FAQ – NONPROFIT ACCOUNTING, AUDITING, COMPLIANCE AND GOVERNANCE ISSUES

(FAQNP)

BY

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GUIDE TO THE PROGRAM

OBJECTIVE OF THE PROGRAM

Participants will be able to:

- Address major accounting and disclosure issues
- Understand the governance issues faced by nonprofits in today's highly scrutinized and regulated environment
- Address auditing issues that arise in audits under the Uniform Guidance

PRESENTATION METHOD

Group-live

LEVEL OF KNOWLEDGE

Intermediate

PREREQUISITES

Basic familiarity with nonprofit accounting

ADVANCE PREPARATION

None

CPE CREDITS

Accounting – 4 hrs.
Auditing – 4 hrs.

PROGRAM EVALUATION

At the end of the session, you should evaluate the program using the appropriate program evaluation form.

COURSE AUTHOR

Marci Thomas, MHA, CPA, CGMA, licensed as a CPA in Georgia and North Carolina, is an author and presenter on various not-for-profit, healthcare and governmental topics to nonprofits, CPA firms and state societies of CPAs around the country. She also writes and teaches courses in governance, financial management, grants accounting, strategy and various operational topics. Marci is a clinical assistant professor in the School of Public Health at the University of North Carolina at Chapel Hill and is an adjunct professor at Emory University in the Goizueta Business School. Marci works with numerous accounting firms, performing quality control and efficiency reviews and with nonprofit boards on strategic planning, internal control and governance issues.

Marci is also an author of a book published by Jossey Bass in 2004, Essentials of Physician Practice Management. Her book, Best of Boards: Sound Governance and Leadership for Nonprofit Organizations, was published by the AICPA in June 2011 and is on its second printing. Her newest book on Health Care Financial Management was published by Wiley Publishing in January 2014.

Marci serves on the Professional Development Advisory Council and the Not-for-Profit Committees for the North Carolina Association of CPAs. She is on the fundraising committee for Georgians for a Healthy Future and for several Basset Hound Rescue Groups. She is on several committees at her church.

Marci received her Bachelor in Business Administration with a concentration in accounting from the Georgia State University and her Masters in Health Administration at the University of North Carolina at Chapel Hill. She is a frequent speaker at local, regional and national conferences.

TECHNICAL REVIEWER

Nina Sorelle, CPA, licensed as a CPA in New Jersey and Pennsylvania, is a Partner with Bowman & Company LLP. She is licensed to practice as a Certified Public Accountant in New Jersey and Pennsylvania, and is also a Certified Fraud Examiner. She holds a Bachelor of Science degree in Business Administration – Summa Cum Laude – from Glassboro State College (currently Rowan University). Ms. Sorelle has received a Certificate of Educational Achievement in Governmental Accounting and Auditing from the American Institute of Certified Public Accountants. More recently, she received the Advanced Single Audit Certificate from the AICPA.

Ms. Sorelle's career includes extensive experience with audits of health care agencies, private schools, other not-for-profit organizations, and governmental entities, including municipalities, school districts, and authorities, with an emphasis on audits conducted in accordance with Government Auditing Standards and the Single Audit Act. She provides consulting services to other CPA firms regarding audits of not-for-profit and governmental organizations.

Ms. Sorelle is currently serving on the Peer Review Executive Committee of the New Jersey Society of Certified Public Accountants and has formerly served as a member of the AICPA Peer Review Board. Since 1990, Ms. Sorelle has performed hundreds of peer reviews.

SECTION ONE

NOT-FOR-PROFIT ACCOUNTING ISSUES

REVENUE RECOGNITION

QUESTION 1:

I'm concerned because my clients are not really thinking about the revenue recognition standard that is going to be effective in 2018. They say they have plenty of time.

Is there anything I need to bring to their attention right now?

ANSWER:

As you noted, the ASU 2014-09 on revenue recognition is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. For all others, which includes most not-for-profit entities the guidance would be effective for annual reporting periods beginning after December 15, 2018, with interim reporting periods within annual reporting periods beginning after December 15, 2019. This ASU may be implemented early.

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 is required to implement one year earlier. This guidance is principles based and, therefore, specific revenue guidance that is in current professional literature will no longer be GAAP. Not all revenue sources of a not-for-profit entity will be affected by the guidance. Contributions and investment income are both scoped out of the standard. Since its issuance, the standard has undergone additional amendments.

The FASB decided to carve contributions out of the scope of the Update. This effectively means that only exchange transactions will need to be considered under the standard. Where this may be good news for many not-for-profit entities whose source of revenue is contributions from donors, many not-for-profits have exchange transactions or transactions that are part contribution and part exchange.

Over the past few years not-for-profits have been looking for ways to diversify their funding and may be entering into transactions that are part exchange and part contribution. In the cases of larger entities where there is an advancement department, the nature of an arrangement with an existing funding source may change but not be communicated to the accounting department since advancement personnel generally do not understand accounting.

The NFP audit guide provides a list of indicators that can be used to help distinguish an exchange transaction from a contribution. Once determined as an exchange transaction, ASU 2014-09 applies. Note that the term exchange is not used in the new standard. The new term is “contract with customer”.

Question	Contribution	Exchange
What was the not-for-profit's intent when they requested the revenue source?	The not-for-profit was seeking a donation and would use it for the benefit of the organization with no reciprocal benefit to the donor.	The not-for-profit was willing to provide services/goods in exchange for the revenue.
What was the resource provider's intent?	The provider acknowledges that there is no direct benefit due to them but that they are making a contribution.	The resource provider acknowledges that there will be a benefit to the entity in exchange for payment to the not-for-profit.
How are the goods/services delivered?	The not-for-profit decides how to deliver the benefits. With a contribution, the benefits go to the constituents of the not-for-profit.	The resource provider states how and when the goods/services to them will be delivered. Note that the goods/services could be delivered to the constituents of the resource provider instead.
How much will the not-for-profit receive for the services?	The resource provider decides how much to give the not-for-profit.	The not-for-profit will receive payment commensurate with the value of the goods/services the not-for-profit provides.
Will penalties be assessed if the not-for-profit organization fails to deliver the goods/services on a timely basis?	The not-for-profit is not penalized per se for nonperformance. However, if the funds are not spent according to the donor's purpose, they may need to be returned.	The not-for-profit could receive penalties for nonperformance, just like any other organization, if the resource provider so chose.
How will the not-for-profit deliver the goods/services to the resource provider?	Goods and services are not delivered to the resource provider. The contribution may be used for the general benefit of the not-for-profit but may also be used for the constituents of the not-for-profit, depending on the donor's instructions.	The goods/services may need to be delivered to the resource provider or they could be delivered to a constituent of the resource provider.

EXAMPLE

An operating foundation (Foundation) receives contributions from individuals and corporations. Since Foundation is associated with diabetes, pharmaceutical companies provide grants to the entity for various projects. For the past 10 years, Pharma A made a grant to Foundation in the amount of $100,000 to help pay for a quarterly magazine on juvenile diabetes that is distributed primarily in pediatrician's offices. Pharma A derived no significant benefit other than to be thanked for sponsoring the magazine. In 20X7, the Foundation was looking for additional revenue since there was a decline in individual contributions. The advancement director approached Pharma A and asked for more money. Pharma A was willing to double the contribution for 20X7. However, in return it wanted space in the magazine to promote one of its drugs that was used by patients with juvenile diabetes. The advancement director agreed and reported the increase in the contributions to accounting but did not report the change in terms.

The character of the transaction changed and it is now part contribution and part exchange. Had the accounting department been aware they would have recognized the contribution as donor restricted immediately and the exchange portion, which should be quantified as deferred revenue which would be recognized over a period of time.

Under ASU 2014-09, Foundation would bifurcate the transaction so that the exchange portion can be evaluated. After determining the transaction price for the exchange transaction, the remainder is the contribution.

Step 1: Identify the Contract with the Customer. *In this case:*

- *The contract has commercial substance*
- *The parties have approved the contract*
- *Each party's rights regarding the goods or services can be identified*
- *The entity can identify payment terms*
- *Collection is probable*

Step 2: Identify Separated Performance Obligations within a Contract. *Performance obligations must also be "distinct" as defined as:*

- *Capable of being distinct (can stand alone) AND*
- *Distinct within the context of the contract (not highly dependent on anything else)*

The contract is bifurcated between the exchange portion (advertising) and the contribution portion. Not-for-profits already bifurcate certain transactions into the exchange and non-exchange portion. This happens with membership dues, bargain purchases, certain grants, naming opportunities and donor status transactions. The AICPA Revenue Recognition Task Force evaluated this implementation issue and determined that the amendments from ASU 2014-09 do not affect the method for a not-for-profit entity to bifurcate transactions received that are in part a contribution and in part an exchange transaction.

Step 3: Determine the Transaction Price of the Contract.

- *Consider the terms of the contract and its customary business practices;* ***and***
- *Assume that the goods/services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.*

When determining the transaction price, an entity must consider the effects of all of the following:

- *Variable consideration (i.e., consideration that is subject to uncertainties – constraints exist)*
- *The time value of money*
- *Noncash consideration*
- *Consideration payable **to** a customer*

*The transaction price of a contract must **exclude**:*

- *Amounts collected on behalf of third parties (for example, sales taxes)*

In this case, since the Foundation does not sell advertising, it will look to the amount of space in the periodical and the amount that would be charged for space in comparable periodicals with a comparable distribution.

Step 4: Allocate the Transaction Price to the Separate Performance Obligations. *In this case, there is one performance obligation – the advertising piece in the periodical.*

In this case, there is only one performance obligation.

Step5: Recognize Revenue when (or as) the Entity Satisfies a Performance Obligation. *The amount of revenue to be recognized would be the amount of the contracts' transaction prices that was allocated in Step 4. The timing of that recognition depends on the timing of the satisfaction of the performance obligation.*

Performance obligations are satisfied when a promised good or service is transferred to a customer. The concept of a "transfer" assumes the customer obtains control of that good or service.

For each performance obligation identified, an entity would have to determine at contract inception whether the obligation is satisfied "over time" or at a "point in time" which would result in different timing and methods of revenue recognition.

In this case, the performance obligation is satisfied over a period of time. There are four quarterly issues. Revenue is recognized when the obligation to provide the advertising is met.

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Amendments to ASU 2014-09

Four amendments to ASU 2014-09 were issued in 2016. The guidance is effective with the implementation of ASU 2014-09.

ASU 2016-08, Principal vs. Agent Considerations

In 2016, the FASB issued its ASU 2016-08 which makes the distinction between whether the entity is acting as a principal or an agent for purposes of recognizing revenue. In some transactions, there is more than one entity involved in providing goods or services to another party. In those cases, the reporting entity will need to determine whether the nature of its promise is *to provide* the specified goods or services to the customer (principal) or *to arrange* for another party to provide them (agent).

If the reporting entity provides the goods or services to the customer, then it is considered the principal and recognizes revenue at the gross amount. But if the entity simply arranges for another party to provide the goods or services it recognizes revenue at the net amount it is entitled to for its agency services. ASU 2016-08 states that a principal in a transaction controls the specified goods or services before they are transferred to the customer.

There may also be times where a contract contains more than one performance obligation. So an entity may be a principal for some goods or services and an agent for others.

There are two steps to evaluating whether an entity is a principal or an agent in transactions involving more than one party delivering goods or providing services:

1. Identify the specified goods or services to be provided to the customer.

2. Assess whether the reporting entity controls the specified goods or services before they are transferred to the customer.

An entity that is a principal obtains control of any one of the following prior to its transfer to a customer:

- An asset from the other party that it then transfers to the customer.

- A right to a service to be performed by the other party. The entity directs the other party in providing the service to the customer on its behalf.

- An asset or a service from the other party that it then combines with other goods or services to provide the specified good or service to the customer.

The following indicators, which are not all inclusive, signify that an entity controls the specified good or service before it is transferred to a customer:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service.
- The entity has inventory risk.
- The entity has discretion in establishing the price for the specified good or service.

EXAMPLE

A not-for-profit organization has a program where youth make and sell products to customers as part of a training program to build technical and financial management skills. The proceeds from the sales of the products go to pay the youth and contribute toward the cost of the financial education the youth receive as part of the program. The products have a component that must be installed by the company that supplies the component. To keep cost lower, the supplier of the component sends the finished product to the customer. The supplier also bills and collects from the customer. If there are any issues with the product, the supplier will handle them under the warranty. Most product defects would be due to the component installed by the supplier. However, the ultimate responsibility for the product lies with the not-for-profit. To ensure a quality product for the customer, it must monitor the work of the supplier.

To determine if the not-for-profit is a principal or agent, in this transaction, the CFO asked the question – is the performance obligation (1) to provide the goods to the customer or (2) to arrange for the goods to be provided by the supplier.

The not-for-profit is responsible to provide the customer with a product in the sales process even though it subcontracted the installation of a component of the product along with the billing and collection to another party. Therefore the controller concluded that since the component is not separate and distinct from the product and that since the not-for-profit is responsible for the overall quality of the product it, in fact, controls the product. The supplier may collect the consideration from the customer and subtract the agreed upon price for the component part but the supplier has no ability to change the product or to redirect the product to another customer. The not-for-profit is considered the principal.

A not-for-profit conducts various fundraisers during the year. One of its more profitable fundraisers is to sell chocolate candy during the holidays. The not-for-profit contracts with a well-known candy company and receives 30% of the sales price for selling the candy. If the chocolate arrives in poor condition, then the customers will report the defect to the not-for-profit. The candy company, however, is ultimately responsible for replacing the product. The controller of the not-for-profit determined that this was an agency arrangement because at no time did the not-for-profit have control of the product. The not-for-profit is not required to commit to a certain amount of sales, it is compensated for sales as they occur.

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ASU 2016-10, *Identifying Performance Obligations and Licensing*

This clarifies how an entity should evaluate the promissory aspects of granting a license of intellectual property. This determines whether the recognition is at a point in time or over a period of time. The ASU also clarifies how an entity would apply the exception of sales and usage-based royalties to licenses of intellectual property (IP) and recognize revenue for those licenses that are not separate performance obligations.

Licensing – With regard to licensing, the decision hinges on whether the licensor performs activities that affect the IP's ability to provide benefits or value. Where the activities affect the IP's ability to provide benefit or value, revenue is recognized over time. If the IP has significant standalone functionality, then the licensor's ongoing activities will not significantly affect the utility of the IP and revenue is recognized at a point in time.

EXAMPLE

A university has developed various software products that enhance its ability to perform medical research. It grants licenses to use the IP to other universities. The licensor's activities have no bearing on this completed product except to provide patches or other fixes to correct functionality. The university's customers are not contractually or practically required to use the latest version should one be issued. Accordingly, the university recognizes revenue at the point in time it is given access. Note that the FASB board expects that entities are not very likely to encounter instances where the revenue would be recognized over time.

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IP can be symbolic, that is, without significant standalone functionality. Examples might be brands, team and trade names or character images. Since the utility of the IP is derived from the licensor's ongoing or past activities, revenue is recognized over time.

Sales and usage-based royalties – Contracts for licenses of intellectual property often include sales-based and usage-based royalties that represent variable consideration. The revenue recognition guidance includes a specific exception to the variable consideration guidance for consideration received in the form of sales- or usage-based royalties on licenses of intellectual property.

That exception requires that an entity that licenses its IP under a contract that includes a sales- or usage-based royalty should include consideration from the sales- or usage-based royalty in the transaction price only when the later of the following events occurs:

- The subsequent sale or usage occurs (that is, when the uncertainty is resolved).
- The performance obligation to which the sales- or usage-based royalty is allocated has been satisfied.

When consideration is provided by the customer as a royalty in exchange for a license and other distinct goods or services, the exception applies only if the license of intellectual property is the primary item in the contract.

<u>EXAMPLE</u>

The film and media department of a not-for-profit university was given a valuable historical movie and the rights to produce related products for sale related to the movies by a donor. The university decides to license the rights to show these movies. The royalty fee to show the movies is $250,000 plus 5% of the sales of movie tickets. The contract is for a period of 2 years. The CFO determined that the main value comes from showing the films and that any revenue associated with the ability to sell products is not significant. Therefore, the transaction should be accounted for as follows:

The university should account for a promise to provide a customer with a right to access its intellectual property as a performance obligation satisfied over time because the customer will simultaneously receive and consume the benefit from the university's performance of providing access to its intellectual property as the performance occurs. This includes the ability to sell products related to the movie. The university should select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

Revenue cannot be recognized from a license of intellectual property before both:

- *An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.*
- *The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property.*

The $1,250,000 fixed royalty fee plus the sales-based royalty fee should be recognized over the period of the contract.

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When an entity determines that the exception applies, it should recognize the royalties wholly in accordance with the exception guidance. When the exception does not apply, an entity looks to the guidance on variable consideration. In other words, an entity should not split a single royalty between an amount accounted for under the sales- and usage-based exception and an amount accounted for as variable consideration.

ASU 2016-12, *Narrow Scope Improvements and Practical Expedients*

ASU 2016-12 was issued to try to reduce the cost and complexity of implementing the new revenue recognition standard. The subject matter of this ASU is related to:

Contracts considered to be completed at transition – For contracts to be considered completed at the transition to the new standard, all or substantially all of the revenue must have been recognized by legacy GAAP. This is a significant amendment because contracts use the modified retrospective transition approach only need to apply the guidance to those contracts that are not complete as of the date of initial application. Those that use the full retrospective approach can apply practical expedients to completed contracts. Before the amendments, the entity was required to transfer all of the identified goods/services in accordance with the current revenue recognition guidance before the date of initial application. Stakeholders were concerned that it might be difficult to determine when a contract is complete.

These amendments also provide the entity with the ability to use the modified retrospective transition approach to all contracts, not just those that are complete. This would mean that although the entity would apply the guidance to all contracts just as they would in the retrospective method, prior periods would not need to be recast in the period of adoption.

Contract modifications – A practical expedient was added to assist entities with contract modifications prior to adoption of the standard. This could be helpful when an entity has multi-year contracts. If an entity elects this option, they will avoid having to evaluate the effects of each contract modification from the inception of the contract through the beginning of the earliest period presented. The entity would determine the aggregate transaction price for all satisfied and unsatisfied performance obligations in the contract at the beginning of the earliest period presented and then perform a single allocation to those performance obligations to the ones unsatisfied based on their relative standalone selling prices. Any modifications after the earliest period presented under the new standards will be accounted for under the standard. If an entity uses this expedient, then it is required to apply it to all contracts with similar characteristics.

Disclosure – If an entity uses the full retrospective approach, it does not need to disclose the effect of the accounting change on financial statement line items affected like it would in implementing other standards or correcting errors.

Collectability – This section provides clarity around collectability. An entity should consider the probability of collecting substantially all the consideration to which it will be entitled, not the total amount promised. Entities are not permitted to consider whether they can repossess assets that have been transferred to customers.

EXAMPLE

A not-for-profit contract research organization had a three-year contract with an entity to perform services. Since it was concerned about collectability, its attorney added a provision in the contract that the entity had the ability to cease providing services when payments were 3 months past due. This helped them to use only the period during which it expected to perform services rather than the entire period of the contract. The CFO noted that even though the period was shortened for purposes of assessing collectability, the entire term of the contract was used when determining or allocating the transaction price.

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The FASB also added another event that would trigger recognition of nonrefundable consideration received as revenue when collectability is not probable. Under this update, an entity can recognize nonrefundable consideration if it has transferred control of the goods/services and has stopped transferring additional goods and services, for example, termination of the contract. Before this ASU, there were two events:

- The entity has completed performance and received substantially all consideration.
- The contract has been terminated.

Noncash consideration – The fair value of noncash consideration should be measured at the inception of the contract when determining the transaction price. Changes in the value of the noncash consideration that are not because of form are not included in the transaction price. They may be recorded as gains or losses. An example of form would be equity in the customer (shares of stock). When the variability of the noncash is due to both the form and other reasons, i.e., performance considerations, the constraint on variable consideration applies to the variability for reasons other than the form.

EXAMPLE

A country club accepted shares of stock in exchange for services performed for a company of one of its members. These shares were marketable securities and were publicly traded. The exchange was recorded at the time that the transaction with the country club met the criteria for revenue recognition. However, the shares were not delivered for another month. By that time, the fair value of the equity securities had increased. Upon delivery, the increase was accounted for as a gain. The value of the consideration was not adjusted.

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Presentation of sales and similar taxes – An entity can make a policy election to exclude certain types of taxes that are collected from its customers if it discloses the policy. In that way, revenue would be presented net of sales taxes, for example.

<u>EXAMPLE</u>

A charity sells a variety of books, videos and gift items in its store. The net proceeds of these items go to further the entity's mission. Sales taxes are collected on the sales of the items. The charity has a policy of excluding the taxes collected from these customers and discloses the policy in the notes to its financial statements.

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ASU 2016-20, *Technical Corrections and Improvements*

This update includes more technical corrections to the revenue recognition standard.

Quantitative disclosures related to performance obligations – Entities do not have to make quantitative disclosures about remaining performance obligations. They can elect not to disclose variable consideration allocated to performance obligations related to:

- Sales- or usage-based royalties on licenses of intellectual property, or
- Variable consideration allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that is par to a single performance obligation when certain criteria are met.

This should help entities by eliminating the need to estimate variable consideration for disclosure purposes when it is not needed to recognize revenue.

Entities do not need to make the disclosure for revenue recognized in accordance with the "right to invoice" practical expedient to variable consideration. They will need to disclose fixed consideration recognized under the right to invoice practical expedient.

When entities choose to use any of the exemptions allowed by the standard not to disclose the aggregate transaction price allocated to the remaining performance obligations, they will need to disclose which exemptions they are applying, the nature of the performance obligations and the remaining duration of the contract. They also have to describe the variable consideration excluded from the quantitative disclosure.

Other assets and deferred costs – The update clarifies the amounts that are included in consideration the entity expects to receive when testing capitalized contract costs for impairment and clarifies the interaction of impairment guidance in ASC 340-40 with other impairment guidance in the Codification.

Scope clarifications – The ASU deletes the term “insurance” to clarify that all contracts within the scope of ASC 944, *Financial Services*, are excluded from the revenue recognition standard. The ASU adds a scope exemption to ASC 924-815 (derivatives and casinos). These are not relevant to not-for-profits.

Updates to examples – The FASB updated certain examples and made other miscellaneous clarifications.

AICPA Task Force on Revenue Recognition

The AICPA Task Force has been working on implementation issues in certain industries. The not-for-profit task force addressed five issues as follows.

Issue	Status
Tuition and Housing Revenue – Tuition and housing revenue for not-for-profit higher education institutions. This implementation issue will discuss considerations needed to determine the transaction price and when to recognize revenue for tuition and housing.	Finalized to be included in the AICPA Guide Revenue Recognition
Contributions – A technical clarification was submitted to FASB staff, recommending that the FASB clarify the application of FASB ASC 606 by adding language in FASB ASC 606-10-15 that specifically excludes contributions from the scope of FASB ASC 606. TRG agenda reference #34: March 2015 Meeting – Summary of Issues Discussed and Next Steps Paragraph 40: TRG members discussed whether contributions are in the scope of the new revenue recognition standard. TRG members agreed with the staff view that contributions are not in the scope of the new standard and that the standard includes adequate guidance to come to this conclusion.	Finalized to be included in the AICPA Guide Revenue Recognition
Grants (see next question)	Referred to FASB
Subscriptions and Membership Dues – This implementation issue will discuss how NFP organizations should account for Membership Dues, Life-time Membership Dues, Subscription Revenue and Life-time Subscriptions.	Submitted to AICPA RRWG

Following is an illustration of how the AICPA's preliminary conclusions on tuition and room and board in institutions of higher education (IHE) (or others that provide similar services) might be applied.

