt securities at fair value, use of the held-to-maturity classification (which permits business entities to measure debt securities using an amortized cost basis) is not permitted for NFPs. Changes in fair value of available-for-sale debt securities that are part of net assets without donor restrictions are reported below the performance indicator. All other changes in value related to debt securities included in net assets without donor restrictions, including realized gains and losses and impairment losses, are included in the performance indicator. Other NFPs wishing to more closely parallel business entity reporting may voluntarily classify debt securities into categories using the NFP HCO classification parameters.

LI 8 discusses the application of the available-for-sale debt security impairment model in accordance with ASC 326-30.

9.5 *Equity interests—general requirements*

Equity interests are investments that represent ownership interests in another entity, such as common stock, partnership interests, and interests in limited liability companies (LLCs).

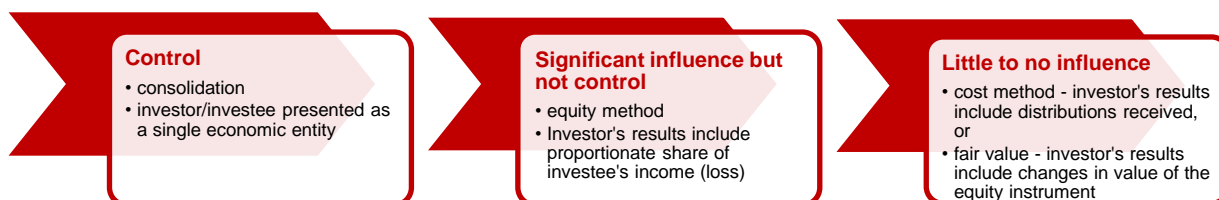
Equity interests acquired by purchase are initially measured at their acquisition cost, and interests acquired by contribution are initially measured at fair value. Under ASU 2016-01, acquisition cost excludes brokerage and other transaction fees; prior to adoption of the ASU, brokerage and other transaction fees were included in initial measurement.

Subsequent to acquisition, equity interests are accounted for by either (a) consolidating the investee, (b) applying the equity method, or (c) periodically remeasuring the investment to fair value. Prior to an entity’s adoption of ASU 2016-01, a fourth approach – the cost method – must also be considered.

Within the NFP financial reporting model, these approaches view the economic relationship between the investor and investee along a spectrum of rights granted to the investor through ownership. Figure NP 9-3 illustrates this spectrum.

Figure NP 9-3

Spectrum of economic relationships underlying the investment accounting approaches



A hierarchy exists regarding the order in which these approaches must be considered. An investor begins by considering the most substantial potential economic relationship—that is, whether the investor controls the investee, meaning that the investor can control the direction of the investee's management and policies to such an extent that the entities should be presented as a single economic entity (consolidation). If that is the case, the investor includes the investee's assets, liabilities, revenues, and expenses in its own financial statements. The next type of relationship considered is whether the investor can significantly influence the operating and financial policies of the investee. If so, a portion of the investee's income or loss earned should be included in the investor's activities for the period (equity method). If neither of those relationships exists, the investor recognizes income as the value of the investment changes (fair value), or, prior to the adoption of ASU 2016-01, only when it receives distributions from the investee (the cost method).

In some cases, application of the hierarchy's requirements can be overcome by adopting one or more fair value measurement options, discussed in NP 9.3. For example, an NFP that adopts the PWFVO or the general fair value option in ASC 825-10 is permitted to apply fair value measurement to an investment that would otherwise require application of the equity method. NP 9.6 provides further information on the interaction of the PWFVO with the hierarchy of approaches. NP 9.7, NP 9.8, and NP 9.9 discuss application of the hierarchy to investments in common stock, interests in limited partnerships, and LLC interests, respectively.

9.6 Investment portfolios carried at fair value

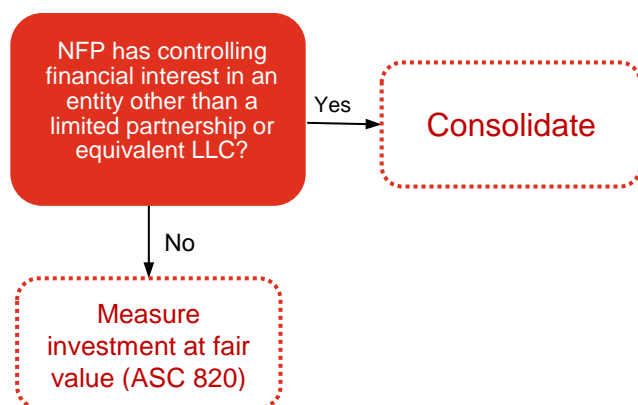
As discussed at NP 9.3, NFPs (other than NFP HCOs) can elect fair value measurement of investments in a portfolio held for the objective of earning investment return (current income, capital appreciation, or both). This election is referred to as the portfolio-wide fair value option, or PWFVO. In our view, the PWFVO's scope is limited to investments entered into for purposes of earning investment return; it should not be applied to investments made for purposes of carrying out the NFP's operating mission.

When this approach is taken, the spectrum of accounting approaches for equity interests in Figure NP 9-3 (in NP 9.5) is largely disregarded, and the model is highly simplified.

Figure NP 9-4 illustrates the accounting for equity interests in portfolios for which the PWFVO has been elected.

Figure NP 9-4

Decision tree—accounting for equity interests under the portfolio-wide fair value option

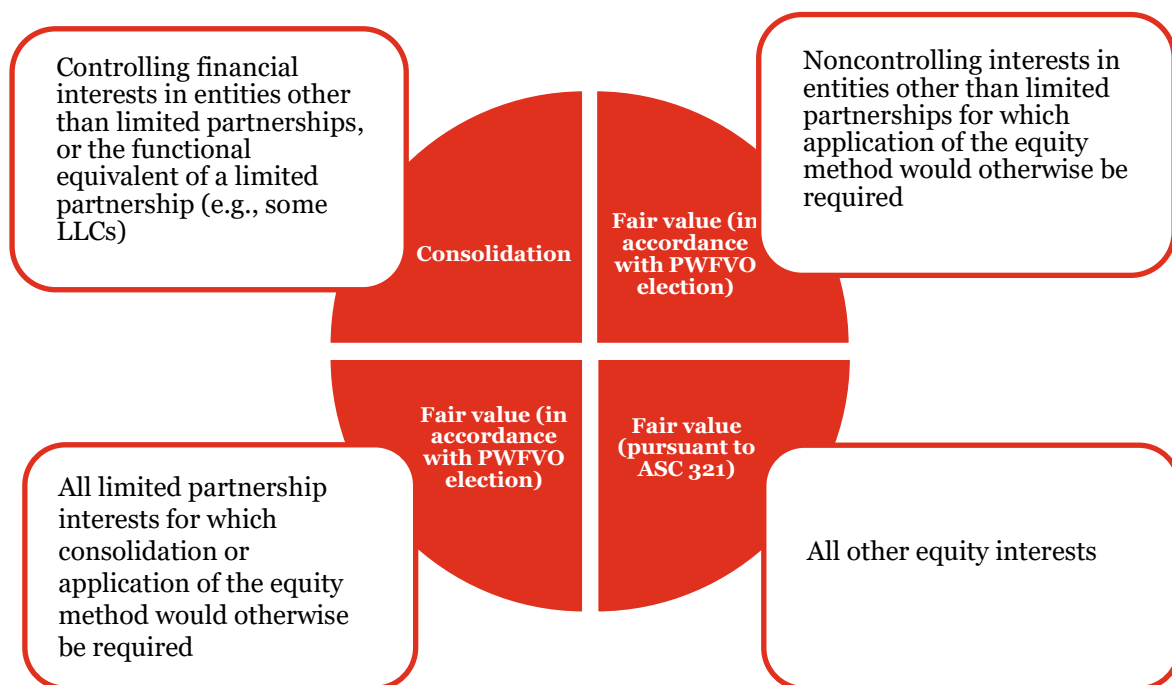


For equity interests in the form of shares of common stock, an NFP must evaluate whether consolidation is required (see NP 9.7.1). If not, fair value measurement can be used. For equity interests in limited partnerships, fair value measurement is used regardless of the level of ownership or extent of control. For equity interests in limited liability companies, the ability to use fair value measurement depends on whether the LLC is the functional equivalent of a corporation or is more like a limited partnership, as discussed in NP 9.9.1.

Figure NP 9-5 depicts the measurement of various equity interests within a portfolio subject to a PWFVO election.

Figure NP 9-5

Measurement approaches for investments in a portfolio subject to a PWFVO election



Equity interests measured at fair value under the PWFVO are generally reported at fair value on a recurring basis. Fair value is determined in accordance ASC 820. However, for investments in funds that have the characteristics of an investment company (as specified in ASC 946, such as hedge funds, private equity funds, and the like), the fair value of the investment can be measured by reference to the net asset value (NAV) reported by the investee, as long as certain disclosures regarding the investment's nature and risk are provided by the investor. This "NAV practical expedient," which is an accounting policy election, is described in ASC 820-10-35-59. FV 6.2.6 discusses the NAV practical expedient and the circumstances in which it can be elected.

ASC 321 provides a measurement alternative for equity investments within its scope that do not have readily determinable fair values and do not qualify for the NAV practical expedient. For those investments, if the measurement alternative is elected, an entity will measure the investment at cost, less any impairment, adjusted for changes (increases or decreases) in value based on observable transactions in an orderly market for the identical or a similar investment of the same issuer. For additional information on the measurement alternative, see NP 9.7.3.

Example NP 9-1 illustrates the analysis for an NFP that wishes to use the ASC 321 measurement alternative for qualifying investments within the portfolio.

EXAMPLE NP 9-1

Using the ASC 321 measurement alternative for an investment in a portfolio for which PWFVO has been elected

University has an endowment portfolio for which the ASC 958-810 portfolio-wide fair value option has been elected. All of the portfolio's investments are measured at fair value except for those that require consolidation (i.e., investments of common stock or functionally-equivalent LLC interests that represent a controlling financial interest). University wants to use the measurement alternative in ASC 321 for qualifying investments.

University acquires the following investments for the portfolio:

- Common stock representing a 10% interest in the investee
- A general partner interest in a limited partnership in which no substantive rights are granted to the limited partners
- A limited partner interest in a real estate partnership that provides substantive kick-out rights, but the University holds less than a majority of the limited partner interests that have substantive kick-out rights
- A limited partner interest in a non-real estate partnership which provides no substantive rights to limited partners

For which of these investments can University consider using the measurement alternative in ASC 321?

Analysis

The measurement alternative is only available for qualifying investments that are within the scope of ASC 321 (see NP 9.6). Even though University has elected the PWFVO, the analysis of whether the measurement alternative in ASC 321 can be applied depends on the nature of the individual investment. University's analysis of these four investments would likely conclude as follows.

- *10% common stock holding.* Based on the guidance discussed in NP 9.5, neither consolidation nor application of the equity method would be required for this investment; thus, it is within the scope of ASC 321. If the stock meets the ASC 321 criteria for using the measurement alternative described in LI 2.3.2 (i.e., it does not have a readily-determinable fair value; it does not qualify for use of the NAV practical expedient; and the fair value option under ASC 825 was not elected), University would be permitted to measure this investment using the measurement alternative.
- *General partner interest in limited partnership.* Outside of the PWFVO, consolidation of a general partner interest would be required based on the guidance in ASC 958-810. Because the use of fair value measurement is based on the PWFVO in ASC 958-810 (and not ASC 321), we do not believe the measurement alternative would be available, consistent with our views on interests for which fair value measurement has been elected under the ASC 825-10 fair value option (see LI 2.3.2).
- *Limited partner interest in real estate partnership.* Outside of the PWFVO, this investment would be within the scope of ASC 321 neither consolidation nor equity method accounting is required, analyzed as follows:

- Although the limited partners hold substantive kick-out rights, the University does not own a majority of the limited partnership interests and therefore this interest would be noncontrolling (and thus, not require consolidation).
 - To determine whether the equity method would otherwise apply, the key determination is whether the interest would be viewed as “more than minor” or “minor” under the requirements of ASC 958-810-15-4(d), which is discussed in NP 9.8.3. Judgment should be applied based on the specific facts and circumstances of the investment. If the interest is “more than minor,” application of the equity method would have otherwise been required. In that case, because the use of fair value measurement is based on the PWFVO election in ASC 958-810, we do not believe the measurement alternative would be available. If the interest is “minor,” on the other hand, the investment would fall within the scope of ASC 321, and the measurement alternative would be available.
- *Limited partner interest in non-real estate partnership.* Outside of the PWFVO, this investment would be within the scope of ASC 321 if neither consolidation nor equity method accounting is required, analyzed as follows:
- Because University has no substantive kick-out rights in the partnership, its interest is noncontrolling (and thus, not require consolidation).
 - Under the guidance for noncontrolling interests in limited partnerships other than real estate partnerships, the interest would be within the scope of ASC 321 and, therefore, eligible for use of the measurement alternative. For further information about the evaluation of this type of investment outside of the PWFVO, see NP 9.8.3.1.

Question NP 9-1 addresses whether NFPs need to segregate equity interests measured at fair value based on ASC 321 from those for which fair value measurement is based on the PWFVO.

Question NP 9-1

University A holds equity interests in its portfolio that are not required to be consolidated and has elected the PWFVO. For accounting purposes, must University A distinguish the equity interests in the portfolio that are within the scope of ASC 321 from those that are not?

PwC response

From a practical perspective, the answer is no, unless University A wishes to apply the measurement alternative in ASC 321. This is because the measurement alternative is not available for investments that are outside the scope of ASC 321 (i.e., equity interests that would otherwise need to be consolidated or reported using the equity method if they were outside the portfolio subject to the PWFVO election). Under both ASC 321 and the PWFVO in ASC 958-810, investments are measured at fair value on a recurring basis in accordance with ASC 820 and are subject to the same disclosure requirements.

9.6A Investment portfolios carried at fair value (prior to adoption of ASU 2016-01)

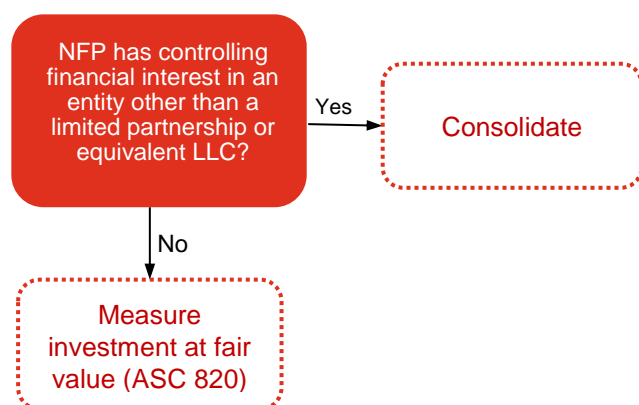
As discussed at NP 9.3, NFPs (other than NFP HCOs) can elect to measure investments in a portfolio held for the objective of earning investment return (current income, capital appreciation, or both) at fair value. This election is referred to as the portfolio-wide fair value option, or “PWFVO.” In our view, the PWFVO’s scope is limited to investments entered into for purposes of earning investment return; it should not be applied to investments made for purposes of carrying out the NFP’s operating mission.

When this approach is taken, the spectrum of accounting approaches for equity interests in Figure NP 9-3 (in NP 9.5) is largely disregarded, and the model is highly simplified.

Figure NP 9-4A illustrates the accounting for equity interests in portfolios for which the PWFVO has been elected.

Figure NP 9-4A

Decision tree—accounting for equity interests under portfolio-wide fair value option

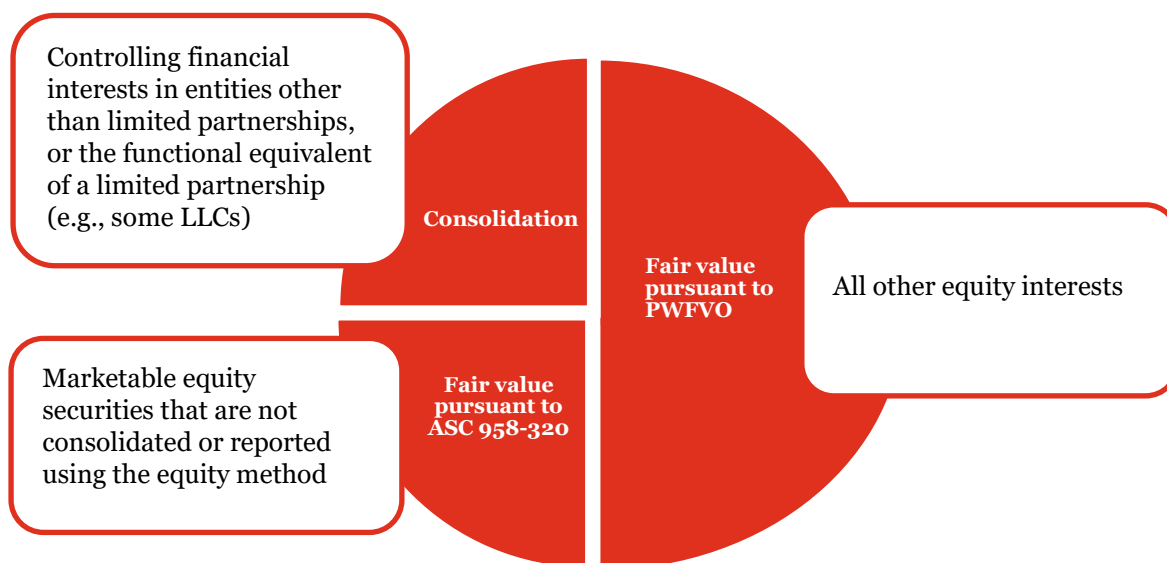


For equity interests in the form of shares of common stock, an NFP must evaluate whether consolidation is required (see NP 9.7.1). If not, fair value measurement can be used. For equity interests in limited partnerships, fair value measurement is used regardless of the level of ownership or extent of control. For equity interests in limited liability companies, the ability to use fair value measurement depends on whether the LLC is the functional equivalent of a corporation or is more like a limited partnership, as discussed in NP 9.9.1.

Figure NP 9-5A depicts the measurement of various equity interests within a portfolio subject to a PWFVO election.

Figure NP 9-5A

Measurement approaches for investments in a portfolio subject to a PWFVO prior to adoption of ASU 2016-01



Equity interests measured at fair value under the PWFVO are reported at fair value on a recurring basis. Fair value is determined in accordance ASC 820. However, for investments in funds that have the characteristics of an investment company specified in ASC 946 (such as hedge funds, private equity funds, and the like), fair value of the investment can be measured by reference to the net asset value (NAV) reported by the investee, as long as certain disclosures regarding the investment's nature and risk are provided by the investor. This so-called "NAV practical expedient," which is an accounting policy election described in ASC 820-10-35-59. FV 6.2.6 discusses the NAV practical expedient and the circumstances in which it can be elected.

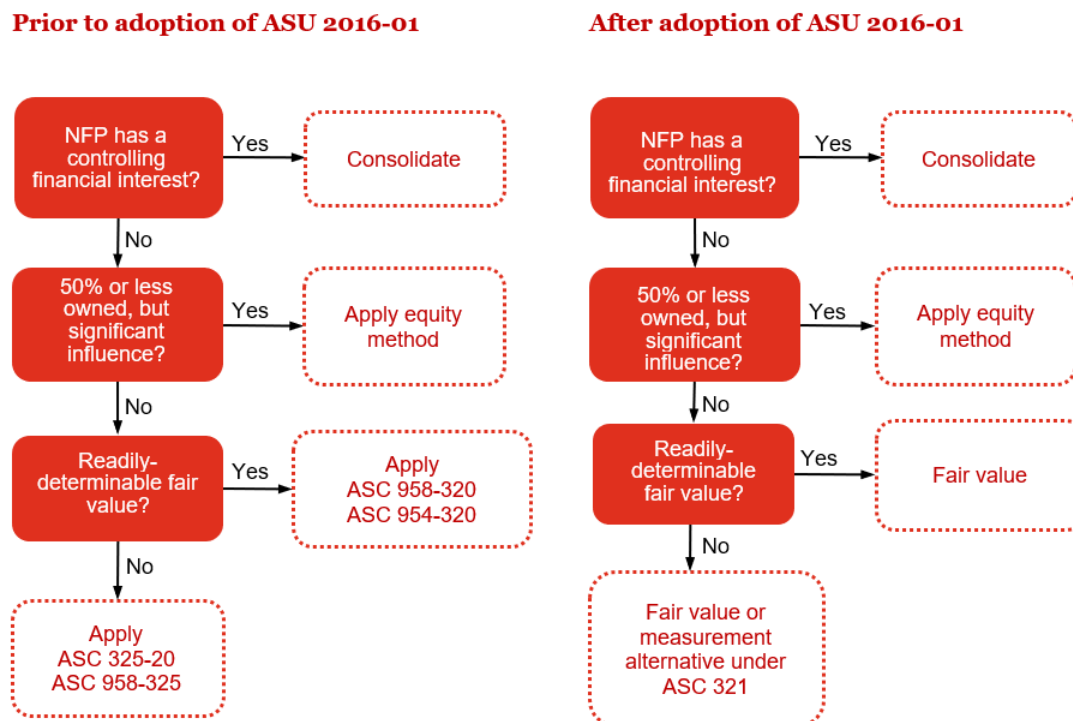
9.7 Common stock and interests in certain LLCs

This section discusses application of the general accounting requirements described in NP 9.5 to investments in common stock of corporations. Except for considerations related to application of the equity method, it also applies to interests in limited liability companies (LLCs) that are the functional equivalent of corporations (see NP 9.9.1).

Figure NP 9-6 illustrates the decision tree used in accounting for common stock and LLC investments when the PWFVO has not been elected.

Figure NP 9-6

Decision tree—investments in common stock when the PWFVO is not elected



If a common stock investment or LLC interest is held within a portfolio for which the PWFVO has been elected, the decision tree in Figure NP 9-4 would instead be applied.

9.7.1 Consolidation

An NFP that owns a controlling financial interest in a corporation or functionally-equivalent LLC should consolidate that entity. According to ASC 958-810-15-4(a) (ASC 954-810-15-3(b) for NFP HCOs), an NFP applies the guidance in ASC 810-10, *Consolidation*, to determine whether it has a controlling financial interest. ASC 810-10 describes two models used to evaluate relationships for consolidation: the voting interest entity (VOE) model and the variable interest entity (VIE) model. NFPs are required to use the voting interest model, which is detailed in the “General” subsections of ASC 810-10. When applying that guidance, NFPs should disregard all references to VIEs, including the need to consider whether a potential investee is subject to the VIE guidance prior to applying the VOE model (as would be required for a business entity).

ASC 958-810-15-4(a)

An NFP with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a limited partnership or similar legal entity shall apply the guidance in the General Subsections of Subtopic 810-10. However, in accordance with paragraph 810-10-15-17, NFPs are not subject to the Variable Interest Entities Subsections of that Subtopic.

According to ASC 810-10-25-1 and ASC 810-10-15-8, a controlling financial interest usually exists when an investor owns over 50% of a corporation's outstanding voting shares (or for a functionally-equivalent LLC, over 50% of the member interests). This gives the investor a majority voting interest over matters on which shareholders or members are entitled to vote. Typically, the holder of a controlling financial interest will be able to control significant financial and operating decisions made for an investee. CG 3.3 discusses situations when control might exist with less than a majority voting interest.

ASC 810-10-25-1

For legal entities other than limited partnerships, consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest is ownership of a majority voting interest, but in some circumstances control does not rest with the majority owner.

ASC 810-10-15-8

For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest and, therefore, as a general rule, ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

If circumstances indicate that control does not rest with the owner of the majority of the voting interests, however, the majority owner would not have a controlling financial interest, and consolidation would not be appropriate. Control might not rest with a majority owner if, for example, the investee is in legal reorganization or bankruptcy, or if other owners can participate in certain financial and operating decisions made in the ordinary course of business (referred to as "substantive participating rights"). See NP 9.8.4.2 for information on substantive participating rights; in this context, the rights of noncontrolling shareholders would be analogous to the rights of limited partners. CG 3.2.3 provides additional information regarding situations when control would not rest with a majority owner.

9.7.2 *Equity method investments*

If consolidation of the corporation or functionally-equivalent LLC is not required, the NFP must assess whether it should apply the equity method. The rules for applying the equity method to LLC interests differ from those for common stock; for information on applying the equity method to LLC interests, see NP 9.9.2.

The equity method applies when a noncontrolling investor can nonetheless exercise significant influence over the investee's operating and financial policies. According to ASC 958-810-15-4(c), an NFP applies the guidance in ASC 323-10, *Investments—equity method and joint ventures—overall*, to evaluate whether significant influence exists based on ownership of voting stock.

ASC 958-810-15-4(c)

An NFP that owns 50 percent or less of the voting stock in a for-profit entity shall apply the guidance in Subtopic 323-10 unless the investment is measured at fair value in accordance with applicable GAAP, including the guidance described in (e).

According to ASC 323-10, an investor that holds between 20% and 50% of a company's voting stock is presumed to have the ability to exercise significant influence over the operating and financial policies of an investee, unless evidence exists to the contrary. However, use of the equity method may also be appropriate when the holding falls outside this range and may be inappropriate for some entities within this range, depending on the nature of the actual relationship between the investor and investee. Exercise of judgment may be required in light of the facts and circumstances associated with a particular investment.

ASC 958-810-15-4(e) discusses use of fair value measurement as an alternative to applying the equity method. Those situations relate to interests held within portfolios that are subject to a "portfolio-wide" fair value accounting policy election (see NP 9.6) and interests for which an irrevocable election to report at fair value pursuant to the fair value option subsections of ASC 825-10 has been made (see NP 9.3).

9.7.3 Investments that are not consolidated or reported using the equity method

Investments in stock (or member interests in an LLC that is functionally-equivalent to a corporation) that require neither consolidation nor application of the equity method are accounted for at fair value in accordance with ASC 321, *Investments—equity securities*.

The scope of ASC 321 applies to both equity securities with readily-determinable fair values and equity interests that do not have readily-determinable fair values. Under ASC 321, equity interests that are not equity securities—such as member interests in partnerships, unincorporated joint ventures, and limited liability companies—are accounted for as if they were equity securities. LI 3 provides a comprehensive discussion of ASC 321.

The default measurement principle under ASC 321 is that investments within its scope are measured at fair value on a recurring basis in accordance ASC 820. If the investment does not have a readily-determinable fair value, two optional measurement accommodations may be available:

- *Net asset value practical expedient.* The net asset value (NAV) practical expedient is described in ASC 820-10-35-59. If elected, the fair value of investments in funds that have the characteristics of an investment company specified in ASC 946 (such as hedge funds, private equity funds, and the like), can be measured using the per-share NAV reported by the investee without any adjustment, as long as the investor provides certain disclosures regarding the investment's nature and risk. FV 6.2.6 discusses the NAV practical expedient and the circumstances in which it can be elected.
- *Measurement alternative.* ASC 321 provides a "measurement alternative" that can be elected for an investment that does not have a readily-determinable fair value and which is ineligible for the NAV practical expedient. This measurement alternative is defined as cost, less impairment, adjusted (increased or decreased) for information about fair value of the investment from observable price changes, whenever those occur, rather than an obligation to remeasure the investment at fair value at each reporting date. Under this measurement alternative, observable

price changes are from orderly transactions for an identical or similar investment of the same issuer. An entity must elect to apply the measurement alternative upon acquisition of an eligible equity interest and is made on an instrument-by-instrument basis. The measurement alternative is not available for equity instruments for which the fair value option in ASC 825-10 has been elected. Its use may also be limited for investments in portfolios for which the portfolio-wide fair value option has been elected as discussed in NP 9.6. For more information about the measurement alternative and the circumstances in which it can be elected, see LI 2.3.2.