EXAMPLE

Step 1: Identify the Contract with the Customer. *ASU 2014-09 states that a contract does not exist if each party to the contract has the unilateral, enforceable right to terminate a wholly underperformed contract without compensating the other party. As applied to tuition, room and board and deposits, the IHE will need to decide if recognition of the consideration received in exchange for the services it has begun to deliver or will eventually deliver is warranted.*

The FinREC believes that when a student pays a nonrefundable deposit for enrollment or housing, the student has the right to receive instruction or housing, and the IHE is obligated to provide it. Therefore, when a deposit is received even if nonrefundable, a contract liability should be recorded. When the student eventually enrolls, the deposit will be included in the transaction price and revenue recognized as the IHE meets the performance obligation.

Step 2: Identify the Performance Obligation(s). *An IHE will need to evaluate the number of contracts it actually has when tuition and housing are bundled into one contract. ASU 2014-09 states that two or more contracts can be combined if they are entered at or near the same time with a single customer and if they meet one or more of the criteria below:*

- *The contracts are negotiated as a package with one commercial objective.*
- *The amount paid under one contract depends upon the price or performance under another contract.*
- *The goods or services to be transferred under the contracts constitute a single performance obligation.*

If these objectives are met, then the contracts may be combined.

Another consideration relates to financial aid which has been provided as part of a bundled agreement.

If none of the stated criteria is met, the entity would account for tuition and housing as separate contracts for applying the revenue recognition standards. FinREC believes that more often than not, tuition and housing are separate services with separate performance obligations.

Step 3: Determine the Transaction Price.

Transaction Price – *The IHE should evaluate all the consideration it would expect to be entitled to when determining transaction price(s). Some IHEs use multiple tuition rates for different situations or categories of students (e.g., international or out of state). This means that contract prices would depend on the individual contract each student has with the IHE.*

Consideration includes amounts that will be paid by a third party, such as the federal government, on behalf of the student. The IHE will identify a distinct transaction price for each separate performance obligation.

Financial Aid – *Some IHEs provide financial aid to students in the form of reductions to tuition and housing. If the IHE provides these types of reductions to a student without the student providing a distinct good or service, it would be accounted for as a reduction of the transaction price.*

Right to Withdrawal – *Most IHEs have "add/drop" periods where students may receive a full or partial refund. In many of these cases, consideration will have been received from a student in advance. This is a case of variable consideration and the entity would recognize a refund liability. The liability would be measured at the amount of consideration received or receivable that the IHE does not expect to be entitled to.*

The revenue recognition standard provides two methods for estimating variable consideration. One is the expected value method, which is the sum of probability-weighted amounts in a range of possible consideration amounts. The other is the portfolio approach. It may be impractical to estimate a refund liability at an individual contract level. This approach is only allowable if the application on a portfolio basis would not differ materially from application on a contract-by-contract basis. Variable consideration is included in the transaction price only to the extent that it is probable that a significant reversal in revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved.

If the IHE has significant predictive experience in estimating withdrawals, and the uncertainty regarding a student's withdrawal will be resolved in a short timeframe, the FinREC believes that the IHE generally will not expect a significant reversal of recognized revenue. Therefore, the IHE would include the **anticipated** *amount of withdrawals in the transaction price.*

Impact of Collectability to the Measurement of Revenue – *Revenue recognized would not reflect any reductions for amounts that the IHE may not be able to collect from a customer. Instead, the IHE would need to provide for impairment (bad debt) and present and disclose it as it has in the past.*

Step 4: Allocate the Transaction Price to the Performance Obligation in the Contract. *When the IHE determines that tuition and housing are separate performance obligations, the transaction price should be allocated to each performance obligation on a relative standalone selling price basis. The best evidence for a standalone selling price is the observable price of a good or service when the IHE sells that good or service separately in similar circumstances to similar customers. For example, some students may be commuter students and some may live on campus. Accordingly, some may pay for tuition but not for housing. Since this is the usual business practice, the standalone selling price for tuition will probably be observable. However, it is unlikely that the IHE will sell housing without tuition. So the IHE may need to go outside to similar observable housing to obtain a standalone selling price. The ASU also provides guidance on estimating the standalone selling price when it is not observable.*

Step 5: Recognize Revenue when (or as) the Entity Satisfies a Performance Obligation. *The FinREC believes that, in most cases, since students receive instruction and housing concurrently during the academic term, they simultaneously receive and use all the benefits provided by the IHE. The FinREC also takes the view that it would be appropriate for the IHE to recognize revenue ratably over academic terms based on time elapsed.*

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Following is an illustration of how the AICPA's preliminary conclusions on dues and memberships might be applied.

<u>EXAMPLE 1</u>

Scenario: A not-for-profit membership entity has annual dues of $250. *It has a website with educational material that can be accessed by members. The public has access to the website but only to limited parts of the content. The entity advocates for the members related to legislative matters. The entity has a monthly periodical that is sent to members. It also sells the periodical to anyone who wants it for a yearly subscription price. In addition, members can purchase educational programs from the entity at a discount.*

Step 1: Identify the Contract with the Customer *– The contract in this case is for the monthly periodical and the professional educational and advocacy services. Although nonmembers can access certain content on the website, only members can access substantially all of the content to help them discharge their professional responsibilities.*

The products sold by the entity are specifically identifiable but there is no certainty that they will be purchased so there is no contract that they are excluded from this analysis. They will be considered an exchange transaction when a contract is present.

Step 2: Identify the Performance Obligations under the Contract *– The obligation is 1) to provide the periodical to the members (a product), 2) to provide advocacy, and 3) to provide educational content to the members via the website. Items 2 and 3 fall under the category of services to the members.*

Step 3: Determine the Transaction Price *– The transaction price is a bundled price of $250, which includes the content on the website, the periodical, the advocacy services and the opportunity for discounted educational programs.*

Step 4: Allocate the Transaction Price to the Performance Obligations *– There are two performance obligations. The first is the subscription to the journal. The entity sells it and it is a standalone product. The fair value is $75. This is the price for which it is sold to nonmembers. The remaining $175 is allocated to the services.*

Step 5: Recognize Revenue When (or as) Each Performance Obligation is Satisfied – *The next step is to determine whether the obligations are satisfied at a point in time or over time. The performance obligation is to deliver 12 monthly issues during the year. The services are also delivered over time.*

The subscription is reciprocal and so are the services so there is no contribution.

Initial Journal Entry (multiple members)

Cash	*250,000*	
Subscription – deferred revenue		*75,000*
Member services – deferred revenue		*175,000*

Monthly (both are shown together)

Deferred revenue	*20,833*	
Dues revenue		*20,833*

Note that this represents 1,000 members.

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EXAMPLE 2

Scenario: A not-for-profit theater group sells memberships for $100. *It has a website that is completely open to the public. The entity has a monthly periodical that is sent to members which includes interviews and articles that are of interest to theatergoers. The main reason people become members of the theater is to support the arts.*

Step 1: Identify the Contract with the Customer – *The contract in this case is for the monthly periodical.*

Step 2: Identify the Performance Obligations under the Contract – *The obligation is to provide the periodical to the members.*

Step 3: Determine the Transaction Price – *The fair value of the periodical was determined to be $25. It was determined using the market method.*

***Step 4: Allocate the Transaction Price to the Performance Obligations** – There is only one performance obligation so the $25 is allocated to the periodical.*

***Step 5: Recognize Revenue When (or as) Each Performance Obligation is Satisfied** – The next step is to determine whether the obligations are satisfied at a point in time or over time. The performance obligation is to deliver 12 monthly issues during the year.*

The subscription is reciprocal but it is only a portion of the membership dues price. The remaining $75 is a contribution. It does not fall under the revenue recognition guidance but falls under ASC 958-605.

Initial Journal Entry (multiple members)

Cash	*100,000*	
Contribution – without donor restrictions		*75,000*
Deferred revenue		*25,000*

Monthly

Deferred revenue	*2,083*	
Dues revenue		*2083*

Note that this represents 1,000 members.

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The audit guide (AAG-NPE) currently states that if initiation and life membership fees, rather than future fees, are expected to cover those costs, then those fees received in exchange transactions would be recognized as revenue over the average duration of membership, the life expectancy of members, or another appropriate time period.

<u>QUESTION 2</u>:

My clients receive a number of government grants. One of my clients has a grant from HUD that was a gift of a building that the entity can use as long as it continues to house disabled adults. The building was recorded with a debit to property and a credit to donor restricted revenue. Now that we have new revenue recognition criteria, I am wondering if this is still the appropriate accounting treatment.

What do I need to consider?

<u>ANSWER</u>:

Grants have always been a difficult area because the word has no accounting definition. Grants can sometimes be exchange transactions. They can also be contributions.

Exchange transactions are defined in ASC 958-605 as **reciprocal transfers** in which each party receives and sacrifices approximately equal value. Exchange transactions in not-for-profit organizations usually involve their efforts in providing goods or **services to members, clients, students, customers and other beneficiaries for a fee**. Another significant type of exchange transaction for not-for-profit organizations involves **services performed for federal, state and local governments, generally under the terms of grant agreements**. Revenue from exchange transactions will always be recorded in the net asset class without donor restrictions.

In April 2016, the FASB, based on recommendations from the NFP Advisory Committee (NAC), added a discussion of the accounting for grants and contracts with governmental agencies to its agenda. There are two issues presently under discussion:

- <u>Issue 1</u> – Are grants and contracts with governmental agencies reciprocal or nonreciprocal?

  Grants and contracts may be reciprocal (exchange transactions) or nonreciprocal (contribution). The distinction is whether the resource provider receives commensurate value in return for those resources (reciprocal transaction).

- <u>Issue 2</u> – If they are nonreciprocal, how does an entity distinguish between conditions and restrictions?

<u>EXAMPLE</u>

KIDZ KAMP received funding from a governmental agency that was to be used for meals for children participating in the program whose family met certain income levels. The CFO was uncertain as to whether this represented a "public benefit" or would be considered services purchased by the government from KIDZ KAMP.

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The accounting for these transactions may differ based on the guidance applied. Based on NAC outreach efforts, it appears that most NFPs currently account for grants (in particular, government grants) as reciprocal transactions because they believe that the government is purchasing services that it would have had to perform otherwise, in other words, the government is outsourcing the provision of the services. The FASB believes that they are misinterpreting the guidance.

Some NFPs account for similar transactions as reciprocal and some as nonreciprocal. ASU 2014-09, *Revenue from Contracts with Customers*, introduced the additional wrinkle for reciprocal transactions by putting greater focus on a customer taking control of a good or service and the newly-required disclosures for those transactions.

The AICPA's Audit & Accounting Guide, *Not-for-Profit Entities*, presents a table of indicators that were supposed to be helpful in practice when assessing the difference between the receipt of resources in a reciprocal transaction and the receipt of resources in a contribution as discussed in an earlier question. These indicators need clarification.

The FASB staff identified some possible solutions that would help to clarify the existing guidance on how to characterize grants and similar contracts as reciprocal or nonreciprocal transactions.

Clarification of the scope of ASC 958-605 – This clarification would involve these aspects:

- Instances in which the general public receives the primary benefit.
- Instances in which a specified group receives the primary benefit.
- Types of value that do not constitute commensurate value.
- That the type of resource provider ought not to override the substance of the transaction.

Additional indicators – Feedback during outreach indicates that certain important indicators are not included in the table.

- These include grants in which a resource provider retains proprietary rights.
- Grants where the benefit of the transfer of the assets is made available only to the resource provider.

Both of these would indicate an exchange transaction. The Board is concerned that stakeholders may be using the indicators as a checklist and not using judgment when evaluating which indicators are more significant in the determination.

The FASB staff recommends the following insert to the table of indicators:

Indicator	Contribution	Exchange
Proprietary rights retained by resource provider	The resource provider reserves no proprietary rights, although the resource provider may ask for acknowledgment of its support.	The resource provider reserves rights to patents, copyrights, advance and exclusive knowledge of research outcomes, or other proprietary rights and privileges.
Benefits resulting from assets to be provided to the recipient NFP	The benefits resulting from the assets provided are made available to the general public. The recipient NFP determines the specific beneficiaries or recipients.	The benefits resulting from the assets provided are made available only to the resource provider, or to third parties specified by the resource provider.

Additional illustrative examples to be provided by the FASB will be a flowchart and examples to clarify the terminology that will be added to the glossary.

Stakeholders believe that a flowchart would be a useful addition to the guidance. In addition, the FASB staff believes that the clarification of terminology will be important to help distinguish between reciprocal and nonreciprocal transactions (Issue 1) and between conditions and restrictions (Issue 2). The staff plans additional outreach efforts. Definitions that could use clarification are “contribution,” “donor-imposed condition,” and “donor-imposed restriction.”

On February 22, 2017, the FASB decided to clarify and refine existing guidance in ASC 958-605 by indicating that the definition of a donor imposed **condition** would include the following:

- A **right of return**, entailing either a return of assets transferred or a release of a promisor from its obligation to transfer assets. (Vote: unanimous)

- A **barrier** that must be overcome before the recipient is entitled to the assets transferred or promised. (Vote: 6 to 1)

The Board also agreed that the barrier would be described through the use of indicators and illustrative examples.

Based on the FASB's decisions to date, in the case mentioned in the question, the transaction would be considered a contribution but the entity would have to determine whether or not it was conditional. It appears there is a right of return of the asset, so unless the chances are remote that the entity would not use the asset for the stipulated purpose (conditional), the transaction would not be considered a contribution. If the chances were remote that the asset would not be used for the stipulated purpose, then the transaction would be recorded as a contribution without donor restriction.

EXAMPLE

A not-for-profit research organization has a diabetes research center. The center regularly performs research on the newest treatment options. It receives contributions from donors and grants from companies to support its research efforts. The donations and grants, which are designated specifically for research programs, are recorded as with donor restrictions until they are used for the intended purpose. The donors may specify that the donations are used for research but they receive no direct benefit from the research.

The research organization also receives resources from pharmaceutical companies. These companies will pay for the costs of clinical trials using diabetes medication that they developed. The pharmaceutical company dictates the drug testing protocol. They require a detailed report. These services have commercial value to the pharmaceutical company. Therefore, this revenue is not a contribution. It is an exchange transaction.

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EXAMPLE

A not-for-profit research organization obtains a grant from the National Institutes of Health (NIH) to study diabetes treatments. The grant specifies the eligible participants to the study, as well as costs that are allowable under the terms of the grant. The research organization is required to produce a report on how the moneys were spent.

The controller of the research organization was evaluating whether this transaction was a contribution or an exchange transaction. This type of funding had always been considered an exchange transaction under the theory that the government could not perform this work so it "hires" the research organization to do it.

The controller considered the following indicators of a contribution currently under discussion by the FASB:

Proprietary rights retained by resource provider	*The resource provider reserves no proprietary rights, although the resource provider may ask for acknowledgment of its support.*
Benefits resulting from assets to be provided to the recipient NFP	*The benefits resulting from the assets provided are made available to the general public. The recipient NFP determines the specific beneficiaries or recipients.*

He knew that the FASB's current position, although not yet codified into professional literature, was that government agencies do not directly benefit from the activities; it is the general public or a specific group of constituents that benefit from the activity. Therefore, it would be rare that a government grant would be considered an exchange transaction so the controller determined that this activity would be considered a contribution.

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NOT-FOR PROFIT FINANCIAL STATEMENT PRESENTATION

QUESTION 3:

The new not-for-profit financial statement standard has several provisions and on the face of it they are not difficult to implement. I would love to have something I can just hand to my client.

Where can I find a comprehensive example with the provisions explained?

ANSWER:

This guidance has been in development for several years with considerable focus towards outreach to the different types of entities in the industry. The users of the financial statements of charitable entities, colleges and universities and independent schools and healthcare entities have different needs. The original exposure draft (ED) included provisions that were not acceptable to many entities and practitioners in public accounting. Consequently, the issued ASU does not contain the more controversial provisions from the ED. The FASB intends to address issues in phase two of the financial statement project related to:

- Whether to require an operating measure for all entities.
- How to define the operating measure and what should be included.
- Realignment of the statement of cash flows.

In addition, it intends to reevaluate the requirement in the ASU related to the presentation of expenses by natural and functional classification for business-oriented healthcare entities. Instead of the functional information, NFP healthcare entities would provide disaggregated information about revenues and expenses by segment. There have been no deliberations to date on this issue.

ASU 2016-14 is effective for fiscal years beginning after December 15, 2017 and interim periods thereafter. Application is retrospective. However, there are two disclosures where entities have the option of presenting one year in the year of implementation with a comparative presentation in year two. This is to ease the burden where it is more challenging to accumulate the information. Those areas are:

- Functional expense presentation.
- Liquidity information.

ASU 2016-14 is essentially a disclosure standard. However, there are two provisions that are also accounting related:

- Classification of the underwater portion of endowment funds.
- Requirement to use the placed-in-service approach for long-lived assets.

The major changes are discussed below. Following the discussion is a set of financial statements where ASU 2016-14 has been implemented.

Net asset classifications – NFPs will be required to present two classifications of net assets as opposed to three. Net assets will be classified as *without donor restrictions* or *with donor restrictions.* This effectively collapses “temporarily restricted” and “permanently restricted” into one net asset class. The distinction between permanent and temporary is less meaningful due to state implementation of a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

It may appear that the aggregation of what was called temporary and permanently restricted into one net asset category would provide less useful information to users of the financial statements. The ASU states that a NFP may wish to disaggregate net assets with donor restrictions between those expected to be maintained in perpetuity and those expected to be spent over time or for a particular purpose on the face of the statement of financial position. If that disclosure is not on the face of the statements, information about the nature and amounts of different types of restrictions that affect how and when, if ever, the net assets can be used must be provided in the footnotes.

NFPs must also provide information about additional limitations placed on net assets without donor restrictions, such as information about the amounts and purposes of board designations such as quasi-endowment funds or liquidity reserves. This information may be on the face of the statement of financial position or it may be in the notes.

Placed-in-service approach for long-lived assets – Although not a prevalent accounting treatment, existing GAAP allowed entities to continue to carry long-lived assets or gifts to purchase long-lived assets as temporarily restricted (now part of “with donor restrictions”) even after the assets were placed in service. Amounts equal to the depreciation on the asset were released from restriction each period. This election is no longer available with the implementation of ASU 2016-14. An adjustment will be required where the election was previously used to release the remaining net asset balance of long-lived assets (or cash to purchase them) placed in service to net assets without donor restriction.

Endowment funds – Entities with underwater endowment funds have, to date, classified the portion of the loss that causes the individual endowment to fall below the original gift to the unrestricted net asset class (now without donor restrictions). When implemented, entities with underwater endowment funds will reclassify the underwater portion of the endowment fund from “without donor restrictions” to “with donor restrictions”.

Although not a prevalent accounting treatment, existing GAAP allowed entities to continue to carry long-lived assets as temporarily restricted (now part of “with donor restrictions”) even after the assets were placed in service. Amounts equal to the depreciation on the asset were released from restriction each period. This election is no longer available with the implementation of ASU 2016-14. An adjustment will be required where the election was used to release the remaining net asset balance to net assets without donor restrictions.

There are other disclosures required for underwater endowment funds:

- Policy on appropriations from the fund, that is, whether to reduce expenditures or not spend from these funds and actions taken during the period. Note that UPMIFA is adopted by states that adapt it for their purposes. Some states do not permit spending from underwater funds.

- Aggregate fair value of endowment funds under water.

- Aggregate original endowment gift or level required by donor stipulation or law to be maintained.

- Aggregate amount of deficiencies.

Statement of cash flows – NFPs that use the indirect method to prepare the statement may continue to do so. Those that use the direct method will no longer have to perform the reconciliation of cash provided/used in operating activities.

Investment returns – NFPs currently present investment return net of investment related expenses. They also present disclosure of the components of investment return. ASU 2016-14 requires investment return to be net of related expenses. Before the update, the amount of expenses was required to be disclosed; however, after the update, the amount is not disclosed. The ASU requires entities to include direct internal investment expenses in the amount netted from investment return. Direct internal expenses include personnel costs that develop, execute and monitor the investment strategy. This could result in additional expenses netted against investment return, as many NFPs did not keep track of direct internal expenses. This should increase comparability because some NFPs manage investments in house and others outsource the function.

In addition, those NFPs that use an operating measure may find that amounts that represented operating expenses could be reclassified to nonoperating. Note that programmatic investments are not included.

Liquidity and availability – NFPs will be required to provide qualitative as well as quantitative information on the way they manage their liquidity and availability of funds. This includes information about the availability of financial assets to meet general expenditures within one year of the financial statement date. Those assets that are unavailable due to donor restriction, law, contracts, board decisions, etc., are not presented as liquid financial assets.

Functional and natural expense presentation – Currently, NFPs are all required to present information by function. Voluntary health and welfare entities are also required to present a statement of functional expenses. ASU 2016-14 requires all NFPs to present expense information by natural and functional classification. It does not have to take the form of a statement and the FASB expects that most entities will present the information in the footnotes. It cannot be presented as supplementary information. All expenses must be shown in one place so entities that have special events will need to include the expense information related to direct donor benefits in the expense presentation even if it results in a reconciliation to the statement of activities/operations. Investment-related expenses are not presented.

The guidance also clarifies the types of activities that constitute management and general and fundraising. These are considered supporting activities and often costs are allocated between these categories and program functions. NFPs will also be required to discuss their allocation methodology.

Operating measure – The FASB decided not to require NFPs to present an intermediate measure of operations. As discussed above, this is a discussion that has been deferred to phase two. There are some NFPs such as large foundations, independent schools, colleges and universities, which already present an intermediate measure. If it includes amounts that are designated by the board, such as for a quasi-endowment fund, this must be described on the face of the statements or in the footnotes. KIDZ KAMP, Inc., decided against presenting an operating measure. Most charitable organizations did not present one previously.

INDEPENDENT AUDITOR'S REPORT

The Board of Directors KIDZ KAMP, Inc.
Atlanta, GA

Report on the Financial Statements

We have audited the accompanying financial statement of KIDZ KAMP, Inc. (KIDZ KAMP), which comprise the statement of financial position as of June 30, 20X1, and the related statement of activities, functional expenses, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of KIDZ KAMP, Inc. as of June 30, 20X1 and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Edison & Pike

Atlanta, GA
September 15, 20X1

Note 1: The auditor should consider an emphasis paragraph since the standard will have a significant impact on the financial statements of most entities.

Note 2: All expenses (except those netted against investment return) are required to be presented in one place. If the entity chooses not to present a Statement of Functional expenses, it may present the information in a footnote. The information may not be presented in a supplemental schedule and still meet the requirement.