Investments that are structured similar to mutual funds (for example, hedge funds, private equity funds, and common collective or commingled trusts) must be evaluated against the ASC Master Glossary definitions of *equity security* and *readily determinable fair value* when evaluating their ability to use the NAV practical expedient or the measurement alternative. If such an investment is a security that has a fair value per share (unit) that is published and is the basis for current transactions, then its fair value is readily determinable, and it is not eligible for either of the measurement accommodations. FV 6.2.6.2 discusses considerations for making these evaluations.

9.7.3A *Investments that are not consolidated or reported using the equity method (prior to adoption of ASU 2016-01)*

Prior to an entity's adoption of ASU 2016-01, investments in common stock (or member interests in an LLC that is the functional equivalent of a corporation) that neither require consolidation nor application of the equity method are measured at either fair value or cost less impairment (cost method).

If the interest is an equity security with a readily-determinable fair value, it must be accounted for at fair value in accordance with ASC 958-320. See LI 2.2 and LI 2.3 for discussion of the ASC Master Glossary definitions of "equity security" and "readily determinable fair value," as well as circumstances in which investments with structures similar to mutual funds are considered to have readily determinable fair values. FV 6 discusses the requirements in ASC 820 for the measurement of financial assets.

As discussed in NP 9.11.1, changes in fair value of investments are reported within the respective category of net assets—with donor restrictions or without donor restrictions—as required by ASC 958-321-15-3 and ASC 958-220-45-8. For NFP HCOs, such changes in fair value are included in or excluded from the performance indicator as prescribed by ASC 954-220-45-9 through ASC 954-220-45-11. As discussed at NP 9.2.2A, NFP HCOs must classify equity securities within the scope of ASC 958-320 into "trading" and "other than trading" categories. Changes in fair value of equity securities classified as "other than trading" are reported below the performance indicator, while changes in the fair value of equity securities classified as "trading" are included within the performance indicator. Other NFPs are not required to make this distinction but may apply the NFP HCO reporting conventions voluntarily. Once ASU 2016-01 is adopted, the classification requirement for equity securities with readily-determinable fair values will be eliminated but will continue to apply to debt securities, as discussed in NP 9.4.

9.7.3.1A *Reporting investments using the cost method*

Prior to adoption of ASU 2016-01, the cost method is used to account for investments in stock of a corporation (or member interests in an LLC that is the functional equivalent of a corporation) that do not require consolidation, require application of the equity method, and do not have readily-

determinable fair values. Application of the cost method varies slightly by types of NFPs; for additional information on those variations, see NP 9.2.3A.

Guidance for applying the cost method is contained in ASC 325-20. Under the cost method, an investment is reported at its historical cost, which is not subsequently adjusted unless an impairment occurs. “Historical cost” refers to the purchase price or, if contributed, the fair value of the investment on the date of acquisition. The methodology for determining impairment and evaluating whether the impairment is other than temporary is described in ASC 320-10-35-25 and ASC 958-325-35-8 through ASC 958-325-35-13.

ASU 2016-01 eliminates the cost method. Subsequent to its adoption, equity interests previously subject to the cost method will instead be reported at fair value, or the measurement alternative (see NP 9.7.3) in accordance with ASC 321.

9.8 *Limited partnerships and functionally-equivalent LLCs*

This section discusses the application of the general accounting requirements described in NP 9.5 to investments in limited partnerships and LLCs that are the functional equivalent of limited partnerships (see NP 9.9) that are not held within a portfolio for which the portfolio-wide fair value option has been elected. The accounting for limited partnership interests held within such portfolios is addressed in NP 9.6.

Throughout this section, any reference to a limited partner includes nonmanaging members of LLCs that are the functional equivalent of limited partnerships, and references to general partners refers to managing members of those LLCs.

A limited partnership is comprised of one or more general partners and one or more limited partners. In these arrangements, voting power and economic interests usually are not aligned, as decision-making authority typically resides with a general partner who may have a small ownership interest relative to the limited partners. The general partner has the authority to transact on the partnership’s behalf, direct the partnership’s operations, and bind the partnership by entering into contracts. The limited partners, on the other hand, invest capital and typically cannot act on behalf of or direct the activities of the partnership.

Evaluations of control or significant influence in these structures cannot be based solely on the level of ownership by the investor, as they are in investments in common stock of a corporation or an LLC that is the functional equivalent of a corporation, discussed in NP 9.7, in which investor voting rights typically are proportionate to their ownership percentages. Because of the fundamentally different nature of the governance model for limited partnerships, a different model is used to assess control.

ASC 958-810 contains guidance specific to NFPs for evaluating limited partnership interests for consolidation or application of the equity method. Under the ASC 958-810 framework, NFPs do not consider the guidance in ASC 810-10 for business entities that have interests in limited partnerships. NFPs exclusively use a voting interest model when evaluating relationships for consolidation. Even when a business entity would apply a voting interest entity model to a limited partnership interest, that model is significantly different from the voting interest entity model applied by NFPs to limited partnership interests. NP 9.8.1 highlights the differences (and similarities) between the NFP and

business entity voting interest entity (VOE) models used in accounting for limited partnership interests.

The model used by NFPs to account for interests in limited partnerships differs based on whether the NFP is a general or limited partner.

Figure NP 9-7 summarizes the model used by NFPs to account for interests in limited partnerships.

Figure NP 9-7

Decision tree—accounting for equity interests in limited partnerships

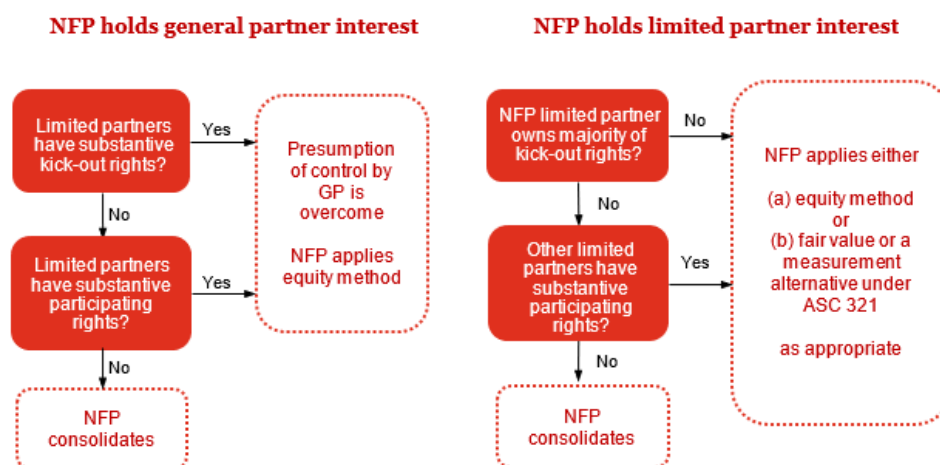
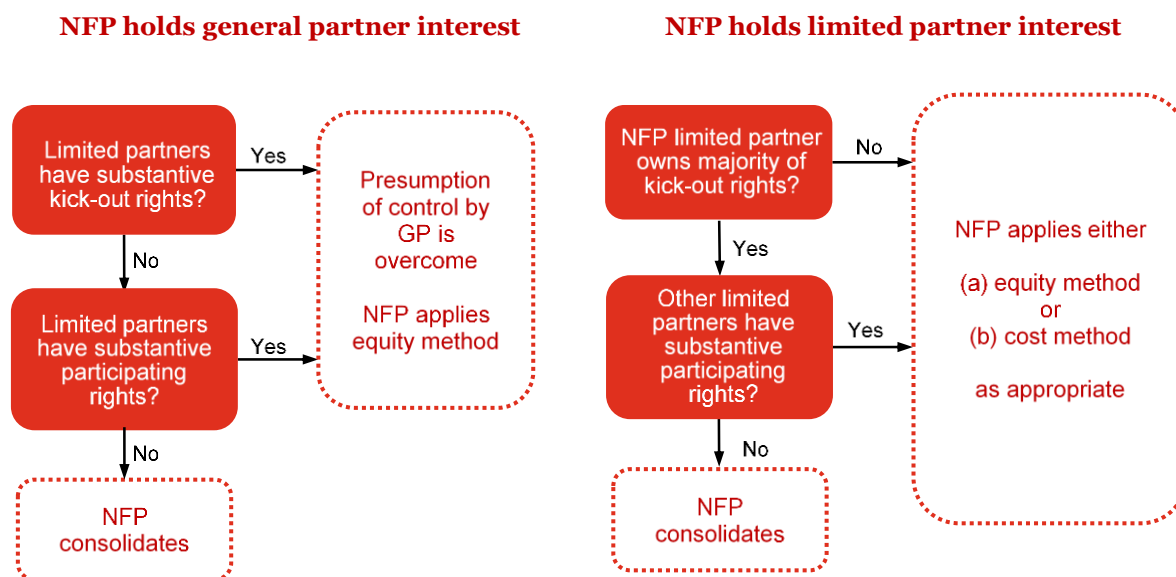


Figure NP 9-7A summarizes the model used by NFPs to account for interests in limited partnerships prior to adoption of ASU 2016-01.

Figure NP 9-7A

Decision tree—accounting for equity interests in limited partnerships (prior to adoption of ASU 2016-01)



9.8.1 Comparing the business entity and NFP voting interest model

Figure NP 9-8 highlights the similarities and differences between the NFP and business entity voting interest entity (VOE) models used in accounting for limited partnership interests.

Figure NP 9-8

Comparison of business entity and NFP voting interest entity (VOE) models used for evaluating investments in limited partnerships

NFP model (ASC 958-810)	Business entity model (ASC 810-10)
<ul style="list-style-type: none"> Both general and limited partner interests are evaluated under a VOE model; VIE model is not applicable. 	<ul style="list-style-type: none"> VOE model applies only to limited partner interests and only if the limited partnership is not a VIE.
<ul style="list-style-type: none"> If limited partners do not hold substantive participating rights or substantive kick-out rights, the general partner consolidates. 	<ul style="list-style-type: none"> If limited partners do not hold substantive participating rights or substantive kick-out rights, the VIE model applies (for both general partner and limited partner interests). Party with both power and benefit consolidates, which could be GP, LP, or neither.

NFP model (ASC 958-810)	Business entity model (ASC 810-10)
<ul style="list-style-type: none"> □ If limited partners hold substantive participating rights or substantive kick-out rights, presumption of control by general partner is overcome. 	<ul style="list-style-type: none"> □ If limited partners hold substantive participating rights or substantive kick-out rights, presumption that the VIE model is more relevant is overcome, and the VOE model is used instead.
<ul style="list-style-type: none"> □ Existence of substantive participating rights or substantive kick-out rights focuses the analysis on whether an individual limited partner has a controlling financial interest and should consolidate. 	<ul style="list-style-type: none"> □ For the evaluation of the limited partner interest, existence of substantive participating rights or substantive kick-out rights focuses the analysis on whether that individual limited partner has a controlling financial interest and should consolidate. Same as NFP model.

9.8.2 *Consolidation of interests in limited partnerships*

ASC 958-810-25-11 through ASC 958-810-25-29 set forth the NFP-specific consolidation model used to evaluate investments in limited partnerships and similar legal entities. According to ASC 958-810-15-4(b), this model does not apply to interests in limited partnerships that are held within portfolios for which the PWFVO has been elected; the accounting for those interests is subject to the guidance in ASC 321 (or ASC 958-320 prior to adoption of ASU 2016-01) and is addressed in NP 9.6.

ASC 958-810-15-4(b)

An NFP that is a general partner or a limited partner of a for-profit limited partnership or a similar legal entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I. However, the guidance in those paragraphs does not apply to the following:

1. A general partner or a limited partner that reports its partnership interest at fair value in accordance with [ASC 958-810-15-4](e).
2. Entities in industries, such as the construction or extractive industries, in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).

As described in ASC 958-810-25-12, the analysis begins with a presumption that the general partner controls a limited partnership, regardless of the general partner's level of ownership. Unless that presumption is overcome, the general partner must consolidate.

ASC 958-810-25-12

The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

According to ASC 958-810-25-15, the presumption of control by the general partner is overcome if limited partners hold either substantive kick-out rights or substantive participating rights (see NP 9.8.4). If the presumption is overcome, the general partner's interest in the limited partnership is accounted for using the equity method.

ASC 958-810-25-15

If the limited partners have substantive kick-out rights or substantive participating rights, the presumption of control by the general partners is overcome and each of the general partners shall account for its investment in the limited partnership using the equity method of accounting.

If an individual limited partner owns a majority of the voting interests that control the substantive kick-out rights, that limited partner might be required to consolidate the partnership, as described in ASC 958-810-25-16.

ASC 958-810-25-16

If one limited partner directly or indirectly owns more than 50 percent of a limited partnership's kick-out rights through voting interests, then that limited partner shall be deemed to have a controlling financial interest in the limited partnership and shall consolidate the limited partnership. However, if noncontrolling limited partners have substantive participating rights, then the limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest.

A controlling financial interest that requires consolidation would generally exist if a single limited partner owns a majority of kick-out rights through voting interests. That partner generally would have the ability to unilaterally remove the general partner or cause the partnership to be dissolved. However, if other limited partners hold substantive participating rights (explained in NP 9.8.4.2), the limited partner with a majority of kickout rights would not have a controlling financial interest and should not consolidate the partnership.

If the general partner does not control and no single limited partner has a controlling financial interest, then none of the investors would consolidate the partnership.

Question NP 9-2 illustrates the consolidation analysis for interests in a limited partnership.

Question NP 9-2

Investment LP has three partners, all of which are NFP entities. The partnership agreement provides the general partner with the authority to direct the partnership's operations and enter into binding contracts on behalf of the partnership. The limited partners have no authority beyond certain limited rights granted in the operating agreement that are neither kick-out nor participating rights. How would the partners evaluate their interests for potential consolidation?

PwC response

The partners would evaluate their interests for potential consolidation using the guidance in ASC 958-810-15-4(b).

According to the guidance in ASC 958-810-15-4(b), a presumption exists that the general partner controls the partnership and should consolidate it, unless limited partners have substantive kick-out or participating rights that would overcome the presumption of control. In this fact pattern, the limited partners do not have such rights; thus, the general partner would be required to consolidate the partnership.

9.8.3 *Noncontrolling interests in limited partnerships*

An entity that holds a general partner interest in a limited partnership but concludes that the general partner interest does not represent a controlling financial interest (see NP 9.8.2) must account for that interest using the equity method, pursuant to ASC 958-810-25-15. Alternatively, that interest could be reported at fair value if an election is made under the "Fair value option" subsections of ASC 825-10 (see NP 9.3.)

For noncontrolling limited partner interests, the accounting depends on the nature of the partnership's activities. If the partnership is involved in real estate, ASC 958-810-15-4(d) (ASC 954-810-15-3(i) for NFP HCOs) requires NFPs to apply guidance specific to the real estate industry described in ASC 970-323, *Real estate—investments—equity method and joint ventures*, for noncontrolling interests in real estate limited partnerships. If the partnership is not involved in real estate, the accounting is discussed in NP 9.8.3.1.

Excerpt from ASC 958-810-15-4(d)

An NFP with a more than minor noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar legal entity shall report its noncontrolling interests in such entities using the equity method in accordance with the guidance in Subtopic 970-323 unless that interest is reported at fair value in conformity with the guidance described in [ASC 958-810-15-4](e).

According to ASC 970-323-25-6, use of the equity method by noncontrolling limited partners is generally appropriate unless a partner's interest is so minor that the limited partner has virtually no influence over partnership operating and financial policies. As a result, the threshold for applying the equity method to a partnership investment is significantly lower than is the case for an investment in common stock.

ASC 970-323-25-6

The equity method of accounting for investments in general partnerships is generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, the limited partner should account for its investment in accordance with Topic 321.

Evaluating whether an interest is "minor" or "more than minor" involves judgment. In making those judgments, NFPs often consider, and apply by analogy, the guidance in ASC 323-30-S99-1 that investments of more than 3 to 5% are "more than minor" interests. AAG-HCO 12.49 provides additional information on distinguishing a minor interest from an interest that is more than minor. In general, we believe that use of the equity method may also be acceptable at lower levels of ownership.

As discussed in CG 4.3.1.2, use of the equity method in situations when an investor has a less than 3% investment in a limited partnership or an LLC that maintains separate ownership accounts for each investor (see NP 9.9.2) should be applied consistently by the investor for all such investments.

If the equity method is not used because the interest is deemed to be minor, the limited partner is in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation. In that situation, the accounting depends on whether the NFP has adopted ASU 2016-01.

- Under ASU 2016-01, the interest is accounted for at fair value on a recurring basis or using the measurement alternative, in accordance with ASC 321 (see NP 9.7.3).
- Prior to adoption of ASC 2016-01, use of the cost method described in NP 9.7.3A would generally be appropriate. AAG-NFP 3.101 illustrates application of this guidance. Alternatively, the NFP could elect to report its interest at fair value using the general fair value option in ASC 825-10.

9.8.3.1 *Interests in limited partnerships not engaged in real estate*

If the limited partnership's activities do not involve real estate, NFPs often consider, and apply by analogy, the real estate guidance. Under that approach, the NFP would apply the equity method unless its interest is deemed to be so minor that it has virtually no influence over the partnership's operating and financial policies. If an NFP does not choose to analogize to the real estate guidance, the interest would be reported in accordance with ASC 321 (i.e., fair value).

For additional information, see AAG-NFP 3.88 through AAG-NFP 3.93, AAG-NFP 4.24 through AAG-NFP 4.27, and AAG-HCO 12.44 through AAG-HCO 12.49.

9.8.3.1A *Interests in limited partnerships not engaged in real estate (prior to adoption of ASU 2016-01)*

If the limited partnership's activities do not involve real estate, the accounting differs based on (1) whether the NFP is an HCO and (2) whether a non-healthcare NFP holds the interest in connection with carrying out the NFP's operations (an operating investment) or to generate investment return (a portfolio investment).

NFPs that hold the interest as an operating investment and NFP HCOs will often consider, and apply by analogy, the real estate guidance described in NP 9.8.3. Under that approach, the NFP would apply the equity method unless its interest is deemed to be so minor that it has virtually no influence over the partnership's operating and financial policies. If an NFP does not analogize to the real estate guidance, it would apply the cost method described in NP 9.7.3A or alternatively, could elect to report its interest at fair value using the general fair value option in ASC 825-10.

NFPs other than HCOs must apply the guidance in ASC 958-325 when accounting for limited partnership interests held as portfolio investments. According to ASC 958-325, if a non-HCO NFP holds a limited partner interest for purposes of earning income or capital appreciation, it must account for it at either fair value or using the cost method, based on the portfolio-wide accounting policy selected (see discussion at NP 9.6). Thus, an NFP cannot apply the real estate guidance by analogy, and, therefore, has no basis to apply the equity method to these investments.

AAG-NFP 3.91 through AAG-NFP 3.93 illustrate the accounting for an operating investment that is not a real estate limited partnership. In those situations, AAG-NFP recommends that NFPs apply the equity method of accounting by analogy to the real estate guidance.

Example NP 9-1A illustrates the analysis for a limited partnership not involved in real estate that is held by a non-healthcare NFP as a portfolio investment.

EXAMPLE NP 9-1A

Portfolio investment in limited partnership not involved in real estate

Research Institute holds a noncontrolling limited partnership interest in Tech LP, a limited partnership that invests in emerging technology companies in order to achieve above-market returns. Research Institute is an entity within the scope of ASC 958-325, which requires a portfolio-wide accounting policy election for alternative investments entered into for investment return or profit. Research Institute has not elected the portfolio-wide fair value option.

How would Research Institute account for its limited partnership interest in Tech LP?

Analysis

Because Tech LP is not engaged in real estate activities, Research Institute is not required to apply the accounting model in ASC 970-323 for real estate limited partnerships.

Research Institute must apply the guidance in ASC 958-325 in accordance with its accounting policy election and thus, would measure the interest at lower of cost or market (as described in NP 9.2.3A). If desired, Research Institute could instead report its interest at fair value by making an ASC 825-10 election.

After adoption of ASU 2016-01, the specialized guidance in ASC 958-325 for equity interests will be superseded. Research Institute would be permitted to apply the real estate model by analogy and thus, would apply the equity method unless its interest is not deemed to be “minor.” If the real estate model is not applied by analogy, NFP Research Institute would report its interest at fair value in accordance with ASC 321.

9.8.4 Rights granted to limited partners on consolidation analysis

A partnership agreement may provide limited partners with rights to remove the general partner (kick-out rights) or rights to participate in certain significant financial and operating decisions in the ordinary course of business. If those rights are substantive, they can preclude consolidation by a general partner or limited partner whose interest would otherwise require consolidation. In the NFP model, rights granted to limited partners are discussed in ASC 958-810-25-19 through ASC 958-810-25-29.

As noted in NP 9.8.1, evaluation of the rights granted to limited partners is a key consideration under both the NFP and business entity consolidation models, and, in substance, both use “substantive participating rights” and “substantive kick-out rights” with essentially the same meanings. However, in the business entity model, the existence of such rights only overcomes the presumption that the VIE model should apply, while in the NFP model, the existence of such rights overcomes the presumption of control by the general partner. Ultimately, under either framework—NFP or business entity—the

existence of substantive kick-out or participating rights directs the focus of the consolidation analysis to whether an individual limited partner has a controlling financial interest and should, therefore, consolidate.

9.8.4.1 *Impact of kick-out rights on consolidation*

Kick-out rights are rights that give limited partners the ability to either dissolve (liquidate) the partnership without cause, or the ability to remove or replace the general partner without cause and are defined in the ASC Master Glossary.

ASC Master Glossary

Kick-out rights (voting interest entity definition): The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Kick-out rights are exercised through voting interests. The voting interest that a limited partner possesses in a kick-out right is generally equal to its economic interest in the partnership. CG 3.5.2 provides a further explanation of the concept of kick-out rights and an example.

The existence of kick-out rights can overcome the presumption of control by the general partner. Said differently, if another party or parties have the substantive right to remove the general partner without cause, and that right is substantive, the general partner does not have control over a limited partnership. CG 3.5.2.1 discusses the definition of "without cause." Generally, "without cause" means that no reason need be given to exercise the right. A right to remove the general partner "for cause" (for example, due to gross negligence or illegal acts) would not be considered a kick-out right under the model.

Liquidation rights—that is, rights provided to limited partners to liquidate the partnership without cause—are considered equivalent to kick-out rights because they provide the holder with the ability to effectively remove the entity's decision maker by dissolving the entity. According to ASC 958-810-25-20, withdrawal rights—that is, rights granted to limited partners to withdraw from the partnership in whole or in part—are not liquidation rights unless the dissolution or liquidation of the entire limited partnership is required upon the withdrawal of a limited partner or partners.

Although a limited partnership's organizational documents may state that limited partners have the right to remove the general partner, such a statement is not by itself sufficient to make the right "substantive." According to ASC 958-810-25-19, for a kick-out right to be substantive it must (1) be exercisable based on a simple majority vote of the limited partners and (2) there can be no significant barriers to the limited partners exercising those rights. Both conditions must exist.

Rights are exercisable by simple majority (or lower threshold)

According to ASC 958-810-25-19(a), the first required characteristic of a substantive kick-out right is that the general partner must be able to be removed by a single limited partner or a vote of a simple majority (or lower threshold) of the limited partner interests. When determining the simple majority required, the limited partners' voting interests should exclude any kick-out rights held through voting interests belonging to the general partner, parties under common control with the general partners, and other parties acting on behalf of the general partners. An NFP investor needs to calculate and

ensure that all possible combinations that represent a simple majority of the limited partners' voting interests allow for the limited partners to kick-out or remove the general partner. ASC 958-810-55-26 through ASC 958-810-55-32 provide four cases illustrating the application of the simple majority threshold in exercising kick-out rights.

No barriers exist to exercise of rights

The second required characteristic of a substantive kick-out right is that the limited partners holding the removal or liquidation rights must have the ability to exercise the rights if they choose to do so. ASC 958-810-25-19(b) provides several examples of barriers to the limited partners ability to exercise their kick-out rights. The list is not all inclusive and includes the following examples.

- Conditions that make it unlikely the rights will be exercisable, for example, conditions that narrowly limit the timing of the exercise
- Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive
- The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
- The absence of an explicit, reasonable mechanism by which the limited partners can call for and conduct a vote to exercise the rights
- The inability of the limited partners holding the rights to obtain the information necessary to exercise them

If economic or operational barriers to exercising such rights exists, the substance of the rights granted may be called into question. For example, a kick-out right would not be substantive if the limited partners lack an explicit mechanism to exercise that right—for example, if they are unable to obtain the identities of the other limited partners to convene a general meeting, or if they lack the ability to call for a general meeting. Refer to CG 2.3.3.2 for additional information regarding evaluating whether kick-out rights (including liquidation rights) are substantive. Although that discussion is written from the perspective of using kick-out rights to determine whether an investee should be evaluated under the variable interest entity model, the considerations when determining whether rights are substantive is essentially the same as in the NFP voting interest entity model.

9.8.4.2 *Impact of participating rights on consolidation*

Some partnership agreements allow limited partners to participate in decisions that could impact the partnership's business—for example, a right to block or veto a decision made by a decision-maker. Such "participating rights" allow limited partners to participate in certain financial and operating decisions that occur in the ordinary course of the partnership's business. Unlike a kick-out right, a participating right does not allow the holder to initiate an action or decision; instead, it allows the limited partner to prevent a decision-maker from executing a decision. Participating rights are defined in the ASC Master Glossary.

ASC Master Glossary

Participating rights (voting interest entity definition): Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating rights that are substantive will preclude consolidation by either a general partner or a limited partner that holds a majority of kick-out rights. ASC 958-810-25-27 identifies the following factors to consider when evaluating whether a participating right is substantive:

- The level at which decisions are made, according to the limited partnership agreement
- Related-party relationships between the general partners and the limited partners
- Whether the right involves an operating or capital decision that is not significant to the ordinary course of business
- Whether the probability that an event or transaction that requires the limited partners' approval will occur is remote
- Whether it would be prudent, feasible, and substantially within the control of the general partner(s) to exercise rights to buy out the limited partners

According to ASC 958-810-25-22, examples of substantive participating rights that would preclude consolidation are (1) selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures and (2) establishing operating and capital decisions of the investee (including budgets) in the ordinary course of business.