KIDZ KAMP, INC.
STATEMENT OF FINANCIAL POSITION
JUNE 30, 20X1

Assets	
Cash and cash equivalents	$ 4,874,220
Operating investments	774,223
Accounts receivable, net	502,491
Promises to give, net	941,112
Prepaid expenses and other assets	2,290,813
Cash restricted to building project	1,500,000
Property and equipment, net	23,306,381
Assets held under split-interest agreements	977,102
Beneficial interests in charitable trusts held by others	812,850
Beneficial interest in assets held by community foundation	1,094,842
Beneficial interests in perpetual trusts	4,081,382
Endowment	
Promises to give, net	2,501,416
Investments	27,027,131
Total assets	$ 70,683,963
Liabilities and Net Assets	
Accounts payable	$ 475,002
Accrued expenses and other liabilities	847,722
Deferred revenue	1,467,412
Line of credit	1,111,500
Liabilities under split-interest agreements	1,418,127
Capital lease obligations	69,214
Bonds and notes payable	5,572,605
Interest-rate swap	240,300
Total liabilities	11,201,882
Net Assets	
Without donor restrictions	
Undesignated	3,345,218
Designated by the Board for operating reserve	300,000
Designated by the Board for endowment	6,511,186
Invested in property and equipment, net of related debt	17,150,885
	27,307,289
With donor restrictions	32,174,792
Total net assets	59,482,081
Total liabilities and net assets	$ 70,683,963

See notes to the financial statements.

Note 1: The statement of financial position does not have to be classified unless the entity is under the healthcare audit guide. If it is not, then the accounts should be in liquidity order.

Note 2: There will now be two categories of net assets, with donor restriction and without donor restriction. There is a requirement for descriptive information that may be put on the face of the statements or in a footnote. This presentation illustrates the descriptive information for the "net assets without donor restriction" on the face of the statement. The descriptive information for the "net assets with donor restriction" classification is presented in a footnote.

KIDZ KAMP, INC.
STATEMENT OF ACTIVITIES
YEAR ENDED JUNE 30, 20X1

	Without Donor Restrictions	With Donor Restrictions	Total
Revenue, Support and Gains			
Program service fees	1,256,005	-	1,256,005
Donations	12,427,221	2,858,963	15,286,184
Gift shop sales	112,364	-	112,364
Less cost of goods sold	(48,621)	-	(48,621)
Net gift shop sales	63,743	-	63,743
Exchange portion of membership dues	375,605		375,605
Net investment return	1,131,149	3,404,282	4,535,431
Federal and state contracts and grants	256,663	-	256,663
Contributions	3,352,578		3,352,578
Donated professional services	23,555	-	23,555
In-kind contributions	36,280	-	36,280
Gross special events revenue	98,552	-	98,552
Less cost of direct benefits to donors	(12,501)	-	(12,501)
Net special events revenue	86,051	-	86,051
Change in value of split-interest agreements held by KIDZ KAMP, Inc.	-	130,406	130,406
Distributions from and change in value of			-
beneficial interests in assets held by other	145,649	90,408	236,057
Change in value of interest-rate swap	33,200	-	33,200
Net assets released from restriction			-
pursuant to endowment spending-rate			-
distribution formula	728,892	(728,892)	-
Net assets released from restrictions - other	1,331,720	(1,331,720)	-
Total revenue, support and gains	21,248,311	4,423,447	25,671,758
Expenses and Losses			
Program services expense			
Advisory Program	11,340,977	-	11,340,977
Training Program	2,864,692	-	2,864,692
Total program expenses	14,205,669	-	14,205,669
Supporting services expense			
Management and general	754,593	-	754,593
Fundraising and development	442,867	-	442,867
Total supporting services expenses	1,197,460	-	1,197,460
Loss on uncollectable promises to give	7,109	-	7,109
Impairment loss on building	90,684	-	90,684
Total expenses and losses	15,500,922	-	15,500,922
Change in Net Assets	5,747,389	4,423,447	10,170,836
Net Assets, beginning of Year	21,559,900	27,751,345	49,311,245
Net Assets, End of year	$ 27,307,289	$ 32,174,792	$ 59,482,081

See notes to the financial statements.

Note 1: The entity may use a pancake or columnar approach for the statement of activities. The columnar approach is illustrated here.

Note 2: The FASB decided that an operating measure would not be required of not-for-profits at this time. If the entity chooses to present one, then it may do so. The operating measure is not illustrated here.

KIDZ KAMP, INC.
STATEMENT OF FUNCTIONAL EXPENSES
YEAR ENDED JUNE 30, 20X1

	Program Services			Management	Fundraising and	Cost of	
	Advisory	Training	Total	and General	Development	Goods Sold	Total
Grants and other assistance	$ 294,261	$ -	$ 294,261	$ -	$ -	$ -	$ 294,261
Salaries and wages	6,269,754	1,261,585	7,531,339	290,234	184,176	-	8,005,749
Employee benefits	1,198,503	390,865	1,589,368	99,963	21,222	-	1,710,553
Payroll taxes	441,580	94,927	536,507	29,619	9,923	-	576,049
Professional services	1,006,807	87,197	1,094,004	14,980	1,704	-	1,110,688
Accounting fees	-	-	-	40,073	-	-	40,073
Legal fees	-	7,939	7,939	-	-	-	7,939
Advertising and promotion	33,085	21,006	54,091	79,261	79,478	-	212,830
Office expenses	87,071	56,654	143,725	9,867	22,794	-	176,386
Information technology	37,858	706,535	744,393	12,399	14,653	-	771,445
Occupancy	346,601	29,799	376,400	14,918	53,427	-	444,745
Travel	70,957	18,283	89,240	93,292	-	-	182,532
Conferences, conventions and meetings	32,516	76,285	108,801	16,405	-	-	125,206
Interest	287,428	-	287,428	-	9,457	-	296,885
Insurance	100,500	12,556	113,056	8,443	930	-	122,429
Training and development	157,617	20,659	178,276	8,113	23,669	-	210,058
Gift shop cost of goods sold	48,621	-	48,621	-	-	-	48,621
Cost of direct benefits to donors	-	-	-	-	-	12,501	12,501
Depreciation and amortization	1,042,663	74,425	1,117,088	20,134	13,960	-	1,151,182
Bad debt expense	-	-	-	16,892	-	-	16,892
Other	31,569	5,977	37,546		7,474	-	45,020
Total expenses by function	11,487,391	2,864,692	14,352,083	754,593	442,867	12,501	15,562,044
Less expenses included with revenues on the statement of activities							
Gift shop cost of goods sold	(48,621)	-	(48,621)	-	-	-	(48,621)
Cost of direct benefits to donors	-	-	-	-	-	(12,501)	(12,501)
	(48,621)	-	(48,621)	-	-	(12,501)	(61,122)
Total expenses included in the expense section on the statement of activities	$ 11,438,770	$ 2,864,692	$ 14,303,462	$ 754,593	$ 442,867	$ -	$ 15,500,922

See notes to the financial statements.

Note 1: The Statement of Functional Expenses or a functional expense presentation in the footnotes needs to show all expenses except those that are netted against investment return. If not all of the expenses are included in the expense section of the statement of activities, then a reconciliation must be shown to the statement of activities.

Note 2: The functional expense presentation may not be in the form of a supplemental schedule.

KIDZ KAMP, INC.
STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 20X1

Cash Flows from Operating Activities	
Program service payments received	$ 12,910,429
Membership receipts	263,781
Gift shop sales receipts	112,364
Receipts from federal and state contracts and grants	256,663
Contributions received, net of amounts restricted for long-term purposes	4,264,113
Receipts from special events	98,552
Distributions from beneficial interests and assets held by others	178,520
Other cash receipts	101,275
Grants paid	(294,261)
Payments for salaries, benefits and payroll taxes	(8,403,222)
Payments to vendors	(3,979,515)
Interest paid	(287,428)
Net Cash from Operating Activities	5,221,271
Cash Flows from Investing Activities	
Purchases of operating investments	(575,000)
Proceeds from sales of operating investments	183,520
Purchases of property and equipment	(1,507,903)
(Addition to) withdrawal from assets held under split-interest agreements	86,476
(Addition to) withdrawal from endowment	536,301
Net Cash used for Investing Activities	(1,276,606)
Cash Flows from Financing Activities	
Collections of contributions restricted to building project	200,000
Collections of contributions restricted to endowment	365,963
Payments to beneficiaries of split-interest agreements	(176,588)
Net borrowings (repayments) under line of credit	(50,000)
Proceeds from issuance of bonds and notes	-
Principal payments on bonds, notes and capital leases	(305,236)
Net Cash from Financing Activities	34,139
Net Change in Cash and Cash Equivalents and Restricted Cash	3,978,804
Cash and Cash Equivalents and Restricted Cash, Beginning of Year	2,395,916
Cash and Cash Equivalents and Restricted Cash, End of Year	$ 6,374,720
Cash paid during the year for Interest	$ 441,514
Supplemental Disclosure of Non-cash Investing and Financing Activity	
Accounts payable for property and equipment	$ 445,369

See notes to the financial statements.

Note 1: The entity may choose the direct method or the indirect method. The direct method is illustrated here. If the entity chooses the direct method then it is not required to include the reconciliation to change in net assets from operating activities.

Note 2: If the entity has restricted cash and cash equivalents and cash and cash equivalents without restrictions on the statement of financial position, a reconciliation must be performed to the statement of cash flows.

KIDZ KAMP, INC.
NOTES TO FINANCIAL STATEMENTS
YEAR ENDED JUNE 30, 20X1

NOTE A – PRINCIPAL ACTIVITY AND SIGNIFICANT ACCOUNTING POLICIES

Organization

KIDZ Kamp, Inc. (KIDZ KAMP) was founded in 20XX as a 501(c)(3) nonprofit organization. It is located in Atlanta, GA. Its mission is to change the lives of underprivileged children from kindergarten through middle school by providing them with enrichment programs and mentorship to help them succeed in school and prepare them for high school. KIDZ KAMP has after school and summer camp programs. The organization is primarily supported by donations but also charges fees to parents on a sliding scale for the programs. KIDZ KAMP also provides advisory services to similar nonprofit programs around the country.

Cash and Cash Equivalents[1]

KIDZ KAMP considers all cash and highly liquid financial instruments with original maturities of three months or less, which are neither held for nor restricted by donors for long-term purposes, to be cash and cash equivalents. Cash and highly liquid financial instruments restricted to building projects, endowments that are perpetual in nature, or other long-term purposes are excluded from this definition.

Receivables and Credit Policies

Accounts receivable consist primarily of noninterest-bearing amounts due for advisory services. KIDZ KAMP determines the allowance for uncollectable accounts receivable based on historical experience, an assessment of economic conditions, and a review of subsequent collections. Accounts receivable are written off when deemed uncollectable. At June 30, 20X1 the allowance for doubtful accounts was $15,300.

[1] This example assumes that the CDs that the entity holds are brokered CDs. These are other investments under GAAP. The CDs are reported in the footnotes at fair value. If the entity holds CDs with a financial institution that are not brokered then they are cash and cash equivalents if they meet the original maturity of 90 days or less timeframe.

Promises to Give[2]

KIDZ KAMP records unconditional promises to give that are expected to be collected within one year at net realizable value. Unconditional promises to give expected to be collected in future years are initially recorded at fair value using present value techniques incorporating risk-adjusted discount rates designed to reflect the assumptions market participants would use in pricing the asset. In subsequent years, amortization of the discounts is included in contribution revenue in the statement of activities. KIDZ KAMP determines the allowance for uncollectable promises to give based on historical experience, an assessment of economic conditions, and a review of subsequent collections. Promises to give are written off when deemed uncollectable. At June 30, 20X1 the allowance was $145,539.

Property and Equipment

KIDZ KAMP records property and equipment additions over $5,000 at cost, or if donated, at fair value on the date of donation. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets ranging from 3 to 20 years, or in the case of capitalized leased assets or leasehold improvements, the lesser of the useful life of the asset or the lease term. When assets are sold or otherwise disposed of, the cost and related depreciation or amortization are removed from the accounts, and any resulting gain or loss is included in the statement of activities. Costs of maintenance and repairs that do not improve or extend the useful lives of the respective assets are expensed currently.

KIDZ KAMP reviews the carrying values of property and equipment for impairment whenever events or circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. When considered impaired, an impairment loss is recognized to the extent carrying value exceeds the fair value of the asset. KIDZ KAMP has determined that certain long-lived assets were impaired during the year ended June 30, 20X1, and has recorded an impairment loss of $90,684 at June 30, 20X1.

[2] The AICPA prefers the term “promises to give” or “contributions receivable” instead of “pledges receivable”. They believe that the term pledges is ambiguous.

NOTE A – PRINCIPAL ACTIVITY AND SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Beneficial Interest in Assets Held by Community Foundation[3]

During 20X4, KIDZ KAMP established an endowment fund that is perpetual in nature (the fund) under a community foundation's (the CF) Non-Profit Preservation Endowment Challenge Grant Program. KIDZ KAMP granted variance power to the CF, which allows the CF to modify any condition or restriction on its distributions for any specified charitable purpose or to any specified organization if, in the sole judgment of the CF's Board of Directors, such restriction or condition becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community. The fund is held and invested by the CF for our benefit and is reported at fair value in the statement of financial position, with distributions and changes in fair value recognized in the statement of activities.

Beneficial Interests in Perpetual Trusts

We have been named as an irrevocable beneficiary of several perpetual trusts held and administered by independent trustees. Perpetual trusts provide for the distribution of the net income of the trusts to us; however, KIDZ KAMP will never receive the assets of the trusts. At the date KIDZ KAMP receives notice of a beneficial interest, a contribution with donor restrictions of a perpetual nature is recorded in the statement of activities, and a beneficial interest in perpetual trust is recorded in the statement of financial position at the fair value of the underlying trust assets. Thereafter, beneficial interests in the trusts are reported at the fair value of the trusts' assets in the statement of financial position, with trust distributions and changes in fair value recognized in the statement of activities.

Investments

KIDZ KAMP records investment purchases at cost, or if donated, at fair value on the date of donation. Thereafter, investments are reported at their fair values in the statement of financial position. Net investment return/(loss) is reported in the statement of activities and consists of interest and dividend income, realized and unrealized capital gains and losses, less external and direct internal investment expenses[4].

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[3] This example assumes that the funds transferred were originally restricted for endowment. The transfer itself to the CF does not impact the classification because a donor is not involved.

[4] Direct internal investment expenses are now included in the expenses that are netted against investment return. The amount of the investment expenses should not be disclosed.

NOTE A – PRINCIPAL ACTIVITY AND SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Net Assets

Net assets, revenues, gains, and losses are classified based on the existence or absence of donor or grantor imposed restrictions. Accordingly, net assets and changes therein are classified and reported as follows:

Net Assets Without Donor Restrictions – Net assets available for use in general operations and not subject to donor (or certain grantor) restrictions. The governing board has designated, from net assets without donor restrictions, net assets for an operating reserve and board-designated endowment.

Net Assets With Donor Restrictions – Net assets subject to donor- (or certain grantor-) imposed restrictions. Some donor-imposed restrictions are temporary in nature, such as those that will be met by the passage of time or other events specified by the donor. Other donor-imposed restrictions are perpetual in nature, where the donor stipulates that resources be maintained in perpetuity. Donor-imposed restrictions are released when a restriction expires, that is, when the stipulated time has elapsed, when the stipulated purpose for which the resource was restricted has been fulfilled, or both.

Revenue and Revenue Recognition

Revenue is recognized when earned. Program service fees and payments under cost-reimbursable contracts received in advance are deferred to the applicable period in which the related services are performed or expenditures are incurred, respectively. Contributions are recognized when cash, securities or other assets, an unconditional promise to give, or notification of a beneficial interest is received. Conditional promises to give are not recognized until the conditions on which they depend have been substantially met.

Donated Services and In-Kind Contributions

Volunteers contribute significant amounts of time to our program services, administration, and fundraising and development activities; however, the financial statements do not reflect the value of these contributed services because they do not meet recognition criteria prescribed by generally accepted accounting principles. Contributed goods are recorded at fair value at the date of donation. KIDZ KAMP records donated professional services at the respective fair values of the services received.

Advertising Costs

Advertising costs are expensed as incurred, and approximated $212,830 during the year ended June 30, 20X1.

NOTE A – PRINCIPAL ACTIVITY AND SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Functional Allocation of Expenses[5]

The costs of program and supporting services activities have been summarized on a functional basis in the statement of activities. The statement of functional expenses present the natural classification detail of expenses by function. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Income Taxes

KIDZ KAMP is organized as a Georgia nonprofit corporation and has been recognized by the IRS as exempt from federal income taxes under IRC Section 501(c)(3). Thus it qualifies for the charitable contribution deduction under IRC Sections 170(b)(1)(A)(vi). The organization is annually required to file a Return of Organization Exempt from Income Tax (Form 990) with the IRS. In addition, the entities are subject to income tax on net income that is derived from business activities that are unrelated to their exempt purposes. Management has determined that the organization is not subject to unrelated business income tax and has not filed an Exempt Organization Business Income Tax Return (Form 990-T) with the IRS.

Estimates

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

[5] Required by ASU 2016-14.

NOTE A – PRINCIPAL ACTIVITY AND SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Financial Instruments and Credit Risk

KIDZ KAMP manages deposit concentration risk by placing cash, money market accounts, and certificates of deposit with financial institutions believed by us to be creditworthy. At times, amounts on deposit may exceed insured limits or include uninsured investments in money market mutual funds. To date, KIDZ KAMP has not experienced losses in any of these accounts. Credit risk associated with accounts receivable and promises to give is considered to be limited due to high historical collection rates and because substantial portions of the outstanding amounts are due from Board members, governmental agencies, and foundations supportive of our mission. Investments are made by diversified investment managers whose performance is monitored by management and the investment committee of the Board of Directors. Although the fair values of investments are subject to fluctuation on a year-to-year basis, management and the investment committee believe that the investment policies and guidelines are prudent for the long-term welfare of the organizations.

Recent Accounting Guidance

During the year ended June 30, 20X1 the organization implemented ASU 2016-14, *Financial Statements of Not-for-Profit Entities.* Accordingly, the beginning balances of the donor restricted net asset categories (temporarily and permanently restricted) have been retroactively adjusted to consolidate all donor restricted net assets into one classification, *with donor restrictions*. The ASU requires additional disclosures in the areas of liquidity and endowment funds and modifies the direct method presentation of the Statement of Cash Flows, requires reclassification of investment expenses which are netted in investment return to include internal investment expenses. In addition, it requires any underwater portion of the organization's endowment funds to be adjusted from net assets without donor restrictions to net assets with donor restrictions.

Subsequent Events

Management has evaluated subsequent events through September 15, 20X1, the date the financial statements were available to be issued.

NOTE B – LIQUIDITY AND AVAILABILITY[6]

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of the balance sheet date, comprise the following:

Cash and cash equivalents	$ 3,651,231
Accounts receivable	312,216
Operating investments	502,491
Promises to give	132,505
Distributions from assets held under split-interest agreements	95,000
Distributions from beneficial interests in assets held by others	130,110
Endowment spending-rate distributions and appropriations	544,705
	$ 5,368,258

The organization's endowment funds consist of donor-restricted endowments and funds designated by the board as endowments. Income from donor-restricted endowments is restricted for specific purposes, with the exception of the amounts available for general use. Donor-restricted endowment funds are not available for general expenditure.

Our board-designated endowment of $6,511,186 is subject to an annual spending rate of 4.5%. Although we do not intend to spend from this board-designated endowment (other than amounts appropriated for general expenditure as part of our Board's annual budget approval and appropriation), these amounts could be made available if necessary.

As part of our liquidity management plan, we invest cash in excess of daily requirements in short-term investments, CDs, and money market funds. Occasionally, the Board designates a portion of any operating surplus to its operating reserve, which was $300,000 at June 30, 20X1.

[6] This is new presentation under ASU 2014-16. The entity reports the financial assets available for general expenditure within one year.

NOTE C – FAIR VALUE MEASUREMENTS AND DISCLOSURES[7]

The organization reports certain assets and liabilities at fair value in the financial statements. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal, or most advantageous, market at the measurement date under current market conditions regardless of whether that price is directly observable or estimated using another valuation technique. Inputs used to determine fair value refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. Inputs may be observable or unobservable. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from sources independent of the reporting entity. Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available. A three-tier hierarchy categorizes the inputs as follows:

Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that we can access at the measurement date.

Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, and market-corroborated inputs.

Level 3 – Unobservable inputs for the asset or liability. In these situations, the organization develops inputs using the best information available in the circumstances.

In some cases, the inputs used to measure the fair value of an asset or a liability might be categorized within different levels of the fair value hierarchy. In those cases, the fair value measurement is categorized in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement. Assessing the significance of a particular input to entire measurement requires judgment, taking into account factors specific to the asset or liability. The categorization of an asset within the hierarchy is based upon the pricing transparency of the asset and does not necessarily correspond to our assessment of the quality, risk, or liquidity profile of the asset or liability.

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[7] Equity method investments are not reported at fair value so they should not be included in the hierarchy. In addition, certain split interest agreements, pledges receivable and CDs (unless brokered) are not reported in the hierarchy.

NOTE C – FAIR VALUE MEASUREMENTS AND DISCLOSURES – CONTINUED

A significant portion of our investment assets are classified within Level 1 because they comprise open-end mutual funds with readily determinable fair values based on daily redemption values. We invest in CDs traded in the financial markets. Those CDs and U.S. government obligations are valued by the custodians of the securities using pricing models based on credit quality, time to maturity, stated interest rates, and market-rate assumptions, and are classified within Level 2. The fair values of beneficial interests in charitable and perpetual trusts are determined by us using present value techniques and risk-adjusted discount rates designed to reflect the assumptions market participants would use in pricing the underlying assets and are based on the fair values of trust investments as reported by the trustees. The fair value of our beneficial interest in assets held by the community foundation is based on the fair value of fund investments as reported by the community foundation. These are considered to be Level 3 measurements.

We use net asset value (NAV) per share, or its equivalent, such as member units or an ownership interest in partners' capital, as a practical expedient to estimate the fair values of certain hedge funds, private equity funds, funds of funds, and limited partnerships, which do not have readily determinable fair values. Investments that are measured at fair value using NAV per share as a practical expedient are not classified in the fair value hierarchy.

The interest rate swap agreement is valued using a third party's proprietary discounted cash flow model, which considers past, present, and future assumptions regarding interest rates and market conditions to estimate the fair value of the agreement. This is classified within Level 2.

The following table presents assets and liabilities measured at fair value on a recurring basis, except those measured at cost or by using NAV per share as a practical expedient[8] as identified in the following, at June 30, 20X1:

[8] ASU 2015-07 creates a practical expedient that can be elected whereby the assets valued at NAV no longer have to be "leveled". It is effective for fiscal years beginning after December 15, 2015 for public entities and fiscal years beginning after December 15, 2016 for all others. Early implementation is permitted.

NOTE C – FAIR VALUE MEASUREMENTS AND DISCLOSURES – CONTINUED

Assets	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Investments Measured at NAV
Operating investments					
U.S. Government obligations	$ 276,313	$ -	$ 276,313	$ -	$ -
Short-term bond mutual fund	497,910	497,910	-	-	-
	$ 774,223	$ 497,910	$ 276,313	$ -	$ -
Assets held under split-interest agreements					
Cash and money market funds (at cost)	$ 178,411	$ -	$ -	$ -	$ -
U.S. Government obligations	512,904	-	512,904	-	-
Global equity mutual funds	1,285,787	1,285,787	-	-	-
	$ 1,977,102	$ 1,285,787	$ 512,904	$ -	$ -
Beneficial interests in					
Charitable trusts held by others	$ 812,850	$ -	$ -	$ 812,850	$ -
Perpetual trusts	4,081,382			$ 4,081,382	
Assets held by community foundation	1,094,842	-	-	1,094,842	-
	$ 5,989,074	$ -	$ -	$ 5,989,074	$ -
Endowment investments					
Cash and money market funds (at cost)	$ 538,964	$ -	$ -	$ -	$ -
Certificates of deposit	711,544	-	711,544	-	-
U.S. Government obligations	1,237,881	-	1,237,881	-	-
Global equity mutual funds	6,595,804	6,595,804	-	-	-
Global equity funds	572,375	-	-	-	572,375
Long/short hedge funds	5,961,036	-	-	-	5,961,036
Private equity funds	5,456,648	-	-	-	5,456,648
Real estate funds	6,491,843	-	-	-	6,491,843
	$ 27,027,131	$ 6,595,804	$ 1,949,425	$ -	$ 18,481,902
Liabilities					
Interest-rate swap	$ 240,300	$ -	$ 240,300	$ -	$ -

NOTE C – FAIR VALUE MEASUREMENTS AND DISCLOSURES – CONTINUED

The following is a reconciliation of the beginning and ending balance of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended June 30, 20X1:

	Fair Value Measurements at report Date Using Significant Unobservable Inputs (Level 3)		
	Beneficial Interests		
	Charitable Trusts	Assets Held by Community Foundation	Perpetual Trusts
Balance at December 31, 20X0	$ 804,179	$ 1,090,505	$ 3,998,524
Purchases/contributions of investments	24,334	-	-
Investment return, net	21,209	41,209	188,635
Distributions	(36,872)	(36,872)	(105,777)
Balance at December 31, 20X1	$ 812,850	$ 1,094,842	$ 4,081,382

Investments in certain entities that are measured at fair value using NAV per share as a practical expedient are as follows at June 30, 20X1:

	Number of Investments	Fair value	Unfunded Commitments	Redemption Frequency	Redemption Notice Period
Global equity funds	1	$ 572,375	$ -	Quarterly	30 days
Long/short hedge funds	9	5,961,036	-	Daily, Monthly	None, 30 days
Private equity funds	5	5,456,648	500,000	Annually	30 days
Real estate funds	13	6,491,843	225,000	Illiquid	None, 30 days
		$ 18,481,902	$ 725,000		

(1) The liquidity of certain investments is limited until the original capital commitment has been met. Additionally, the provisions of two investment contracts require a term exceeding one year for complete divestiture.

Global Equity Funds – Funds focused on private equity investments primarily in foreign markets, including emerging markets.

Long/Short Hedge Funds – Funds that can invest long and short, primarily in common stocks. Fund managers may invest in value, growth, or event-driven equity opportunities and typically are not restricted by market capitalization, industry sector, or geography. Leverage may be utilized, which can magnify changes in the values of the underlying securities.

NOTE C – FAIR VALUE MEASUREMENTS AND DISCLOSURES – CONTINUED

Private Equity Funds – Funds focused on growth in equity, buyout opportunities, or distressed debt. These investments are not readily redeemable; however, a secondary market does exist. Distributions normally are received through the liquidation of the underlying assets in the fund. The terms of these investments range from three to seven years.

Real Estate Funds – Funds focused on real estate assets primarily located in the United States. These investments are not redeemable. Instead, distributions are received through the liquidation of the underlying assets in the fund. The terms of these investments range from 2–10 years.

Fair values of assets measured on a nonrecurring basis at June 30, 20X1 are as follows:

		Fair Value Measurements at Report Date Using			
Assets	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses
Long-lived asset held and used					
Administration Building	$ 2,475,000	$ -	$ 2,475,000	$ -	$ 90,684

During the year ended June 30, 20X1, our administration building, with a carrying amount of $2,535,000, was written down to its appraised fair value of $2,475,000, resulting in an impairment loss of $90,684 which was included in the change in net assets without donor restrictions for the year.

NOTE D – PROMISES TO GIVE

Unconditional promises to give are estimated to be collected as follows at June 30, 20X1:

Within one year	$ 759,572
In one to five years	622,072
Over five years	165,000
	1,546,644
Less discount to net present value at rates ranging from 2.96% to 3.50%	(122,994)
Less allowance for uncollectable promises to give	(145,539)
	$ 1,278,111

Promises to give appear as follows in the statement of financial position:

Promises to give, net	$ 941,112
Endowment promises to give, net	2,501,416
	$ 3,442,528

At June 30, 20X1, three donors accounted for 47% of total promises to give. Two contributors accounted for approximately 31% of total contribution revenue for the year ended June 30, 20X1.

NOTE E – PROPERTY AND EQUIPMENT

Property and equipment consists of the following at June 30, 20X1:

Land and improvements	$ 4,141,389
Buildings and improvements	23,983,581
Equipment	1,520,946
Furniture and fixtures	7,363,123
	37,009,039
Less accumulated depreciation and amortization	(16,730,012)
	$ 20,279,027

Depreciation and amortization expense totaled $1,151,182 for the year ended June 30, 20X1.

During the course of our line of credit renewal negotiations, the administration building was appraised at a fair value below its carrying value. Accordingly, an impairment loss of $90,684 was recorded in the statement of activities at June 30, 20X1, and the carrying value of the property was reduced to its estimated fair value.

NOTE F – LINE OF CREDIT

We have a $1,500,000 revolving line of credit with a bank, secured by accounts receivable. Borrowings under the line bear interest at the bank's prime rate plus 0.75%, or a floor of 5.00% (4.25% at June 30, 20X1). Accrued interest and principal are due at maturity (June 30, 20X5). The agreement requires us to comply with certain financial and non-financial covenants. At June 30, 20X1 the amount outstanding on the line of credit was $1,111,500.

NOTE G – BONDS AND NOTES PAYABLE

Bonds Payable

On November 1, 2008, the Municipal Financing Authority (the Authority) issued $14,000,000 of Series 2008 Floating Rate Charity Advancement Development Bonds (the Bonds). The Authority then loaned the proceeds of the Bonds to us for construction of a new training center. The Bonds are special limited obligations of the Authority and are payable solely out of the amounts received by the Authority from us pursuant to the terms and provisions of the indenture and agreement. The Bonds are 30-year serial bonds maturing on November 1, 2038, with floating rates based on the SIFMA Municipal Swap Index Rate plus 1.00% (4.38% at June 30, 20X1), provisions for optional and mandatory redemption sinking funds, and a provision for early redemption. Payment of principal and interest on the Bonds is guaranteed by a loan agreement, which provides the Authority with rights and title to program revenues and is secured by the training center building. Interest on the Bonds is payable semi-annually on May 1 and November 1.

Bonds payable consist of the following at June 30, 20X1:

Principal amount	$ 5,303,605
Less unamortized premium	(125,675)
Less debt issuance costs	(69,000)
	$ 5,372,605

NOTE G – BONDS AND NOTES PAYABLE – CONTINUED

Notes Payable

Notes payable consist of the following at June 30, 20X1:

3.85% note payable, principal and accumulated accrued interest due on December 31, 20X4, unsecured	$	165,000
Note payable, due in monthly installments of $750, plus interest at bank's prime lending rate (3.25 at December 31, 20X1), to March 1, 20XX, secured by property and equipment		35,000
	$	200,000

Bonds payable (net)	$	5,372,605
Notes payable		200,000
Amount reported on statement of financial position	$	5,572,605

Future maturities of bonds and notes payable are as follows:

Years Ending December 31,	Bonds Payable	Notes Payable	Total
20X2	$ 199,676	$ 8,549	$ 208,225
20X3	198,835	8,329	207,164
20X4	196,213	8,149	204,362
20X5	207,522	32,060	239,582
20X6	212,734	10,312	223,046
Thereafter	4,357,625	132,601	4,490,226
	$ 5,372,605	$ 200,000	$ 5,572,605

To hedge against interest rate risk on our floating-rate bonds, we entered into an interest rate swap (the Swap) with a major U.S. bank as the counterparty. The Swap has a declining notional value matching the outstanding bond principal over time. We pay interest on the notional value at 4.98% and receive interest on the notional value at the floating SIFMA Municipal Swap Index Rate plus 1.00% (4.38% at June 30, 20X1). The Swap matures on November 1, 2038. The effect of the Swap is to convert our floating-rate bond debt to fixed-rate debt.

During the year ended June 30, 20X1, the fair value of the liability under the Swap decreased $33,200, which has been reflected in the accompanying statement of activities. At June 30, 20X1, the fair value of the Swap liability was $240,300.

NOTE H – LEASES

We lease office and storage space under various operating leases, and vehicles and equipment under various capital leases expiring at various dates through 20X8.

Future minimum lease payments are as follows:

Years Ending December 31,	Capital Leases	Operating Leases
20X2	$ 21,984	$ 178,493
20X3	21,984	159,027
20X4	21,984	87,212
20X5	10,992	72,038
20X6	-	54,777
Thereafter	-	12,901
Total minimum lease payments	76,944	$ 564,448
Less amount representing interest	(7,730)	
Capital lease obligation	$ 69,214	

Rent expense for the years ended June 30, 20X1 totaled $190,329.

Leased property under capital leases at June 30, 20X1 includes the following:

Vehicles	$ 70,000
Equipment	24,700
	94,700
Less accumulated amortization	(28,410)
	$ 66,290

NOTE I – ENDOWMENT

Our endowment (the Endowment) consists of approximately 45 individual funds established by donors to provide annual funding for specific activities and general operations. The Endowment also includes certain net assets without donor restrictions that have been designated for endowment by the Board of Directors.

Our Board of Directors has interpreted the Georgia Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the date of the donor-restricted endowment funds, unless there are explicit donor stipulations to the contrary. At June 30, 20X1 there were no such donor stipulations. As a result of this interpretation, we retain in perpetuity (a) the original value of initial and subsequent gift amounts (including promises to give net of discount and allowance for doubtful accounts donated to the Endowment and (b) any accumulations to the endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added. Donor-restricted amounts not retained in perpetuity are subject to appropriation for expenditure by us in a manner consistent with the standard of prudence prescribed by UPMIFA. We consider the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

NOTE I – ENDOWMENT – CONTINUED

- The duration and preservation of the fund
- The purposes of the organization and the donor-restricted endowment fund
- General economic conditions
- The possible effect of inflation and deflation
- The expected total return from income and the appreciation of investments
- Other resources of the organization
- The investment policies of the organization

As of June 30, 20X1, we had the following endowment net asset composition by type of fund:

	Without Donor Restriction	With Donor Restriction	Total
Board-designated endowment funds	$ 6,511,186	$ -	$ 6,511,186
			-
Donor-restricted endowment funds			-
Original donor-restricted gift amount			-
and amounts required to be maintained			-
in perpetuity by donor	-	19,864,750	19,864,750
Accumulated investment gains	-	988,194	988,194
	$ 6,511,186	$ 20,852,944	$ 27,364,130

From time to time, certain donor-restricted endowment funds may have fair values less than the amount required to be maintained by donors or by law (underwater endowments). We have interpreted UPMIFA to permit spending from underwater endowments in accordance with prudent measures required under law. At June 30, 20X1, funds with original gift values of $16,864,750, fair values of $16,842,250 and deficiencies of $22,500 were reported in net assets with donor restrictions[9].

[9] Information required by ASU 2016-14.

NOTE I – ENDOWMENT – CONTINUED

Investment and Spending Policies

We have adopted investment and spending policies for the Endowment that attempt to provide a predictable stream of funding for operations while seeking to maintain the purchasing power of the endowment assets. Over time, long-term rates of return should be equal to an amount sufficient to maintain the purchasing power of the Endowment assets, to provide the necessary capital to fund the spending policy, and to cover the costs of managing the Endowment investments. The target minimum rate of return is the Consumer Price Index plus 5% on an annual basis. Actual returns in any given year may vary from this amount. To satisfy this long-term rate-of-return objective, the investment portfolio is structured on a total-return approach through which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). A significant portion of the funds are invested to seek growth of principal over time.

We use an endowment spending-rate formula to determine the maximum amount to spend from the Endowment, including those endowments deemed to be underwater, each year[10]. The rate, determined and adjusted from time to time by the Board of Directors, is applied to the average fair value of the Endowment investments for the prior 12 quarters at June 30 of each year to determine the spending amount for the upcoming year. During 20X1, the spending rate maximum was 4.5%. In establishing this policy, we considered the long-term expected return on the Endowment and set the rate with the objective of maintaining the purchasing power of the Endowment over time.

Changes in Endowment net assets for the year ended June 30, 20X1 are as follows:

	Without Donor Restriction	With Donor Restriction	Total
Endowment net assets, beginning of year	$ 5,912,222	$ 19,839,035	$ 25,751,257
Investment return, net	1,143,669	1,412,392	2,556,061
Contributions	-	330,409	330,409
Appropriation of endowment assets pursuant to spending-rate policy	-	(728,892)	(728,892)
Other changes:			-
Distribution from board-designated endowment pursuant to distribution policy	(544,705)	-	(544,705)
Endowment net assets, end of year	$ 6,511,186	$ 20,852,944	$ 27,364,130

[10] Information required by ASU 2016-14.

NOTE J – NET ASSETS WITH DONOR RESTRICTIONS[11]

Net assets with donor restrictions are restricted for the following purposes or periods.

Subject to expenditure for specified purpose:	
Operation of the training center	$ 448,377
Educational programs	2,403,288
Promises to give, the proceeds from which have been restricted by donors for educational programs	504,007
	3,355,672
Subject to the passage of time:	
Beneficial interests in charitable trusts held by others	812,850
Assets held under split-interest agreements	1,977,102
	2,789,952
Endowments:	
Subject to appropriation and expenditure when a specified event occurs:	
Restricted by donors for	
Available for general use	223,171
Educational programs	186,492
Financial aid	3,578,531
	3,988,194
Subject to NFP endowment spending policy and appropriation:	
Operation of the Training Center	4,058,300
Educational programs	8,280,462
Financial aid	1,308,911
General use	738,161
Unconditional promises to give, net - restricted in perpetuity to general endowment	2,501,416
Underwater endowments	(22,500)
	16,864,750
Total endowments	20,852,944
Not subject to spending policy or appropriation:	
Beneficial interest in assets held by community foundation	1,094,842
Beneficial interests in perpetual trusts	4,081,382
	5,176,224
	$ 32,174,792

[11] Net assets without donor restrictions may be disclosed on the face of the statement of financial position or in the footnotes.

NOTE J – NET ASSETS WITH DONOR RESTRICTIONS – CONTINUED

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purpose or by occurrence of the passage of time or other events specified by the donors as follows for the year ended June 30, 20X1:

Expiration of time restrictions	$ 15,000
Satisfaction of purpose restrictions	
Operation of the training center	801,146
Educational programs	247,793
Financial aid	219,021
Distributions (proceeds are not restricted by donors)	
Beneficial interests in charitable trusts held by others	36,872
Assets held under split interest agreements	11,888
	1,331,720
Restricted-purpose spending-rate distributions and appropriations	
Educational programs	130,619
Financial aid	75,240
General use	523,033
	728,892
	$ 2,060,612

NOTE K – DONATED PROFESSIONAL SERVICES AND MATERIALS

We received donated professional services and materials as follows during the years ended June 30, 20X1:

	Program Services	Management and General	Fundraising and Development	Total
Legal services	-	8,800	-	8,800
Food	12,873	-	-	12,873
Supplies	4,538	-		4,538
Advertising	-	787	9,213	10,000
	$ 17,411	$ 9,587	$ 9,213	$ 36,211

NOTE K – FUNCTIONAL EXPENSES

The financial statements report certain categories of expenses that are attributed to more than one program or supporting function. Therefore, expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include occupancy, depreciation, and amortization, which are allocated on a square footage basis, as well as salaries and wages, benefits, payroll taxes, professional services, office expenses, information technology, interest, insurance, and other, which are allocated on the basis of estimates of time and effort.

NOTE L – RELATED PARTY TRANSACTIONS

During the year ended June 30, 20X1, we purchased printing services totaling $87,590 from a company owned by a member of our Board of Directors.

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QUESTION 4:

My organization is embarking on a capital campaign. The intent is to raise $3 million for a new building which will be LEED (Leadership in Energy Environmental Design) certified. The campaign was designed so that donors would give ratably over a five-year period. We will not be investing this money as it will go, at first, to pay for architect fees and other initial costs. We will issue debt to pay for the majority of the construction. The pledges will be used to service the debt. We have never done this before.

How do I account for the contributions and the building?

ANSWER:

Contribution revenue is initially measured at the fair value of the assets or services received or promised or the fair value of the liabilities satisfied. When long-term promises to give or contributions are received, the not-for-profit management will determine the amount and the timing of the future cash flows and apply a discount rate to arrive at the contribution's fair value. In considering the fair value, the not-for-profit considers the creditworthiness of the parties, the not-for-profit's past collection experience and its policies about enforcing promises to give.

For an unconditional promise to give which is expected to be collected in one year or more, the unit of account specified in ASC 958-605 is the individual promise to give. This means that the exit price is the amount that a market participant would pay to acquire the right to receive the cash from the donor. Although this would not happen, it is a good measurement focus. The not-for-profit would assume that the market participant is stepping into the shoes of the not-for-profit. The valuation of long-term promises to give is generally made using the income approach.

ASC 820-10 replaces the previous guidance in the AAG-NPO[12] to use a risk-free rate as the discount rate. The guidance discusses a present value technique where a risk-free rate is appropriate (Method 1 of the expected present value technique). If this method is used, it includes an evaluation of the amount that will eventually be collected from the donors, as well as a discount reflecting the time value of money. Both expected present value method 2 and the discount rate adjustment technique discussed below are other acceptable methods of determining fair value of long-term promises to give.

Not-for-profit organizations generally follow the accounting pronouncements used by for-profit companies. However, since certain prevalent transactions in not-for-profits (e.g., contributions, split interest agreements and perpetual trusts) have unusual characteristics that were not anticipated in ASC 820, *Fair Value Measurements,* the AICPA issued a whitepaper in October 2011 to provide suggestions on how fair value could be interpreted for these transactions. The term "whitepaper" will be used throughout this program to refer to that document.

Method 1 of the expected present value technique (EPV) discussed in ASC 820 discusses a present value technique for which a **risk-free** rate of return is appropriate. The expected (**probability weighted**) cash flows (or expected value) are adjusted for general market risk by subtracting the cash risk premium. The fact that they are probability weighted means that they are not conditional cash flows. Therefore, the risk-adjusted expected cash flows then represent a certainty-equivalent cash flow.

[12] The Audit and Accounting Guide, *Not-for-Profit Entities* is referred to in this manual by its acronym, AAG-NPO.

Method 2 of the expected present value technique uses a probability weighted cash flow or expected value. In this method, they are not risk adjusted. An **adjusted risk-free rate** is used. The risk-free rate is adjusted for general market risk by adding a risk premium. This adjusted rate is the expected rate of return. As in Method 1, the fact that the cash flows are probability weighted means that they are not conditional cash flows. A pricing model (such as the capital asset pricing model) is sometimes used.

DRA (the discount rate adjustment technique) uses a single set of cash flows. The whitepaper describes them as contractual or promised; most likely cash flows. These are referred to as projected cash flows. The discount rate used is derived from observed rates of return for comparable assets or liabilities that are traded in the market. This would be a market rate of return that corresponds to an observed market rate associated with conditional cash flows (the amount that market participants would demand for bearing the uncertainty inherent in the cash flows).

The whitepaper points out that even though it appears that the DRA method may be the easiest to apply since it uses a single set of cash flows and the discount rate is derived from observed rates, it may be hard to estimate default rates and factor them into the discount rate. The whitepaper suggests that it is important to use a rate which considers that some of the risk is inherent in the projected cash flows to avoid double counting. Additionally, it is important to consider whether the not-for-profit has a practice of not enforcing its right to receive promises to pay.

The DRA method (as described in the whitepaper) can either use the promised cash flows with a higher discount rate or the most likely cash flows with a lower discount rate.

Since the discount rate adjustment does not incorporate the level of risk that EPV 1 and 2 do, the discount rate would be higher. Each of these methods considers risk in two ways, the probability weighted cash flows or most likely cash flows and the discount rate. To the extent that the risk has not been incorporated in one, it would be incorporated in the other.

The whitepaper provides not-for-profits with a **starting point** to evaluate a risk adjusted discount rate (or more than one rate). A starting point for an individual donor might be based on the average credit characteristics of a homogeneous group of donors. The not-for-profit might use a borrowing rate that would be available to that group of donors for unsecured debt. If the donor were a corporation, a risk adjusted discount rate might be determined using the yield on publicly traded debt – whether issued by that corporation or a similar corporation. The same would be true of a foundation but the whitepaper cautions that the rate would be the taxable yield even if the foundation issues tax-exempt debt.

EXAMPLE

The not-for-profit school held a capital campaign and raised $3,000,000. The amounts were to be paid by the donors ratably over five years. The controller evaluated the results of the previous capital campaign which was held six years ago in 20X0 to determine the most likely amount that would be collected.

Experience from 20X0 Capital Campaign					
Type of Donor	**Average Donation**	**Amount Pledged Total for Campaign**	**Percentage of Total Pledged**	**Amount Collected**	**Percentage Collected**
Individual (parents - high net worth, large givers)	130,781	2,615,620	78.50%	2,432,527	93%
Individual (parents - smaller givers)	511	583,100	17.50%	524,790	90%
Teachers and employees of the school	1,111	83,300	2.50%	73,304	88%
Corporations	12,495	49,980	1.50%	50,000	100%
	144,897	3,332,000	100%	3,080,621	92%

The controller sought information from three similar schools that had capital campaigns. She did this because she wanted to first use probability-weighted cash flows. Even though she performed the calculation, since much of this information was derived from other schools in periods when a recession was on, she decided on what she believed was the ***most likely cash flow****. Because different donors default at different percentages, she considered the most likely cash flow to be derived from the campaign by donor type.*

Information From Other Independent Schools with More Recent Campaigns	**20X4 Campaign**	**20X6 Campaign**	**20X6 Campaign**
	% Collected of Amounts Promised To Date	**% Collected of Amounts Promised To Date**	**% Collected of Amounts Promised To Date**
Type of Donor	**School 1**	**School 2**	**School 3**
Individual (parents - high net worth, large givers)	90%	95%	94%
Individual (parents - smaller givers)	85%	87%	91%
Teachers and employees of the school	82%	89%	92%
Corporations	100%	100%	100%

She then developed the most likely amount to be received. This was somewhat subjective with more emphasis being placed on the actual experience of her school for the 20X0 campaign, where all possible donations had been collected. In addition, more emphasis was placed on the 20X6 campaign than the 20X4 campaign. The controller's rationale was that in 20X4-20X7, even though the campaign receipts were more complete, the incoming cash flows were less in this campaign due to problems in the economy. By 20X6, she believed the economy was beginning to recover, thus the collection experience from those schools was considered more heavily. Note that the cash flows were calculated as the amount received vs. the amount expected at that date. So the amounts received during the first two payment periods of the 20X6 campaign were evaluated against what was expected to be received in those two collection periods.