Rights that allow a limited partner to block or veto a decision that is expected to occur outside the ordinary course of business—for example, the right to approve or veto amendments to the partnership agreement—are not participating rights. Rather, they are considered protective rights—that is, they are designed to protect the value of the interest of the party holding the right. ASC 958-810-25-28 lists examples of protective rights that are often provided to limited partners. Protective rights held by limited partners would not preclude consolidation by either a general partner or a limited partner that owns a majority of kickout rights. Refer to CG 3.4 for more information on distinguishing participating rights from protective rights.

Judgment should be applied based on the specific facts and circumstances in each arrangement in order to determine whether limited partner rights should be considered protective or participating, and if participating, whether the rights are substantive. To assist in this evaluation, ASC 958-810-55-16A through ASC 958-810-55-16I provides examples (not all-inclusive) of possible assessments of individual limited partner rights. The factors and examples in ASC 958-810-25-27 and ASC 958-810-55-16A through 958-810-55-16I are substantially the same as the factors and examples for evaluating noncontrolling shareholder participating rights in corporations in ASC 810-10-25-13 and ASC 810-10-55-1, discussed in CG 3.4.2. When considering the discussions in CG 3.4.2, “noncontrolling rights” or “rights of noncontrolling shareholder” are analogous to “limited partner rights.”

Question NP 9-3 addresses whether the existence of participating rights could result in consolidation.

Question NP 9-3

If an individual limited partner possesses a majority of substantive participating rights, does that limited partner have a controlling financial interest that requires consolidation?

PwC response

No. A participating right provides the holder with the ability to veto decisions, but not the ability to initiate actions. Therefore, unlike a kick-out right, it cannot result in a limited partner having control of the partnership.

9.9 *Equity interests—limited liability companies*

This section discusses the application of the general accounting requirements described in NP 9.5 to investments in limited liability companies (LLCs).

An LLC is a hybrid form of organization which can have characteristics of both a corporation and a partnership but is dissimilar from both in certain respects. The owners of an LLC are called “members,” and their ownership interests are referred to as “membership interests.” As a result of these hybrid characteristics, special considerations apply when evaluating equity interests in LLCs for potential consolidation or applicability of the equity method of accounting.

Some states allow the formation of nonprofit LLCs. An example might be an LLC where all of the members are 501(c)(3) tax-exempt organizations and the LLC operates exclusively to further the charitable, educational, or scientific purposes of the members. Although its purpose is to carry out a nonprofit activity, the LLC would nevertheless be evaluated for consolidation using the guidance in this chapter, rather than the guidance for evaluating consolidation of other NFP entities. Because the LLC provides its members with ownership interests, it would not meet the definition of an NFP entity for accounting purposes, as discussed at NP 5.2.

For LLC interests held within portfolios for which the PWFVO described in NP 9.3 and NP 9.6 has been elected, the determination of whether the LLC is the functional equivalent of a limited partnership or the functional equivalent of a corporation must be made in order to determine whether the interest can be measured at fair value or alternatively, must be consolidated.

9.9.1 *Consolidation of LLCs*

As discussed in NP 9.2.1, ASC 958-810 requires one consolidation model for evaluating interests in limited partnerships and a different model for evaluating interests in other types of entities. Thus, consolidation conclusions related to LLCs will depend on whether the entity is the functional equivalent of a limited partnership or the functional equivalent of a corporation.

To identify the appropriate model, the NFP must analyze how the LLC is governed. This involves reviewing the LLC’s structural features as set forth in its articles of organization and its operating agreement (or if there is no operating agreement, based on the laws of the state in which it was established). All relevant facts and circumstances should be considered.

In some multi-member LLCs, one investor will be designated as the managing member and the others designated as non-managing members. As explained in ASC 958-810-25-11, if the managing member has the right to make significant operating and financial decisions on behalf of the entity, the LLC is the functional equivalent of a limited partnership (and the managing member is analogous to the general partner), and consolidation is evaluated using the model for limited partnerships discussed in NP 9.8.2. Under the limited partnership model, a presumption exists that the general partner controls the partnership and should consolidate it, unless limited partners have rights that overcome the presumption of control.

Excerpt from ASC 958-810-25-11

A similar legal entity is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In those entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.

If an LLC does not have the equivalent of managing and non-managing members, the evaluation of consolidation would use the model discussed in NP 9.7.1 for investments in common stock of a corporation. Typically, corporate-equivalent LLCs will have either a single member or will be governed by a board of members. Under this model, the usual condition for consolidation is ownership by the investor of a majority voting interest in the entity. For an LLC, this would translate to ownership of over 50% of the member interests.

Question NP 9-4 illustrates a consolidation analysis for an LLC that is the functional equivalent of a limited partnership.

Question NP 9-4

Investment LLC has three members. The LLC's operating agreement designates one of the members as the managing member and provides that member with the authority to direct the LLC's operations and enter into binding contracts on the LLC's behalf. The two non-managing members have no authority beyond certain limited rights granted in the operating agreement that are neither kick-out rights nor participating rights. How would the members evaluate their interests in the LLC for potential consolidation?

PwC response

In this arrangement, decision-making is vested in a single managing member in a structure that closely resembles a limited partnership. Therefore, the members would evaluate their interests for potential consolidation using the guidance in ASC 958-810-15-4(b).

According to that model, a presumption exists that the managing member controls the LLC and should consolidate it, unless non-managing members have substantive kick-out rights or substantive participating rights that would overcome the presumption of control. In this fact pattern, the non-managing members do not have such rights; thus, the managing member would consolidate the LLC.

Example NP 9-2 in NP 9.9.2 illustrates the consolidation analysis for a board-managed LLC.

Question NP 9-5 addresses consolidation of a single-member LLC.

Question NP 9-5

An NFP hospital wishes to expand its services by forming a tax-exempt subsidiary. Under IRS rules, an LLC can carry out tax-exempt activities on behalf of a Section 501(c)(3) exempt parent without obtaining a separate tax-exemption determination. Therefore, instead of creating a separate NFP corporation that would need to apply for tax-exempt status, the hospital chooses to organize the subsidiary as a single-member LLC. How would the LLC be evaluated for potential consolidation?

PwC response

As a single-member entity, the LLC has no other owners with whom the hospital must share decision-making or profits. In this fact pattern, the LLC is the functional equivalent of a wholly-owned corporate subsidiary. Consolidation would be evaluated based on the guidance in ASC 958-810-15-4(a) for investees other than limited partnerships. Because the hospital holds all decision-making authority through its membership interest, it would be required to consolidate the LLC.

An LLC's structure may not clearly resemble either a corporation or a limited partnership. For example, an LLC may have both a managing member and a board of members. In that case, a careful analysis would be required to determine which consolidation model to apply. CG 3.5.4 discusses this situation.

9.9.2 Noncontrolling interests in LLCs

An NFP with a noncontrolling interest in an LLC must determine whether to account for the investment using the equity method or the guidance in ASC 321 (see NP 9.7). Instead of focusing on governance and decision-making rights (as is required for the consolidation evaluation), selection of the appropriate model focuses on how the LLC determines its members' interests in its underlying net assets—i.e., how it would distribute its equity to the members.

Many LLCs maintain individual capital accounts that track members' cumulative investments, participation in profits and losses, and distributions in a manner similar to partnership capital accounts. In other LLCs, the operating agreement attaches voting rights, participation in profits and losses, and entitlement to equity to units in a pro-rata fashion so that economically, the rights associated with any one unit are indistinguishable from another (similar to the rights associated with common stock). In those cases, a member's equity is determined based on the number of units it holds relative to other members. (This would not include situations when "units" are used as a bookkeeping mechanism to facilitate allocations of profits and losses among members.)

ASC 958-810-15-4(d) directs NFPs to apply the guidance in ASC 323-30-35-3 to determine whether noncontrolling interests should be accounted for using the limited partnership model described in NP 9.8.3 or the corporation model described in NP 9.7.2 and NP 9.7.3. According to that guidance, the model for limited partnerships is used if individual capital accounts are maintained; otherwise, the model for corporations is used.

Because this evaluation considers a different attribute of the LLC's structure, an LLC that is viewed as similar to a corporation when evaluating consolidation might be viewed as similar to a limited partnership for purposes of the equity method evaluation. Example NP 9-2 illustrates such a situation.

EXAMPLE NP 9-2

Evaluating consolidation of an LLC shared services entity

Shared Services Entity (SSE) is a nonprofit LLC with four members, all of which are 501(c)(3) tax-exempt organizations. SSE is organized exclusively for tax-exempt purposes and operates exclusively to further the charitable, educational, or scientific purposes of its members. Note that because the LLC provides its members with ownership interests, it does not meet the definition of an NFP entity for accounting purposes, even though its purpose is to carry out a nonprofit activity. See related discussion at NP 5.2.

According to the operating agreement, the responsibility for SSE's governance, oversight, and management is vested in a board comprised of the members. Decisions of the board are legally binding (that is, the board is not merely advisory in nature.) The operating agreement also stipulates each member's "participation percentage" for purposes of voting and distribution of profits or losses (which are 40%, 30%, 20%, and 10%, respectively). Each member has a capital account that rolls forward its cumulative investments, participation in profits and losses, and distributions received.

How should SSE's members account for their interests?

Analysis

Each member would first consider whether its interest requires consolidation. When evaluating consolidation, the members would use the model described in NP 9.7.1 (for entities other than limited partnerships). SSE has no "managing member" who possesses exclusive decision-making responsibility. Instead, all members participate in decision-making through the board of members, with voting rights that are proportional to their participation percentages. In this fact pattern, none of the members has a controlling financial interest that would require consolidation, as no single member has a participation percentage of over 50%.

Next, each member would evaluate whether the equity method of accounting or the guidance in ASC 321 should be applied. Because SSE maintains separate capital accounts for each member (similar to a partnership capital account), the model for noncontrolling interests in limited partnerships would be used. Because SSE is not engaged in real estate activities, its members are not required to apply the model in ASC 970-323 for real estate limited partnerships but may apply that model by analogy. If a member chooses to analogize, the equity method would generally be applied, as its members all participate in management (that is, SSE has no non-managing members).

If a member does not wish to analogize to the real estate model, it would report its interest at fair value in accordance with ASC 321.

Question NP 9-6 illustrates the analysis for an interest in a real estate LLC that has member capital accounts similar to a partnership.

Question NP 9-6

Real Estate LLC has 3 members: a managing member with authority to direct the LLC's operations and two non-managing members with no authority beyond certain limited rights granted to them in the operating agreement. The managing member controls and consolidates the LLC. Each member has a capital account that rolls forward its cumulative investments, participation in profits and losses, and distributions received. What accounting would the non-managing members apply to their noncontrolling interests?

PwC response

Because Real Estate LLC maintains separate capital accounts for each member (similar to partnership capital accounts) the non-managing members are required to evaluate the investment in the LLC as a limited partnership.

According to the model in ASC 970-323 for real estate limited partnerships, the equity method should be applied by limited partners unless the partner's interest is so minor that it has virtually no influence over the partnership's operations and financial policies. Therefore, if the non-managing members' interests are "more than minor," they would apply the equity method. For information on evaluating "more than minor," see NP 9.8.3.

9.10 *Endowment funds*

In large NFPs, e.g., universities, the majority of investments will typically be associated with the institution's endowment funds. Endowment funds are defined in the ASC Master Glossary.

ASC Master Glossary

Endowment funds: An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP). The use of the assets of the fund may be with or without donor-imposed restrictions. Endowment funds generally are established by donor-restricted gifts and bequests to provide a source of income in perpetuity or for a specified period. See *Donor-Restricted Endowment Fund*. Alternatively, an NFP's governing board may earmark a portion of its net assets as a Board-Designated Endowment Fund. See *Funds Functioning as Endowment*.

This section focuses on "true endowments," which are endowments established by donor-restricted gifts to provide a source of income in perpetuity. Boards can also set aside an institution's own funds to be invested, managed, and spent in a manner that resembles a true endowment. Board-designated endowments (sometimes called "quasi-endowments" or "funds functioning as endowments") are discussed in NP 2.3.1.3.

True endowments arise when a donor makes a gift and requires that the gift be invested in perpetuity. Such gifts are pooled and invested to provide an ongoing source of cash flow to support the NFP's operations. Endowments are typically invested with an objective of maximizing total return—that is, the highest combination of current income (for example, dividends and interest) and capital appreciation. Only a portion of the total return will be spent; the remainder will be reinvested to ensure that the endowment keeps pace with inflation.

Endowments give rise to questions about how the funds should be invested, how the accumulated fund should be displayed within net assets, and how much of the total return can be spent in a year in order to ensure it lasts in perpetuity. The general accounting and reporting requirements are codified in ASC 958-205-45-13 through ASC 958-205-45-13J and ASC 958-205-50-1A through ASC 958-205-50-2, and are illustrated in ASC 958-205-55-31 through ASC 958-205-55-52.

9.10.1 *Uniform Prudent Management of Institutional Funds Act*

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) is a model rule setting out principles for the manner in which institutions should administer their endowments. Laws requiring application of UPMIFA principles have been enacted in most, but not all, states. The state laws provide guidance on the management and investment of charitable funds such as endowments. In addition, they guide board decision-making on how much of the total return should be distributed (that is, “appropriated for spending”) and how much should be reinvested to ensure that the fund will last in perpetuity.

A donor that makes a gift to create an endowment fund is instructing an NFP to invest the funds, spend the income therefrom, and preserve the principal for either a specified period or in perpetuity. An NFP must comply with a donor’s specific instructions set forth in the gift instrument with respect to spending vs. accumulation of the return on the invested funds (which includes net appreciation). If a donor’s intent with respect to spending versus accumulation of the income is not clearly expressed, however, laws such as UPMIFA provide a “rule of construction” to guide an NFP’s decision-making regarding distributions to be made from a donor-restricted fund under a total-return spending policy.

For accounting and financial reporting purposes, UPMIFA’s standards governing expenditure from donor-restricted endowment funds in such cases are considered to be extensions of the donor’s original instructions. Consequently, ASC 958-205-45-13D states that the original gift amount, any additional gifts to that fund, and any resulting investment returns must be reported as net assets with donor restrictions until appropriated for expenditure by the organization.

The requirement to classify investment return as net assets with donor restrictions until it is appropriated for spending results in an implied time restriction on that portion of the endowment. According to ASC 958-205-45-13E, the implied time restriction lapses only when and to the degree that a governing board appropriates an amount for expenditure from the fund after weighing the factors detailed in UPMIFA’s “prudent spending” guidelines. If a donor-restricted endowment also carries a purpose restriction (that is, the return must be used for purposes stipulated by the donor), the implied time restriction must be met (through appropriation for spending) before the purpose restriction can be considered to be met in order to comply with the requirements of ASC 958-205-45-9 (discussed in NP 6.7.2) for reporting releases of restrictions when two or more restrictions have been imposed on a single gift.

9.11 *Investment return*

When investments are reported at fair value, the fair value changes are reported within the appropriate class of net assets—with donor restrictions or without donor restrictions—as required by ASC 958-321-15-3 and ASC 958-220-45-8. For NFP HCOs, those changes are included in or excluded from the performance indicator as prescribed by ASC 954-220-45-9 through ASC 954-220-45-11. General presentation and disclosure requirements for equity interests measured at fair value can be found in LI 12, FSP 20, and FSP 9.

Apart from these minimum requirements, NFPs have significant latitude in how investment return is displayed and disclosed. Prior to the recent changes in financial statement presentation guidance in ASU 2016-14, NFP entities were required to either present or disclose the details of the components of investment return (i.e., interest income, dividends, realized and unrealized appreciation) either on the face of the statement of activities or in the notes. That requirement no longer exists and while still permissible, NFPs may now collapse investment return into a single line item without further disaggregation.

NFPs with endowments will typically use a "total return" or "spending rate" concept for internal reporting, for investment management, and for budgetary purposes. The total return approach is a method of managing endowment fund assets so that a portion of capital gains is made available for current use (see NP 9.10). Often when an organization uses a total return approach and includes a measure of operations in their statement of activities, the amount of investment return in operations is based on the budgeted or board-approved spending rate. ASC 958-220-45-14 (and a related example in ASC 958-220-55-20) provide guidance on the flexibility in the display of income, gains, and losses from investments, including the presentation of operating and nonoperating components.

Excerpt from ASC 958-220-45-14

An NFP may present the amounts of net investment return from portfolios that are managed differently or derived from different sources as separate, appropriately labeled line items on the statement of activities. For example, if an NFP has net investment return generated from operating cash, it may present that return separately from net investment return generated from its endowment. In addition, if appropriately labeled, an NFP may present the amounts of net investment return appropriated for spending separate from net investment return in excess of amounts appropriated for spending.

For example, any of the following displays is acceptable for an organization that chooses to divide its changes in net assets into operating and nonoperating components, as long as the NFP provides a description of the policy used to determine the amount that is included in the measure of operations and a discussion of circumstances leading to a change, if any, in that policy:

- ☐ All dividend and interest income and gains in operating revenue, on one or more lines
- ☐ Dividend and interest income in operating revenue; all gains and losses in nonoperating revenue
- ☐ Income and realized gains in operating revenue; unrealized appreciation in nonoperating revenue
- ☐ Investment return up to the institution's set "spending rate" in operating revenue; the difference between that amount and actual total return (which difference may be either positive or negative) in nonoperating revenue

ASC 958-220-45-27 through ASC 958-220-45-30 provides additional guidance for NFPs that present an operating measure.

9.11.1 Net asset classification of investment return

ASC 958-220-45-8 addresses the reporting of investment return by net asset class. Gains and losses on investments and dividends, interest, and other investment income are reported in the statement of

activities as increases or decreases in net assets without donor restrictions, unless their use is limited by donor-imposed restrictions (including limitations imposed by UPMIFA laws, as discussed in 9.10.1).

An exception is provided for NFPs that have adopted a policy to report gains and investment income that are limited to specific uses by donor-imposed restrictions as increases in net assets without donor restrictions if the restrictions are met in the same reporting period as the gains and income are recognized (often referred to as a “simultaneous release” policy). NFPs must also have a similar policy for reporting contributions received. This allows the NFP to “bypass” the initial classification as donor-restricted and the subsequent reclassification to net assets without donor restrictions (sometimes presented as release from restriction.) For more information on simultaneous release policies, see NP 6.7.2.3.

9.11.2 *Presentation and disclosure of investment expenses*

ASC 958-220-45-14 requires NFPs to report investment return (related to total return investing and not programmatic investing) net of external and direct internal investment expenses. “Direct internal investment expenses” are defined in ASC 958-220-45-15.

ASC 958-220-45-15

Direct internal investment expenses involve the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. These include, but are not limited to, both of the following:

- a. Salaries, benefits, travel, and other costs associated with the officer and staff responsible for the development and execution of investment strategy
- b. Allocable costs associated with internal investment management and supervising, selecting, and monitoring of external investment management firms.

ASC 958-220-45-16 clarifies that direct internal investment expenses do not include items that are not associated with generating investment return. For example, the costs associated with unitization and other such aspects of endowment management would not be allocated.

As discussed in NP 3.5, investment expenses do not follow the general rule under the NFP financial reporting framework that all expenses should be reported as decreases in net assets without donor restrictions. Because investment expenses must be netted against investment return, they will be reported in the same categories (with or without donor restrictions) in which the investment return is reported. Similarly, in accordance with ASC 958-205-45-6 and ASC 958-720-45-15, investment expenses that have been netted against investment return are not included in the analysis of expenses by nature and function (see NP 3.5.2).

Chapter 10:

Long-lived assets

10.1 Long-lived assets chapter overview

This chapter provides a high-level overview of the general GAAP framework used in accounting for long-lived assets including PP&E and intangibles, highlighting areas of particular interest for NFPs (for example, incremental or unique guidance).

In addition, it describes the application of the general framework for PP&E to unique types of long-lived assets particular to NFPs, e.g., works of art, historical treasures, and similar assets held within or outside of museum collections.

10.2 Property, plant, and equipment

Property, plant, and equipment (PP&E) refers to the long-lived tangible assets employed in day-to-day operations to deliver an NFP's goods or services. The value of such assets is derived from using them during their useful lives in carrying out the entity's mission, rather than from holding them for capital appreciation or resale. Similar assets that are acquired and held for investment purposes (for example, real estate held by an endowment) are accounted for using the investment guidance discussed in NP 9.

The general rules used in accounting for PP&E for NFPs are similar to business entities. Long-lived assets are capitalized, classified as held-and-used or held-for-sale, depreciated over their estimated useful lives, and tested for impairment in accordance with ASC 360, *Property, plant, and equipment*. PwC's guide *Property, plant, equipment and other assets* (PPE) summarizes the authoritative guidance and provides additional interpretive guidance on accounting for PP&E.

ASC 958-360, *Not-for-profit entities – Property, plant, and equipment*, provides incremental guidance on NFP-specific aspects of the accounting for PP&E, including specialized guidance on accounting for museum collections and depreciation.

10.2.1 Initial recognition of PP&E

NFPs must capitalize PP&E (including contributed PP&E), with exceptions for certain works of art or historical treasures (i.e., collections), discussed at NP 10.3.2. PP&E is initially measured at cost if purchased, or at fair value at the date of contribution if donated.

Sometimes donors will contribute a long-lived asset for use in an NFP's operations. Consistent with the requirements for similar items acquired in exchange transactions, ASC 958-360-30-1 requires that the amount initially recognized include all of the costs incurred by the NFP to place the contributed asset into service.

ASC 958-360-30-1

Similar to items acquired in exchange transactions, the amount initially recognized for contributed property, plant, and equipment shall include all the costs incurred by the entity to place those assets in use. Examples of such costs include the freight and installation costs of contributed equipment and cataloging costs for contributed library books.

PPE 1.2 provides guidance on the accounting for costs incurred in connection with construction projects. If an NFP is constructing an asset for its use and has borrowings outstanding during the

construction period, interest costs must be capitalized as part of the cost of the constructed asset (or assets). When the construction is financed with tax-exempt municipal bonds, the interest capitalization rules differ from the rules generally used for determining capitalized interest and are described in NP 11.5.

The characteristics and expected use of individual items of PP&E should be considered in evaluating whether they will benefit the NFP for more than a single period (and thus, require capitalization). For example, if sets and costumes owned by opera, ballet, and theater companies relate to a production that is given season after season, they would be capitalized and depreciated. However, for companies that do not perform the same production on a regular schedule, the costumes and scenery provide no probable future economic benefit beyond the current production and should be expensed.

10.2.2 Subsequent measurement of PP&E

ASC 958-360-35-1 requires that all PP&E, apart from land, must be depreciated (including PP&E acquired by contribution) except for certain works of art or historical treasures (discussed at NP 10.3.2).

ASC 958-360-35-1

A not-for-profit entity (NFP) shall recognize the cost of using up the future economic benefits or service potentials of its long-lived tangible assets—depreciation.

As described and discussed more fully in PPE 3, depreciation accounting allocates an asset's cost in a systematic and rational manner over the periods during which the NFP benefits from its use.

Grants and contracts that reimburse incurred costs may require the NFP to account for capital costs in a specific manner (for example, to use a specific method of depreciation or to include the entire fixed asset expenditure as a reportable cost in the period acquired.). Such terms are considered in calculating the amount of contract or grant revenue to which the NFP is entitled under the arrangement. However, under ASC 958-360-35-7, those terms do not impact the accounting under GAAP for the underlying assets and do not affect the recognition and measurement of depreciation expense for financial reporting purposes.

ASC 958-360-35-7

The terms of certain grants and reimbursements from other entities may specify whether depreciation or the entire cost of the asset in the year of acquisition should be included as a cost of activities associated with those grants or reimbursements for contractual purposes (sometimes referred to as allowable costs). Those terms shall not affect the recognition and measurement of depreciation for financial reporting purposes.

As discussed in PPE 4, impairment testing is required when events or changes in circumstances occur that indicate the cost of long-lived assets may not be recoverable. Long-lived assets (or asset groups) are tested for recoverability by comparing the undiscounted net cash flows to be generated from the use and eventual disposition of those assets to their net carrying value. In accordance with ASC 958-360-35-8, an NFP whose operations rely in part on contribution income may need to consider the cash

flows from contributions when determining the cash flows to compare with the carrying amount of the assets.

ASC 958-360-35-8

When grouping assets for impairment testing as described in paragraphs 360-10-35-23 through 35-28, an NFP that relies in part on contributions to maintain its assets may need to consider those contributions in determining the appropriate cash flows to compare with the carrying amount of an asset. If future contributions without donor restrictions to the entity as a whole are not considered, the sum of the expected future cash flows may be negative or positive but less than the carrying amount of the asset. For example, the costs of administering a museum may exceed the admission fees charged, but the museum may fund the cash flow deficit with contributions without donor restrictions.

Subsequent to acquisition, outlays will be required to keep long-lived assets in good working order. The normal, recurring expenditures required to maintain a long-lived asset in an efficient operating condition are expensed as period costs, as are repairs required to restore an asset to its normal operating efficiency. However, expenditures that will increase the economic life or functionality of a long-lived asset should be capitalized and depreciated. See PPE 1.2.1.4.

10.2.3 Disposal of PP&E

When an NFP disposes of a long-lived asset through sale, the asset is derecognized, the sales proceeds are recognized, and a gain or loss from the sale is recognized. Disposition of a long-lived asset other than by sale—e.g., abandonment or scrap—involves derecognizing the asset and recognizing a corresponding amount of loss on disposal based on the asset's carrying value. However, if an NFP disposes of a long-lived asset by contributing it to another entity, GAAP requires the NFP to recognize contribution expense based on the fair value of the asset, which could give rise to a gain or loss (from the adjustment of the carrying amount of the asset to fair value). Example NP 7-4 in NP 7.4.3 illustrates the accounting for a disposal of equipment via contribution.

10.2.4 Leases of PP&E

An NFP may have access to use property or equipment that it does not own. If the property or equipment is used under the terms of a lease agreement that at its inception requires lease payments at fair value, NFPs would apply the same accounting and reporting rules as business entities.

For NFPs that are conduit bond obligors with publicly-traded debt, ASU 2016-02, *Leases* (Topic 842) is effective for fiscal years (and interim periods within those fiscal years) beginning after December 15, 2018. For all other NFPs, the ASU will be effective for fiscal years beginning after December 15, 2020 and for interim periods within fiscal years beginning after December 15, 2021, with early application permitted. See PwC's *Leases* guide for information regarding ASC 842. Prior to adoption of ASC 842, if the right to use PP&E is obtained through a lease agreement that requires lease payments at fair value, the NFP would apply the guidance in ASC 840, *Leases*.

Both ASC 842 and ASC 840 apply to leases that are exchange transactions – that is, when an entity obtains the right to use the asset in exchange for payment of consideration. NFPs may also enter into leases that involve below-market rates, or arrangements similar to leases that provide free use of space or other PP&E. Arrangements that give an NFP the use of space or other PP&E for free fall outside the scope of ASC 842 or ASC 840 and are accounted for under the contribution accounting guidance

discussed in NP 7.6. A lease of space or other PP&E at below-market rates is accounted for as part-exchange, part-contribution. In those situations, the accounting for the exchange portion will be dictated by ASC 842 or ASC 840 (as appropriate), and the contribution portion will be accounted for using contribution accounting guidance. For additional information, see chapter 5 of AAG-NFP.

10.2.5 *Gifts of PP&E*

An NFP that receives gifts of long-lived assets (or of cash that is restricted to the acquisition of long-lived assets) must appropriately classify the increase in net assets associated with the gift based on the absence or presence of donor-imposed restrictions. If restrictions exist, the NFP must also determine the timing of reclassifications from net assets with donor restrictions to net assets without donor restrictions based upon the expiration of time and purpose restrictions.

If a donor gives a long-lived asset without specifying how or how long it must be used, the gift will increase net assets without donor restrictions. Example NP 7-4 in NP 7.4.3 illustrates the accounting by a donee for a contribution of medical equipment that does not involve a time restriction.

If a donor gives cash that is restricted for acquisition of PP&E and does not stipulate how or how long the acquired asset must be used, the donor restriction expires when the purpose restriction is satisfied (that is, when the assets are acquired and placed in service, as discussed in NP 6.7.2). At that time, the NFP would reclassify the gift amount from net assets with donor restrictions to net assets without donor restrictions.

If a donor gives a long-lived asset (or cash to acquire a long-lived asset) with a stipulation on the length of time the asset must be used (or used in a certain way), an explicit donor-imposed time restriction exists. As per ASC 958-360-45-1, a time restriction expires over the time period specified by the donor (not all at once upon its expiration).

ASC 958-360-45-1

If the property, plant, and equipment item being depreciated was contributed to the not-for-profit entity with an explicit donor-imposed restriction on the length of time of the item's use, net assets with donor restrictions shall be reclassified as net assets without donor restrictions in a statement of activities as those restrictions expire.

The amount of net assets to be reclassified each period is based on the length of the donor-imposed restriction. If the time restriction and the economic useful life of the asset coincide, the amount of net assets reclassified from those with donor restrictions to those without donor restrictions will offset the amount of depreciation expense recognized and there will be no impact on net assets without donor restrictions. If, however, as illustrated in Example NP 10-1, the depreciable life of the asset and the donor-imposed time restrictions differ, depreciation and the lapsing of the restrictions will not directly coincide.

EXAMPLE NP 10-1

Accounting for gift of PP&E subject to explicit time restriction

On January 1, 20X1, a donor contributed a computer to Local Charity with a stipulation that it be used in the entity's operations for at least two years. The fair value of the computer on the date of donation was \$900, and its estimated useful life was three years.

How would this gift impact net assets without donor restrictions in Local Charity's statement of activities for the year ended December 31, 20X1?

Analysis

Because an explicit time restriction was imposed by the donor, the gift will initially increase net assets with donor restrictions by \$900. One-half of the two-year time restriction will expire in 20X1. Therefore, at December 31, 20X1, Local Charity would reclassify \$450 from net assets with donor restrictions to net assets without donor restrictions to reflect the partial release of the donor restriction. Because the estimated economic life of the computer is three years, depreciation expense for 20X1 is \$300 (\$900/3 years).

The "net assets without donor restrictions" column in Local Charity's statement of activities for the year ended December 31, 20X1 would reflect an increase in net assets of \$450 (for the partial release of the donor-restriction), and a decrease of \$300 related to the depreciation expense.

10.2.6 Presentation and disclosure of PP&E

As described in NP 3.4.2, some NFPs choose to classify revenues, expenses, gains, and losses as operating or nonoperating in the statement of activities (or for an NFP HCO, in the statement of operations). When an "operating" performance measure or subtotal is presented, ASC 958-220-45-11 requires that it include any gain or loss on disposal of long-lived assets (or a group of long-lived assets). Similarly, if an impairment of PPE is recognized, impairment losses must be included within that subtotal.

NFPs must provide the general disclosures for PP&E required by ASC 360, discussed in FSP 8.6. In addition, ASC 958-360-50 requires a number of incremental disclosures for NFPs, including:

- The capitalization policy for PP&E and for collections
- The basis for valuation (e.g., cost for purchased PP&E or fair value for PP&E received via contribution)
- An explicit disaggregation of PP&E between nondepreciable assets (e.g., land, collections), PP&E not held for use in operations, and improvements to leased facilities and equipment
- Restrictions on liquidity or use of the PP&E, such as PP&E pledged as collateral, donor or legal limitations on the use of proceeds from disposal, or PP&E for which title may revert to another party
- The terms of exchange transactions, such as federal contracts, when the resource provider retains legal title to the PP&E but it is probable that the NFP will be permitted to keep the assets

10.3 Works of art, historical treasures and similar assets

ASC 958-360 provides guidance on the accounting for works of art, historical treasures, and similar assets which have aesthetic, cultural, or historical significance and are employed in an NFP's day-to-day operations. Such assets include landmarks, monuments, cathedrals, historical treasures, and collections (a special class of long-lived assets used in carrying out the operations of museums and similar entities), as described in ASC 958-360-35-5.

Excerpt from ASC 958-360-35-5

The future economic benefits or service potentials of individual items comprising collections (as that term is commonly used, not necessarily as defined within this Subtopic) and of buildings and other structures—including those designated as landmarks, monuments, cathedrals, or historical treasures—are used up not only by wear and tear in intended uses but also by the continuous destructive effects of pollutants, vibrations, and so forth. The cultural, aesthetic, or historical values of those assets can be preserved, if at all, only by periodic major efforts to protect, clean, and restore them, usually at significant cost.

The value of these long-lived assets, like other PP&E, is derived from using them in carrying out the NFP's mission, rather than from holding them for capital appreciation or resale. Similar assets that are acquired and held for investment purposes (for example, a work of art held as an investment) would be accounted for using the investment accounting guidance discussed in NP 9.

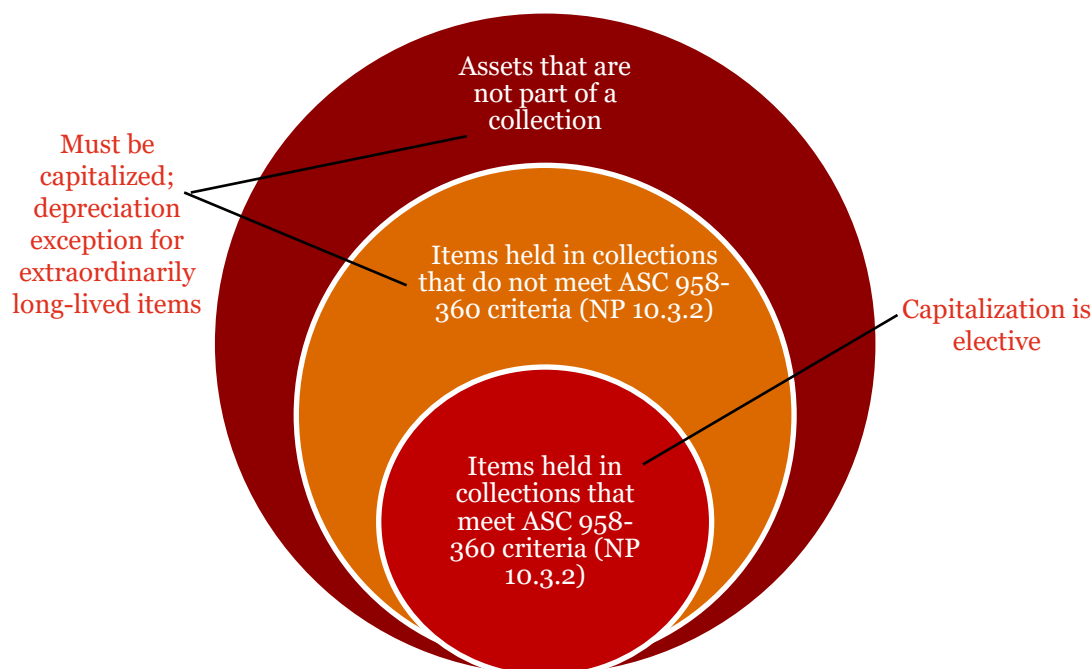
The principles of accounting for PP&E discussed in NP 10.2 generally apply to these assets; that is, they should be capitalized and depreciated over their estimated useful lives, regardless of whether they were acquired by purchase, by contribution, or discovery. However, there are two exceptions:

- An individual work of art or historical treasure that has been capitalized does not have to be depreciated if it has an extraordinarily long estimated useful life (see NP 10.3.1).
- If collections meet certain criteria established under ASC 958-360 (see NP 10.3.2), some or all of the items may be exempt from capitalization based on an accounting policy election (see NP 10.3.2.2).

Figure NP 10-1 depicts the categories of works of art, historical treasures, and similar items that do and do not require capitalization and depreciation.

Figure NP 10-1

Accounting for works of art, historical treasures, and similar assets



Presentation and disclosure considerations for collections that meet the requirements for policy elections on capitalization are discussed beginning at NP 10.3.2.3.

Regardless of the category into which they fall, effort is generally required to protect, clean, and restore these assets in order to preserve their value. ASC 958-360-35-6 requires that costs of major preservation and restoration efforts that provide future economic benefit or service potential be capitalized and depreciated, regardless of whether depreciation is recognized on the underlying asset being protected or restored. The depreciable life of those improvements would be based on the time expected to elapse until the next expected preservation or restoration.

See AAG-NFP 7.17 through AAG-NFP 7.29 for additional commentary on accounting for works of art, historical treasures, and similar assets.

10.3.1 Depreciation exception – extraordinarily long-lived items

For some rare works of art or historical treasures that have been capitalized, the economic benefit or service potential is used up so slowly that the amount related to any particular accounting period is inconsequential. Due to their extraordinarily long estimated useful lives, ASC 958-360-35-3 indicates that depreciation does not need to be recognized (similar to non-depreciation of land). To qualify for this exception, there must be verifiable evidence that the asset has cultural, aesthetic, or historical value worth preserving perpetually, and that the owner has the technological and financial ability to preserve and protect the asset's service potential and is doing so.

ASC 958-360-35-3

Consistent with the accepted practice for land used as a building site, depreciation need not be recognized on an individual work of art or historical treasure whose economic benefit or service potential is used up so slowly that its estimated useful life is extraordinarily long. A work of art or historical treasure shall be deemed to have that characteristic only if verifiable evidence exists demonstrating both of the following characteristics:

- a. The asset individually has cultural, aesthetic, or historical value that is worth preserving perpetually.
- b. The holder has the technological and financial ability to protect and preserve essentially undiminished the service potential of the asset and is doing that.

While having an extraordinarily long useful life is not limited solely to assets that have already been in existence for a long period, an asset that has come into existence relatively recently cannot be assumed to possess an extraordinarily long life in the absence of verifiable evidence that its value is worth preserving perpetually and that the holder has the intent and ability to protect and preserve it essentially undiminished. As used in ASC 958-360-35-3, “verifiable” embodies the concepts of FASB Concepts Statement No. 8, paragraph QC26 that different knowledgeable and independent observers could reach consensus that a particular depiction or assertion faithfully represents what it purports to represent.

10.3.2 Accounting and reporting guidance for collections

Some NFPs, like museums, collect, preserve, interpret, and display collections of artifacts and other objects of artistic, cultural, historical, or scientific significance for the education of the public. As described in the ASC Master Glossary, the nature of collections held vary widely, ranging from art and historical objects to living zoological or botanical specimens.

Excerpt from ASC Master Glossary

Collections: Collections generally are held by museums; botanical gardens; libraries; aquariums; arboretums; historic sites; planetariums; zoos; art galleries; nature, science, and technology centers; and similar educational, research, and public service organizations that have those divisions; however, the definition is not limited to those entities nor does it apply to all items held by those entities.

Some collections are the cornerstone of standalone organizations established for that specific purpose. Other collections are held and managed as a discrete operation within a larger entity, such as a museum within a university.

In essence, collections that are held and managed by an NFP belong to the general public. As stewards of these resources, NFPs manage the collection for the benefit of the public and must preserve and protect the collection items for the benefit of future generations. The commitment to preserve and protect collections for the benefit of future generations requires that careful consideration be given to the acceptance of items for the collection (referred to as “accessioning”) and for making decisions in the public interest about disposing, selling, or trading items in the collection (“deaccessioning”). NFP collections differ from privately-owned collections in these respects. Although private collections are

sometimes made available to the public for viewing or study, decisions related to acquiring or disposing of items in the collection can be carried out according to the owners’ wishes, rather than as fiduciaries acting in the public interest.

The foregoing background information provides context regarding collections generically, as the term is commonly used. As used in GAAP, however, the term *collection* has a special purpose and significance. The GAAP definition of collection is shown in Figure NP 10-2.

Figure NP 10-2
ASC Master Glossary definition of “collections”

Original definition	As amended by ASU 2019-03
<p>Collections: Works of art, historical treasures, or similar assets that meet all of the following criteria:</p> <ul style="list-style-type: none">a. They are held for public exhibition, education, or research in furtherance of public service rather than financial gain.b. They are protected, kept unencumbered, cared for, and preserved.c. They are subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.	<p>Collections: Works of art, historical treasures, or similar assets that meet all of the following criteria:</p> <ul style="list-style-type: none">a. They are held for public exhibition, education, or research in furtherance of public service rather than financial gain.b. They are protected, kept unencumbered, cared for, and preserved.c. They are subject to an organizational policy that requires the use of proceeds from items that are sold to be for the acquisition of new collection items, the direct care of existing collections, or both.

Items held within a collection that meets the GAAP definition are eligible for special accounting treatment, described in NP 10.3.2.1. To be eligible, the collections must be held in trust for the public and made accessible for the public benefit (as opposed to private collecting), must be appropriately cared for to preserve them for future generations, and must be subject to an organizational policy requiring that proceeds from items sold be reinvested in the collection. This last criterion typically distinguishes the collections that qualify for special treatment from those that do not.

Recent standard-setting

As noted in Figure NP 10-2, ASU 2019-03, *Updating the Definition of Collections*, amended the criterion regarding use of deaccessioning proceeds to clarify that use of proceeds for direct care of the collection is also permissible. This conforms the FASB’s criteria to align with a change made by the American Alliance of Museums in its guidelines for management of collections, on which the FASB’s criteria are based. For accounting purposes, holders of collections can choose whether or not to utilize the broader spending policy.

The ASU also requires all entities that hold collections to disclose their policy regarding the use of deaccession proceeds. If that policy allows proceeds to be used for the direct care of collections, the entity must also disclose how it defines “direct care” for operational purposes (see NP 10.3.2.6).

ASU 2019-03's amendments are effective for annual financial statements issued for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments are to be applied on a prospective basis, with early application permitted.

10.3.2.1 Capitalized collections

If a collection does not meet all of the criteria in the definition in Figure NP 10-2, the collection items must be capitalized and depreciated as discussed in NP 10.3. If the collection contains individual items that are extremely long-lived, those items would be exempt from depreciation as discussed in NP 10.3.1.

Figure NP 10-3 provides an example of an accounting policy disclosure for a capitalized collection that is derived from an example in AAG-NFP 7.29.

Figure NP 10-3

Illustrative policy note disclosure for capitalized collection

Derived from Example 1 in AAG-NFP 7.29

Collections

If purchased, items accessioned into the collection are capitalized at cost, and if donated, they are capitalized at their fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees). Gains or losses on the deaccession of collection items are classified on the statement of activities as support without donor restrictions or donor-restricted support depending on donor restrictions, if any, placed on the item at the time of accession. Collection items are depreciated over their estimated useful lives unless they have cultural, aesthetic, or historical value that is worth preserving perpetually, and the organization is protecting and preserving essentially undiminished the service potential of the collection item.

10.3.2.2 Accounting policy elections for collections that meet the criteria

According to ASC 958-360-25-3, NFPs with collections that meet all of the criteria in Figure NP 10-2 can choose from among three accounting policy alternatives regarding the capitalization of collection items.

ASC 958-360-25-3

An NFP that holds works of art, historical treasures, and similar items that meet the definition of a collection has the following three alternative policies for reporting that collection:

- a. Capitalization of all collection items
- b. Capitalization of all collection items on a prospective basis (that is, all items acquired after a stated date)
- c. No capitalization

Capitalization of selected collections or items is precluded.

Prior to issuance of the standard underlying these requirements, which dates back to 1993, most NFP collection-holding entities did not report collections on their balance sheets. Many had acquired a significant portion of their collection items (or in some cases, entire collections) through gifts or bequests rather than by purchase. The FASB concluded that because valuation information necessary to recognize collections may not have been compiled in the past or may not have been retained, and was likely to be too costly to obtain, the incremental benefits of the information gained by requiring retroactive capitalization would not justify the cost that entities would incur. Accordingly, the FASB concluded that entities who wished to do so could make an accounting policy election to not capitalize them (or to capitalize only items acquired from a certain date forward).

The policy selected must be disclosed (ASC 958-360-50-1(d)) and is applied on an “all or nothing” basis. An entity is not permitted to selectively capitalize only certain items within a particular collection and not capitalize other items within that collection. Similarly, if an entity has several different qualifying collections, the same capitalization or non-capitalization election applies to all of them.

10.3.2.3 Policy to capitalize all collection items

If an NFP with collections that meet the definition in Figure NP 10-2 nonetheless has elected to capitalize them, the accounting and reporting considerations would be similar to those discussed in NP 10.3.2.1 for collections that are required to be capitalized. ASC 958-360 provides minimal additional presentation and disclosure requirements. The balance sheet must display the total amount capitalized in a separate line item titled “collections” or “collection items” (ASC 958-360-45-3). If the NFP has other works of art, historical treasures, or similar assets that do not meet the definition in Figure NP 10-2, the amounts capitalized for those items must be disclosed separately, either on the face of the balance sheet or in the notes (ASC 958-360-45-4).

The NFP must also disclose its accounting policy choice as required by ASC 958-360-50-1(d). This might be accomplished, for example, by adding a statement such as “The organization has capitalized its collections since its inception” to the policy disclosure illustrated in Figure NP 10-3.

10.3.2.4 Policy not to capitalize collection items

If an NFP with collections that meet the definition in Figure NP 10-2 has elected an accounting policy not to capitalize, ASC 958-360-45-3 requires that the face of its balance sheet display a separate line item with no corresponding amount that refers the reader to a note describing that accounting policy.

Excerpt from ASC 958-360-45-3

If an NFP does not recognize and capitalize its collections or capitalizes its collections prospectively, a line item shall be shown on the face of the statement of financial position that refers to the disclosures about collections required by paragraph 958-360-50-6. That line item shall be dated if collections are capitalized prospectively, for example, collections acquired since January 1, 20X1 (Note X).

This presentation is illustrated in Figure NP 10-4.

Figure NP 10-4

Example financial statement line item when collections are not capitalized

	20X1
Collections (Note X)	\$ —

In the statement of activities, the accounting anomaly that results from the noncapitalization policy requires special presentation, as discussed in ASC 958-360-45-5.

ASC 958-360-45-5

An NFP that does not recognize and capitalize its collections shall report all of the following on the face of its statement of activities, separately from revenues, expenses, gains, and losses:

- a. Costs of collection items purchased as a decrease in the appropriate class of net assets
- b. Proceeds from sale of collection items as an increase in the appropriate class of net assets
- c. Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets.

Similarly, an entity that capitalizes its collections prospectively shall report proceeds from sales and insurance recoveries of items not previously capitalized separately from revenues, expenses, gains, and losses.

Normally, purchases of capital assets would not be reported in the statement of activities, and dispositions would only give rise to recognition of a gain or loss. When collection items are not capitalized, however, any purchases, sales, and insurance recoveries will be reported as increases or decreases in net assets. Because these do not represent revenue, expense, gains, or losses under GAAP, they must be reported in a special section of the statement of activities as follows.

- Collection items purchased are reported as decreases in net assets without donor restrictions, unless they were purchased with contributions restricted for that purpose. If the collection items were purchased with donor-restricted contributions, the transaction is reported as a decrease in net assets with donor restrictions. Because these decreases in net assets do not represent expenses, they are not included in the analysis of expenses by nature and function (see NP 3.5).
- Proceeds from sales of collection items (or from insurance recoveries for lost or damaged items) are reported as increases in the appropriate net asset categories, depending on the existence and type of donor-imposed restrictions, if any.
- Collection items received or disposed of by gift are not reported in the statement of activities but instead, are disclosed in the notes.

Figure NP 10-5 illustrates the required display of these transactions in the statement of activities.

Figure NP 10-5
Statement of activities –non-capitalized collection items

	Without donor restrictions	With donor restrictions	Total
Revenues and other support	\$ 100	\$1,000	\$1,100
Net assets released from restrictions	600	(600)	--
Expenses	(750)	--	(750)
Change in net assets before changes related to collection items not capitalized	50	400	450
Change in net assets related to collection items not capitalized:			
Proceeds from sales of collection items	25	60	85
Proceeds from insurance recoveries	10	45	55
Collection items purchased	(40)	(150)	(190)
	(5)	(45)	(50)
Change in net assets	\$ 45	\$ 355	\$400

The presentation of activity in the statement of cash flows is consistent with when collections are capitalized. Cash inflows and outflows associated with purchases and sales of collection items and from insurance recoveries related to such items are classified as investing activities, and collection items received by donation are disclosed as noncash investing activities.

As required by ASC 958-360-50-1(d), the NFP must disclose its accounting policy of noncapitalization, AAG-NFP 7.29 provides an example.

In order for financial statement users to understand the size and significance of the unrecognized collections, certain disclosures are required by ASC 958-360-50-6. AAG-NFP 7.29 Example 3 illustrates this disclosure.

ASC 958-360-50-6

An NFP that does not recognize and capitalize its collections or that capitalizes collections prospectively shall describe its collections, including their relative significance, and its stewardship policies for collections. If collection items not capitalized are deaccessioned during the period, it also shall describe the items given away, damaged, destroyed, lost, or otherwise deaccessioned during the period or disclose their fair value.

Excerpt from AAG-NFP 7.29

Example 3

Note X: Summary of Significant Accounting Policies

The collections, which were acquired through purchases and contributions since the organization's inception, are not recognized as assets on the statement of financial position. Purchases of collection items are recorded as decreases in net assets without donor restrictions in the year in which the items are acquired, or as decreases in net assets with donor restrictions if the assets used to purchase the items were restricted by donors. Contributed collection items are not reflected on the financial

statements. Proceeds from deaccessions or insurance recoveries are reflected as increases in the appropriate net asset classes.

10.3.2.5 *Policy to capitalize collection items acquired after a certain date*

If an NFP with collections that meet the definition in Figure NP 10-2 has elected to only capitalize collection items acquired after a specified date (prospective capitalization), the presentation and disclosure requirements prescribed by ASC 958-360-45-3 are a hybrid of the requirements described in NP 10.3.2.3 (for capitalized collections) and NP 10.3.2.4 (for noncapitalized collections).

Excerpt from ASC 958-360-45-3

If an NFP does not recognize and capitalize its collections or capitalizes its collections prospectively, a line item shall be shown on the face of the statement of financial position that refers to the disclosures about collections required by paragraph 958-360-50-6. That line item shall be dated if collections are capitalized prospectively, for example, collections acquired since January 1, 20X1 (Note X).

As illustrated in Figure NP 10-6, the balance sheet will display the total amount capitalized in a separate line item captioned "collections" or "collection items," identifying when collections began to be capitalized and referring to the policy note disclosure required for non-capitalized collections (per ASC 958-360-45-3). If the NFP has other works of art, historical treasures, or similar assets that do not meet the definition of a collection, the amount capitalized for those items must be disclosed separately, either on the face of the balance sheet or in the notes (per ASC 958-360-45-4).

Figure NP 10-6

Example financial statement line item when collections are capitalized after a certain date

	20X1
Collections acquired since January 1, 1995 (Note X)	\$ XX,XXX,XXX

AAG-NFP 7.29 provides an example of the policy note disclosure.

Excerpt from AAG-NFP 7.29

Example 2

Note X: Summary of Significant Accounting Policies

Collection items acquired on or after July 1, 19X0: Accessions of these collection items are capitalized at cost, if the items were purchased, or at their fair value on the accession date (the date on which the item is accepted by the Acquisitions Committee of the Board of Trustees), if the items were contributed. Gains or losses from deaccessions of these items are reflected on the statement of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions. Collection items are depreciated over their estimated useful lives unless they have cultural, aesthetic, or historical value that is worth preserving perpetually, and the

organization is protecting and preserving essentially undiminished the service potential of the collection item.

Collection items acquired prior to July 1, 19X0: Collection items purchased prior to July 1, 19X0, were recorded as decreases in net assets without donor restrictions. No financial statement recognition was made for contributed collection items. Proceeds from insurance recoveries or deaccessions of these items are reflected on the statements of activities as changes in the appropriate net asset classes, depending on the existence and type of donor-imposed restrictions.

Any proceeds from sales or insurance recoveries of items acquired prior to the capitalization date must be reported in the statement of activities as increases in the appropriate category of net assets, using the presentation illustrated in Figure NP 10-5. Disclosures required by ASC 958-360-50-6 (discussed in NP 10.3.2.4) must be provided for the portion of the collection that is not capitalized.

10.3.2.6 *Direct care of collections*

As discussed in NP 10.3.2, ASU 2019-03 changed the definition of “collection” to acknowledge that an entity’s policy for the use of deaccession proceeds could be expended for direct care of existing collection items as well as for reinvestment in new items for the collection. Once an entity adopts ASU 2019-03, the pending content in ASC 958-360-50-7 requires disclosure of the entity’s policy regarding the use of deaccession proceeds. If that policy allows proceeds to be used for the direct care of collections, the entity must also disclose how it defines “direct care” for operational purposes.

ASC 958-360-50-7 (as amended by ASU 2019-03)

A collection-holding NFP shall disclose its organizational policy for the use of proceeds from deaccessioned collection items, including whether those proceeds could be used for acquisitions of new collection items, the direct care of existing collections, or both. If the collection-holding entity allows proceeds from deaccessioned collection items to be used for direct care, the entity shall disclose its definition of direct care.

“Direct care of collections” is not defined in the codification. The American Alliance of Museums defines direct care as “an investment that enhances the life, usefulness or quality of a museum’s collection.” For GAAP purposes, it may be appropriate to think of direct care in a manner similar to the assessment required under GAAP for whether repair and maintenance expenditures on PP&E should be capitalized or expensed. Repairs and maintenance that simply maintain a fixed asset in its current operating condition are expensed, whereas outlays that increase the economic life or functionality of the asset are capitalized. Applying this principle by analogy to a restoration of an exhibit, artifacts, or a painting, expenditures that enhance the life, usefulness, or quality of individual items held within a collection could reasonably be considered “direct care” expenditures. AICPA TQA 6140.27, *Definition of Direct Care of Collection Items*, also discusses characteristics to consider when determining which costs are considered direct care of collection items.