(Expected pledges of $3,000,000 - rounded)	
Probability weighted cash flows	**Individual High Net Worth**
Seventy-five percent chance of getting 92%	1,624,950
Ten percent chance of getting 95%	223,725
Fifteen percent chance of getting 90%	317,925
Projected collections	2,166,600
Percentage Collectible (weighted average)	92%
Probability weighted cash flows	**Individual - Smaller**
Fifty percent chance of getting 90%	236,250
Twenty percent chance of getting 87%	91,350
Twenty percent chance of getting 91%	95,550
Ten percent chance of getting 85%	44,625
	467,775
	89%
Probability weighted cash flows	**Teachers & Employees**
Fifty percent chance of getting 93%	34,875
Twenty percent chance of getting 92%	13,800
Fifteen percent chance of getting 89%	10,013
Fifteen percent chance of getting 82%	9,225
	67,913
	91%
Probability weighted cash flows	**Corporations**
Ninety percent chance of getting 100%	40,500
Ten percent chance of getting 95%	4,275
	44,775
	100%
Total expected pledges to be collected	2,747,063
Percentage of total pledges dollars	92%

The next step was to develop a discount rate. Since the DRA method was ultimately used, the controller consulted the whitepaper from the AICPA. As discussed in the whitepaper, the controller performed research and identified an unsecured borrowing rate for an individual of 5.5%. This was used for the most credit-worthy of the donors. 2% was added to the unsecured rate for the credit-worthy for a resulting rate of 7.5%, reflecting the risk in the teacher/employee category and the smaller donor category. A corporate rate of 3.5% was used. The controller wanted to be conservative in the amount she recorded so as to limit adjustments for bad debts later on. In addition, since rates are low at the present time, she did not adjust them downward for the risk already anticipated in the expected cash flows. The present value of an annuity table was used to calculate the discounted amount using the rates and the expected amount to be collected per period.

Actual Experience 20X7 Campaign - Pledged	**Pledged**	**Amount per Year**	**Estimated % Collectible**	**Estimated Amount Collectible**	**Discount Rate**	**Discounted**
Individual (parents - high net worth, large givers)	2,196,000	439,200	93%	408,456	5.50%	1,744,223
Individual (parents - smaller givers)	610,000	122,000	90%	109,800	7.50%	444,238
Teachers and employees of the school	457,500	91,500	88%	80,520	7.50%	325,775
Corporations	250,000	50,000	100%	50,020	3.50%	225,843
	3,513,500	702,700	93%	648,796		2,740,079
Amount of the discount on pledges receivable [(648,796 X 5) - 2,470,079]	503,901					

The journal entry below was made:

Pledges receivable	*3,243,980*	
Discount on pledges receivable		*503,901*
Contribution revenue temporarily restricted		*2,740,079*

To record pledges receivable and contribution revenue restricted for purpose and timing.

Each year as the cash is due in (this is not necessarily when received) the release from restriction occurs provided the purpose restriction is met (building or payment on mortgage of building). The discount is amortized into contribution revenue – unrestricted.

As the building is built, the inputs to the building will go into construction in process. Interest is capitalized when expenditures to construct the asset have been made, the activities that are necessary to get the asset ready for its intended use are in progress and interest cost is being incurred. Interest capitalization on tax-exempt borrowings begins when the debt is incurred (ASC 835-20-25). (The mechanics of capitalizing interest are not discussed here.)

ASC 958-605-45 states that gifts of long-lived assets received without a stipulation of how long they must be used would be reported in temporarily restricted net assets if it is the not-for-profit's accounting policy to imply a time restriction that expires over the use of the asset. This is also true when long-lived assets are acquired with gifts of cash. The exception to this is not-for-profit health care organizations. Accordingly, if the not-for-profit has such a policy, then the amounts are not released from restriction when spent for the purpose as described above. This would also hold true for the amortization of the discount.

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<u>QUESTION 5</u>:

When I have a long-term contribution receivable, do I need to recalculate the remaining discount every year if projected borrowing rates change? What about bad debts, if my donors don't pay?

ANSWER:

Current GAAP states that long-term receivables, once discounted, are not re-discounted because they are not required to be carried at fair value. So when organizations have not elected fair value, once the discount rate has been determined, it is not subsequently adjusted.

As noted in the question above, in subsequent periods the discount should be amortized using the effective interest method, unless another method would not result in a material difference. The amount amortized should be recorded as a contribution and increase the net asset class in which the contribution was originally reported.

If the organization has elected to measure the promise to give at fair value in conformity with the fair value option provisions in ASC 825, *Financial Instruments,* the discount would be revised at each re-measurement date. If fair value was elected under ASC 825, then the long-term contribution would be reported as a Level 3 because the inputs are not observable. The inputs consider the not-for-profit's specific characteristics (i.e., the willingness to enforce collection) as well as, in some cases, inputs that are observable.

Every period, however, the risk that the pledges will not be collectible is evaluated. Risk is considered when evaluating the donors' ability to pay as promised on the pledges, along with its past collection experience and policies regarding the collection of past due pledges. Therefore, if the expected collection percentage is within the parameters originally estimated there is no need for an additional allowance.

If the need for an additional allowance arises, then the additional allowance could take the form of bad debt expense if the amounts were originally recorded as unrestricted. If not, which is the more likely case, then it would be considered a loss on pledges receivable.

SPLIT-INTEREST AGREEMENTS

<u>QUESTION 6</u>:

I have a new client whose development department focuses on contribution arrangements where the donor receives payments until death and then the client organization receives the amount remaining in the trust. In some cases my client is the trustee but in other cases there is an outside trustee.

Can you talk about any differences in the accounting for them?

ANSWER:

Some not-for-profit organizations actively seek donations in which the not-for-profit organization receives benefits but they are shared with other parties. The agreements are also referred to as split-interest or deferred giving arrangements. There may or may not be trusts involved. In addition, some trusts are held by a third party over whom the not-for-profit organization has no control.

Under the split-interest agreement, the donor makes the initial gift to a trust or to the not-for-profit organization. The not-for-profit has a beneficial interest but is not the sole beneficiary. The arrangement will specify an event or a period of time under which it is effective. For example, the time period could be the remaining life of the donor or some other individual. The arrangement could also span a certain number of years. Generally, the arrangement will be irrevocable.

There are two main types of agreements, lead interests and remainder interests. With the lead interest, the not-for-profit receives the periodic payments and then at the end of the agreement, the donor or donor's designee receives the remainder. With the remainder interest, the donor (or some party designated by the donor) receives periodic payments during the term of the agreement. When the agreement terminates, which is most often but not always through the death of the donor, the remainder goes to the not-for-profit. Split-interest agreements, therefore, have two transaction elements – a contribution element and an exchange element. These are discussed in FASB ASC 958-30.

Lead Interests

In a lead interest, generally the donor will establish and fund a trust with specific payments to be made to a designated not-for-profit over a specified period. The payments could be fixed (annuity trust) or could be a unitrust where the payments are based on a fixed percentage of the trust's fair value. Fair value would be determined each year. At the death of the donor or termination of the trust, the remainder is paid to the donor or donor's designee.

Remainder Interests

There are three general types of remainder agreements: Charitable remainder trusts, charitable gift annuities, and pooled income funds.

Charitable Remainder Trusts

In a charitable remainder trust, the donor establishes and funds a trust with specified payments to be made to a designated beneficiary over the term of the trust. In some cases, these periodic payments are for a specific dollar amount, called an annuity trust. Another form of charitable remainder trust is the unitrust or CRUT. It was established by the IRS in 1969. If the periodic payments go to pay a life insurance policy, then it is a way to provide for the heirs without paying estate taxes. The donors get a tax deduction up front and the not-for-profit gets the remainder. The trustee determines the fair value of the CRUT's assets at the time of contribution, and thereafter on the applicable valuation date.

To meet the IRS requirements, the fixed annuity percentage must be at least 5% and no more than 50% of the fair value of the assets in the corpus. The remainder (the amount expected to go to charity) must be at least 10% of the fair value of the assets contributed to the CRUT. Some charitable remainder unitrusts limit the annual payout to the lesser of the stated percentage or the actual income earned. Obligations to the beneficiaries are limited to the trust's assets.

Charitable Gift Annuities

Charitable gift annuities are similar to charitable remainder trusts, except that there is no trust. The assets are held as general assets of the not-for-profit, and the annuity liability is a general obligation of the not-for-profit. Under charitable gift annuities, the not-for-profit agrees to pay a fixed amount for a specified period of time to the donor, or individuals, or entities designated by the donor.

Pooled Income Funds

A pooled income fund is a trust where the not-for-profit is a trustee. The trust pools the contributions of many donors and invests those gifts as a group. Donors are assigned a specific number of units in the pooled income fund 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. Until a donor's death, the donor (or the donor's designee) is paid the actual income earned on the donor's assigned units. This is defined by the agreement. When the donor dies, the value of the assigned units belongs to the not-for-profit.

Initial Measurement

ASC 958-30 requires that the assets, liabilities, and contribution inherent in the split-interest agreement where the not-for-profit has a remainder interest are initially measured at fair value. The income approach was typically used.

For lead interests in agreements where the assets are held by the not-for-profit (either in trust with the not-for-profit as trustee or as general assets of the not-for-profit), the fair value of the contribution can be directly estimated based on the present value of the future distributions to be received by the not-for-profit as a beneficiary. The AAG-NPO discusses the use of IRS guidelines and actuarial tables to determine the reasonableness of the method used to measure fair value.

For split-interest agreements where independent trustees hold the transferred assets and the not-for-profit has a beneficial interest, the agreement is initially and subsequently re-measured at fair value. The income approach is used.

Subsequent Re-measurement

Revenue is recognized as temporarily restricted support when the trust is formed. During the term of the agreement, the liability is adjusted by amortizing the discount associated with the liability to the donor and if necessary, by revaluations of future payments to beneficiaries based on changes in life expectancy and other actuarial changes. The discount rate is not changed.

If the not-for-profit elects fair value under ASC 958-30-35, then the liability would be adjusted to fair value as discussed below. The changes in the value of the split-interest agreement are recorded as such in the statement of activities. This may include a release from a timing and purpose restriction according to the terms of the agreement. Note that most not-for-profit organizations will not find it necessary to elect fair value.

Subsequent Re-measurement (If Fair Value is elected)

One good reason to elect fair value would be if the split-interest agreement has an embedded derivative in it. This would happen when the provisions of the agreement call for a payment based on an "underlying" which is generally the value of the trust and the term of the agreement is based on a time period other than the life of the donor. The entity can either value the derivative portion of the split-interest agreement or mark the split-interest agreement to fair value. This appears in practice to be the easier option.

Summary Fair Value of the Contribution at Inception and Subsequent Re-measurement (ASC 958-30)

Agreement	Initial Recording of Fair Value of the Contribution	Subsequent Re-measurement
Remainder interests – held by the not-for-profit in trust with the not-for-profit as trustee or as general assets and liabilities of the not-for-profit	Estimated based on the fair value of the assets transferred by the donor less the present value of the payments to be made to the other beneficiaries. See discussion below relative to income and market approaches for split-interest agreements with variable and fixed payment streams.	The discount is amortized and changes are made if there are changes in any of the assumptions such as the life expectancy of the donor.
Lead Trusts – if held in trust by the not-for-profit	Fair value of the contribution can be estimated directly based on the present value of the future distributions to be received by the not-for-profit as a beneficiary. The future payments to be made to other beneficiaries are made by the not-for-profit only after the not-for-profit receives its benefits.	The discount is amortized and changes are made if there are changes in any of the assumptions such as the life expectancy of the donor.
Trusts where there is an outside trustee	Initial recording is as noted above but is made by the trustee. The not-for-profit will have a beneficial interest that is reported to it by the trustee. This may be 100% of the trust or may be less.	The trust is marked to fair value with an adjustment for appreciation/ depreciation so that the trust is stated at fair value. The adjustment is made to temporarily restricted net assets.

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<u>QUESTION 7</u>:

My organization is a museum. One mechanism that we have started using to try to get donors to give is the charitable remainder trust. This provides the donor with a way to give and still have the cash flow that she is used to having from the investment income. This is our first year of this program and we were successful in getting one arrangement where the donor gave $500,000. We are the trustee. Under the terms of the agreement, we will pay the donor 5% of the value of the trust for the remainder of her life. She is 58 right now.

How do we calculate the liability to the donor?

ANSWER:

There are several pieces of information you need to record the initial agreement at fair value. This is impacted by the amount of the expected payout to the donor.

Assets contributed to the trust	$500,000
Age of donor – female	58
Payout over time	5% of the net assets of the trust until the donor's death
Expected return on assets	Assume 7% over time

Since the amount of the periodic payment is based on the value of the trust, the income approach should be used. If the payment were fixed, it might be possible to use a market approach since insurance companies and other financial institutions sell annuities.

Market Approach

Since in some ways a split-interest agreement looks like fixed or variable rate annuity contracts that are sold by insurance companies, a market approach could possibly be used for the initial valuation. However, it is important to realize that there are certain differences that exist between annuities offered by insurance companies and annuities offered by not-for-profits.

Since a donor will obtain a tax deduction for the donation and there is also the intrinsic value of giving to a not-for-profit, the assumption is that the donor is willing to take lower payout than it would with an insurance contract. Not-for-profits are also willing to take most types of agreements. A donor who enters into a-split-interest agreement is able to take a charitable contribution deduction on his or her tax return in the year the agreement is signed and funded. Split-interest agreements that do not result in an initial charitable contribution deduction have other tax benefits. Insurance company contracts are investment vehicles, some of which offer tax-deferral opportunities.

Annuities offered by insurance companies generally pay out at a higher rate of return than annuities offered by not-for-profits. Because of the individual's intention to make a tax-deductible contribution, individuals generally are willing to accept a lower payout rate from a not-for-profit than they would accept from an insurance company. Insurance guarantee associations provide the purchasers of insurance products with limited protection against an insurance company that cannot meet its obligations. This would not be true in a not-for-profit. Insurance companies generally include fees and/or a profit margin in its contracts, but a not-for-profit that enters into an annuity or unitrust agreement would not. The not-for-profit will be getting additional benefits in the form of a contribution.

The market approach under ASC 820 requires the entity to adjust the observed market prices for the differences between the item being measured and the item for which the price was observed. It would be difficult to adjust for the tax deductibility, protection provided by the guarantee association, and removal of the profit and fee components from the observed market prices for the insurance company contracts. Therefore, it may be easier to use the income approach.

Income Approach

In practice, not-for-profits have used the average rate of return on their investment portfolio or average interest rate on outstanding borrowings as a proxy for surrogates for a "discount rate commensurate with the risks involved". This has been justified by saying that the use of those surrogates did not result in material misstatement of the financial statements.

ASC 820 states that a fair value measure of a liability should capture the following elements from the perspective of market participants as of the measurement date:

- Estimate of cash flows being measured
- Expectations about the variations in the amount or timing of cash flows (uncertainty)
- Risk premium for bearing the uncertainty
- Nonperformance risk including the entity's credit risk
- Other factors specific to the situation

In determining the present value of the cash flows, entities should consider the risk that actual cash flows (in both timing and amount) may differ from the cash flows used in the calculation. Therefore, the higher the risk that actual cash flows may differ from the cash flows used in the calculation, the higher the discount rate or rate of return.

When a split-interest gift is to be funded from a trust, the obligation to make payment to the donor rests with the trust. In using an income approach, a question might be raised about the risk of whose nonperformance is being considered, the not-for-profit or the trust. Use of a risk-free rate, such as the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows, can be a base line for this determination.

Split-interest Agreements with Fixed Income Streams

In its whitepaper, the AICPA concluded that a market approach using Level 2 inputs will provide the best measure. The differences discussed above between an insurance company's annuity and a not-for-profit are (to them) irrelevant in determining the fair value of liabilities to donors under split-interest agreements. In other words, the fair value of a liability for a fixed payment stream would be the same as long as there are similar risk profiles. The AICPA noted that observable quoted prices are readily available from the websites of insurance companies and brokers with similar vehicles and there is an active market.

The next question is whether or not the not-for-profit should make adjustments to market prices offered by insurance companies to estimate the fair value of liabilities under these fixed agreements to take risk into consideration. The assumption is that market participants will put some emphasis on the credit standing of the payer, but since typically there has not been a history of defaults and guarantee associations stand ready to make good if there are defaults, there may be no additional risk to consider.

There is another factor, though that may make a difference in a donor's willingness to enter into the arrangement. Donors generally would not worry about the not-for-profit organization as the payer because of their affinity to the organization. But the risk is there for some.

The AICPA believes that the market approach really is appropriate only when the credit risk of the not-for-profit is low. This would mean that the annuity is adequately funded from assets held in an irrevocable trust, that the not-for-profit has a credit standing that reflects strong, superior or excellent capacity to meet commitments or that the not-for-profit holds a commercially available annuity to provide cash flows for the term of the agreement to the beneficiary.

In other situations, the income approach might be more appropriate. Present value techniques that use observable inputs for interest rates, yield curves and life expectancy tables will be the best valuation method. Market quotes from insurance companies already include a risk premium for the uncertainty in the cash flows due to life span so this inherently builds a risk premium into the evaluation.

The AICPA has stated for several years in its AAG-NPO that the IRS tables and use of planned giving software are helpful in estimating the fair value of liabilities under the remainder agreements with fixed payments but they may not be adequate for financial statement purposes. For example, the IRS only updates its tables every 10 years and the tables are built based on populations that may not be reflective of the population who would purchase an annuity or participate in a split-interest agreement. In fact, according to the whitepaper, statistics show that the people who are likely to participate in split-interest agreements are wealthier and would have better health and a longer life span. Using quoted market prices for fixed payment annuities in active markets would consider this fact.

As noted earlier, ASC 958-30-35 states that the not-for-profit can elect fair value or it can amortize the discount associated with the obligation (or contribution in a lead trust) and adjust for changes in the life expectancy of the donors if payments are life dependent. The not-for-profit, if using fair value, should use the same method it used to value the agreement originally. So if market quotes were originally used, then that process should be repeated. But if present value techniques were used, that process should be repeated.

Split-interest Agreements with Variable Income Streams

For liabilities under split-interest agreements with variable income streams, the AICPA believes that the income approach is the best technique to use for valuation. The market approach is not feasible because of the diversity of annuities with variable income streams and the fact that the terms on insurance company annuities are different than those used by not-for-profits. To use the income approach, the not-for-profit will need to identify the following elements:

- Expected rate of return on the investments in the trust
- Discount rate
- Expected mortality of the person whose life determines the termination of the agreement (if this is how the agreement ends)

Where the cash is invested, the investor is subject to market risk, credit risk and inflation risk. So the risk that the trustee bears is the risk that the beneficiary of the cash flows bears. If the trust, for example, expects a rate of return of 6%, then the minimum discount rate would be 6%. Since defaults rarely occur (not-for-profits make good trustees), as long as the not-for-profit is complying with its duties as a trustee, then using the expected rate of return on investments makes sense.

The whitepaper recommends that life expectancy information be obtained from sources other than the IRS. Good sources are the Society of Actuaries Annuity 2000 Mortality Table which was adopted by the National Association of Insurance Commissioners (NAIC) in 1996 or the NCHS United States Life Tables in the National Vital Statistics Reports.

EXAMPLE

To continue with the example started above, a not-for-profit received a remainder trust for which it was to be the trustee.

Assets contributed to the trust	*$500,000*
Age of donor – female	*58*
Life expectancy according to Society of Actuary tables	*84*
Payout over time	*5% of the net assets of the trust until the donor's death – another 26 years (measured at the beginning of the year).*
Expected return on assets	*Assume 3.95% average return over time. This assumes that the trust's portfolio has more diversity than just treasuries which pay out at a very low rate. However, it is a prudent return given that this is a trust, which in turn, pays out benefits to a donor. The spreadsheet below could be altered to model various expectations of return and various donors' life expectancies.*

Accounting personnel created the following model to calculate the amount of the fair value of the liability to the donor and the fair value of the contribution.

Estimate of Fair Value of Obligation to the Beneficiary and Museum's Contribution					
Year	**Projected Trust Balance Beginning of the Year**	**Projected Trust Income (3.95%)**	**Projected Trust Payout (5%) Paid at End of the Year**	**Present Value Factor**	**Present Value of Payout**
Year 1	500,000	19,750	(25,000)	0.96015	(24,004)
Year 2	494,750	19,543	(24,738)	0.9246	(22,872)
Year 3	489,555	19,337	(24,478)	0.889	(21,761)
Year 4	484,415	19,134	(24,221)	0.8548	(20,704)
Year 5	479,328	18,933	(23,966)	0.8219	(19,698)
Year 6	474,295	18,735	(23,715)	0.7903	(18,742)
Year 7	469,315	18,538	(23,466)	0.7599	(17,832)
Year 8	464,388	18,343	(23,219)	0.7307	(16,966)
Year 9	459,512	18,151	(22,976)	0.7026	(16,143)
Year 10	454,687	17,960	(22,734)	0.6756	(15,359)
Year 11	449,912	17,772	(22,496)	0.6496	(14,613)
Year 12	445,188	17,585	(22,259)	0.6246	(13,903)
Year 13	440,514	17,400	(22,026)	0.6006	(13,229)
Year 14	435,888	17,218	(21,794)	0.5775	(12,586)
Year 15	431,312	17,037	(21,566)	0.5553	(11,975)
Year 16	426,783	16,858	(21,339)	0.5339	(11,393)
Year 17	422,302	16,681	(21,115)	0.5134	(10,840)
Year 18	417,867	16,506	(20,893)	0.4936	(10,313)
Year 19	413,480	16,332	(20,674)	0.4746	(9,812)
Year 20	409,138	16,161	(20,457)	0.4564	(9,337)
Year 21	404,842	15,991	(20,242)	0.4388	(8,882)
Year 22	400,592	15,823	(20,030)	0.422	(8,452)
Year 23	396,385	15,657	(19,819)	0.4057	(8,041)
Year 24	392,223	15,493	(19,611)	0.3901	(7,650)
Year 25	388,105	15,330	(19,405)	0.3751	(7,279)
Year 26	384,030	15,169	(19,201)	0.3607	(6,926)
		Fair Value of the Donor's Interest			**359,313**
		Fair Value of the Museum's Interest			**140,687**

The museum would make the following journal entry:

Cash (to the trust for investment)	*500,000*	
Liability to the donor		*359,313*
Contribution to the museum – temp restricted		*140,687*

To record the contribution at fair value at the date of donation and the liability to the donor.

As is evident from the model above, the amounts to be paid out are less than the amounts earned. However, since the model is built around a percentage of the trust, the trust will never be drained. This is an improvement over past models where a fixed annuity payment was the norm and trusts could find themselves paying the donor substantially more than anticipated. Some donors live longer than normal life expectancy even using the preferred tables.