10.3.3 *Collections acquired in a business combination*

If an NFP that does not capitalize its collections (as discussed in NP 10.3.2.4) acquires another NFP that has collections, ASC 958-805-25-23 provides an exception to the general rule that all assets acquired in a combination must be recognized and measured. That exception applies only to items

from the acquiree's collections that will continue to be included within the consolidated collections subsequent to the acquisition. Acquired collection items that will not be incorporated into the consolidated collections would be recognized as long-lived assets acquired and measured at fair value in acquisition accounting, as illustrated in ASC 958-805-55-49.

Excerpt from ASC 958-805-25-23

An NFP acquirer that has an organizational policy of not capitalizing collections in accordance with paragraph 958-360-25-3 shall not recognize as an asset those items (works of art, historical treasures, or similar assets) that it acquires as part of an acquisition and adds to its collection. Rather, the acquirer shall do both of the following:

- a. Recognize the cost of the collection items purchased (either by the transfer of consideration or the assumption of liabilities in excess of assets acquired) as a decrease in the appropriate class of net assets in the statement of activities and as a cash outflow for investing activities
- b. Not recognize the fair value of collection items contributed – either as an asset or as contribution revenue.

The illustrations in ASC 958-805-55-49 through ASC 958-805-55-54 provide guidance on determining whether collection items acquired in a business combination have been purchased or contributed and, if purchased, the appropriate amount of cost to attribute to the purchased items. The distinction is important because the portion of the collection item that is contributed will have no impact on the acquisition accounting, while the outflows associated with the purchased portion will need to be reported as a decrease in the appropriate class of net assets in the acquisition accounting (see NP 10.3.2.4 for more information).

10.4 Intangible assets

Like PP&E, intangible assets are long-lived assets employed in day-to-day operations to deliver an NFP's goods or services or to otherwise generate revenues. Unlike PP&E, however, they lack physical substance. Figure NP 10-7 includes examples of intangibles assets that might be held by NFPs.

Figure NP 10-7

Typical intangible assets held by NFPs

- | | |
|---|--|
| <input type="checkbox"/> Licenses | <input type="checkbox"/> Software |
| <input type="checkbox"/> Patents | <input type="checkbox"/> Goodwill |
| <input type="checkbox"/> Copyrights | <input type="checkbox"/> Broadcast rights |
| <input type="checkbox"/> Trademarks | <input type="checkbox"/> Ownership rights to artistic works such as plays, ballets, musical compositions |
| <input type="checkbox"/> Formulas and compounds | |
| <input type="checkbox"/> Curriculum developed | |

10.4.1 Overview of intangible asset recognition and measurement

For NFPs, the GAAP applied to accounting for intangible assets is generally the same as for business entities. Outlays for intangible assets are capitalized or expensed according to prescriptive rules. If capitalized, assets are amortized over their estimated useful lives (if finite lived) and tested for impairment as necessary.

The rules for recognition and measurement vary based on how an intangible asset arose or was acquired, and whether it has finite-life or an indefinite life. Figure NP 10-8 provides a road map to the locations of this guidance within the FASB's codification.

Figure NP 10-8

Road map to intangible asset GAAP

Goodwill and intangible assets acquired in NFP combinations

ASC 958-805	<input type="checkbox"/> Day 1 accounting for goodwill
ASC 350-20	<input type="checkbox"/> Day 2 accounting for goodwill
ASC 805-20	<input type="checkbox"/> Day 1 accounting for other intangibles
ASC 350-30	<input type="checkbox"/> Day 2 accounting for other intangibles

Intangible assets obtained/arising through other means

	<input type="checkbox"/> Intangibles acquired individually
ASC 350-30	<input type="checkbox"/> Intangibles acquired as part of a group of assets
	<input type="checkbox"/> Internally-generated intangibles
ASC 350-40	<input type="checkbox"/> Internal-use computer software developed or obtained
	<input type="checkbox"/> Internal-use hosting arrangements (cloud computing)
ASC 350-50	<input type="checkbox"/> Website development costs

Like PP&E, intangible assets can be purchased, acquired by gift, internally-developed, or acquired in business combinations. However, similar to business entities, an NFP only recognizes an intangible asset on the balance sheet if it acquires it from another party, either in a business combination or in an asset acquisition. In accordance with ASC 350-30-25-3, if an intangible asset is self-developed in its entirety, none of the costs may be capitalized.

ASC 350-30-25-3

Costs of internally developing, maintaining, or restoring intangible assets that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business or nonprofit activity and related to an entity as a whole, shall be recognized as an expense when incurred.

As a result, an NFP with internally-developed intangibles may have valuable revenue-generating assets that are not reflected on its balance sheet. However, as illustrated in Example NP 10-2, if another entity subsequently licenses the rights to use the intangible or acquires the developer of the intangible in a business combination, the other entity is permitted to recognize the intangible (or its rights to use the intangible).

EXAMPLE NP 10-2

Accounting for acquired versus internally-developed intangible assets

NFP A creates a unique logo that it trademarks. NFP A subsequently licenses to Company B the rights to use the logo for 5 years. One year later, NFP A is acquired by NFP C.

How would NFP A account for the logo in each of these transactions?

Analysis

When NFP A creates the logo, it possesses an intangible asset with economic value. However, NFP A cannot capitalize the costs of developing the logo because GAAP requires entities to expense the costs associated with internally-developed intangible assets.

NFP A would recognize revenue for the license fees received from Company B in accordance with ASC 606 (see NP 12); however, the underlying asset itself would remain unrecognized on NFP A's books.

When NFP C acquires the logo in connection with its acquisition of NFP A, NFP C would recognize the logo (trademark) as an asset that is initially measured at its fair value on the date acquired.

10.4.2 **Acquired identifiable intangible assets**

Intangible assets might be acquired individually, as part of a group of assets in a transaction that is not a business combination (referred to an "asset acquisition"), or in a business combination.

Intangible assets acquired individually or as part of a group in an asset acquisition are initially measured at cost if purchased, or at fair value if received through contribution. If intangibles are acquired as part of a group of assets, see PPE 2.3 for a discussion of the considerations related to their initial measurement and PPE 2.4 for a discussion of the allocation of the cost.

Intangible assets acquired in a business combination are initially measured at their fair values, as described in NP 5.5.2 and BCG 4.

Subsequently, the accounting for the acquired intangible asset follows the general guidance in ASC 350 that is applicable to business entities. If the intangible asset's life is finite, the asset should be amortized over its estimated life in accordance with ASC 350-30-35 and tested for impairment using the guidance for long-lived assets in ASC 360-10. PPE 3 provides information on determining estimated lives and various methods of amortization, and PPE 4 discusses how to assess, calculate, and record impairments of finite-lived intangibles. If the intangible asset's life is indefinite, the asset is not amortized, but is tested for impairment at least annually in accordance with ASC 350-30-35. See BCG 8 for considerations regarding assets acquired in business combinations or asset acquisitions, including how to determine if an intangible asset is indefinite lived.

10.4.3 **Goodwill**

Goodwill arises less frequently in NFP acquisitions than in business entity acquisitions due to fundamental differences in the nature of the transactions. See NP 5.

ASC 958-805's guidance on initial recognition and measurement of goodwill by an NFP differs from the guidance provided in ASC 805 for business entities. Goodwill is only recognized in the following situations:

- When a net deficit is acquired (i.e., the fair value of liabilities assumed exceeds the fair value of identifiable assets acquired) and the combined entities will operate predominantly with fee for service revenues. If the acquiree's operations are expected to be predominantly supported by contributions and returns on investments, an acquired net deficit is instead immediately written off (as if the acquirer had made a contribution in taking on the acquired entity). The meaning of "predominantly" is discussed at NP 5.5.3.2.
- When consideration is paid, and the fair value of liabilities assumed and consideration transferred exceeds the fair value of identifiable assets acquired. This might occur, for example, in an acquisition of a business entity (for example, an NFP health care system acquires a for-profit physician practice). The goodwill created in these transactions is similar in nature to that of business entities.

10.4.3.1 Subsequent accounting for goodwill

Subsequent to initial recognition, goodwill is accounted for in accordance with ASC 350-20, consistent with the requirement for business entities. ASC 350-20 provides guidance on impairment testing and derecognition, other presentation matters, and disclosures.

NFPs can make a one-time decision to adopt an accounting alternative used by private companies in subsequently accounting for goodwill at any time without assessing whether using the alternative is preferable. An NFP that elects the alternative will:

- Amortize goodwill existing at the beginning of the fiscal year in which the alternative is adopted prospectively on a straight-line basis over ten years (or less if the NFP can demonstrate that a shorter period is more appropriate)
- Make an accounting policy election as to whether it will test for impairment going forward at the entity level or at the reporting unit level
- Perform future impairment tests only upon the occurrence of a triggering event that indicates carrying value may be less than fair value (in lieu of the annual impairment test)
- Amortize goodwill arising from future acquisitions on a straight-line basis over 10 years (or less, if appropriate)

For additional information on the private company accounting alternative for goodwill, see BCG 9.12.

10.4.4 Intangibles associated with internal-use software

ASC 350-40, *Internal-Use Software*, provides guidance on accounting for costs of computer software developed or obtained for internal use. The determination of which costs are capitalized as intangible assets and which are expensed depends on the nature of the cost and the stage of the software development project. SW 2.1 discusses the types of costs that fall into each stage, whether they can be capitalized or expensed, and the subsequent accounting considerations (e.g., amortization and impairment).

Existing systems may be upgraded voluntarily (based on management determination), or upgrades may be required as a result of regulatory changes (for example, Congressionally-mandated changes to US health system rules and regulations). The costs of upgrades are accounted for based on the guidance for the “post-implementation” stage of ASC 350-40. Modifications that add “additional functionality” are considered “upgrades or enhancements” whose costs are expensed or capitalized in accordance with guidance in ASC 350-40-25-8 through ASC 350-40-25-10 (see SW 3.4.1). AICPA TQAs 6400.34, *Accounting for Computer Systems Costs Incurred in Connection With the Health Insurance Portability and Accountability Act of 1996* and 6400.48, *Accounting for Costs Incurred during Implementation of ICD-10*, provide factors to consider in making such assessments. While these TQAs are specific to HCOs, they may also be helpful to other types of NFPs.

Large-scale system changes often will require changes to an entity’s business processes. In those situations, ASC 720-45, *Other Expenses, Business and Technology Reengineering*, requires that project costs be segregated among process reengineering activities, activities that develop or modify software, and costs associated with acquisition of PP&E when evaluating whether they are capitalized or expensed.

***Chapter 11:
Bonds payable and
derivatives—updated
November 2022***

11.1 Chapter overview—bonds payable and derivatives

The municipal bond market is a primary source of capital project funding for many NFPs. This chapter provides an overview of municipal securities and how they are issued, retired, and regulated. It also summarizes the guidance needed to account for and present bond-related activity in the financial statements, addressing, among other topics:

- Issuance of bonds
- Refunding and other extinguishment transactions
- Interest capitalization rules
- Balance sheet presentation
- Special reporting situations

Typically, municipal bonds are issued by a government agency that then loans the proceeds to the NFP. In legal terms, the government agency is the “issuer” of the bonds and the NFP is the “conduit borrower” or “conduit obligor.” In this chapter, usage of the term “issuer” refers to the NFP conduit obligor, unless the context clearly indicates otherwise.

AAG-NFP Chapter 10 and AAG-HCO Chapter 7 are helpful sources of information regarding these matters. PwC’s *Financing transactions* guide (FG) contains comprehensive discussions of many general debt-related topics, much of which would apply to issuers of municipal bonds.

Frequently, issuers will use interest rate swaps to effectively convert fixed-rate debt to variable-rate debt or vice versa. This chapter also discusses NFP-specific guidance related to derivatives and the use of hedge accounting (see NP 11.8).

11.2 Overview of municipal bonds

Most but not all municipal bonds are tax-exempt, meaning that the interest received by the bondholder is exempt from federal income tax. Accordingly, municipal bonds are issued subject to stringent requirements imposed by the Internal Revenue Service.

Tax-exempt municipal bonds provide low-interest, long-term capital project financing for 501(c)(3) nonprofits (such as charities and many educational and healthcare organizations). Under IRS rules, in order to qualify for tax exempt treatment to the holder, the proceeds must be used by the nonprofit either for a qualifying capital project or for refinancing existing tax-exempt debt. The bonds are issued in “conduit financing arrangements” in which a governmental financing authority (the “issuer”) issues the securities and lends the proceeds to the NFP (the “conduit (bond) obligor” or “conduit borrower”). Although the securities bear the name of the governmental issuer, the issuer has no obligation for repayment of the debt. Instead, principal and interest is paid solely from resources of the NFP, generally through payments made by the NFP to the issuer under the loan agreement.

The majority of tax-exempt (and taxable) municipal bonds issued on behalf of NFPs are revenue bonds (i.e., bonds secured by a pledge of the entity’s future revenues). In most cases, they are serial bonds with maturity dates spread over 20–40 years. They may bear interest at a fixed rate or a variable rate and may provide for a single interest rate structure for the life of the obligation, or a multi-modal structure providing the issuer the ability to convert from one interest rate mode to another.

Variable-rate (also called floating-rate) bonds bear interest at a rate that is reset from time to time. The interest rate may be based upon financial indices available in the market or may be determined by an actual remarketing of the bonds. Two forms of variable-rate bonds discussed in this chapter are variable-rate demand obligations (see NP 11.2.1) and auction rate securities (see NP 11.2.2).

Bonds may be sold in public offerings or privately placed. Bonds sold in public offerings are exempt from registration under the Securities Act of 1933 but are subject to SEC enforcement and indirect oversight (see NP 11.7.1). After new bonds are issued, they trade in a decentralized, over-the-counter dealer market rather than on a centralized exchange. Most bonds sold in public offerings are subject to SEC requirements to provide financial and operating information regarding the borrower (including the conduit obligor) to investors on an annual basis (or more often) for as long as the bonds are outstanding. NFPs with publicly-issued bonds may be subject to more extensive disclosure requirements than other NFPs and in some cases may be required to adopt new FASB standards on the same timetable as SEC registrants. See NP 1 for a discussion of the various definitions of “public entity” for purposes of determining adoption dates and the applicability of various FASB standards to conduit bond obligors.

Tax-exempt municipal bonds are subject to strict IRS requirements both at the time of issuance and throughout the life of the bonds (see NP 11.7.1). Because of the low interest rates on municipal borrowings, the IRS prohibits investing borrowed funds in other financial instruments merely to benefit from an interest rate arbitrage opportunity (that is, benefiting from the spread between what can be earned from investing the borrowed proceeds and the cost of borrowing). Taxable bonds carry a higher interest rate and are subject to fewer IRS restrictions on their use.

11.2.1 Variable-rate demand obligations

Variable-rate demand obligations (VRDOs), sometimes referred to as variable-rate demand notes, are bonds that pay interest based on a floating rate that resets periodically. Although they are viewed as long-term debt by issuers, a demand feature allows bondholders to “put” or “tender” the bonds back to the issuer on the interest reset dates, making the bonds permissible investments for money market funds.

Under normal market conditions, if a bondholder exercises the “put” feature, a remarketing agent usually can obtain funds to repay the bondholder by reselling the bonds to another investor. If a new investor cannot be located within the time period for remarketing, a “failed remarketing” occurs. To provide for liquidity in this event, most VRDO issues are accompanied by a liquidity facility from a financial institution. The liquidity provider purchases the bonds, thus providing the resources needed to pay the former bondholder. The bonds that were not successfully remarketed then become “bank bonds,” and the issuer must pay off the resulting obligation pursuant to the liquidity facility’s contractual terms (for example, over a stipulated period of months or years rather than the bonds’ original stated maturities, and at an interest rate negotiated with the bank, rather than the bonds’ coupon rate).

The liquidity facilities used take the form of either an irrevocable letter of credit (LOC) or a conditional standby bond purchase agreement (SBPA). Although each provides liquidity that enables bondholders to sell their holdings on short notice, the mechanics of the LOC and SBPA arrangements differ. The LOC’s commitment is unconditional; with an SBPA, the liquidity provider may have the right to terminate the liquidity support under certain conditions (termination events). Further, an SBPA provides only liquidity support, while the LOC also typically guarantees the payment of all scheduled principal and interest payments to bondholders.

Some issuers with high credit quality and substantial liquid resources may set aside their own assets to fund liquidity for puts (“self liquidity”).

11.2.2 *Auction-rate securities*

Auction-rate securities (ARS) have a variable interest rate that is designed to regularly reset through a Dutch auction. In these auctions, bids are submitted by buyers and sellers, with the rate determined after all bids to buy or sell have been submitted. The auction agent receives orders to sell and orders to buy from various broker-dealers (acting for their clients) and determines the lowest interest rate at which all of the securities that have been offered for sale will clear (the “clearing rate”). The intervals at which the interest rate resets will occur (generally 7, 28, or 35 days) are established when the bonds are issued.

In some ways, ARS resemble VRDOs in that both are long-term instruments that trade at par but are tied to short-term interest rates with periodic rate resets. The significant difference between them is the put feature embedded in VRDOs. VRDO holders can put bonds back to the issuer and demand repayment, while ARS holders can only sell to other investors.

If a “failed auction” occurs (that is, an auction where the number of investors wishing to sell exceeds the number of investors wishing to buy), the interest rate resets to a maximum rate defined for the issue (typically a multiple of a reference rate, typically LIBOR historically, or a fixed percentage). The maximum rate is designed to compensate the holder for the loss of liquidity resulting from a failed auction and to encourage the issuer to consider restructuring or redeeming the securities if future auctions also fail. The market for ARS froze during the recession of 2008. While many auction-rate issuers subsequently repurchased (and retired) their bonds, the market has remained largely frozen for ARS that remain outstanding.

An issuer of ARS has the right to redeem (or “call”) the bonds early, on any interest payment date. Generally, this is accomplished either by issuing new debt (e.g., VRDOs or fixed-rate bonds) to obtain proceeds to pay off the outstanding ARS (a refunding, discussed at NP 11.4.1) or, if the ARS were structured as “multi-modal,” by exercising an “interest mode conversion” option (NP 11.4.2).

11.3 *Issuance of new bonds*

Municipal bonds are issued in either a public offering or a private placement.

Excerpts from AAG-NFP 10.24 and AAG-HCO 7.12

Municipal bonds are issued through negotiated sales, competitive bids, or private placements. In a *negotiated sale*, the issuer or obligor negotiates a price with one or more underwriters. In a *competitive bid sale*, the securities are sold to one or more underwriters who submitted the best acceptable bid(s). The underwriters then resell the securities to the general investing public. Municipal bonds issued in negotiated sales or competitive bids are deemed to be traded in public markets.... In a *private placement*, the securities generally are sold directly to qualified investors (for example, an institutional investor), rather than through an offering to the general investing public. Municipal bonds issued in private placements are not deemed to trade in public markets because the investors typically are subject to restrictions on resale.

11.3.1 *Public offering of municipal bonds*

Municipal bonds sold in public offerings are exempt from registration under the Securities Act of 1933 but are subject to SEC enforcement and indirect oversight (see NP 11.7).

New bonds are issued pursuant to an indenture (sometimes referred to as a trust agreement). A bond indenture is a contract between the governmental issuer and a bond trustee (typically a financial institution) that represents the rights of the bondholders. The indenture establishes the rights, duties, responsibilities, and remedies of the issuer and the trustee, the features of the bonds, the security for the bonds, and whether the bonds can be repaid prior to maturity.

In most conduit offerings involving NFPs, the issuer loans the bond proceeds to the conduit obligor (the party responsible for repaying the bonds). This occurs simultaneous with issuing the bonds. The loan agreement establishes the terms of repayment of the loan, the security for the loan, and various covenants with which the borrower must comply. Through the indenture, the issuer will collaterally assign the right to receive these loan payments to the trustee, to serve as security for the bonds. While loans are the most common mechanism used for repayment of the bonds, sometimes a lease/leaseback structure, an installment sale agreement, or some other form of contract is used.

The prospectus used to market the offering to the public is referred to as an Official Statement (OS) if proceeds from the offering are tax exempt, or an Offering Memorandum (OM) if the proceeds are taxable. The OS/OM provides information about the offering and the participants, including the fact that the issuer has no responsibility for repayment, the identity of the conduit obligor who is responsible for repayment, the purpose for which the bonds are being issued, the sources of funds available for the project (including money from sources other than bond proceeds), and the security for the bonds. Usually, a separate appendix provides detailed information about the conduit bond obligor, its operations, and its finances (including the most recent financial statements).

Subsequent to issuance, these bonds will be regarded as “publicly traded,” even though trading typically occurs relatively infrequently. In FASB pronouncements, NFPs with publicly-traded debt are identified as “a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.”

Accounting considerations related to recording a new debt issue are discussed in FG 1.2. If bonds are issued at a premium or discount, see FG 1.2.1. Debt issuance costs incurred in connection with the new bonds (incremental fees and commissions paid to third parties in connection with a new bond issue, including investment banks, law firms, and auditors) would be capitalized and amortized as discussed in FG 1.2.2. If bond insurance is taken out on the new issue, any prepaid premium would be included in the capitalized debt issuance costs.

11.3.2 *Private placement of municipal bonds*

New offerings of municipal bonds can also be privately placed. In the conduit financing context, “private placement” typically refers to either a single party (typically a bank) that purchases and holds an entire bond issue or a limited offering to a small group of investors. In a private placement, the transaction is directly negotiated among the investors, the issuer, and the obligor. Investors often must meet certain standards of sophistication and agree to restrictions on resale of the bonds. Generally, private placements of municipal bonds do not characterize an entity as a public entity.

In these issuances, the offering document might be referred to as an offering circular, an offering memorandum, a private placement memorandum or a limited offering memorandum. If the securities are placed with a bank (in economic substance, a loan), in addition to the authorizing and governing documentation typically found in a public offering (e.g., the bond indenture), a separate agreement between the bank and the issuer typically will set forth structures or terms similar to commercial lending transactions.

11.3.3 *Forward delivery bonds*

Forward delivery bonds are municipal bonds for which the offering occurs in two stages. At inception of the forward delivery arrangement, the bonds are priced (i.e., the interest rate is determined). The issuance of the bonds (cash funding and closing of the offering) occurs at some future date. During times of low interest rates, issuers find forward-delivery bonds attractive as they enable them to “lock in” a lower rate and protect against future interest rate increases. Typically, issuers pay a premium (in the form of additional basis points) to lock in the interest rate until the closing of the offering.

In general, an issuer will not recognize an asset or a liability for the forward delivery bonds until the closing of the offering.

11.4 *Extinguishment of municipal bonds*

For accounting purposes, ASC 405-20-40-1 states that debt is considered extinguished (and removed from an entity’s books) only when either (a) the debtor is released from its obligation based on having paid the creditor or (b) the debtor is legally released from being the primary obligor under the liability.

Excerpt from ASC 405-20-40-1

[A] debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
 1. Delivery of cash
 2. Delivery of other financial assets
 3. Delivery of goods or services
 4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Also relevant is the guidance in ASC 470-50-55-9 on transactions or events that do not result in extinguishment of debt.

ASC 470-50-55-9

The following situations do not result in an extinguishment and would not result in gain or loss recognition under either paragraph 405-20-40-1 or this Subtopic:

- a. An announcement of intent by the debtor to call a debt instrument at the first call date
- b. In-substance defeasance
- c. An agreement with a creditor that a debt instrument issued by the debtor and held by a different party will be redeemed.

FG 3.7 provides a comprehensive discussion on accounting for debt extinguishments.

If bonds remain outstanding until maturity, the debt obligation amortizes in the typical fashion as the NFP services the debt and satisfies the obligation over time. When bonds are repaid prior to maturity, however, the issuer removes the bonds (and any remaining debt issuance costs and discount or premium related to that issue, if applicable) from its books and recognizes a gain or loss on the extinguishment. The gain or loss is calculated by comparing the amount paid to retire the old bonds (the principal, call premiums, other costs of reacquisition) to the carrying amounts of the old bonds and related accounts written off. The mechanics of the calculation are discussed in FG 3.7.

If the old bonds were insured and the issuer retains the insurance policy to cover new bonds issued to finance the extinguishment, the unamortized prepaid bond insurance would not be written off with the other debt issuance costs but would remain on the books and continue to be amortized.

See FSP 12.11.1 for a general discussion of financial statement presentation and disclosure considerations for extinguishments.

11.4.1 Refunding bonds

“Refunding” is the process of paying off an outstanding bond issue using the proceeds from a new bond issue. The older bonds are referred to as “refunded bonds” and the new bonds are referred to as “refunding bonds.” In most cases, refundings occur prior to maturity of the bonds to take advantage of a decline in interest rates (much like a homeowner might refinance a mortgage to benefit from lower interest rates). Refundings might also be undertaken to remove or revise burdensome bond covenants or restructure debt service payments.

The structure of a refunding is affected by whether the bond indenture allows the issuer to repay the bonds prior to maturity. If so, this will be stated in an optional call provision (known as a “call privilege”) as distinguished from provisions for extraordinary calls and mandatory calls based on specified events. The bonds cannot be “called away” from the bondholder prior to the date specified in the call provision (the “call date”). If an issuer would like to refund bonds early but does not have a call privilege, or if the call date has not yet been reached on bonds that are callable, a refunding transaction might involve a defeasance.

Usually, issuing new debt to pay off the old bondholders will legally extinguish the old debt. For accounting and financial reporting purposes, however, in some cases the replacement of one debt obligation with another might be considered a modification rather than an extinguishment. When

evaluating these transactions as extinguishments or modifications, NFPs are subject to the same guidance as business entities: ASC 470-50, Modifications and Extinguishments (in particular, ASC 470-50-40-6 through ASC 470-50-40-12) and ASC 405-20, Extinguishments of Liabilities.

FG 3.4 contains a comprehensive discussion of how to differentiate an extinguishment from a modification. The IRS rules for tax-exempt bonds also require a modification analysis for refundings. Its focus is on whether a refunding results in a “reissuance” of the old securities for purposes of complying with IRS regulations related to arbitrage and other matters. The determination made for IRS purposes has no bearing on the determination made for financial reporting purposes.

11.4.2 *Interest mode conversions*

Some bonds are structured as “multi-modal.” As explained in FG 1.4.4, variable-rate bonds issued with a “multi-modal” option provide the issuer with a contractual right to change the interest feature of the bond from one form to another (for example, converting a variable rate to a fixed rate; converting an auction-based variable rate to an index-based variable rate). FG 1.4.4 explains the steps typically involved in an interest mode conversion.

Because in most cases a mode conversion involves a tender (i.e., call) of the old bonds and marketing of new bonds (to new investors as well as existing bondholders), a mode conversion is similar to a traditional bond refunding. Thus, the accounting considerations described in NP 11.4.1 also apply to mode conversions. When considering the guidance in FG 1.4.4, it should be noted that the tender offer in a municipal securities mode conversion typically is mandatory. Investors cannot choose to continue to hold their bonds; all bondholders will be repaid.

11.4.3 *Defeasance of municipal bonds*

If an NFP would like to retire or refund outstanding bonds early but the issue does not contain a call privilege (or the call date has not yet been reached for a callable bond issue), it might undertake a defeasance. In a defeasance, the old bondholders are not paid off immediately, but instead will be paid either at maturity or on the call date, using proceeds that have been placed in trust for that purpose. While it is possible to effect a defeasance using an issuer’s own cash, typically a defeasance will use funds provided by proceeds of a new bond issue (i.e., a refunding).

When a bond issue permits defeasance, the necessary terms and requirements will be described in a “defeasance provision” contained in the indenture. A defeasance provision describes circumstances under which the issuer will be deemed to have repaid the bondholders in full and have the lien of the indenture discharged without having actually paid off the bondholders. Typically, defeasance requires placing funds into a defeasance trust or escrow in an amount that, when invested, will generate sufficient cash flow to pay all principal and interest (and if applicable, the call premium) on an outstanding debt issue through either the call date or maturity, whichever is required. The defeasance provision will specify the types of investments permitted to be held by the defeasance trust. Often, the trust will hold special risk-free US Treasury bonds called State and Local Government Securities (also known as SLGS or “slugs”), which are issued specifically for purposes of defeasance trusts. The maturities of SLGS can be tailored to match the maturities of bonds in tax-exempt advance refundings so IRS yield restrictions are not violated (see NP 11.7.1). SLGS can also be used for taxable advance refundings of tax-exempt bonds. The trust assets must be irrevocably pledged to repayment of the obligation to those bondholders and be beyond the reach of the issuer’s debtors in bankruptcy.

If the conditions described in the indenture are met, the bonds are considered to be “legally defeased,” and the issuer has no further responsibility for their repayment. Sometimes an issuer will request a “defeasance opinion” from legal counsel to verify that a defeasance trust has satisfied and discharged its covenants, agreements, and obligations with respect to refunded bonds.

Not every bond issue contains a defeasance provision. In those situations, an issuer might similarly set aside funds in trust to pay the debt service and any redemption premium on the prior bonds when due for purposes of making revenues pledged as security for a revenue bond offering available for other purposes; however, the lien imposed by the indenture is not released. This is sometimes described as an “in-substance” or “economic” defeasance. In-substance defeasance is defined in the ASC Master Glossary.

ASC Master Glossary definition

In-substance defeasance: Placement by the debtor of amounts equal to the principal, interest, and prepayment penalties related to a debt instrument in an irrevocable trust established for the benefit of the creditor.

In an in-substance defeasance, the prior bonds will continue to be regarded as outstanding debt of the issuer, with principal and interest payments made using the assets in the trust. If the trust funds prove insufficient to make all future payments on the outstanding debt, the issuer would continue to be legally obligated to make payments from the pledged revenues.

The primary accounting consideration associated with a defeasance is whether the old bond issue (and defeasance trust assets) can be derecognized for financial reporting purposes. As discussed at NP 11.4, debt is considered extinguished for accounting purposes only where (a) the debtor is released from its obligation by paying the creditor; or (b) the debtor is legally released from being the primary obligor under the liability. In a defeasance, the holders of the old bonds will not have been repaid; thus, the old bonds are considered extinguished for accounting purposes only if the debtor has been legally released from being the primary obligor. ASC 405-20-55-9 contrasts a legal defeasance and an in-substance defeasance.

ASC 405-20-55-9

In a legal defeasance, generally the creditor legally releases the debtor from being the primary obligor under the liability. Liabilities are extinguished by legal defeasances if the condition in paragraph 405-20-40-1(b) is satisfied. Whether the debtor has in fact been released and the condition in that paragraph has been met is a matter of law. Conversely, in an in-substance defeasance, the debtor is not released from the debt by putting assets in the trust. For the reasons identified in paragraph 405-20-55-4, an in-substance defeasance is different from a legal defeasance and the liability is not extinguished.

If the terms of the bond indenture are deemed to have been satisfied by establishing the defeasance trust so that the issuer is legally released from being the primary obligor, the old bonds can be derecognized (typically, along with the assets in the trust). Normally, a legal defeasance results in simultaneous de-recognition of both the liability and the assets placed in the defeasance trust. However, if there is an indication that the debtor has continuing involvement with the assets placed in the trust, an evaluation of the criteria of ASC 860-10-40-4 through ASC 860-10-40-5 may be necessary

to determine whether the defeasance escrow trust may be derecognized. FG 3.8 discusses the requirements for derecognition of defeasance-related liabilities and assets, along with factors or indicators which may be considered in evaluating the form and extent of continuing involvement, if any.

If the proceeds to fund the trust were obtained from a new bond issue, a refunding is deemed to have occurred (that is, a replacement of the old debt with new debt). If the issuance has met the requirements for legal defeasance and thus satisfied the condition for extinguishment accounting, the financial statements will only reflect a single outstanding bond issue. In that case, the entity will need to evaluate whether a gain or loss should be recognized on the refunding, based on the considerations discussed at NP 11.4.

As described in ASC 405-20-55-4, an in-substance defeasance transaction normally does not meet the criteria to derecognize either the liability or the escrowed assets.

ASC 405-20-55-4

An in-substance defeasance transaction does not meet the derecognition criteria in either Section 405-20-40 for the liability or in Section 860-10-40 for the asset. The transaction does not meet the criteria because of the following:

- a. The debtor is not released from the debt by putting assets in the trust; if the assets in the trust prove insufficient, for example, because a default by the debtor accelerates its debt, the debtor must make up the difference.
- b. The lender is not limited to the cash flows from the assets in trust.
- c. The lender does not have the ability to dispose of the assets at will or to terminate the trust.
- d. If the assets in the trust exceed what is necessary to meet scheduled principal and interest payments, the transferor can remove the assets.
- e. Subparagraph superseded.
- f. The debtor does not surrender control of the benefits of the assets because those assets are still being used for the debtor's benefit, to extinguish its debt, and because no asset can be an asset of more than one entity, those benefits must still be the debtor's assets.

If the proceeds to fund the trust were obtained from a new bond issue, both the old and new bond issues will be reflected as obligations in the issuer's financial statements, along with the assets of the defeasance trust. Because the old debt has not been "replaced" in this scenario, the analysis in of whether an extinguishment or modification has occurred is not necessary.

FG 3.8.1 provides additional general discussion on legal defeasance versus in-substance defeasance involving a broader range of transactions than just municipal bonds. For additional discussion of bond defeasance, see AAG-NFP 10.28 through AAG-NFP 10.34 and AAG-HCO 7.20 through AAG-HCO 7.26.

11.4.4 *Reacquisition of bonds through open market purchase*

An entity may decide to reacquire its own bonds by purchasing them through the market (open market purchases). As discussed in NP 11.4, a liability should be considered extinguished (and derecognized) if the debtor pays the creditor and is relieved of its obligation for the liability. This explicitly includes situations when an issuer reacquires its own outstanding debt securities, regardless of whether the reacquired securities will be retired or held by the issuer “in treasury” for possible future reissuance (as discussed in ASC 405-20-40-1(a)(4)). It would not be appropriate for the issuer’s financial statements to reflect the reacquired bonds as an asset along with an obligation for their repayment.

11.5 *Bonds payable—capitalized interest*

During construction of a debt-financed project, interest costs must be capitalized as part of the cost of the asset (or assets). Pursuant to ASC 835-20, the capitalization rules for interest associated with tax-exempt municipal bonds differ from the rules generally used for determining capitalized interest. The primary differences are the dates when capitalization should begin, the calculation of amounts capitalizable during the capitalization period, and the treatment of investment income earned on unexpended bond proceeds. This special treatment, described in ASC 835-20-30-10, is due to the interrelationship of the IRS rules governing permitted uses of bond proceeds, investment income earned on those proceeds, and the plan of financing undertaken.

Excerpt from ASC 835-20-30-10

[In tax-exempt borrowings,] the funds flows from borrowing, temporary investment, and construction expenditures are so intertwined and restricted as to require accounting for the total net cost of financing as a cost of the qualifying assets.

Under the tax-exempt debt rules in ASC 835-20-25-8, the capitalization period begins at the inception of the borrowing and extends through the date that the constructed asset is ready for use. For example, if the financing is executed (and proceeds are received) six months prior to commencing construction, all of the interest cost incurred prior to commencing construction would be capitalized.

ASC 835-20-25-8

In situations involving qualifying assets financed with the proceeds of tax-exempt borrowings that are externally restricted as specified in this Subtopic, the capitalization period begins at the date of the borrowing.

Contrast this with the general rules, which require that an entity wait until construction expenditures commence to begin capitalization. Under those rules, interest incurred on funds borrowed six months prior to commencing construction would have to be expensed as period costs. Once construction begins, the amount capitalizable each period under the general rules is limited to the amount of interest attributable to the cumulative funds actually expended for construction. Under the tax-exempt rules, the issuer capitalizes all of the bond-related interest cost associated with the project during the capitalization period, without regard to the extent to which construction expenditures have been made.

The rules also differ with respect to the interest earned on unexpended debt proceeds. IRS rules require issuers to invest tax-exempt borrowed proceeds in interest-bearing securities until they are needed to pay for construction costs. Under the terms of the bond indenture (and IRS rules), the estimated earnings on unexpended funds are restricted for payment of project costs and thus, are factored into the calculation of the amount borrowed. Said differently, the issuer will need to borrow less than would be the case if it were not required to apply the investment income toward defraying the cost of the project. Accordingly, ASC 835-20-30-11 requires an issuer of tax-exempt bonds to offset the interest earned on unexpended debt proceeds against the interest cost associated with the borrowing during the capitalization period, so that only the net cost of financing is capitalized.

ASC 835-20-30-11

The amount of interest cost capitalized on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted as specified in the previous paragraph shall be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings from the date of the borrowing until the assets are ready for their intended use. The interest cost and interest earned on any portion of the proceeds of the tax-exempt borrowings that are not designated for the acquisition of specified qualifying assets and servicing the related debt are excluded.

During the early stages of construction, investment income earned may exceed the interest cost incurred on the borrowed funds. Thus, application of this net approach may actually result in capitalization of net investment income during the early years of a project.

Under the general rules, because capitalizable interest costs are linked to construction expenditures, the concept of “unexpended proceeds” is irrelevant and thus, any income on those proceeds is included in current period income.

Once the tax-exempt project is completed, the issuer will continue to incur interest costs on the outstanding bonds. At that point, if the issuer has other construction projects underway, interest on the tax-exempt debt may be capitalizable as part of the other projects, consistent with the “avoidable-interest concept” of the general rules.

ASC 835-20-55-4 (Example 1) illustrates the special capitalization rules for interest on tax-exempt debt. For additional information on the interest capitalization rules, see PPE 1.3, Chapter 9 of AAG-NFP, and Chapter 6 of AAG-HCO.

Question NP 11-1

Sometimes an issuer will finance a construction project with a combination of tax-exempt and taxable municipal bond proceeds. Should the treatment of interest costs and investment income on unexpended proceeds of the taxable bond issue be consistent with the special rules for tax-exempt bonds?

PwC response

No. In such situations, capitalization of interest on the taxable bonds is determined using the general rules in ASC 835-20-30-2 through ASC 835-20-30-7.

11.6 *Conduit obligor financial statement presentation and disclosure*

Conduit financing arrangements between a government financing agency and an NFP can take many forms, but most often will involve execution of a loan agreement. The bond issue and the loan agreement are executed simultaneously and in substance, represent a single, integrated transaction. Typically, the loan agreement will contain principal and interest payment requirements that correspond to the payment schedules on the bonds, such that the debt service payments on the bonds are funded through that mechanism.

In accordance with ASC 958-470-25-1 (NFP) and ASC 954-470-25-1 (HCO), in its financial statements, the entity “looks through” the loan agreement and reports a liability to the bondholders, consistent with the bondholders’ understanding of who is responsible for repayment. This expectation is mirrored in the continuing disclosure agreement for a public offering, which requires that the financial and operating disclosures to bondholders throughout the life of the issue be those of the conduit obligor.

ASC 958-470-25-1

A not-for-profit entity may finance part of its activities from the proceeds of tax-exempt bonds or other obligations issued through state and local financing authorities. Because the NFP is responsible for the repayment of those obligations, that financing shall be recognized as a liability in its statement of financial position.

ASC 954-470-25-1

When a financing authority issues tax-exempt bonds or similar debt instruments and uses the proceeds for the benefit of a health care entity, the obligation shall be reported as a liability in the entity's balance sheet if the health care entity is responsible for repayment. In some cases, this obligation may take the form of a liability arising from a lease. If a health care entity has no obligation to make payments of principal and interest on the debt or lease payments on related buildings or equipment, the entity shall not reflect the liability on its balance sheet. In such circumstances, proceeds from the bond issue shall be reported as contributions from the sponsoring entity.

11.6.1 *Conduit obligor—balance sheet classification*

As discussed at NP 2.3.1, assets and liabilities are segregated into current and noncurrent categories when a classified balance sheet is presented (see FSP 2 and FSP 12).

11.6.1.1 *Conduit obligor—demand bonds supported by liquidity facility*

As discussed in NP 11.2.1, VRDOs typically are supported by a liquidity facility (such as an irrevocable letter of credit from a financial institution) that provides the issuer with the ability to refinance obligations that may arise if tendered bonds cannot immediately be remarketed to another investor. ASC 470 addresses balance sheet classification in these situations. See FSP 12.6.

11.6.2 **Conduit obligor—interim financial reporting**

Some continuing disclosure agreements entered into by NFPs in connection with tax-exempt financing will require the provision of financial information on a quarterly basis as well as an annual basis. This has become standard practice for NFP health care sector borrowings.

When evaluating interim financial reporting requirements, it is important to distinguish between presentations that are considered “financial statements” and those that are simply presentations of financial information (for example, providing an interim balance sheet and statement of operations without a statement of cash flows). When an interim reporting presentation constitutes an “issuance of financial statements,” it can trigger adoption of new accounting pronouncements in the interim period, including provisions requiring retrospective application.

Interim financial statements are generally prepared based on the expectation that users will have read the prior annual financial statements. Therefore, interim financial statements are not expected to repeat extensive annual disclosures but, rather, provide an update from the prior year end. Interim financial statements may be condensed and include limited footnote disclosures.

ASC 270, *Interim Reporting*, provides the minimum disclosure requirements for all reporting entities that prepare interim financial statements. Certain requirements are specific to public entities, which would include NFP conduit obligors. For more information on ASC 270's requirements, see FSP 29.

11.6.3 **Conduit obligor—obligated group reporting issues**

Some conduit bond obligors (particularly in the health care sector) coordinate multiple borrowings using a master trust indenture (MTI) structure. This indenture is separate from, and serves a different purpose than, the indenture discussed in NP 11.3.1. In these arrangements, a conduit obligor selects a bank to serve as “master trustee” for a credit group (often referred to as an “obligated group”) whose aggregated revenue, cash, and assets are used as collateral for various financings. Normally, the obligated group is comprised of specifically identified entities within the consolidated financial reporting entity. In most cases, the entities within an obligated group have joint and several liability for the payment of any debt secured by the MTI, which means that in theory, any one of the parties to the arrangement could be liable for the entire amount of the bonds.

Continuing disclosure agreements for obligated group financings will usually require the issuer to provide financial information on the assets, liabilities, revenues, and expenses of the obligated group. Typically, the consolidated external financial statements of the consolidated reporting entity are used, with balance sheet and income statement information of the obligated group provided in combining or consolidating schedules that are presented as supplemental information. For example, a supplemental schedule might include individual columns for each entity in the obligated group, an obligated group subtotal column, an aggregate column for all other entities, and the consolidated total column that corresponds to the consolidated financial statements.

When separately issued statements are required for an individual entity within the obligated group, that entity's obligation and its joint-and-several liability must be appropriately presented and described. ASC 405-40, *Obligations Resulting from Joint and Several Liability Arrangements*, provides accounting and financial statement presentation guidance on these matters.

Based on the requirements of ASC 405-40-30-1, an obligated group member's individual financial statements would reflect a liability for the portion of the obligation that has been allocated to it for repayment, plus any amount that it expects to pay on behalf of its co-obligors.

ASC 405-40-30-1

Obligations resulting from joint and several liability arrangements included in the scope of this Subtopic initially shall be measured as the sum of the following:

- a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors.
- b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors. If some amount within a range of the additional amount the reporting entity expects to pay is a better estimate than any other amount within the range, that amount shall be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range shall be the additional amount included in the measurement of the obligation.

The amount that an individual group member expects to pay on behalf of its co-obligors is measured based on principles that are similar to those in ASC 450-20, *Loss Contingencies*. The amount recorded should be the best estimate of the expenditure required to settle the obligation. If the best estimate is a range, and if one amount in that range represents a better estimate than any other amount within the range, that amount should be accrued. If no amount in the range is a better estimate than any other, the minimum amount in the range is included (which could be zero).

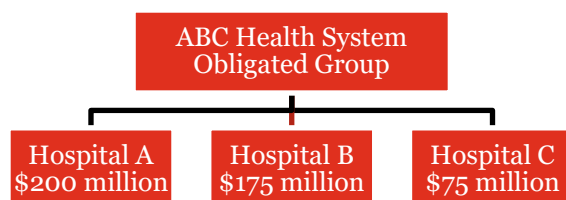
Disclosure should be made regarding the joint-and-several nature and amount of the overall obligation as well as information about the risks that the obligation poses to the entity's future cash flows.

Example NP 11-1 illustrates the application of this guidance.

EXAMPLE NP 11-1

Joint and several liability – obligated group

ABC Health System has an obligated group consisting of three hospitals. In 20X1, the obligated group issues \$450 million of bonds, with the proceeds allocated among the hospitals as shown. The hospitals are jointly and severally liable for repayment of the bonds. Each individual hospital is expected to repay the portion of the proceeds that were allocated to it.



Hospital A prepares and issues standalone financial statements. How should Hospital A reflect the bond liability?

Analysis

Under ASC 405-40, Hospital A's statements should reflect a liability for the amount that has been allocated to it for repayment (\$200 million), plus an additional amount reflecting the amount it expects to pay on behalf of another member (if any). If each member of the group is solvent and expected to pay its allocated share of the obligation, Hospital A's balance sheet would reflect a \$200 million liability at the outset, and the notes would disclose the \$250 million contingent obligation. The disclosures should include the nature and amount of the obligation as well as information about risks such obligations pose to Hospital A's future cash flows.

If in 20X3 it appears that Hospital C might become unable to repay some or all of its \$75 million allocation, Hospital A's estimate of the additional amount it expects to pay on behalf of others may increase above zero. Hospital A would develop a range of exposure (for example, \$15-50 million). If no amount is better than any other in that range, Hospital A would increase the liability by \$15 million.

For more information on accounting for joint and several obligations, see FG 2.9.

11.7 *Regulatory considerations for municipal bonds*

Issuers of municipal bonds are subject to direct regulation by the IRS and indirect regulation by the SEC.

Municipal bonds issued in public offerings are broadly exempted from the registration and reporting requirements of the Securities Act of 1933 and the Exchange Act of 1934, except for the antifraud provisions of those Acts. Thus, regulation of these securities under federal securities laws differs significantly from the regulatory regime applicable to registered offerings. Because the SEC does not have direct regulatory authority, indirect regulation is accomplished primarily through requirements imposed on underwriters of these offerings by Exchange Act Rule 15c2-12.

Rule 15c2-12 establishes a regime for municipal securities disclosure at the time of the public issuance and thereafter throughout the life of the bonds. In connection with a new offering, underwriters must obtain and review the official statement prior to commencing sales to investors. Underwriters must also (with limited exceptions) ensure that the issuer has agreed to implement a system of continuing disclosure that will remain in effect as long as the bonds are outstanding. This entails:

- Providing certain financial information and operating data to the market at least annually. The specific information to be provided as well as the associated due date will be agreed upon by the parties to the financing transaction and enumerated in a "continuing disclosure agreement." There is no prescribed reporting format for submission of the information.
- Agreeing to make timely disclosure of any failure to file the annual financial information by the agreed-upon deadline.
- Disclosing the occurrence of specific events enumerated within the Rule within 10 days.

Disclosure documents are submitted to the Municipal Securities Rulemaking Board via its Electronic Municipal Market Access (EMMA) data portal. Essentially, EMMA makes municipal disclosure information available to the market in a manner similar to the SEC's EDGAR system for corporate disclosures.

The SEC's Office of Municipal Securities is responsible for coordinating the administration of the Commission's rules pertaining to municipal securities. A specialized Public Finance Abuse Unit within the SEC's Division of Enforcement investigates potential violations of the antifraud laws involving municipal securities issues and issuers.

For additional information, see Chapter 10 of AAG-NFP and Chapter 7 of AAG-HCO.

11.7.1 *Municipal bonds—IRS oversight and enforcement*

Issuers of tax-exempt municipal bonds receive benefits under the Internal Revenue Code that lower their borrowing costs. To qualify for and retain these benefits, issuers must comply with stringent federal tax laws and Treasury regulations related to issuance and refunding of bonds, appropriate use of bond proceeds and bond-financed property, and limitations on how bond proceeds may be invested (arbitrage yield restriction and rebate requirements).

Regarding the latter, IRS arbitrage rules ensure that NFP issuers do not attempt to benefit inappropriately from the low borrowing rates associated with tax-exempt bonds by investing bond proceeds in higher yielding investments. If the ultimate yield earned from investing tax-exempt bond proceeds is higher than the interest rate on the bonds, the issuer may be subject to an arbitrage rebate liability that must be paid to the US Treasury in order for the bonds to maintain their tax-exempt status. The arbitrage rebate liability may be substantial if the bond proceeds are not spent as quickly as planned (for example, if an NFP encounters a delay in a major construction project) or in volatile interest rate environments.

These rules are enforced by the IRS's Tax-Exempt Bond office, primarily through its Examination program. For additional information, see AAG-NFP 10.54 through AAG-NFP 10.58 and AAG-HCO 7.40 through AAG-HCO 7.44.

11.8 *Derivatives*

Like business entities, NFPs report derivatives as assets or liabilities on the balance sheet, measured at fair value on an ongoing basis in accordance with ASC 815, *Derivatives and hedging*. The discussion in this section focuses on the incremental guidance provided in ASC 815 and ASC 954-815 for NFPs related to derivatives, including the use of hedge accounting. For a comprehensive discussion of accounting considerations related to derivatives, refer to PwC's *Derivatives and hedging* guide (DH).

Hedge accounting links derivative instruments with items or transactions whose changes in fair values or cash flows are expected to offset each other. ASC 815 segregates hedges into three categories – cash flow, fair value, and net investment. DH 5 provides helpful background on hedge accounting and how it works.

To qualify for hedge accounting, the hedged items or transactions and the hedging instruments must be eligible for hedging treatment. In addition, the hedging relationship must be highly effective in offsetting changes in fair values or cash flows, both at the hedge's inception and on an ongoing basis thereafter. Hedge effectiveness must be evaluated and demonstrated at least quarterly, even if an entity only issues financial statements on an annual basis (as is the practice of most NFPs).

Hedge accounting is allowed only if appropriate documentation is prepared. NFPs that are not conduit bond obligors may elect to perform the initial and all quarterly effectiveness assessments before the date on which the next interim (if applicable) or annual financial statements are available to be issued.

Although ASC 815 provides a simplified hedge accounting approach as an accounting alternative for private companies, NFPs are not considered “private companies” and thus, cannot utilize the simplified hedge accounting alternative.

Many NFPs will enter into derivatives for purposes of hedging specific risks or transactions, but not designate them as hedges under the accounting literature. For example, an NFP might enter into a floating-to-fixed swap as a hedge of interest rate risk; however, unless it is an NFP HCO, it will be precluded from applying ASC 815’s cash flow hedge accounting provisions (see NP 11.8.2). Similarly, an NFP that enters into a fixed-to-floating swap might be unwilling to commit the time and resources that would be needed (initially and on an ongoing basis) to apply fair value hedge accounting. Such situations, which are common in the NFP sector, are referred to as “economic hedging.”

11.8.1 Interest rate swaps

A common hedging strategy used by NFPs is to enter into an interest rate swap in connection with issuing municipal bonds. Most often, the objective of using an interest rate swap is that the combined cash flows of the derivative and the debt will effectively convert fixed rate debt to variable-rate debt or vice versa. Swaps can also be used to convert variable rate bonds from one interest rate to another (a basis swap), as discussed in DH 6.3.6.

If the NFP qualifies (and elects) to use hedge accounting for the swap, the accounting differs based on the type of hedge. An NFP HCO with floating rate debt that enters into a floating-to-fixed swap would account for it as a cash flow hedge (see ASC 815-30). If an NFP has fixed rate debt and enters into a fixed-to-floating swap to hedge the fair value of its debt (essentially the payoff value), it would account for the hedge as a fair value hedge (see ASC 815-25).

For certain plain-vanilla hedges of interest rate risk, a “shortcut method” allows an entity to assume that the hedge is perfectly effective without having to perform ASC 815’s quantitative effectiveness assessments either at inception or on an ongoing basis, significantly simplifying hedge accounting (see DH 9.4). “Interest rate risk” is defined as the risk of changes in the hedged item’s fair value or cash flows attributable to changes in a designated benchmark interest rate. ASC 815-20-25-6A identifies the designated benchmark interest rates as eligible for the shortcut method (the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate, the Secured Overnight Financing Rate (SOFR) Overnight Index Swap Rate, direct obligations of the US Government, LIBOR, or the Fed Funds Effective Rate Overnight Index Swap (OIS) Rate). NFPs most commonly use swaps for which the underlying is the SIFMA Municipal Swap Rate (a benchmark floating rate derived from interest rate resets on a selected group of municipal variable rate demand obligation issues).

11.8.2 Presentation of derivative gains and losses—NFPs other than HCOs

NFPs other than HCOs recognize the gain or loss on all derivative instruments, whether hedging or nonhedging, as changes in net assets in the period of change. The gains or losses are classified as changes in net assets without donor restrictions unless they are donor-restricted (as might be the case for certain investments in derivative instruments).

If the NFP qualifies for and uses fair value hedge accounting, the changes in the fair value of the hedged item are reported in the same line item as the changes in the fair value of the derivative, so that they effectively offset in whole or in part (see ASC 815-25-35-19). NFPs are not permitted to use cash flow hedge accounting because they do not report a standardized earnings measure (see ASC 815-30-15-2). Therefore, most NFPs will account for economic hedges of cash flows as nonhedging derivatives that are presented in accordance with ASC 815-10-35-3. However, we believe that NFPs that voluntarily report a performance measure that is identical to the earnings measure (performance indicator) reported by NFP HCOs may apply cash flow hedge accounting by analogy. See NP 11.8.3 for information on cash flow hedge accounting by NFP HCOs.

Excerpt from ASC 815-25-35-19

An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit entity [NFP] or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that circumstance, the provisions of paragraphs 815-20-25-66 and 815-35-35-1 through 35-2 shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraphs 815-25-35-1 through 35-4 in a fair value hedge as a change in net assets in the period of change.

Excerpt from ASC 815-30-15-2

The guidance in [the cash flow hedges subtopic] does not apply to ... entities that do not report earnings. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately.