At the donor's death the remainder in the trust comes back to the museum. Unless the museum elected fair value as a reporting mechanism, the liability would not be adjusted unless there were changes in the underlying assumptions such as the donor's life expectancy. If there are amounts of liability on the books, they are reversed as is any remaining contribution to unrestricted.

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Derecognition of Liability

Some not-for-profits may prefer not to have a liability on the books. When a not-for-profit organization has control over the assets in a split-interest agreement, it also has a liability to the donor or donor's heirs which represents either the lead or the remainder interest. In cases where the liability represents the present value of payments to be made to the donor and the not-for-profit organization has the lead interest, it may appear reasonable to purchase an annuity to make the payments to the donor or donor's heirs. The not-for-profit organization may choose this course of action but it cannot remove the liability from its books. ASC 405 states that a debtor can derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

- The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

<u>QUESTION 8</u>:

I am an auditor of a not-for-profit hospice. This is a new client for us. During our testing of revenue I noted that the organization received two payments from a financial institution trust account. I asked the client for donor correspondence but there was none. I am not sure what these payments are.

Can you shed some light on this for me?

ANSWER:

It is possible that the hospice may have a beneficial interest in a perpetual trust. With a perpetual trust the organization receives the income from the trust in perpetuity. Often the not-for-profit doesn't even know that it is a beneficiary of the trust until the payments start coming in. The hospice should pursue this because there is an asset associated with the beneficial interest. The not-for-profit organization is not able to exercise control over the assets.

The hospice would recognize its interest in the assets by recording the present value of the expected future benefits to be received once the trust is terminated. If it is determined that the hospice only has a partial beneficial interest in the trust because other organizations also participate, the pro rata share would be recognized.

The AICPA's whitepaper on fair value for not-for-profits states that not-for-profits should assume that the trustee stands in the shoes of the not-for-profit in making investment decisions and therefore their control over the investment decisions does not enhance or diminish the not-for-profit. The whitepaper also affirms the discussion in ASC 820 which states that the fair value can be measured using the fair value of the assets contributed to the trust. If it is determined that there are other factors related to distribution such as where the trustee has been instructed not to distribute the assets from the trust for two or more years or to only distribute a minimal amount for several years then the value may need to be adjusted. With perpetual trusts, the assets and revenue continue to be measured at fair value.

A beneficial interest is really a stream of future cash flows. It is considered a financial asset because it is expected to be settled in cash. The income approach is used to value the perpetual trust. If the trustee provides the information and has adjusted the value of the trust to fair value, this amount is the value of the trust. As noted above, the not-for-profit may only be entitled to a share of the perpetual trust and so the proportion to which it is entitled is used to estimate the fair value. This is an appropriate proxy for using income valuation technique because the assumption is based on the stream of payments into perpetuity which would equal the value of the trust.

As noted, a not-for-profit may be the sole beneficiary to the trust or may have rights to a share. In addition, a trustee may provide summary information or detailed information. The whitepaper states that a beneficial interest in a perpetual trust would be disclosed as a Level 3 investment. This is because the not-for-profit will never receive the assets in the trust; therefore, it is comparable, in a way, to assets that are valued at NAV and included in Level 3 investments because they are not able to be redeemed.

AGENCY TRANSACTIONS

QUESTION 9:

My client, an independent school, recently created a foundation which will exist to serve it in two ways. First, the school just transferred $2,000,000 in investments to it so the foundation can manage them. Second, the school will use the foundation as a vehicle to raise money. These entities are consolidated and the activity would be eliminated but the foundation will probably need to issue standalone statements.

So how would the transactions be reflected by them?

ANSWER:

This is a great question not only for when the two are consolidated, but when they are not. ASC 958-605-30 classifies this relationship as an agency transaction. An agency transaction is defined as a type of exchange transaction in which the reporting organization (in your case the foundation) acts as an agent, trustee or intermediary for another party (the school) that may be a donor or donee. In some cases not-for-profits may set up another organization to raise money or hold and invest assets. This organization may serve one or more related organizations.

The terminology that is used to describe the three parties to the majority of the transactions covered by ASC 958-605-30 is the **donor** or **resource provider**, the **recipient organization** and the **beneficiary**. The term resource provider is used when the entity that initiates the transaction transfers resources to another entity and the transaction is not a contribution. The recipient is the party that receives the assets in a transfer. The beneficiary is the party for whom the assets are intended.

Some not-for-profit organizations are financially interrelated with foundations that exist to raise, hold and invest assets for them. It is important to distinguish which transactions are contributions and which are equity transactions.

Entities are **financially interrelated** when the following two conditions are met:

1. One must have the ability to influence the operating and financial decisions of the other. For example:

    - Organizations are affiliates
    - One has considerable representation on the board of the other
    - Charter or bylaws of one limit its activities to those that benefit the other
    - An agreement between the two allows one to participate in policymaking processes for the other

2. One organization has an ongoing economic interest in the net assets of the other. In this case, one organization's interest either increases or decreases as a result of the fundraising and operating activities of the other.

There are also times when foundations and financially interrelated not-for-profit organizations have transactions that are not characterized as contributions but are equity transactions. A transaction is an **equity transaction** if all of the following conditions are present:

1. The resource provider specifies itself or an affiliate as the beneficiary

2. The resource provider and the recipient are financially interrelated

3. Neither the resource provider nor affiliate expects payment of the transferred assets although they may expect the investment return to be paid

EXAMPLE

The board of an independent school (grades K-6) decided to expand the school to encompass grades 7-12. To do this effectively and attract students, they knew that they would need to receive significant funding to build a new building and athletic fields. They would also need additional furniture, equipment and money to expand the staff and teachers. The school was "home grown" by a religious organization. It started as a pre-school and over the past 10 years grew to be a larger entity. Since inception, the organization held at least one fund raiser a year with the proceeds dedicated to the growth of the organization. As a result, the organization had amassed $2,000,000 in temporarily restricted net assets that it was holding in an investment account at a financial institution. The net assets were temporarily restricted by the donors for expansion of the school and could be used for building, equipment, or anything related to expanding the school's curriculum to reach students through high school.

Since the organization made a commitment in its strategic plan to grow to include grades 7-12 over the next five years, the board decided that it would be prudent to create a foundation to hold the assets and to begin to raise money for the expansion. To keep the entities separate, the board of related Foundation has the CEO of the school on it, but there are no other overlapping board members between the two boards.

The two are financially interrelated because the School has the ability to influence the operating and financial decisions of the Foundation. The charter and bylaws limit the activities of the Foundation to those that benefit the school ***and*** *the school has an ongoing economic interest in the net assets of the Foundation. In this case, the school's interest either increases or decreases as a result of the fundraising and operating activities of the Foundation.*

The first step was to transfer the $2,000,000 in investments to the newly created Foundation. The School's attorneys drafted an agreement that would allow the school to request distributions from both the original investments and the return on those investments subject to the approval by the governing board of the Foundation. The agreement states that any reasonable requests will not be denied. The agreement also covers any other assets transferred to Foundation by the School.

To accomplish the accounting for this initial transaction, the CFO of the School and the CFO of the Foundation evaluated ASC 958-605-30 and created the following ***decision tree****.*

Resource provider: School
Recipient: Foundation
Specified beneficiary: School

Consideration	***Answer***
Was there a transfer of assets?	***YES***
Does the resource provider retain the right to redirect the assets to another beneficiary?	***NO***
Is the transfer accompanied by a conditional promise to give or is it revocable or repayable?	***NO***
Does the resource provider control the recipient organization and specify an unaffiliated beneficiary?	***NO***
Does the resource provider specify itself or its affiliate as the beneficiary?	***YES***
Does the transfer meet all of the criteria for an equity transaction?	***NO***

The transfer did not meet all of the criteria for an equity transaction because although the resource provider specified itself as the beneficiary and the resource provider and the recipient are financially interrelated, the resource provider expects payment of the transferred assets.

Resource Provider	***Recipient***	***Specified Beneficiary***
DR Asset	*DR Investments*	*Beneficiary is the resource provider so no additional entries are necessary*
CR Investments	*CR Liability to resource provider*	

The School also knew that it wanted to raise $4,000,000 to fund the building, furniture, equipment and the costs to hire additional personnel and teachers. The Foundation sent out the pledge letters that stated that all of the money would be used to fund the expansion activities of the School to grades 7-12. The donations were supposed to be sent to the Foundation and when they were accidentally sent to the School they were promptly forwarded to the Foundation.

*The CFO made the following **decision tree** to help him understand the accounting treatment:*

Consideration	***Answer***
Was there a transfer of assets?	***YES***
Does the resource provider retain the right to redirect the assets to another beneficiary?	***NO***
Is the transfer accompanied by a conditional promise to give or is it revocable or repayable?	***NO***
Does the resource provider control the recipient organization and specify an unaffiliated beneficiary?	***NO***
Does the resource provider specify itself or its affiliate as the beneficiary?	***NO***
Did the donor grant variance power to the recipient organization?	***NO***
Are the recipient and the specified beneficiary financially interrelated organizations?	***YES***

Recipient	***Specified Beneficiary***
DR Cash	*DR Interest in the net assets of the Foundation*
CR Contribution revenue	*CR Change in interest in the net assets of the Foundation (this could be recorded at the time or periodically)*

(Note that the resource provider is the donor and their accounting doesn't have an impact on the School or the Foundation.)

As the School and its Foundation began raising more money, the CFO of the School consulted the auditor to determine when the transactions with the Foundation would be considered unrestricted and when they would be considered temporarily restricted. The auditor pointed the CFO in the direction of the AICPA Technical Practice Aid (TPA) that was issued after the guidance on agency transactions to clarify such questions. The guidance has been incorporated into the FASB Codification as implementation guidance.

When an operating entity (School) and the financially interrelated foundation (Foundation) have agency transactions, the accounting depends on whether or not the School has the ability to influence the financial decisions of the Foundation so that it is able to determine the timing and amount of distributions.

Circumstance	*Accounting Treatment*
School ***can influence*** *the timing and amount of distributions.*	*School would classify the interest in the net assets of the Foundation as* ***unrestricted****. The accounting is transparent, just as if it were only the school and the donor. If there were other restrictions placed on the donations by the donor, then those would have to be met as well.*
School was ***not able to influence*** *the timing and amount of distributions flowing to it. This creates an* ***implied*** *timing restriction.*	*School would need to classify the interest in the net assets of the Foundation as* ***temporarily restricted****. If there were other restrictions placed on the donations by the donor, then those would have to be met as well.*
School ***was able to influence*** *the timing and extent of distributions and there were purpose restrictions set forth by the donor.*	*When School spent the money for the restricted purpose, this would cause the restrictions to be released unless there were other timing restrictions imposed by the donor.*
School was ***not able to influence*** *the financial decisions of the Foundation and there were purpose restrictions where the Foundation* ***has no discretion.*** *For example, if the money were restricted for expenditures for a specific building or for architectural drawings or specific furniture or equipment.*	*When School spent the money for the restricted purpose, this would cause the purpose restrictions to be released. There are no implied timing restrictions because of the specificity of the donation.*
School was ***not able to influence*** *the financial decisions of the Foundation and there were purpose restrictions that were so broad that the Foundation had discretion to determine whether the restrictions were met. For example, if the money were restricted to expand the reach of the School to grades 7-12.*	*When School spent the money for the restricted purpose, this would* ***not*** *cause the restrictions to be released. The Foundation would need to transfer the money or commit to transfer the money to cause a release from restriction. The implied timing restriction is present.*

When the documents were drafted, the stated purpose was to fund the expansion of the School to grades 7-12. The documents between the Foundation and the School stated that any request for funding would not be withheld unreasonably.

Due to the fact that the School has the ability to request amounts to be spent from the Foundation and the Foundation cannot withhold them unless they are unreasonable, the CFO decided that a little more clarification was needed in the governing documents. He was aware that the donations had purpose restrictions for the broader purpose of expanding the reach of the School to grades 7-12 and that there were many specific items that could be identified by the donor. For example, one donor already requested that the gymnasium bear their name as a condition of the donation. However, there were others that wanted the reach to be expanded but were less specific. Even if the CFO believed the requests were reasonable, there could be disagreement. He decided this was not an accounting issue but a governance issue.

The Foundation board clarified the documents so that when amounts were restricted by the donor for a specific identifiable purpose, the board did not have discretion but that when amounts were given for a general purpose, it did. This was to put an extra level of check and balance on management and make the donor feel more comfortable about the level of scrutiny that would be given for spending.

The CFO was happy to have that clarification and created the following example for the accountants.

Circumstance	***Accounting Treatment***
Donation received by Foundation for $200,000 and the donors have no restrictions.	*DR – interest in net assets of Foundation $200,000 – unrestricted (this entry may be made at the end of the period).* *CR – change in interest in net assets of Foundation – unrestricted*
Donation received by Foundation for $100,000 and the donors have purpose restrictions. Purpose restrictions are very specific (equipment for the library).	*DR – interest in net assets of Foundation $100,000 – temporarily restricted* *CR – change in interest in net assets of Foundation – temporarily restricted*
Donation received by Foundation for $50,000 and the donors have purpose restrictions. Purpose restrictions are not specific.	*DR – interest in net assets of Foundation $50,000 – temporarily restricted.* *CR – change in interest in net assets of Foundation – temporarily restricted*
Money is spent for the very specific purpose (equipment for the library – $25,000).	*DR – equipment* *CR – cash* *DR – net assets temporarily restricted* *CR – net assets unrestricted*
Money is spent for the purpose but it's not specific to a donor $15,000.	*DR – equipment* *CR – cash* *No other entry until the Foundation agrees and commits the money or transfers the money.*

After the school was built and the expansion was complete, the Board of the School thought it would be helpful to have an endowment set up to fund scholarships. It turned again to the Foundation for fundraising.

This time the CFO wanted to understand what impact Uniform Prudent Management of Institutional Funds Act (UPMIFA) would have on the situation. The documents to be sent to the donors stated that the amounts donated would be held in perpetuity with the income and the appreciation to be temporarily restricted for scholarships. With the endowment, the documents between the Foundation and the School stated that the Foundation would control the timing of the distributions according to its spending policy.

The guidance on endowments states that amounts of income and appreciation/depreciation will go through temporarily restricted net assets until appropriated.

The CFO instructed the accountant to record the amounts of the interest in the net assets of the Foundation for the endowment to be permanently restricted to the extent of the donation; and because there was no law requiring additions to permanently restricted net assets (and the donor did not place any restrictions in that regard), the changes in the interest in net assets each period would be recorded as temporarily restricted net assets until the Foundation appropriated them for expenditure and notified the School. Then they would be released from restriction and available for expenditure.

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QUESTION 10:

My client, a social welfare organization, has a relationship with a Community Foundation (CF). This year, under audit, they transferred $500,000 in investments to the CF because they didn't feel like they had enough to diversify the investments and the CF has a good track record in managing its investments. The CF provided my client with a pamphlet describing how the relationship worked. It stated the following:

"All contributions to the Foundation are subject to the Foundation's variance power, as stated in your fund agreement. Variance power, though rarely invoked, gives the Foundation the right to redirect the use of any fund if we determine that distributions from that fund have become unnecessary, cannot be fulfilled, or are inconsistent with the charitable needs of the community or area served by the Foundation. All funds accepted by the Foundation are subject to this variance power, and all community foundations have this policy, which allows them to remain flexible and relevant as grant making organizations over a long period of time."

It seems to me that the assets will no longer belong to my client so we are going to propose an entry to remove them.

Is that the correct accounting treatment?

ANSWER:

No. Not-for-profits that accept financial assets from a donor and agree to use the assets on behalf of a specified unaffiliated beneficiary or transfer the assets themselves or the income from those assets to a specified unaffiliated beneficiary should recognize the fair value of the assets, as well as the liability to the beneficiary. In this case, the Community Foundation is acting as an **agent**.

Although the agreement states that the Community Foundation will not ever return the assets themselves to the not-for-profit organization, it will give the not-for-profit organization the return on the assets; and even though the agreement goes on to say that the Community Foundation has the right to redirect the assets, the FASB determined that this was a reciprocal transaction. The not-for-profit organization is transferring the assets in exchange for future distributions. At the time of the transfer, the Community Foundation is stating that it has the ability to fulfill the obligation and that the transfer of the investment return to the not-for-profit organization is consistent with its mission. Following is an example of the journal entries that would be made by your client, the social service organization.

EXAMPLE

In the initial transaction, the resource provider (the social service organization) will record the following:[13]

Beneficial interest in assets held by Community Foundation	*XX*	
Investments		*XX*

The recipient (Community Foundation) will record the following:

Investments	*XX*	
Liability to resource provider		*XX*

In subsequent periods, the social service organization will increase cash when there are transfers to the organization. It will adjust the beneficial interest for changes in asset valuation. The recipient will account for the change in the value of the investments and investment income. It will also decrease the investments for any amounts transferred to the resource provider.

[13] Note that present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest. Other valuation techniques are also available as described in ASC 820, *Fair Value Measurement.* If present value techniques are used, the contribution revenue and the beneficial interest should be measured as the present value of the future cash inflows over the expected term of the agreement.

Creating a Fund at the Community Foundation

Frequently not-for-profits will also establish a fund at the Community Foundation (CF). In these arrangements the donors are solicited by the not-for-profit and sometimes the CF. The pledge materials specify that gifts sent to CF will be used to establish a fund for the not-for-profit and that some or all of the investment return is intended to be used for the not-for-profit. However, variance power is also provided for in the agreement. As noted in the language above, the CF has the right to redirect the assets if it chooses to.

In these arrangements, the CF records contribution revenue when the donation is received. And then in subsequent periods, when some or all of the return is transferred to the not-for-profit from the CF, the CF recognizes expense and a decrease in cash. The not-for-profit does not have a contribution until it is notified of the distribution from the CF.

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SPECIAL EVENTS

QUESTION 11:

I just received an invitation to the annual charity gala for one of my clients. In an effort to raise more money, they restricted the use of the proceeds to one of their programs. The examples in the Codification show the special events being unrestricted. This is restricted.

How is this shown?

<u>ANSWER</u>:

The issue you raise seems to be occurring in many fundraising events now. It is an important point to discuss with your not-for-profit clients **before** the advertising mailings/invitations go out. If a marketing piece restricts the proceeds from the event to a specific purpose, this refers to amounts raised. If the marketing piece restricts the **net proceeds** of the event, then this means after the expenses have been deducted. Failure to pay attention to this important distinction could cause the organization to pay for the event from unrestricted sources. The exact amount depends on whether the participants pay for the event or not.

<u>EXAMPLE</u>

A charity held a fund-raising dinner. There was no charge to those who were invited to attend; therefore, the amounts raised are all contributions and there is no exchange element to the transaction. Therefore, if the proceeds of the event were restricted, the direct costs of the event such as the food, venue and entertainment cost would need to be covered by unrestricted funds.

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<u>EXAMPLE</u>

A charity held a golf tournament. There was a charge to play golf in the event. Therefore, there is an exchange and contribution portion of the revenue. The revenue associated with the event and the direct donor benefits are considered the exchange portion of the transaction. Therefore, the sales/cost of sales would be unrestricted (see following example). Any remaining revenue would be considered a donation and would be temporarily restricted if the proceeds were restricted.

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Disclosure

The FASB has relatively little to say about special events. In ASC 958-225-55 it notes that organizations that hold special events which are ongoing and major activities should report the gross revenues and expenses of those activities. If the events are peripheral or incidental transactions, then they may be reported net. However, only direct costs may be netted against the revenue. Other than that statement, the FASB only provides implementation suggestions on the presentation for financial reporting purposes. Three different methods are presented.

Disclosure Example 1 – The costs of direct donor benefits can be deducted from special event gross revenue

Contributions and Net Revenue from Special Event:		
Contributions		$250,000
Special event revenue	$25,000	
Less: Costs of direct benefits to donors	6,500	18,500
Contributions and net revenue from special events		268,500
Expenses:		
Program		120,000
Management and General		52,000
Fund-Raising		10,000
Total Expenses		182,000
Increase in unrestricted net assets		$ 86,500

Disclosure Example 2 – Special event revenue (gross) can be presented in the revenue section and the costs of direct benefits to donors in the same section as all other expenses

Contributions and Net Revenue from Special Event:	
Contributions	$250,000
Special event revenue	25,000
Total Revenue	275,000
Expenses:	
Program	120,000
Cost of Direct Donor Benefits	6,500
Management and General	52,000
Fund-Raising	10,000
Total Expenses	188,500
Increase in unrestricted net assets	$ 86,500

Disclosure Example 3 – The contribution and exchange portion of the gross revenues are presented separately, with the cost of direct donor benefits deducted from the exchange portion

Contributions and Net Revenue from Special Event:		
Contributions		$267,500
Golf tournament sales **(exchange)**	$7,500	
Less: Costs of direct benefits to donors **(exchange)**	6,500	1,000
Contributions and net revenue from special events		268,500
Expenses:		
Program		120,000
Management and General		52,000
Fund-Raising		10,000
Total Expenses		182,000
Increase in unrestricted net assets		$ 86,500

Note that the costs of the event that are in excess of the direct donor benefits are reported as fund-raising costs or management and general. The $10,000 of fund-raising costs in the example above consists of $750 in connection with the events and $9,250 general fund-raising costs. The same is true for the management and general expenses.

If the costs of direct donor benefits are provided in transactions that are not exchange transactions, then they should be reported as fund-raising costs. An example would be a fund-raising dinner where the participants did not pay to attend.

If the contribution portion of the special event is really **conditional** in that it is contingent upon the event occurring, then that portion of the special event payment would be recorded as a refundable advance. The portion of the special event payment that is an exchange transaction ($7,500) would be recorded as deferred revenue since revenue recognition should take place after the benefits are provided to the donor.

When Net Proceeds are Temporarily Restricted

The FASB examples anticipate that the contributions to the event are unrestricted. Following is an example where the net proceeds were considered to be restricted.

EXAMPLE

A not-for-profit dialysis clinic held a golf tournament. The net proceeds of the event were to be restricted to the purchase of dialysis equipment. The statement of operations and a note disclosure are illustrated below.

Horizon Dialysis Clinic	
Statement of Operations	
For the year ended September 30, 2011	
Revenue, gains and other support	
Net Patient Service Revenue	$ 1,572,052
Grants	27,928
Net assets released from restrictions	24,113
Special events income	33,032
Total revenue, gains and other support	1,657,125
Expenses	
Program services	
Patient care	1,212,577
Supporting services	
General and administrative	263,509
Direct expense of special events	33,032
Fundraising	58,557
Total expenses	1,567,675
Operating income	89,450
Nonoperating items	
Investment return	44,504
Loss on disposal of fixed assets	(1,370)
Other income	87
	43,221
Excess of expenses (over) revenues	
and changes in unrestricted net assets	$ 132,671

Horizon Dialysis Clinic	
Statement of Changes in Net Assets	
For the year ended September 30, 2011	
Unrestricted net assets	
Increase in unrestricted net assets	$ 132,671
Temporarily restricted net assets	
Contributions	4,375
Special events income	19,738
Net assets released from restrictions	(24,113)
Increase (decrease) in temporarily restricted net assets	-
Increase in net assets	132,671
Net assets, beginning of year	4,123,192
Net assets, end of year	$ 4,255,863

Note L – Special Event

During the year ended September 30, 2012, the Clinic held a golf tournament with the net proceeds restricted by the donors to pay for new dialysis equipment. By September 30, 2012, the net proceeds were spent for dialysis equipment.

Special event revenue - temporarily restricted	$ 19,738
Special event revenue - unrestricted	33,032
Less direct donor expenses	(33,032)
Net proceeds	19,738
Amount released from restriction for charity care	(19,738)
Temporarily restricted amount at year-end	$ -

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CAPITALIZED INTEREST IN A NOT-FOR-PROFIT

QUESTION 12:

I work for a national foundation. We are going to begin construction on a building soon. We are not planning to borrow specifically for the building although if we run short, we could draw down on our line of credit.

Are we required to capitalize interest?

ANSWER:

Yes, interest cost should be capitalized for all assets that take a period of time to prepare them for use. This could be building construction or even an asset installation. Of course in some cases where the amount of time or expenditure is not material (such as the installation of cubicles in office space), capitalization of interest would not be required.

The theory related to the capitalization of interest is that it represents interest that could have been avoided during the assets' acquisition period. This means that the money used to construct the building would not have needed to be borrowed (i.e., and interest not incurred), or could have been used to pay down existing debt if the expenditures had never been made. So interest is seen as an avoidable cost.

The only time that interest would not be capitalized is if there were no other borrowings outstanding. It would not be possible to capitalize interest, if the interest did not exist.

QUESTION 13:

My client, a university, is preparing to construct a new fine arts center (Center). The project costs are budgeted at $10 million. The financing for the Center follows:

- $4 million government grant, which must be used for this construction project. It is payable $1 million per year.
- $4 million tax-exempt borrowing at an interest rate of 4% (interest expense is $160,000 per year)
- $2 million from operations

The University has $10 million in other borrowings that are outstanding throughout the construction of the project. The interest rate on those borrowings is 6%. Other qualifying assets of the entity never exceed $5 million during the construction of the project.

The proceeds from the borrowing and the initial phase of the grant are received one year in advance of starting construction on the project and are temporarily invested in interest-bearing investments yielding 2%. Interest income earned from temporary investments is not reinvested.

The University believes that the project will take four years after start of construction to complete.

How do we capitalize the interest when we are dealing with tax-exempt bond financing?

ANSWER:

Whether the entity is a commercial entity, a not-for-profit, or even a government (the GASB has adopted capitalization accounting principles that are similar to FASB) does not matter. There are, however, special rules for interest on tax-exempt bonds, as discussed below.

Capitalization Period

The capitalization period begins when expenditures are incurred, when the activities are in progress and when interest cost is present. As long as those three circumstances continue, interest is capitalized. If part of the asset is placed in service, then the capitalization stops on that asset.

There is an exception related to tax-exempt borrowings. Capitalization begins at the date of the borrowing for qualifying assets financed with the proceeds of tax-exempt borrowings that are restricted for that purpose, regardless of when the expenditures are incurred.

Capitalization Rate

The average qualifying expenditures for the period are multiplied by a capitalization rate. Since your University has more than one source of borrowings, it would essentially use more than one rate in the calculation because the capitalization rates are based on the rates applicable to borrowings during the period. If the project was solely financed with one source of debt, then that specific rate would be used. But in your case, the bonds were only $4 million of the funding; therefore, the expenditures for the asset will exceed the amounts of specific new borrowing. At that point, a weighted average of the rates applicable to the University's other borrowings would be used. In your case, there is only one additional borrowing. However, if there were more than one, the University would need to use a blended rate.

The entity would not capitalize more interest than was incurred. If this were a consolidated entity, the limitation would be that of the consolidated interest. However, when statements are separately issued, the limitation is to the interest costs incurred by that entity.

Tax-Exempt Borrowings, Gifts and Grants

If, as you describe, the building is financed with the proceeds of tax-exempt borrowings and those funds are externally designated for the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized is computed differently than if the debt were from a financial institution or if taxable bonds were issued. Interest earned on the proceeds of the tax-exempt borrowings is offset against the cost of the borrowings.

This is the case because the FASB believes that when an entity considers financing with tax-exempt borrowings, the interest it earns is considered significant to the initial decision to acquire the asset. Therefore, the funds flow from borrowing, temporary investment, and construction expenditures are all considered a part of the decision process.

The amount of the interest cost that is capitalized would be the 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 asset is ready for its intended use. However, if the entity financed the construction with tax-exempt debt, but the proceeds were not designated for the acquisition of the asset or its debt service, this would not apply.

Illustration of Capitalized Interest Using the University as an Example

The facts are laid out in the question. The numbers below describe the steps performed on each line item in the calculation.

Calculation of Capitalized Interest

(000's omitted)			***20X1***	***20X2***	***20X3***	***20X4***	***20X5***
(1)	*Average qualifying assets*		-	*2,000*	*5,000*	*8,000*	*9,000*
(2)	*Average funding received*						
a.	*Tax-exempt borrowing ($4 million)*		*4,000*	*4,000*	*4,000*	*4,000*	*4,000*
b.	*Government Grant ($4 million)*		*1,000*	*2,000*	*3,000*	*4,000*	*4,000*
(3)	*Average temporary investments, not less than zero*	*(1-2)*					
a.	*Tax-exempt borrowing ($4 million)*		*4,000*	*3,000*	*1,000*		
b.	*Government Grant ($4 million)*		*1,000*	*1,000*	*1,000*		
(4)	*Interest earned (at 2%)*						
a.	*Tax-exempt borrowing ($4 million)*		*80*	*60*	*20*		
b.	*Government Grant ($4 million)*		*20*	*20*	*20*		
(5)	*Average qualifying assets in excess of borrowing,* ***LESS*** *interest earned on grant*	*((1)-(2a, b)-60)*					*940*
(6)	*Interest cost capitalized – other borrowings*	*((5)*6%)*					*56*
(7)	*Interest capitalized – tax exempt borrowings*	*((2)*4%)*	*160*	*160*	*160*	*160*	*160*
(8)	*Interest capitalized*	*((7)-(4a))*	***80***	***100***	***140***	***160***	***216***
(9)	*Amount of capitalized interest added to construction*		***696***				

Interest rate on the bonds is 4%
Interest rate on other borrowings is 6%
Interest rate for earnings on qualifying assets is 2%

(3) a. & b. Note that the entity may choose to use the grant funds first or the borrowings first. This grant is a federal award. This is the amount over the average qualifying assets that is assumed to earn interest at 2%.

*(5) Note that the average qualifying assets in excess of borrowing is the sum of the average qualifying assets (1) less the average funding received (2) less the interest on the **grant** (9,000-8,000-60).*

(6) Interest cost on other borrowings is line (5) times 6%, the assumed interest cost on the other borrowings.

(7) Interest earned on tax-exempt borrowings is line 2 times 4%, the bond rate.

(8) Interest capitalized is the interest capitalized from the tax-exempt borrowings (7) and other borrowings (6) less interest earned on tax-exempt borrowings in temporary investments (4a).

Step-by-step explanation by line number:

(1) As noted in the calculation below, the construction began in 20X2, which was one year after the tax-exempt borrowing occurred. The amounts in line one are cumulative because they represent the amounts upon which the capitalization rate is applied.

(2) Line 2 represents the average funding received. Note that the tax-exempt borrowing occurs one year earlier than the construction. Therefore, the amount of interest income earned begins at that point. This is illustrated on line 4.

(3) Line 3 represents the average temporary investments. Note that the temporary investments only last until the construction reaches the point where the money is spent.

(4) Line 4 represents the interest earned not only on the tax-exempt borrowing but also on the grant. ASC 835-20 calls for the interest that would be earned on the amounts restricted for the project to be charged with the interest in just the same way as the borrowings.

(5) Line 5 represents the calculation of the amount of qualifying assets remaining where interest will need to be capitalized. These are the “other borrowings” after subtracting the cumulative interest earned on the grant. In this case, the $1,000 represents the $9,000 of construction costs to date less the $8,000 in tax-exempt bonds issued for the purpose and the grant money restricted for the construction. The amount of interest **earned** on the grant money is subtracted from that, leaving the amount of other borrowings subject to interest calculation.

(6) Line 6 represents the calculation of interest on line 5.

(7) Line 7 represents the interest cost on the tax-exempt borrowings for the period (to date)

(8) Line 8 is total interest capitalized. This is the sum of line 6 and 7 less the interest earned on the tax-exempt borrowing.

The resulting project costs anticipated are the $10 million plus the interest capitalized, which is the sum of line 8 for the five years ($696).

<u>QUESTION 14</u>:

My client is constructing a building. The loan is for $2.5 million. Based on the details of the construction plan, we believe that the building being constructed will not appraise for any more than that.

Would the interest capitalized drive the recorded value above fair value?

ANSWER:

The FASB addresses this in ASC 835-20-25-7 stating that interest capitalization does not stop because the recorded value is higher than the fair value. The provision for impairment would come into play according to ASC 360-10. Interest is capitalized anyway.

CONSOLIDATIONS

QUESTION 15:

I heard there were changes in consolidation literature.

Do they apply to not-for-profits?

<u>ANSWER</u>:

Although there have been changes in professional literature such as ASC 810-10, currently, not-for-profit organizations still follow the provisions of ASC 958-810*.* This guidance addresses consolidation of not-for-profit organizations with for-profit entities and with other not-for-profit organizations. Some not-for-profit organizations, especially those in health care are involved in joint ventures, partnerships and own portions of for-profit organizations. Many not-for-profits have subsidiaries. ASC 810 states that the purpose of providing consolidated financial statements is to provide the most meaningful information to the users and this is particularly important when one entity has a controlling interest in another. Not-for-profit organizations that are larger may have relationships with special purpose leasing entities (SPE). Under certain circumstances those need to be consolidated as well. This case study presents a refresher of consolidation literature as it relates to not-for-profit entities and includes a discussion of ASU 2015-02, *Consolidation Analysis,* and how that amendment to GAAP affects not-for-profits.

Case Study

Grove Park Hospital System

Grove Park Hospital System (GPHS) is a $50 million not-for-profit hospital system and affiliates that include:

- One hospital (reporting entity)
  - Free standing laboratory (wholly owned) **(presently consolidated)**
  - A skilled nursing facility (wholly owned) **(presently consolidated)**
  - Special purpose leasing entity (Health Care Capital) **(not presently consolidated)**
  - 5% general partnership interest in a real estate partnership **(not presently consolidated)**
  - 45% ownership interest with a physician group (for-profit) in a rehab center **(not presently consolidated)**
  - 35% participation in an imaging center with another not-for-profit group **(presently consolidated)**

The auditor who was auditing this client for the first time was challenging how the organization presented its consolidated financial statements. The way GPHS had been treating the affiliates is noted in bold above. The auditor agreed with client's decision to consolidate the lab and the skilled nursing facility but performed additional research on the other affiliates as follows:

Consolidation with For-Profit Organizations

The guidance for determining whether a for-profit entity should be consolidated with a not-for-profit organization is found in ASC 958-810. The major decision point is whether or not the not-for-profit organization has a controlling financial interest in the for-profit organization through direct or indirect ownership of a majority voting interest. This is generally direct or indirectly over 50% of the shares. It is possible that minority rights could keep the not-for-profit from having a controlling interest with this level of ownership. Not-for-profit organizations are not required to apply the guidance for variable interest entities under ASC 810-10.

A not-for-profit organization that owns 50% or less of the common stock or in-substance common stock of a for-profit organization and has significant influence would account for the investment using the equity method unless fair value was elected.

If the entity has a research and development arrangement where all of the funds for those activities are provided by the sponsor, then the entity applies the guidance in ASC 810-30 to determine whether the sponsor should consolidate the arrangement.

If the reporting entity has a contractual management relationship with another entity, then it should apply the guidance in ASC 810-10 to determine whether or not it should be consolidated.

Special Purpose Leasing Entity (not presently consolidated)

In an effort to continue to be a player in the community, it decided to build a new facility for a women and children's hospital. After it built the facility, it sold it back to a Health Care Capital, a leasing organization. Health Care Capital had five lessees. However, GPHS represented 85% of its revenue. Since HCC was formed to purchase the hospital and lease it back to GPHS, GPHS guaranteed its debt.

ASC 958-810-25-8 states that a not-for-profit lessee should consolidate an SPE if all of the following conditions exist:

- Substantially all of the activities of the SPE involve assets that are leased to a single lessee
- The substantive risks and substantially all of the residual rewards and the obligation imposed by the debt reside directly or indirectly with the lessee by virtue of:
  - The lease agreement
  - A residual value guarantee through assumption of the first dollar loss provisions
  - A guarantee of the SPE's debt
  - An option granting the right to purchase the asset at a fixed price or a defined price that is other than fair value determined at the date of exercise or receive any of the lessor's sales proceeds in excess of a stipulated amount
- The owner(s) of record of the SPE have not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease. If the owners of record of the SPE are not independent third parties, then the criterion is not met.

Auditor's conclusion: The auditor did not agree. GPHS guaranteed the debt of HCC and was also responsible for 85% of the activity of HCC. Therefore, HCC had to be consolidated with GPHS.

Real Estate Partnership – 5% ownership (not presently consolidated)

GPHS had relationships with for-profit entities. One was a real estate partnership in which GPHS was the general partner but owned only 5% of the entity.

Not-for-profits that have a general partnership interest in a limited partnership are assumed to control the limited partnership even if the interest is a minority interest. This presumption can be overcome, if the limited partners have participatory rights. If the presumption is overcome, the general partner would apply the equity method of accounting or if elected, fair value. ASC 958-810 also permits investments in real estate partnerships, limited liability companies and similar investments to be reported at fair value by not-for-profit organizations.

GPHS determined that it did not need to consolidate the real estate partnership. The limited partners had participatory rights and one aspect of those rights was the ability to remove the general partner. The interest was accounted for at fair value.

Auditor's conclusion: The auditor agreed with the client.

Recent ASUs Affecting Partnership Interests

The FASB issued ASU 2015-02 with the objective to revise certain criteria used to determine when reporting entities are required to consolidate “certain legal entities” – in particular, limited partnerships and Variable Interest Entities (VIEs). Although the perceived need for these changes relates primarily to the investment management industry, the ASU applied to all entities, including not-for-profits.

However, ASU 2015-02 inadvertently caused issues for NFPs because it eliminated the presumption that a general partner controls the limited partnership regardless of the size of the ownership interest. The ASU addressed when a general partner should consolidate under the variable interest entity (VIE) model. Since the VIE model does not include NFPs in its scope, this left NFPs without clear guidance for these situations.

ASU 2017-02 reinstates the provisions that the general partner controls the limited partnership regardless of the size of the ownership interest unless the presumption can be overcome due to the limited partners having substantive kick-out or participatory rights. Under ASU 2017-02, kick-out rights are substantive if they can be exercised by a simple majority vote or a lower threshold of the limited partners’ voting rights.

The guidance contained in ASU 2017-02 is included in ASC 958-810. The guidance is effective for annual periods beginning after December 15, 2017. If the NFP has not adopted ASU 2015-02, then it adopts both ASUs at the same time using the same transition method.

It is not likely that many NFPs early implemented ASU 2015-02, but in the event they did, the NFP would adopt the latest amendment as of the effective date using a retrospective approach for all periods presented beginning with the fiscal year that ASU 2015-02 was adopted.

In addition, ASU 2017-02 clarifies that amendments in ASU 2016-01, *Recognition of Financial Assets and Financial Liabilities*, were not intended to affect the ability of NFPs, except business-oriented health care entities, with investments in certain for-profit entities to elect to measure them at fair value. This amendment is effective for NFPs for years beginning after December 15, 2018.

Ownership Interest (45%) with a Physician Group (not presently consolidated)

GPHS determined that the equity method should be used for the 45% ownership interest in the joint venture. GPHS had significant influence because of the representation on the board of directors and participation in policy-making decisions. Significant influence is defined as the ability to exercise significant influence over operating and financial policies of an investee and may be indicated in several ways, including the following:

- Representation on the board of directors
- Participation in policy-making processes
- Material inter-entity transactions
- Interchange of managerial personnel
- Technological dependency
- Extent of ownership by an investor in relation to the concentration of other shareholdings

An investment of 20% or more of the voting stock of an investee causes a presumption that unless there is predominant evidence to the contrary, the investor has the ability to exercise significant influence over an investee.

Auditor's conclusion: The auditor agreed with the client.

Consolidation with Other Not-for-Profit Organizations

The rules for consolidation in ASC 958-810 related to not-for-profit organizations with investments in other not-for-profit organizations state:

- The not-for-profit organization **should consolidate** when it has a majority voting interest through stock ownership. The only thing that would negate this is if control does not rest with the majority owner or sole corporate member. This would occur, for example, if the entity was in bankruptcy.
- The not-for-profit organization **should consolidate** another not-for-profit organization if the not-for-profit organization has a majority voting interest in the board and an economic interest in that entity.

- A not-for-profit with control through other than majority ownership or a **majority voting interest in the board and economic interest** may consolidate but it is not required.

- **A not-for-profit with control or economic interest (but not both) may not consolidate.** It should disclose the nature of its relationship with the other party.

- Consolidation is required when one not-for-profit entity is the **sole member** of another not-for-profit entity.

Economic interest exists if one entity holds or utilizes significant resources that must be used for the unrestricted or restricted purposes of the other either directly or indirectly by producing income or providing services. In addition:

- One organization may be responsible for the liabilities of the other

- One organization may guarantee debt of another

- One organization also may assign certain significant functions to another

- One organization may solicit funds in the name of and with the expressed or implied approval of the reporting organization and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or to be used at its direction

- A reporting organization transfers significant resources to another entity whose resources are held for the benefit of that organization

Control is the direct or indirect ability to determine the direction of management and policies through ownership, contract or otherwise. Other examples of control may be through the organization's charter or bylaws or through an affiliation agreement.

Participation in an Imaging Center with Another Not-for-Profit Group (presently consolidated)

GPHS had a 35% interest in the imaging center with another not-for-profit. There were eight people on the board of the imaging center. A simple voting majority is required to approve board actions. GPHS has the ability to appoint five of the imaging center's board members.[14]

Auditor conclusion: The auditor agreed with the client.

[14] Note that if five of GPHS' board members, employees, or officers served on the board of imaging center but GPHS did not have the ability to require that those members serve on the imaging center's board, GPHS would not have a majority voting interest in the board of the imaging center.

Noncontrolling Interests

The portion of the net assets in a subsidiary not attributable directly or indirectly to a parent is referred to as a noncontrolling interest. A noncontrolling interest is sometimes referred to as a minority interest. The guidance on noncontrolling interests was added with the adoption of ASU 2010-07. It is effective for reporting periods beginning on or after December 15, 2009 and is applied prospectively.

The noncontrolling interest should be reported in the statement of financial position within the net assets, separate from the parent's net assets and it should clearly be labeled (i.e., noncontrolling interest in subsidiaries).

Revenues and expenses, gains and losses, excess of revenues over expenses and changes in unrestricted net assets should be reported in the statement of operations and include amounts attributable to the parent and the noncontrolling interest.

The net asset portion of the statement of financial position is illustrated below:

Amounts designated for capital spending	100,000
Total unrestricted net assets GPHS	433,000
Noncontrolling interest in GPHH	**48,000**
Total unrestricted net assets	481,000
Temporarily restricted net assets	15,000
Total net assets	$ 496,000
Total liabilities and net assets	$1,051,000

A not-for-profit parent that has one or more consolidated subsidiaries with a noncontrolling interest is required to provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest either in the footnotes or on the face of the financial statements. This schedule would reconcile beginning and ending balances of the controlling and noncontrolling interests for each class of net assets that is applicable to the reporting period.

This schedule would include a performance indicator, in the case of a health care organization, discontinued operations (if any), extraordinary items (if any), changes in ownership interest and an aggregate amount of all other changes.

Footnote H			
Changes in Consolidated Unrestricted Net Assets Attributable to GPHS and Transfers to and from the Noncontrolling Interest			
Year Ended June 30, 20X1			
	Controlling Interest	**Noncontrolling Interest**	**Total**
Balance July 1, 20X0	$400,000		$400,000
Excess of revenues over expenses from continuing operations	17,600	$5,400	$23,000
Discontinued operation (net of tax)	(5,600)	(1,400)	($7,000)
Net unrealized gains and losses on other than trading securities	12,000	3,000	$15,000
Affiliate adjustments (net)	9,000	41,000	$50,000
Change in net assets	33,000	48,000	81,000
Balance June 30, 20X1	**$433,000**	**$48,000**	**$481,000**

Changes in the Parent's Ownership

Changes in the parent's ownership are accounted for as equity transactions so there is no gain or loss in the consolidated excess of revenues over expenses or changes in net assets. The carrying amount of the ownership interest in the subsidiary is adjusted. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted is recognized in the net assets attributable to the parent.

When a not-for-profit entity (parent) has a subsidiary with a noncontrolling interest, it should provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest in the notes to the financial statements or on the face of the statements. The schedule should reconcile beginning and ending balances of the parent's controlling interest for each net asset class where a controlling interest exists. Included should be:

- Operating indicator or performance indicator, if the entity is reported under the health care audit guide.
- Discontinued operations, if any.
- Extraordinary items.
- Changes in ownership interests including investments and distributions to the noncontrolling interests. This should be reported outside of operations and the performance indicator, if any.

Deconsolidation

If a parent deconsolidates, then it accounts for the deconsolidation by recognizing a gain or loss in the change in net assets attributable to the parent which is the difference between:

Aggregate of:

- Fair value of consideration received.
- Fair value of retained noncontrolling investment in the former subsidiary at the date of deconsolidation.
- Carrying amount of any noncontrolling interest in the former subsidiary at the date of deconsolidation.
- And the carrying amount of the former subsidiary's assets and liabilities.

CLASSIFICATION AND ALLOCATION OF EXPENSES

QUESTION 16:

I have several clients that are charitable organizations whose mission is to provide support to individuals and their families that live with certain diseases. I also have some clients that are social services organizations that focus on the welfare of the public such as dealing with abused women and children or people that are homeless. Now that all entities are required to present a functional expense presentation, I need to be able to assist those who have not done so in the past with implementation. They have never done a very good job of allocating expenses. I understand that the entity will also have to describe their allocation methods.

How do I help my client decide what costs should be allocated to the various functions and how to do it?

<u>ANSWER</u>:

Functional Expense Presentation

ASU 2016-14 will require all entities to provide a functional expense presentation. The information can be presented in a statement or in a footnote. A supplemental schedule is not sufficient under ASU 2016-14. The functional categories are **(a) programs (as many as the entity wants to present) and (b) supporting services**. Examples of supporting services are membership development, management, and general and fundraising. In other types of organizations where there are limited contributions and the funding comes from charges for services, there may be no fundraising category. The AICPA recommends that the entity consider whether it is a good idea to disclose why there is no fundraising expense in the notes to the financial statements since users and potential users of the statements generally assume that all not-for-profits get significant amounts of charitable contributions.

The functional classification, as noted above, is one aspect of the matrix, specifically the columns on the statement, while the natural classification forms the rows. Natural classification includes the categories of cost such as salaries, rent, electricity, interest expense, depreciation, subgrants or awards to other entities/people, and professional fees.