ASC 815-10-35-3

An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit entity or a defined benefit pension plan) shall recognize the gain or loss on a nonhedging derivative instrument as a change in net assets in the period of change.

Although ASC 815 does not provide specific guidance on how gains and losses on derivatives that do not use hedge accounting should be presented in the statement of activities, fair value changes generally would be shown in a single line item. Splitting gains and losses into more than one line item or "recycling" the gains and losses by recognizing them in multiple line items in different periods is generally not appropriate. We believe that an NFP may make a policy election regarding the income statement classification of derivatives that are economic hedges. An NFP may either report the fair value fluctuations associated with the derivative (1) in the same line as the hedged item or (2) in another reasonable income statement line item. For additional information, see FSP 19.4.4. AAG-NFP 4.29 through AAG-NFP 4.37 discuss the classification and presentation of the gains and losses on swaps, as well as considerations for investments in derivative instruments.

EXAMPLE NP 11-2

Income statement presentation of interest rate swap

In September 20X1, ABC University, through its state educational financing authority, issued \$200 million of variable rate debt. At the same time, ABC University entered into an interest rate swap for a

notional amount of \$200 million in order to fix the interest rate over the term of the debt. Because ABC University does not have an earnings measure that meets the definition of a performance indicator, it cannot use cash flow hedge accounting. For the year ended June 30, 20X2, ABC University paid \$6.3 million in interest to the bondholders, and received \$0.4 million (net) from the interest rate swap counterparty. As of June 30, 20X2, the interest rate swap from ABC University's perspective had a fair value of negative \$1.2 million (i.e., a liability).

How should the amounts related to the interest rate swap be presented in ABC University's statement of activities?

Analysis

The interest rate swap has two components: unrealized gains and losses due to changes in fair value and realized gains and losses that are the net payments associated with the swap. For the year ended June 30, 20X2, the total impact of the derivative on changes in net assets is a loss of \$0.8 million (the loss due to the change in fair value of \$1.2 million offset by the net realized gain of \$0.4 million from the net settlement of the swap to date).

ASC 815 does not provide specific guidance on the income statement presentation of gains and losses on derivatives that are not designated to be part of a hedging relationship. We believe the presentation in the statement of activities of derivatives that are not designated as hedges is a policy election, although splitting gains and losses into more than one income statement line item is generally not appropriate. As such, ABC University could present the net \$0.8 million loss within interest expense, other income/expense, or another appropriate line item of their choice.

11.8.3 Presentation of derivative gains and losses—NFP HCOs

NFP HCOs report changes in fair value of derivatives in the same manner as business entities, as required by ASC 954-815-25-2. That is, derivative gains and losses are included in or excluded from the performance indicator in the same manner as a business entity would include or exclude them from net income (i.e., report them in other comprehensive income).

ASC 954-815-25-2

Except as provided in paragraph 954-815-50-1, not-for-profit health care entities shall apply the provisions of Topic 815 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit entities. That is, the gain or loss items that affect a for-profit entity's income from continuing operations similarly shall affect the not-for-profit health care entity's performance indicator, and the gain or loss items that are excluded from a for-profit entity's income from continuing operations (such as items reported in other comprehensive income) similarly shall be excluded from the performance indicator by the not-for-profit health care entity.

For fair value hedges, the changes in the fair value of the derivative are reported in the same line item as the changes in the fair value of the hedged item and reported within the performance indicator.

Unlike other NFPs, NFP HCOs are permitted to use cash flow hedge accounting. NFP HCOs can initially present a derivative's change in fair value outside of an earnings measure (the performance indicator), and subsequently reclassify it into earnings in the period that the hedged transaction affects

earnings. See also ASC 954-220-45-8(e). As discussed in ASC 954-815-45-1, the fact that NFP HCOs are not required to report accumulated other comprehensive income (or changes therein) as a separate component of equity in the balance sheet pursuant to ASC 220 is not a barrier to their use of cash flow hedge accounting.

ASC 954-815-45-1

The absence of a requirement to report a separate component of equity in the balance sheet of a not-for-profit, business-oriented health care entity shall not preclude those entities from using comprehensive income reporting for qualifying gains and losses on cash flow hedges. Although accumulated other comprehensive income will inherently be carried forward in a not-for-profit health care entity's net assets, there is no compelling need for it to be reported separately in the balance sheet.

However, ASC 954-815-50 requires NFP HCOs to provide cash flow hedging disclosures that are analogous to those required for business entities, including disclosure of amounts that have been excluded from the performance indicator.

If the NFP HCO does not qualify for or does not elect to use hedge accounting, or if it enters into a nonhedging derivative for purposes other than risk management, the changes in fair value are included within the performance indicator unless they pertain to donor-restricted activity.

AAG-HCO Chapter 5, *Derivatives*, provides additional discussion on these matters.

11.8.4 NFP tabular disclosure requirements of derivatives

ASC 815 requires that certain derivative disclosures be provided in a tabular format, with specific considerations for NFPs discussed at ASC 815-10-50-4G.

ASC 815-10-50-4G

For purposes of the disclosure requirements beginning in paragraph 815-10-50-4A, not-for-profit entities within the scope of Topic 954 should present a similarly formatted table. Those entities shall refer to amounts within their performance indicator, instead of in income, and amounts outside their performance indicator, instead of in other comprehensive income. Not-for-profit entities not within the scope of Topic 954 shall disclose the gain or loss recognized in changes in net assets using a similar format. All not-for-profit entities also would indicate which class or classes of net assets (without donor restrictions or with donor restrictions) are affected.

NFPs must include the location and amounts of gains and losses reported in the statement of activities (or for NFP HCOs, in the statement of operations, identifying the amount of gains and losses recognized in the performance indicator and, where applicable, outside the performance indicator). This disclosure requires separate categories for derivatives designated and qualifying as fair value hedges, those designated and qualifying as cash flow hedges, those not designated or not qualifying as hedging instruments, and other categories, if applicable. Within each category, separate line items should further categorize derivatives by purpose (i.e., the item being hedged, or the exposure created). NFPs also must disclose which class or classes of net assets (without donor restrictions or with donor restrictions) are affected.

Chapter 12:
***Revenue from exchange and
part-exchange transactions***

12.1 Revenue from exchange and part-exchange transactions overview

Many NFPs provide goods or services in the ordinary course of carrying out their mission. In some cases, those goods or services might be purchased by customers in exchange transactions. In other circumstances they might be funded by a government or foundation for the benefit of the public at large.

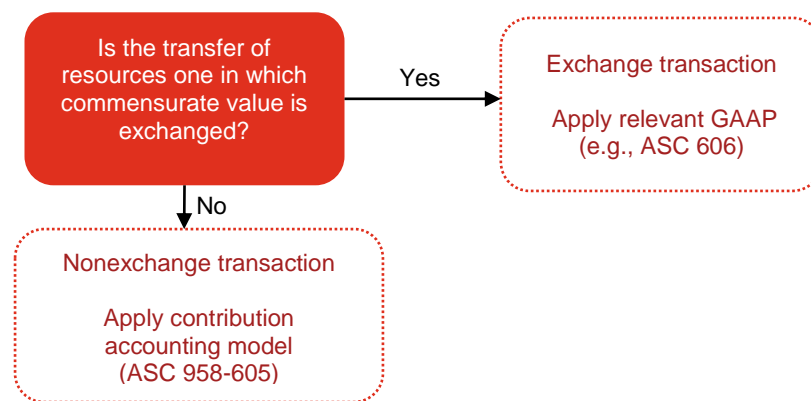
This chapter discusses how to determine whether transactions are exchange or nonexchange under a framework established by ASU 2018-08, *Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*. Exchange transactions are subject to the guidance on revenue from contracts with customers in ASC 606, *Revenue from Contracts with Customers*, which is summarized in this chapter and covered in detail in the PwC *Revenue from contracts with customers* guide. The nonexchange revenue recognition model—ASC 958-605, *Revenue Recognition - Contributions*—is described in NP 6. This chapter also discusses accounting for transactions that are partially exchange and partially contributions.

12.2 Exchange vs. nonexchange evaluation

ASC 958-605 includes a decision-making framework for distinguishing whether a transaction is exchange (reciprocal) or nonexchange (nonreciprocal). As shown in Figure NP 12-1, an entity should apply ASC 606 or other appropriate guidance to exchange transactions and ASC 958-605 to nonexchange transactions.

Figure NP 12-1

Decision framework—evaluating exchange vs. nonexchange



The ASC Master Glossary defines *exchange* as a reciprocal transfer between two parties (for example, when one entity acquires assets or services by surrendering assets or incurring obligations). In distinguishing between exchange transactions and contributions, the definition of *contribution* adds the concept of a *commensurate value* exchange.

Definitions from ASC Master Glossary

Exchange: An exchange (or exchange transaction) is a reciprocal transfer between two entities that results in one of the entities acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations

Contribution (excerpt): An unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, settlement, or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner...

In a contribution transaction, the resource provider often receives value indirectly by providing a societal benefit although that benefit is not considered to be of commensurate value. In an exchange transaction, the potential public benefits are secondary to the potential direct benefits to the resource provider. ASC 958-605-15-5A provides additional clarifying guidance on what commensurate value means, stating that in an exchange of commensurate value, a reciprocal flow of benefits occurs directly between the parties, for example:

- The goods or services provided directly benefit the resource provider or are for its own use.
- The resource provider obtains proprietary rights or other privileges, such as patents, copyrights, or advance and exclusive knowledge of research outcomes.

Example NP 12-1 illustrates the concept of an exchange of commensurate value.

EXAMPLE NP 12-1**Research arrangement—exchange of commensurate value**

PharmaCo conducts new drug research using its own scientists, but also funds research conducted by NFP entities and biotech companies to speed the development of new drugs. PharmaCo enters into a research arrangement with NFP Research Institute. Under the arrangement, PharmaCo has the right to review NFP Research Institute's research and has the right of first refusal to license any compounds discovered. If PharmaCo opts not to license the compounds, NFP Research Institute can look for other buyers.

Is the arrangement between PharmaCo and NFP Research Institute an exchange of commensurate value?

Analysis

Yes, the transaction appears to meet the definition of an exchange. In this fact pattern, PharmaCo is in essence outsourcing research to NFP Research Institute. PharmaCo is providing resources in exchange for the entitlement to receive advance knowledge of research outcomes associated with compounds discovered by NFP Research Institute and the right of first refusal to license them. This entitlement gives PharmaCo a potential advantage in obtaining a proprietary interest in a compound, and therefore it has value to PharmaCo.

NFP Research Institute would account for the arrangement in accordance with ASC 606.

In contrast, if a resource provider does not receive commensurate value in exchange for the resources provided, the transaction would be nonexchange.

Example NP 12-2 illustrates a transaction that would not be an exchange of commensurate value.

EXAMPLE NP 12-2

Private foundation grant

University receives funding from Private Foundation to conduct scientific research for purposes of discovering planets. University is required to submit a summary of research findings to the foundation at the end of the study, but University retains all rights to the findings and has permission to publish them, if desired.

Is the arrangement between University and Private Foundation an exchange of commensurate value?

Analysis

In this fact pattern, Private Foundation does not receive direct commensurate value in exchange for the resources provided; the scientific research is for the benefit of society and not for the direct benefit of Private Foundation. University retains all rights to the research and findings; therefore, University and the general public receive the primary benefits.

This arrangement would be a nonexchange transaction accounted for under the ASC 958-605 accounting model.

At times, the benefits acquired by the resource provider in a transaction may be intangible, uncertain, or difficult to measure. This does not prevent a transaction from being classified as reciprocal, if it is commensurate with the value that a resource provider expects in exchange for the transferred resources, as described in ASC 958-605-55-5.

Excerpt from ASC 958-605-55-5

A resource provider may sponsor research and development activities at a research university and retain proprietary rights or other privileges, such as patents, copyrights, or advance and exclusive knowledge of the research outcomes. The research outcomes may be intangible, uncertain, or difficult to measure, and may be perceived by the university as a sacrifice of little or no value; however, their value often is commensurate with the value that a resource provider expects in exchange.

Figure NP 12-2 includes other factors to consider in evaluating whether arrangements are exchange or nonexchange.

Figure NP 12-2

Indicators of whether transactions are exchange or nonexchange

<i>Indicative of an exchange</i>	<i>Indicative of nonexchange</i>
<ul style="list-style-type: none"> □ The expressed intent by both parties is to exchange resources for goods and services that are of commensurate value □ Both parties agree on the amount of assets transferred in exchange for goods and services that are of commensurate value □ Contractual provisions provide for assessment of penalties beyond the amount of assets transferred if the recipient (e.g., NFP) fails to perform 	<ul style="list-style-type: none"> □ Recipient solicits assets from the resource provider without the intent of providing goods or services of commensurate value □ Resource provider has full discretion in determining the amount of the transferred assets □ Penalties assessed for failure to comply with the terms of the agreement are limited to the delivery of assets/services already provided and the return of unspent funds

12.2.1 Revenue from government grants

ASC 958-605 provides explicit guidance that indicates that government grants with certain features would *not* be commensurate value exchanges. Most of those features focus on grants from federal government agencies, as many activities funded by the federal government are carried out for the public's benefit, rather than in connection with obtaining proprietary benefits or goods and services for the government's own use.

Prior to the adoption of ASU 2018-08, widespread historical practice considered many federal grants as exchange transactions. Figure NP 12-3 describes some of the historical justifications for that practice, along with the explicit clarifications added to ASC 958-605 (primarily in ASC 958-605-15-5A) by ASU 2018-08 to address that practice.

Figure NP 12-3

Comparison of historical practice on classification of federal grants as exchanges to new guidance introduced by ASU 2018-08

Rationale used to support treatment as exchange transaction	ASU 2018-08's clarifications
The federal government does not make "donations;" thus, the use of contribution accounting for federal grants is not appropriate.	<p>Automatically defaulting to "exchange" treatment for federal grants is not appropriate. The type of resource provider should not override the substance of an arrangement with nonreciprocal characteristics.</p> <p>As used in GAAP, the term "contribution" refers to nonexchange or nonreciprocal transactions. It is not focused narrowly on charitable donations.</p>

Rationale used to support treatment as exchange transaction	ASU 2018-08's clarifications
A government agency can carry out its mission through outsourcing certain activities to subcontractors. The value received in exchange is the discharge of the agency's own responsibilities.	<p>In an exchange transaction, the resource provider benefits directly. If the general public receives the primary benefit from the activities, any benefits received by the resource provider would be indirect or incidental.</p> <p>Neither the intangible benefits arising from having its mission furthered nor the positive sentiments arising from acting as a donor would constitute commensurate value received by a resource provider.</p>
Grant-funded activities that benefit the public at large are reciprocal, because "general public" is synonymous with "government." Benefits received by the public at large are tantamount to benefits received by the government itself.	The public and the government cannot be viewed as the same party for revenue recognition purposes.

Notwithstanding historical practice prior to the adoption of ASU 2018-08, most federal grants received by NFPs are subject to the nonexchange (contribution) revenue recognition model.

Many federal grants are awarded on a cost-reimbursement basis. Because of requirements related to most federal grants, the ASC 958-605 model views federal grant cost-reimbursement arrangements as conditional contributions. Because conditions would be satisfied by incurring those same costs, the revenue recognition pattern would likely be similar to historical (pre-ASU 2018-08) accounting for exchange transactions.

The guidance on determining whether government grants are exchange or nonexchange transactions is illustrated in Example NP 12-3.

EXAMPLE NP 12-3

Federal research grant

The National Institutes of Health (NIH), an agency of the federal government, announces the availability of awards for research projects involving certain infectious diseases. NFP Research Institute applies for and receives a \$500,000 research award for this purpose.

Is the arrangement between NIH and NFP Research Institute an exchange transaction?

Analysis

Because the NIH is not receiving benefits in return (apart from the advancement of its mission), the arrangement would be nonreciprocal (nonexchange).

While this might appear similar to the “outsourcing” of research in Example NP 12-1, the focus of the distinction between an exchange transaction and a nonexchange transaction is on whether reciprocal benefits actually flow between the parties to an agreement. Unlike PharmaCo in Example NP 12-1, the NIH is not directly receiving goods, services, or intangible rights (e.g., a license to intellectual property) in return for the resources provided. Although the NIH’s mission is furthered by NFP Research Institute carrying out the research, that benefit is secondary to the benefit received by the general public.

The GAAP framework for classifying government grants as exchange or nonexchange is similar to that used by the Federal government in categorizing federal “extramural” activities (i.e., arrangements with non-federal entities). Federal law establishes parameters surrounding the three types of legal instruments that the federal government must use when funding extramural activity. A *contract* is used if the principal purpose of the funded activity is to provide something for the direct benefit or use of the federal government. (These transactions are referred to as “procurement arrangements.”) Because a contract is used to acquire something for the government’s direct benefit or use, there is a close correlation between this type of instrument and exchange transactions as discussed in ASC 606. If the principal purpose of the activity is to support or stimulate activities that are not for the direct benefit or use of the federal government, the arrangement is considered either a *grant* or a *cooperative agreement*. Those arrangements are closely correlated with transactions classified as nonexchange in ASC 958-605.

Some NFPs that enter into both exchange and nonexchange transactions with the federal government may display all the revenues in a single line in the statement of activities, using a caption such as “Grants and contracts.” When ASC 606 and ASC 958-605 revenues are combined in this manner, the amounts recognized under ASC 606 must be separately disclosed (for example, in notes to the financial statements), consistent with ASC 606’s requirement to present or disclose revenue from contracts with customers separate from other sources of revenue.

12.2.1.1 Government grant pass-through awards

Sometimes an NFP that receives a federal grant or cooperative agreement will pass a portion of the federal program funds to another entity that will provide goods or services related to the activity carried out with the federal funding (a “subaward”). Under federal regulations, “subawards” are either a *subrecipient arrangement* (if the subawardee is deemed to be carrying out part of the federal award) or a *contractor agreement* (if the subawardee is providing goods and services in a procurement relationship).

Subaward arrangements must also be evaluated for classification as exchange or nonexchange transactions under ASC 958-605.

From the perspective of the original (or “prime”) recipient of the federal award, the determination of whether the arrangement is an exchange transaction with or contribution to the subawardee will contemplate issues similar to those that must be considered when classifying relationships with subawardees as “subrecipients” or “contractors” for regulatory compliance purposes. While the purposes of the GAAP and regulatory analyses differ, we expect the results to be substantively consistent.

The subawardee must make an independent determination of the substance of the arrangement (as exchange or nonexchange) under the revenue recognition decision framework. While the classification

assigned by the prime recipient for regulatory compliance purposes is important to consider, the subawardee cannot simply accept the prime recipient's classification as determinative for GAAP purposes.

12.2.1.2 Distinguishing grants from transfers by third-party payers

Certain payments that might appear similar to government grants might instead be payments made by a government on behalf of a beneficiary who is a party to an exchange transaction, as described in ASC 958-605-15-6.

Excerpt from ASC 958-605-15-6

The guidance in the Contributions Received Subsections does not apply to the following transactions and activities:

...

- e. Transfers of assets (typically from a government entity) that are part of an existing exchange transaction between a recipient and an identified customer. Some examples include payments under Medicare and Medicaid programs, provisions of health care or education services by a government for its employees, and Pell Grants or similar state or local government tuition assistance programs. In those instances, an entity shall apply the applicable guidance (for example, Topic 606 on revenue from contracts with customers) to the underlying transaction with the customer, and the payments from the third parties would be payments on behalf of those customers.

One example is Pell Grants made by the federal government to students. In those situations, the government awards the Pell grant to a specific student but transmits the proceeds directly to the university on the student's behalf. From the university's perspective, the underlying revenue transactions (tuition, housing, etc.) arise from contractual arrangements between the university and the student. The government is simply facilitating the payment process.

Similar considerations apply to Medicare and Medicaid payments made to health care entities on behalf of specific patients. In those situations, the revenues arise from an exchange transaction between the patient and the health care provider. The payments are government benefits to the individuals that are transmitted directly to the health care provider. See ASC 958-605-55-14B through 14E for illustrations.

12.3 Transactions that are part-exchange and part-contribution

Sometimes a single revenue transaction may be in part an exchange and in part a contribution. In these situations, only the exchange portion is within the scope of ASC 606; the remainder is contribution revenue accounted for using the principles in ASC 958-605.

ASC 606-10-15-4 provides a principle for bifurcating revenue transactions that are partially within the scope of ASC 606 and partially within the scope of other guidance. That principle indicates that if the

other guidance specifies how to separate or initially measure one or more parts of a “hybrid” transaction, an entity should apply that separation or measurement guidance first.

Consistent with that principle, NFPs look to guidance provided by ASC 958 on separating the contribution and exchange elements of a single transaction. Examples in ASC 958-30-55-4, ASC 958-605-55-10, and ASC 958-220-55-15 illustrate the framework that should be used. That framework requires an NFP to first determine the fair value of the exchange portion of the transaction, and then measure the contribution portion as the excess of the resources received over the fair value of the exchange portion.

Excerpt from ASC 958-30-55-4

The transfer [of assets in a split interest agreement] is partially an exchange transaction—an agreement for annuity payments to a beneficiary over time—and partially a contribution. The contribution received by [the NFP] is the unconditional right to receive the remainder interest of the annuity trust. The amount of the contribution received by [the NFP] is the fair value of the trust assets (\$100,000 cash transferred) less the fair value of the estimated annuity payments (which is the present value of \$5,000 to be paid annually over the expected life of the annuitant if present value techniques are used to measure fair value).

Excerpt from ASC 958-605-55-10

For example, if an NFP has annual dues of \$100 and the only benefit members receive is a monthly newsletter with a fair value of \$25, \$25 of the dues are received in an exchange transaction and should be recognized as revenue as the earnings process is completed and \$75 of the dues are a contribution.

Excerpt from ASC 958-220-55-15

[An NFP] may report the gross revenue from special events and other fundraising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value).

AAG-NFP 5.43 recommends that NFPs apply this fair value residual separation approach to all part-contribution, part-exchange transactions.

Excerpt from AAG-NFP 5.43

The Financial Reporting Executive Committee (FinREC) believes that in circumstances in which the transaction is in part a contribution and in part an exchange, NFPs should first determine the fair value of the exchange portion of the transaction, with the residual (excess of the resources received over the fair value of the exchange portion of the transaction) reported as contributions.

The illustrations provided in ASC 958 involve split-interest agreements (see NP 8.7), dues (see NP 12.4.3), and special events (see AAG-NFP 5.110 to AAG-NFP 5.114). Other situations when resources might be received in transactions that are part exchange, part contribution include:

- Naming opportunities (see AAG-NFP 5.53 to AAG-NFP 5.56)
- Acknowledgement of donors by status or recognition levels (e.g., platinum, gold, or silver levels), with benefits that increase based on the level of recognition (see AAG-NFP 5.57)
- Gala performances (see NP 12.4.4)

12.3.1 ***Contributions inherent in bargain purchase transactions***

Another type of transaction that may be in part an exchange and in part a contribution is a “bargain purchase.” In contrast to the transactions discussed in NP 12.3 in which a good or service is being procured *from* the NFP in a transaction that also includes a contribution element, these are transactions in which the NFP is procuring a good or service for less than fair value because the seller intends for the difference between the consideration paid by the NFP and the fair value of the asset or services transferred to the NFP to represent a donation.

A common example is a bargain purchase of real estate, discussed in ASC 958-605-55-6 and AAG-NFP 5.43.

Excerpt from ASC 958-605-55-6

[A] single transaction may be in part an exchange and in part a contribution. For example, if a donor transfers a building to an entity at a price significantly lower than its fair value and no unstated rights or privileges are involved, the transaction is in part an exchange of assets and in part a contribution to be accounted for as required by the Contributions Received Subsections of this Subtopic.

Excerpt from AAG-NFP 5.43

An individual has a home currently valued at \$150,000, which is subject to a mortgage of \$30,000. If the individual pays off the mortgage and sells the home to an NFP for \$50,000, a contribution of \$100,000 is inherent in the transaction.

In a bargain purchase transaction, the approach illustrated in AAG-NFP 5.43 for measuring the contribution element requires the NFP to compare the fair value of the asset(s) received to the amount of consideration it transfers in exchange. The excess represents contribution revenue that is accounted for in accordance with the “Contributions Received” subsections of ASC 958-605.

12.4 ***NFP-specific revenue streams***

When an NFP provides goods or services in exchange for consideration from a customer, ASC 606, *Revenue from Contracts with Customers* applies. ASC 606 replaces substantially all of the specialized industry guidance previously used to account for various arrangements under US GAAP with a comprehensive, industry-neutral revenue recognition model.

An AICPA audit and accounting guide, *Revenue Recognition* (AAG-REV), has been issued to assist preparers and auditors with understanding and implementing ASC 606 in the context of various industry sectors. Chapter 7, “Health Care Entities,” contains implementation guidance related to health care revenue transactions, and Chapter 8, “Not-for-Profit Entities,” contains implementation guidance for exchange transactions involving entities within the scope of AAG-NFP. For a comprehensive discussion of the guidance in ASC 606, refer to the PwC *Revenue from contracts with customers* guide (RR).

ASC 606 does not address revenue associated with leases, investment income, or contributions, all of which are accounted for under other standards. If a contract is partially within the scope of ASC 606 and partially within the scope of other guidance, ASC 606-10-15-4 provides a principle for bifurcating the transaction. That principle indicates that if the other guidance specifies how to separate or initially

measure one or more parts of a “hybrid” transaction, an entity should apply that separation or measurement guidance first. Application of this framework to certain revenue streams discussed in this section that are part exchange and part contribution is discussed in NP 12.4.3 and NP 12.4.4. Bifurcation might need to be considered in some revenue contracts that include occupancy rights, such as certain student housing contracts or continuing-care retirement community resident agreements. If such a contract is deemed to include a lease component, an NFP would apply the guidance in ASC 842, *Leases*, to separate the portion that would be accounted for under ASC 842 from the portion accounted for under ASC 606.

The core principle that underlies revenue recognition is described in ASC 606-10-05-3.

ASC 606-10-05-3

The core principle of this Topic is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

In order to implement that principle, the standard lays out five broad steps:

- Step 1—identify the contract with the customer (see RR 2)
- Step 2—identify performance obligations (see RR 3)
- Step 3—determine transaction price (see RR 4)
- Step 4—allocate transaction price to performance obligations (see RR 5)
- Step 5—recognize revenue (see RR 6)

This section discusses considerations regarding applying ASC 606 (and, to the extent applicable, any contribution element) to the following revenue streams that are often found in NFPs:

- Tuition, housing, and dining plans
- Patient service revenue
- Continuing-care retirement community contracts
- Dues or memberships
- Ticket sales

12.4.1 Higher education – tuition, housing, and dining revenue

Tuition, housing (room), and dining (board) are perhaps the most common revenue sources for higher education institutions. Interpretive guidance to assist preparers and practitioners with applying ASC 606 to revenue contracts for tuition and housing is contained in AAG-REV 8.6.01 through AAG-REV 8.6.69. Key considerations are highlighted below.

□ *Step 1—identify the contract*

For higher education institutions, specific considerations in identifying the contract include (1) establishing the date of contract inception, and (2) determining the number of contracts (for accounting purposes) between the institution and a particular student.

When evaluating whether and when an agreement with a student creates enforceable rights and obligations (i.e., a contract), an institution must consider its practices and processes related to admission and registration of students and the payment of nonrefundable deposits to secure enrollment and housing. According to AAG-REV 8.6.05, the Financial Reporting Executive Committee (FinREC) believes that payment of a nonrefundable deposit to secure enrollment or housing generally gives a student the right to receive the instruction or housing, respectively, and obliges the institution to stand ready to provide such instruction or housing, thereby creating an enforceable right.

However, in evaluating whether payment of a deposit triggers contract inception under the revenue standard, institutions should also consider whether substantive termination penalties exist if the student forfeits the deposit. According to ASC 606-10-25-4, a contract does not exist if parties have the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party. If a student can withdraw during the initial portion of an academic term and lose only their nonrefundable deposit, entities should assess whether the loss of the nonrefundable deposit is a substantive termination penalty. We believe if the forfeiture of the nonrefundable deposit is not substantive (e.g., the amount of the forfeited deposit is inconsequential compared to the amount of the contract), the contract term would not commence until performance begins (see RR 2.7). These matters are discussed in AAG-REV 8.6.03 through AAG-REV 8.6.05.

Entities must also consider whether a single contract with a student exists for accounting purposes, or whether there are multiple contracts. It is common for higher education institutions to enter into separate agreements with a student, often at or near the same time, for tuition, housing, dining, and other services. If the economics of the arrangements are interrelated, they may need to be combined and accounted for as a single contract for purposes of applying ASC 606. If an institution provides a “discount” to a student based on an evaluation of total “need” or the “total cost of attendance,” combining these contracts could result in a different pattern of revenue recognition or a different allocation of revenue between classes of revenue (e.g., tuition and housing), either as presented on the statement of activities or as disclosed in the notes, than would be the case if the multiple contracts were accounted for individually.

Interpretive guidance on the criteria for combining contracts is contained in AAG-REV 8.6.12.

Other matters related to evaluating whether a contract exists under the revenue standard include assessing a contract’s collectability (AAG-REV 8.6.06 through AAG-REV 8.6.11 and AAG-REV 8.6.39 through AAG-REV 8.6.41) and grouping contracts into portfolios when making the collectability assessment (AAG-REV 8.6.13 through AAG-REV 8.6.14).

□ *Step 2—identify performance obligations*

Some contracts may involve a single performance obligation, while others contain multiple performance obligations. For example, depending on its terms, a contract for a student dining plan might embody a single performance obligation (i.e., a stand-ready obligation to provide

“unlimited” meals during a term) or multiple performance obligations (i.e., a commitment to deliver a specified number of meals during a term). In the latter situation, the standard provides guidance for determining whether multiple performance obligations in an arrangement are distinct or should be combined. In addition, as noted in Step 1, multiple contracts may need to be combined and evaluated as a single contract in some circumstances, in which case the contract consideration will be combined but, in many cases, the promises in the individual contracts will be distinct. Applying ASC 606’s guidance for identifying performance obligations and whether they are “distinct” requires judgment. AAG-REV 8.6.15 through AAG-REV 8.6.19 discusses considerations related to determining whether tuition, housing, and dining are distinct services promised by the institution, or whether they represent a single performance obligation (and thus, need to be combined).

□ *Step 3—determine transaction price*

For higher education institutions, specific considerations in determining the transaction price include the sources of payment of the consideration under the contract, reductions to the published price, and reductions of revenue for potential refunds.

The amounts to which the entity is entitled under the contract could, in some instances, be paid by parties other than the student (the customer). For example, institutions of higher education typically receive federal financial aid on behalf of students. In those cases, the assessment of the transaction price includes both the consideration paid directly by the student and consideration received from external parties.

Information about a school’s cost of attendance for tuition, fees, housing, and meal plans for a given academic year is typically listed on its website or in its academic catalog. While sometimes the stated prices will prove to be the transaction price for its arrangements with a student, in other situations the school will adjust that price. The transaction price in a contract is based on the specific terms entered into with each student. These matters are discussed in AAG-REV 8.6.20 through AAG-REV 8.6.31.

If an institution provides a student with a reduction to the published, or “list” price, the substance of the reduction and the rationale for offering it will determine whether the reduction should affect the transaction price (and, in turn, revenue). A reduction associated with a scholarship awarded by the school reduces the amount of consideration the school expects to be entitled to and, therefore, is a reduction of the transaction price. A reduction offered in exchange for services provided (for example, certain work-study aid packages awarded to students or tuition remission programs for dependents of a school’s employees) might need to be reported as compensation expense, rather than as a reduction of revenue.

Many institutions have a tuition refund policy that allows students the right to withdraw with a full or partial refund during a stipulated period after classes have begun. In such situations, the consideration is considered “variable” at the contract’s outset, because it is contingent on the occurrence (or non-occurrence) of a future event (i.e., the student’s decision to withdraw). Consideration is variable if there are uncertainties surrounding the price or quantity, or contingencies regarding realization (such as a sale with a right of refund). In general, variable consideration needs to be estimated at the inception of the arrangement and included in the transaction price. Until the withdrawal period lapses, the institution would need to estimate the amount of potential tuition refunds and recognize revenue at a reduced amount with a corresponding refund liability. An institution could estimate the potential refund liability on a

portfolio basis—that is, by aggregating its tuition contracts into a portfolio (or portfolios based on different student populations) and estimating the aggregate refund potential of the portfolio (rather than for individual contracts). These matters are discussed in AAG-REV 8.6.32 through AAG-REV 8.6.38.

□ *Step 4—allocate the transaction price*

When multiple performance obligations are associated with a single contract or if multiple contracts are combined into a single contract, institutions will need to allocate the transaction price among the performance obligations. This allocation is made based on the relative standalone selling prices of each performance obligation (the price at which the institution would sell a good or service separately), as described in ASC 606-10-32-29.

If a standalone selling price is not observable, the institution must estimate it. The standard provides examples of suitable methods for estimating standalone selling price. In doing so, institutions will also need to determine how any reductions in amounts charged, such as financial aid awarded to a student as a scholarship, should be allocated, pursuant to ASC 606-10-32-36. That guidance states that except when an entity has observable evidence in accordance with criteria outlined in ASC 606-10-32-37 that the entire discount relates to only one or more, but not all, performance obligations in a contract, the entity shall allocate the discount proportionately to all performance obligations in the contract. AAG-REV 8.6.42 through AAG-REV 8.6.46 discusses these matters. We believe that institutions should consider their policies, practices, and contracts with students to evaluate whether they meet the requirements to allocate the discount (financial aid package) to some but not all of the performance obligations in a contract.

Example NP 12-4 illustrate the allocation of the transaction price and a proportionate allocation of the discount among performance obligations.

EXAMPLE NP 12-4

Allocation of transaction price among performance obligations

A school offers a variety of 12-week courses. The standard tuition for each course is \$2,200, which is determined to be representative of the standalone selling price as it represents the price the school would charge to similar students under similar circumstances. In one particular course, students are provided with two textbooks (normally sold in bookstores for \$150 each) on the first day of class at no additional charge.

How should the transaction price be allocated between the performance obligations?

Analysis

There are two performance obligations in this arrangement – one to provide instructional services and one to provide the textbooks. The contract's transaction price—the amount of consideration to which the school expects to be entitled—is \$2,200, which must be allocated between the two performance obligations based on their relative standalone selling prices. The two textbooks together have a standalone selling price of \$300. The standalone tuition for the school's 12-week course is \$2,200. In this situation, the student is entitled to goods and services with a total standalone selling price of \$2,500 in exchange for paying \$2,200. The difference is considered a discount that must be allocated proportionally between the books and tuition based on their

relative standalone selling prices. The portion of the transaction price allocated to the books and tuition would be as follows:

Performance obligation	Standalone selling prices	Relative percentage	Allocation of transaction price
Instruction	\$2,200	88%	\$1,936
Textbooks	300	12%	264
	<u>\$2,500</u>	<u>100%</u>	<u>\$2,200</u>

□ *Step 5—recognize revenue*

Revenue is recognized when (or as) control of the promised goods or services transfers to the customer. AAG-REV 8.6.47 through AAG-REV 8.6.56 discuss the notion of “transfer of control” in the context of tuition and housing contracts, and whether that occurs “over time” or at a “point in time.” The determination of the timing of revenue recognition is not an accounting policy election. ASC 606 contains specific criteria for assessing whether control transfers at a point in time or over time. For most institutions, academic services and housing services will be satisfied over time, and sales of goods (e.g., books, apparel and other merchandise, athletic tickets, meals) will be satisfied at a point in time.

When a performance obligation is satisfied over time, the institution must also identify the pattern in which the benefits transfer to the customer (student) in order to develop a measure of the institution’s progress toward satisfying the performance obligation. For most higher education institutions, progress is measured using the proportion of time passed to the duration of the arrangement; other measures of progress include the proportion of costs incurred to date to estimated total costs or some other physical output measure.

Example NP 12-5 illustrates the concepts of point-in-time versus over-time recognition.

EXAMPLE NP 12-5

Point-in-time vs. over-time revenue recognition

A school offers a variety of 12-week courses. In one particular course, students are provided instruction over the 12-week period, along with two textbooks, which are provided on the first day of class. The arrangement has two performance obligations—one for providing instructional services and one for providing textbooks—with a transaction price allocated to each of \$1,936 and \$264, respectively.

When should revenue associated with each performance obligation be recognized?

Analysis

The pattern of transfer of control for the textbooks and the instruction differs. The \$264 of revenue associated with the textbooks would be recognized at the point in time when the books are transferred to the student (generally on the first day of class).

The \$1,936 of revenue allocated to the course instruction would be recognized over the period of time that the instructional services are provided to the student. Because the student receives that benefit simultaneously with the instruction being provided and the level of instruction is consistent over the 12-week period, a reasonable measure of progress would be the passage of time. Thus, revenue for the instruction would be recognized straight line over the 12-week period.

12.4.1.1 Recognizing revenue from nonrefundable prepayments

In many circumstances, institutions receive deposits or other nonrefundable payments from students, for example, to hold a spot in a dormitory or in the incoming class. Despite the fact that the payment is nonrefundable, revenue is not recognized at the time the payment is received. Doing so would ignore the fact that the institution may not yet have a contract with the student (as discussed under step 1 in NP 12.4.1) or, even if a contract exists, the institution has not yet transferred control of any goods or services.

If the non-refundable payment relates to a contract, the subsequent accounting will depend on the extent to which the student exercises its rights. If the student enrolls and registers for classes, the school would apply the deposit against the student's obligation to pay tuition, fees, or other amounts due. However, if the student fails to enroll, he or she forfeits the deposit. When a customer does not exercise all of their rights or options in an arrangement, this is referred to as "breakage."

ASC 606 provides specific guidance on how entities should recognize revenue associated with these expired rights. If an NFP expects breakage, the revenue associated with the anticipated breakage should be taken into income proportionately based on the pattern of rights that are exercised by customers. If the anticipated breakage is "all or nothing"—that is, there is no proportional expiration of rights or no ability to estimate the customer's decision—the NFP should recognize revenue when the likelihood of the customer exercising its rights becomes remote.

Example NP 12-6 illustrates a situation when breakage income is estimated based on the proportional expiration of rights.

EXAMPLE NP 12-6

Recognizing breakage revenue

100 students enrolled at University and each student purchases a meal plan that entitles them to 150 meals during the term for a nonrefundable fee of \$600. The right to any meals that a student does not consume by the end of the term will expire. University expects that 10% of the meals will not be consumed, based on history with similar meal plans.

How should University recognize revenue for the unused meals?

Analysis

University estimates that 90% of the meals will be consumed, and that 10% will expire. Therefore, it expects revenue from meals provided of \$54,000 ($\$600 \times 100 \text{ students} \times 90\%$) and estimated breakage of \$6,000 ($\$600 \times 100 \text{ students} \times 10\%$). The ratio of breakage to sales is 0.11 ($\$6,000 / \$54,000$). For each meal sold, University would be entitled to recognize a proportionate amount of breakage income.

In practice, most entities will simply reflect breakage income as an adjusting entry at the end of the accounting period. For example, if 100 meals were consumed in the reporting period, the entity would recognize \$400 of revenue from actual sales of meals ($\$600 / 150 \text{ meals} = \4 per meal ; $100 \text{ meals consumed} \times \$4 \text{ per meal} = \$400$), along with \$44 of breakage income ($\$400 \times 0.11$). The total reported revenue from meal sales would be \$444.

For more information on accounting for “breakage,” see RR 7.4.

12.4.2 Health care revenue transactions

NFP health care providers have unique considerations in applying ASC 606 because of the involvement of third-party payers in most revenue transactions and the fact that providing care to patients who cannot pay is an intrinsic aspect of their business model. Chapter 7 of AAG-REV contains healthcare-specific interpretive guidance.

Aspects of applying the five-step model in ASC 606 to revenue from health care services arrangements that may be particularly challenging or complex are highlighted below.

□ Step 1—identify the contract

Two particularly complex areas regarding the identification of contracts for health care providers are (1) the determination of the counterparty to the contract, and (2) whether a contract is deemed to exist for purposes of the ASC 606 model (and therefore whether revenue can be recognized).

Many health care revenue transactions involve multiple parties: the patient, the physician who orders health care services on behalf of the patient, the healthcare organization that provides the health care services, and a third-party payer who pays the provider on behalf of the patient. A fundamental conclusion reached in the AICPA interpretive guidance is that the “contract with the customer” (for purposes of applying ASC 606) refers to the arrangement between the health care provider and the patient (see AAG-REV 7.6.46). Separate contracts between health care providers and third-party payers, which establish amounts to be paid on behalf of a patient, are not “contracts with customers” under ASC 606, but must instead be considered in determining the transaction price for the goods or services provided under the contract between the patient and the health care provider.

When a health care organization (HCO) is aware of significant credit risk of a customer at the inception of the contract (for example, a patient that is uninsured or underinsured), the HCO must consider those implications in its evaluation of whether the customer is committed to perform its obligations under the contract (i.e., to pay for services rendered). The interpretive guidance describes how HCOs can apply two ASC 606 concepts—implicit price concessions and a portfolio approach—when evaluating whether services provided to high credit risk patients qualify as contracts for which revenue can be recognized under the model. This discussion begins at AAG-REV 7.6.06.

□ Step 2—identify performance obligations

Beginning at AAG-REV 7.2.01, the interpretive guidance discusses general considerations related to identifying the performance obligations in health care contracts, including the notion of

“significant integration” of services. For example, in coordinating a patient’s care during an inpatient stay, a hospital provides a significant service of integrating the goods or services promised in the contract into a bundle of goods and services that represents the combined service for which the patient has contracted. A patient undergoing knee replacement surgery is contracting for the outcome of the replaced knee, not for the individual procedures and supplies used during either the surgery or the hospital stay. Therefore, in many instances, health care providers conclude that the goods and services are not separately identifiable and thus should be combined as one performance obligation.

□ *Step 3—determine transaction price*

The amounts to which the entity is entitled under the contract could, in some instances, be paid by parties other than the customer. For example, hospitals typically receive payments from insurers on behalf of patients. In those cases, the assessment of the transaction price includes both the consideration paid directly by the patient and the consideration received from the external parties.

Providing care to patients who may not be able to pay is an intrinsic part of the health care business model. According to ASC 606 concepts, by knowingly entering into contracts with customers who are significant credit risks, and customarily accepting amounts that are less than the contractually-stated price, an HCO demonstrates a willingness to accept a lower price in exchange for its services than it is otherwise entitled. This is one example of “variable consideration,” which is one of the more complex areas of ASC 606. Consideration is “variable” if there are uncertainties surrounding the price or quantity, or contingencies regarding realization (such as potential retroactive adjustments, discussed below). In general, variable consideration needs to be estimated at the inception of the arrangement and included in the transaction price. The estimate is subject to a constraint if management is unable to conclude that it is probable that a significant reversal of revenue will not occur in the future (if the uncertainty underlying the variable consideration is resolved unfavorably).

Potentially uncollectible amounts are considered an implicit price concession (a form of variable consideration), which reduces the transaction price (i.e., revenue). Such anticipated uncollectible amounts should not be reflected as bad debt expense. This discussion begins at AAG-REV 7.6.19.

“Third-party settlements” is the term used to refer to the estimates of potential retroactive adjustment of revenue associated with portfolios of Medicare or Medicaid patient contracts (see discussion beginning at AAG-REV 7.6.44). A separate discussion beginning at AAG-REV 7.6.73 focuses on estimating performance-based bonus or penalty payments under programs that require providers to share risk with the Center for Medicare and Medicaid Services.

□ *Step 5—recognize revenue*

Revenue is recognized when (or as) control of the promised goods or services transfers to the customer. Beginning at AAG-REV 7.5.01, the interpretive guidance discusses the notion of “transfer of control” in the context of health care services, and whether that occurs “over time” or at a “point in time.” The determination of the timing of revenue recognition is not an accounting policy election. ASC 606 contains specific criteria for assessing whether control transfers at a point in time or over time.

When a performance obligation is satisfied over time, the provider must also identify the pattern in which the benefits transfer to the customer (patient) in order to develop a measure of its

progress toward satisfying the performance obligation. For example, this measure might be based on the proportion of costs incurred to date to estimated total costs, the proportion of time passed to the duration of the arrangement, or some other physical measure (output). The interpretive guidance also discusses these determinations in the context of health care services, noting that judgment may be required when identifying the pattern of transfer.

Other matters discussed include:

- grouping contracts of patients, residents, or members into portfolios that are used in step 1 and step 3 (see AAG-REV 7.7.01)
- presentation (of contract assets and liabilities) and disclosure requirements (see AAG-REV 7.7.16)
- capitalizing or expensing costs incurred in acquiring contracts with customers, primarily by continuing-care retirement communities and prepaid health plans (see AAG-REV 7.7.61).

12.4.2.1 Continuing-care retirement communities (CCRC) revenue transactions

A separate discussion beginning at AAG-REV 7.6.109 provides interpretive guidance on applying the ASC 606 model to resident agreements entered into with CCRCs. Unlike many other healthcare arrangements, CCRC resident agreements are long-term contracts that normally cover the remainder of a resident's life. Complex issues encountered when applying ASC 606 include identifying the performance obligations (including material rights), estimating the transaction price (including adjustments for refundable fees and potential financing components), and the pattern over which revenue should be recognized.

12.4.3 Revenue from dues and memberships

NFPs such as clubs, associations, and professional societies will charge dues to members, sometimes in exchange for providing specified tangible or intangible benefits, for example:

- journal or magazine subscription
- discounted or free continuing professional education classes, conferences, and seminars
- discounted or free tickets to seats at performing arts events
- discounted products or services
- access to locked (behind-the-paywall) website content or a library
- networking opportunities

NFPs with dues-paying members must evaluate whether dues represent exchange transactions, nonexchange transactions, or a combination of the two. If members receive no significant benefits, the dues payments are nonexchange transactions that are accounted for as contributions in accordance with the guidance in NP 6.

If some benefits are provided to members (e.g., a magazine, the right to purchase tickets or books at a discount, discounted admission fees) but their value is not commensurate with the amounts paid, the

dues payments must be apportioned into exchange and nonexchange components for revenue recognition purposes (see NP 12.3). The NFP should first determine the fair value of the exchange portion of the transaction, with the residual (excess of the resources received over the fair value of the exchange portion of the transaction) reported as contribution revenue under the ASC 958-605 model. In some cases, it may be difficult to measure the benefits members receive, and judgment may be required. ASC 958-605-55-12 provides a table of indicators to assist in determining the exchange and nonexchange portions of dues in these situations.

Question NP 12-1 illustrates the consideration of whether dues are an exchange transaction or a contribution.

Question NP 12-1

A library offers memberships for dues of \$250. The dues raised are used to renovate the library. Members are acknowledged in an advertisement in the local paper, but no benefits of substance are provided. Members of the community at large may use the library free of charge.

How should the library account for the dues?

PwC response

The library should account for the dues as contributions because the members are not entitled to any benefits. In this example, both members and nonmembers enjoy the same privileges.

In the statement of activities, the exchange and nonexchange elements of dues do not have to be displayed separately. They can be presented within a single line, if desired. However, if the amounts recognized under ASC 606 are material, they must be separately disclosed (for example, in the notes to the financial statements), consistent with ASC 606's requirement to present or disclose revenue from contracts with customers separately from other sources of revenue.

12.4.3.1 Application of ASC 606 to membership or dues revenue

According to AAG-REV 8.6.75, the Financial Reporting Executive Committee (FinREC) believes that membership dues (excluding any portion determined to be a contribution) generally should be considered an exchange or reciprocal transaction in which the member receives something of value and in return pays the NFP for the benefits of membership. Thus, they would be accounted for under ASC 606 as revenue from contracts with customers.

Interpretive guidance on applying ASC 606 to revenue contracts involving membership dues or subscriptions is contained in AAG-REV 8.6.70 through AAG-REV 8.6.98.

Membership dues often entitle the member to a package of benefits. Under step 2 of the ASC 606 five-step model, if a specific individual element of the member benefits is not distinct, then that element (benefit) should be combined with other promised goods or services until the NFP identifies a bundle of promised goods or services that is distinct (that is, general membership benefits), in accordance with ASC 606-10-25-22. These matters are discussed in AAG-REV 8.6.80 through AAG-REV 8.6.86.

One type of performance obligation that can present unique challenges is a “material right.” A material right is created when, as a result of entering into a contract, customers obtain an option to purchase future goods or services at a discount. For example, a membership organization might provide its dues-paying members with access to discounted pricing on products and services. If so, that right becomes a separate performance obligation to which a portion of the transaction price will ultimately need to be allocated. The member is effectively paying in advance a portion of the price they would otherwise pay for the additional goods or services they are likely to purchase. That revenue will be recognized when the future purchases are made or, if no purchases are made, when the right expires. NP 12.4.1.1 discusses the recognition of revenue associated with expired rights (i.e., breakage). Evaluation of whether material rights have been established that represent a separate performance obligation will require the exercise of judgment. Material rights are discussed in AAG-REV 8.6.86, AAG-REV 8.6.92, and AAG-REV 8.6.96 to AAG-REV 8.6.97. RR 7.4 provides additional information.

An NFP may require a nonrefundable prepayment prior to performing—for example, a lifetime membership or subscription. Despite the fact that the payment is nonrefundable, revenue is not recognized at the time the payment is received. Doing so would ignore the fact that the NFP has a performance obligation to transfer (or stand ready to transfer) goods or services in the future. If the obligation of the NFP is simply to stand ready to transfer benefits over time, the prepayment would be recognized over the term of the membership (i.e., be time based). Assuming that the obligation is satisfied over time, AAG-REV 8.6.95 states that revenue would be recognized over an appropriate time period (such as the life expectancy of the member or subscriber). If a portion of the prepayment represents a material right, revenue would be recognized as described in the previous paragraph. Generally, prepayments would represent contract liabilities.

For more information regarding nonrefundable upfront fees, see RR 8.4.

12.4.3.2 *Gross vs. net revenue when dues are shared*

Many national and regional professional societies establish separate sections, groups, chapters, or other forms of local units, which operate within certain geographical regions or within certain disciplines. Often, there will be some sharing of membership dues between the national and local section or group. In some cases, the section or group receives part of its funding from dues received by the national organization; alternatively, the local organization may collect and process members' dues payments and remit a portion to the national organization. When such dues payments are exchange transactions accounted for under ASC 606, it raises the question of whether the collecting organization should recognize the full amount of dues collected as its revenue, with an expense reflected for the portion remitted to the other organization; or whether the collecting organization should recognize as revenue only the portion of dues that it will retain. RR 10 provides guidance in making these determinations. The terms of the affiliation agreement between the national organization and local unit should also be considered.

12.4.4 *Revenue from ticket sales*

Ticket sales represent an important source of revenue for performing arts organizations such as orchestras, opera companies, ballet, theater, choral, and similar organizations. As exchange transactions, these are accounted for under ASC 606. Ticket revenue should be recognized when the entity has satisfied its performance obligation, that is, when the performance has been held. The revenue from sales of "season" tickets and subscriptions should be allocated to each performance covered by the subscription based on their relative stand-alone selling prices. Advance ticket sales

would result in reporting a contract liability (representing the entity's obligation to transfer goods or services to a customer for consideration already received).

Many performing arts companies designate certain performances as "gala," "opening night," or similar special events and charge substantially higher ticket prices for those performances than for regular performances. The additional increment to the ticket price is usually designated as a contribution. Such tickets would normally be accounted for as part ticket sale (exchange) and part contribution, with the revenue from each portion being recognized in accordance with the regular rules for that category of revenue. See NP 12.3 for further discussion of the framework for allocating a transaction between contribution and ASC 606 revenue components. For additional discussion related to ticket sales for special events, see AAG-NFP 5.110 to AAG-NFP 5.114.

As discussed in AAG-NFP 5.111, the Financial Reporting Executive Committee (FinREC) believes that if a special event is scheduled to take place after the financial statement date, the contribution portion of the amount received for ticket sales prior to the end of the reporting period is presumed to be conditioned on the event taking place, unless the donor explicitly waives the condition.

Example NP 12-7 illustrates the accounting in such situations for a ticket sale that is part exchange and part contribution.

EXAMPLE NP 12-7

Ticket sale—part exchange / part contribution

Performing Arts Center (PAC) sells special \$500 opening night tickets in December for a performance that will take place in January. The normal ticket price for a similar seat thereafter is \$50.

PAC's reporting year ends on December 31. How should PAC's financial statements reflect the revenue from sales of these tickets?

Analysis

The resources received are partially for an exchange transaction—a ticket to a performance—and partially a contribution. The "normal" selling price of the ticket is \$50. The amount of the contribution received is the excess of the resources received over the ticket's value (\$500 - \$50 = \$450).

For each ticket sold in December, PAC's financial statements would reflect \$50 of contract liability (for the prepayment of resources for the exchange portion) and \$450 of refundable advance (for the contribution portion). The contribution is considered conditional (and thus, would not be recognized in income) until the performance is held. As discussed at NP 6.6.1, it is not appropriate to assess the probability of whether the performance will take place when evaluating whether the contribution portion is conditional.

When the performance takes place in January, the contract liability would be reclassified to exchange revenue, and the refundable advance would be reclassified to contribution income. Unless PAC explicitly or implicitly indicated that the contribution element of the ticket was intended to be restricted for a particular purpose, the contribution would increase net assets without donor restrictions.

If at the time of the ticket sale, the patron had been notified that only the normal value of the ticket would be refunded in the event the performance was cancelled, and the patron agreed to purchase the ticket under those terms, it would be reasonable to conclude that the donor waived the implicit condition that otherwise would exist. If that was the case, PAC's financial statements would have reflected \$450 of contribution revenue for each ticket sold in December.