All expenses must be shown in this presentation except those associated with investments. Those are netted against the investment return. Certain expenses such as cost of direct donor benefits or cost of sales may not be included in the statement of activities in the expense section. If that is the case, then a reconciliation must be performed to tie the functional expense presentation to the expenses on the statement of activities.

EXAMPLE

KIDZ KAMP, INC.
STATEMENT OF FUNCTIONAL EXPENSES
YEAR ENDED JUNE 30, 20X1

	Program Services			Management	Fundraising and	Cost of	
	Advisory	Training	Total	and General	Development	Goods Sold	Total
Grants and other assistance	$ 294,261	$ -	$ 294,261	$ -	$ -	$ -	$ 294,261
Salaries and wages	6,269,754	1,261,585	7,531,339	290,234	184,176	-	8,005,749
Employee benefits	1,198,503	390,865	1,589,368	99,963	21,222	-	1,710,553
Payroll taxes	441,580	94,927	536,507	29,619	9,923	-	576,049
Professional services	1,006,807	87,197	1,094,004	14,980	1,704	-	1,110,688
Accounting fees	-	-	-	40,073	-	-	40,073
Legal fees	-	7,939	7,939	-	-	-	7,939
Advertising and promotion	33,085	21,006	54,091	79,261	79,478	-	212,830
Office expenses	87,071	56,654	143,725	9,867	22,794	-	176,386
Information technology	37,858	706,535	744,393	12,399	14,653	-	771,445
Occupancy	346,601	29,799	376,400	14,918	53,427	-	444,745
Travel	70,957	18,283	89,240	93,292	-	-	182,532
Conferences, conventions and meetings	32,516	76,285	108,801	16,405	-	-	125,206
Interest	287,428	-	287,428	-	9,457	-	296,885
Insurance	100,500	12,556	113,056	8,443	930	-	122,429
Training and development	157,617	20,659	178,276	8,113	23,669	-	210,058
Gift shop cost of goods sold	48,621	-	48,621	-	-	-	48,621
Cost of direct benefits to donors	-	-	-	-	-	12,501	12,501
Depreciation and amortization	1,042,663	74,425	1,117,088	20,134	13,960	-	1,151,182
Bad debt expense	-	-	-	16,892	-	-	16,892
Other	31,569	5,977	37,546		7,474	-	45,020
Total expenses by function	11,487,391	2,864,692	14,352,083	754,593	442,867	12,501	15,562,044
Less expenses included with revenues on the statement of activities							
Gift shop cost of goods sold	(48,621)	-	(48,621)	-	-	-	(48,621)
Cost of direct benefits to donors	-	-	-	-	-	(12,501)	(12,501)
	(48,621)	-	(48,621)	-	-	(12,501)	(61,122)
Total expenses included in the expense section on the statement of activities	$ 11,438,770	$ 2,864,692	$ 14,303,462	$ 754,593	$ 442,867	$ -	$ 15,500,922

If expenses are reported in a category other than their natural classification in the statement of activities, they are reported by their natural classification if a statement of functional expenses is presented.

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The entity must disclose additional information on how expenses are allocated. This is best done in the accounting policy footnote and an expanded functional expense footnote.

EXAMPLE

Functional Allocation of Expenses

The costs of program and supporting services activities have been summarized on a functional basis in the statement of activities. The statement of functional expenses present the natural classification detail of expenses by function. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

NOTE K – FUNCTIONAL EXPENSES

The financial statements report certain categories of expenses that are attributed to more than one program or supporting function. Therefore, expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include occupancy, depreciation, and amortization, which are allocated on a square footage basis, as well as salaries and wages, benefits, payroll taxes, professional services, office expenses, information technology, interest, insurance, and other, which are allocated on the basis of estimates of time and effort.

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Program activities are the activities that relate to the not-for-profit's mission. It is important that the components of total program expenses are easy to determine from the details provided on the face of the statement of activities. Otherwise they should be provided in the notes to financial statements.

Management and general expenses include the following:

- Oversight
- Business management
- General record keeping and payroll
- Budgeting
- Financing, including unallocated interest costs
- Soliciting funds other than contributions and membership dues, for example:
  - Promoting the sale of goods or services to customers, including advertising costs
  - Responding to government, foundation, and other requests
  - Proposals for customer-sponsored contracts for goods and services
- Administering government, foundation, and similar customer-sponsored contracts, including billing and collecting fees and grant and contract financial reporting
- Disseminating information to inform the public of the entity's stewardship of contributed funds
- Making announcements concerning appointments
- Producing and disseminating the annual report
- Employee benefits management and oversight (human resources)
- All other management and administration except for direct conduct of program services, fundraising activities or membership development activities. The cost of oversight and management usually includes salaries and expenses of the governing board, the chief executive and support staff. If the chief executive or staff spend time on direct program activities that time should be allocated to those activities

EXAMPLE

The controller of a social service organization was identifying the types of activities that would be included in management and general expenses. She wanted to separate the activities performed in connection with obtaining donations, which are considered fundraising, from those that the organization conducted to respond to government, foundation and other RFPs, administering government contracts including billing and collecting, and providing information to inform the public about the organization's activities. Those would be considered management and general activities.

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Fundraising activities include:

- Publicizing and conducting fundraising campaigns
- Maintaining donor mailing lists
- Conducting special fundraising events
- Preparing and distributing fundraising manuals, instructions, and other materials
- Soliciting contributions from corporations, foundations and other sources. Some government funding can take the form of contributions.

Fundraising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions (ASC 958-605-25).

Membership development activities include costs of solicitation in obtaining members and membership dues, membership relations and other associated activities. However, sometimes there are no significant benefits for being a member. In this case the costs should be considered fundraising. ASC 958-605-55 provides indicators of the criteria that would be used to determine how much membership dues are exchange transactions, and how much should be considered contributions.

Membership activities could be conducted with other activities. For example an organization may solicit membership dues and contributions at the same time. This would be considered a joint activity. ASC 958-720-45-28 talks about activities that include fundraising costs and the various methods that they could be allocated between the two. It is important to note that membership activities could also be conducted with activities that are not fundraising.

EXAMPLE

An historical society conducted an event that was designed to gain new members and at the same time the activity provided services to existing members. Since it did not include fundraising, the controller allocated the costs between the membership development category and the program services category.

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There are also specific rules related to classification of certain costs.

Cost of Premiums – A not-for-profit may choose to send out calendars, address labels or other premiums in a fundraising appeal. Even though it is possible that donations will arise from sending these items, the fact is that they can be kept by the recipients regardless of whether they donate or not. These are fundraising costs.

In addition, the cost of premiums, like coffee mugs which are given to donors to acknowledge receipt of a contribution, are reported as fundraising expenses if the cost is nominal when compared with the donation.

EXAMPLE

A not-for-profit radio station permits donors to choose their premiums as acknowledgement gifts at varying level. A donor giving $75 chose to receive a classical music CD. The CD cost the not-for-profit $1 to produce. The not-for-profit recognized the cost of the premium as fundraising expense. However, if the premiums had been of greater than nominal in value, the transactions would have been reported as part exchange transaction and part contribution.

Ongoing and Peripheral Costs of Sales and Services

A museum has two ongoing services that patrons can access when visiting the museum. One is a store that sells educational videos and books that are associated with its mission. The other is a cafeteria. The controller knew that unless the merchandise was related to the mission, she would show the revenues from the store separately from the cost of sales. The cost of sales would either be displayed right after the revenue or in the expense section. But since all of the items in the store were related to its programs, then the store would be a program service and the cost of sales recognized as program expense. With regard to the cafeteria, the cost of operating it was a not major part of the operations and was not related to the NFP's programs. Therefore, the cafeteria's cost of sales would be reported as supporting services.

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EXAMPLE

A synagogue produced a cookbook to sell to raise money for its religious school. The sales from the cookbook are considered to be a peripheral activity and any gains or losses from the sales are able to be offset and only the net reported.

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Interest Costs – The FASB requires a not-for-profit to allocate interest costs which would include the interest on a building's mortgage to programs or supporting services as much as possible. If there are some interest costs that cannot be allocated they would be reported as part of the management and general function.

Occupancy Costs – Occupancy and building costs are not a separate supporting service but should be allocated.

Payments to National Office – Not-for-profit organizations that are affiliated with a national charity or other local or national organization may be required to make payments to that organization. It is important to try to classify these payments to the extent possible, but if the information is not available then the payments would be treated as a separate supporting service, reported on the statement of activities and labeled unallocated payments to that organization.

Fundraising Expenses Related to Designated Contributions – Federated fundraising entities such as United Way get contributions from donors. Some are designated and some are not. Those that are designated and then passed on other not-for-profits are fundraising costs to the intended beneficiary not-for-profit. Costs to solicit and receive both designated and undesignated contributions and make grants and awards to others are all fundraising expenses to the federated fundraising entity.

Note that as discussed in an earlier question, the financial statement project decisions made to date by the FASB includes a provision for all not-for-profit entities to present functional expense information along with information about how expenses are allocated.

Investment Expenses

The revised AAG-NPE includes a far more robust discussion of the types of items that constitute investment expenses. They include:

- Investment advice (this would include advice by employees)
- Investment acquisition due diligence
- Custodian services
- Other administrative activities in connection with investments
- Other professional services such as legal and accounting
- Interim and year-end monitoring
- Valuation procedures and processes

QUESTION 17:

In allocating costs to the various functional categories, it is easy to pinpoint the direct costs. But what about those that benefit more than one function?

Is there a formula I can use to allocate the costs?

<u>ANSWER</u>:

Direct costs are those that can be traced to the particular cost object under consideration. In the context of a not-for-profit's programs, a cost object is any program or activity where cost data is required. For example if a person works on a particular program then that person's salary and benefits are attributable to that program. Salaries of personnel who work in more than one area can often be directly assigned if proper records are maintained.

<u>EXAMPLE</u>

The executive director of a small charitable organization performed the following functions:

- *Program – time spent teaching classes on how to care for patients with dementia*
- *Management and general – time spent running the organization including time spent writing grants to get Federal and State awards*
- *Fundraising – time spent calling on donors to solicit donations*

She maintained time records to demonstrate how much time was spent in each function. The time allocated to management and general could not be allocated directly because it was related to the overall direction of the not-for-profit.

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Indirect costs are those costs that cannot be easily traced to the particular cost object under consideration. For example a not-for-profit may have several programs and will have supporting services such as management and general and maybe fundraising.

When assigning expenses (costs), it is preferable to assign as many as possible directly. But if it is not possible or practical then there are numerous techniques that are available to assign costs.

There is a difference between functional categories and grant awards. It is important to remember when dealing with Federal Awards that it is important to pay attention to Office of Management and Budget (OMB) Circular A-122, *Cost Principles for Non-Profit Organizations* (or the applicable circular). Note that although Circular A-122 is still in effect at the writing of this manual, for awards made after December 26, 2014, the guidance will come from the OMB's "Uniform Guidance".

Following are some of the bases that could be used to allocate costs to an organization's functions.

Suggested Allocation Methods

Cost Category	Examples	Possible Allocation Bases
Occupancy/ maintaining a building	Depreciation, utilities, maintenance and insurance	Square feet
Financing costs	Interest including that on a mortgage	If unable to allocate to a program or supporting service, report as part of the management and general function (ASC 958-720-45-24) Note: don't forget to disclose the total amount of interest costs incurred and any amount capitalized.
Salary costs	Salaries, benefits, etc.	Allocate directly as much as possible based on time records. For amounts that cannot be allocated directly, an administrative salary pool could be allocated on the basis of direct costs. It might be helpful to consider that direct costs may include amounts passed through to others which do not necessarily use administrative time.
Administrative costs	Accounting	Number of transactions processed
Administrative costs	Budgeting	Direct hours of identifiable services of employees in the budgeting function
Administrative costs	Data processing	Usage
Administrative costs	Disbursing	Checks written
Administrative costs	Insurance management	Dollar value of insurance premiums
Administrative costs	Mail and messenger	Number of documents handled or employees served
Administrative costs	Motor pool costs including automotive management	Miles driven/days used
Administrative costs	Office machines and equipment maintenance and repair	Main
Administrative costs	Legal services	Direct hours spent
Administrative costs	Personnel administration	Number of employees
Administrative costs	Payroll service	Number of employees
Administrative costs	Printing and reproduction	Direct hours, job basis, pages printed, etc.
Administrative costs	Telephone	Number of telephones
Administrative costs	Procurement	Number of transactions processed

Smaller organizations may find it easier to allocate certain administrative costs based on salaries and wages, salaries, wages and benefits or amount of direct costs. The key is to have a rationale and systematic allocation.

EXAMPLE

A not-for-profit organization was preparing a statement of functional expenses. Salaries and wages was the largest category. Many of them could be attributed directly to a program or supporting service. However, there were others such as rent, the salaries of the personnel in the accounting function, utilities, janitorial service, etc., that were not directly attributable to any one program but were considered indirect. These were allocated among all of the programs, fundraising and management and general.

To show the true cost of the programs, at the bottom of the statement of functional expenses, the management and general expenses were allocated out to the different programs on the basis of salaries and wages, which was determined to be a rational and systematic basis.

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In allocating overhead AICPA Technical Practice Aid, TIS Section 6960.12, *Allocation of Overhead,* says that the interprogram transaction is not reported as revenue of the program providing the service but just a reduction of the cost of the program.

ASC 958-720 also provides additional guidance when allocating joint costs. Joint costs are those that contain aspects of fundraising and another function. The IRS guidance on cost allocation can be found in the instructions to Form 990.

It is a good idea for the organization to review its cost allocation methods to ensure that they are still appropriate. An NFP should evaluate its expense allocation methods periodically.

SECTION TWO

SINGLE AUDIT UPDATE

RISK IN GAS AND SINGLE AUDITS

QUESTION 1:

This is the second year that my firm has performed audits using the Uniform Guidance (UG). I am aware that there have been several firms referred to the AICPA Ethics Division in my state.

Can you tell me what we need to know to help ensure that this doesn't happen to us?

ANSWER:

The single audit is one of the most risky engagements that auditors can perform. The President's Council on Integrity and Efficiency (PCIE) identified issues when a statistical sample of audits was performed in 2004. The results, published in 2007, showed that approximately half of the single audits performed had significant deficiencies. Further examination of the data showed that the majority of the dollars were audited properly leading to the conclusion that the smaller award recipient's audits were the ones that were more likely to be deficient. These are more likely to be performed by firms that do not perform a significant number of single audits and therefore do not have the skills that auditors in firms that perform large numbers of single audits do.

Where this may be a natural conclusion, all firms performing single audits need to beware of the consequences of substandard audits because they have changed in the last two years since the AICPA initiated its Audit Quality Initiative in May 2014.

The AICPA identified several issues that lead up to this initiative:

- Complexity in business, regulation and standards
- Public and client expectations growing
- Delivering in a more heavily regulated world
- Accelerating pace of technological change and risk
- Rapid and continual change
- Focus on reliable, high-quality business reporting
- Demand for transparency and scalability

The quality issues were identified in governmental audits (including single audits), broker-dealers, employee benefit plans, and municipal securities. As identified back in 2007, firms that did not specialize in a particular area were more likely to be deficient. To test the audit quality, the AICPA selected 90 engagements to review. Forty-one (41) of them were conducted under Government Auditing Standards (GAS) or were single audits. Of those 41 engagements, 17 were deemed nonconforming. Recent announcements by the AICPA indicate that the number of nonconforming audits is closer to 50%. The AICPA has instituted additional training for peer reviewers since some peer reviewers were found to lack knowledge in the requirements of a single audit. State peer review acceptance bodies are being more critical of peer reviewers. In addition, findings by federal agencies are referred to the AICPA ethics division.

The OMB intends to conduct a study of audit quality in 2018, as required by the UG. The UG requires a study every 6 years that will be a statistically reliable estimate of how single audits are conducted. Federal agencies will be required to make recommendations to address whatever issues arise from the study. **The reviews will be made public.** Since this may be one of the first audits under the UG that a firm conducts, understanding the requirements becomes that much more important.

Documentation

One of the major issues that firms are being referred to the AICPA Ethics Board is a lack of documentation. The position of the AICPA for some time has been that if the documentation is not in the workpapers, the firm did not perform the work. This may not always be the case.

Auditors should watch for specific documentation requirements related to sampling. The requirements are lengthy (type of sampling, what is being tested and what constitutes a deviation, the rationale for sample size, etc.) and a requirement could easily be missed.

Single Audit Assessment – Question 1

Single audits, like employee benefit plan audits, are:

A. A significant risk to the firm

B. Only a risk if firms don't get the proper CPE

C. An area where approximately 25% of engagements are deficient

D. Not a big deal if an auditor has experience

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EFFECTIVE DATE AND OTHER PLANNING CONSIDERATIONS

QUESTION 2:

I was embarrassed recently when my staff identified a finding, shared it with the client and then learned that federal agencies did not implement that portion of the UG. I didn't realize that federal agencies could do that.

How can I determine if there are other agencies with similar exceptions? Can you summarize the effective dates of the guidance?

ANSWER:

The Uniform Guidance (UG) has been in place since December 2013 when federal agencies were required to adopt the UG into its own regulatory structure. Some federal agencies received OMB approval to make exceptions to certain requirements of the UG for their own federal awards. For example, an agency might disallow a particular type of cost that would otherwise be permitted under the UG cost principles.

Appendix 7 of the Compliance Supplement identifies the title and section of agency rules that include exceptions and provides a link to a similar document found on the COFAR website. The AICPA has created a tool to help entities and their auditors identify agency adoption. It can be found at:

https://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/SingleAudit/UniformGuidanceforFederalRewards/DownloadableDocuments/FinalFederalAgencyDifferences.pdf

Practitioners do not need to be a member of the Government Audit Quality Center to access this document.

Practice Point: Auditees should determine the differences early on to ensure that they are following the appropriate guidance. Auditors should review Appendix 7 to ensure that they are aware of instances where federal agencies requested and received exceptions from the OMB. They should also be aware that there could be changes that are not reflected on the COFAR site. The links on the GAQC document will go to the electronic Code of Federal Regulations (e-CFR) thereby providing the most updated guidance.

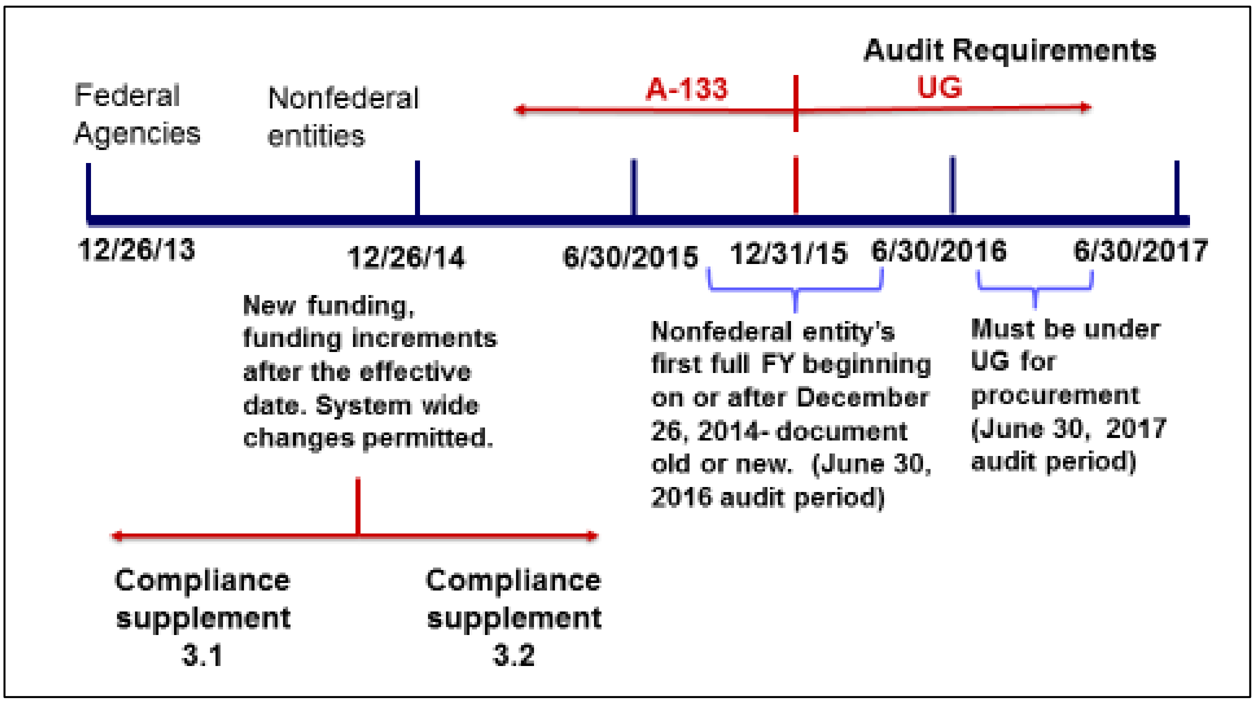
This or That

Entities implementing the UG could have quite a bit of transition due to the implementation guidance. As noted in the charts below, the UG is effective for new awards and funding increments to old awards received after the effective date. This means that entities and their auditors will need a good understanding of whether the legacy circulars (A-87, A-21 and A-122, A-102 and A-110) apply or whether the UG applies.

Chart 1 – Effective Dates of UG Provisions

Stakeholder	Effective Date & Provisions
Non-federal entities	The UG applies as of the federal award date to **new** awards and for agencies that consider incremental funding to the first funding increment issued on or after 12/26/14. For agency incremental funding actions that are subject to the UG, non-federal entities are not obligated to segregate or track old and new funds, but they can do so (§200.39).
Auditors	Single audits will be conducted using the OMB's new Uniform Guidance (UG) for entities with calendar year-ends for 2015. Those with fiscal year-ends other than December 31 will require audits under the UG for their fiscal year ending in 2016. **Remember that auditors are concerned not only with the audit process guidance in the UG but are also responsible for knowing which set of administrative and cost guidance their clients should be using in administering their federal awards.**

Chart 2 – Summary of Audit Requirements



Practice Point: An entity could be under the legacy circulars for several years depending on the length of the grant and whether there is incremental funding. It is not always easy to tell. The client should provide information and a representation to the auditor. The UG Question & Answer document states that an entity will not be penalized for using the UG for all awards.

The UG is generally effective for federal awards. However, there are exceptions. federal awards may take the form of grants, loans, loan guarantees, interest subsidies, insurance, commodities, cost-reimbursement contracts, fixed awards and awards to hospitals. Part 3 of the Compliance Supplement provides a handy table to help the awardees and their auditors understand when portions of the UG are not applicable to a particular award.

Single Audit Assessment – Question 2

Which of the following is NOT true about effective dates?

A. ***All agencies are now in compliance with the Uniform Guidance***

B. ***Entities can choose to be solely under the Uniform Guidance***

C. ***Auditors must determine whether programs should be tested under the old guidance or the UG***

D. ***None of the above***

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<u>QUESTION 3</u>:

I am ready to begin planning my June 30, 2017 single audits. I thought the compliance supplement would be out by now but it isn't.

Can I perform the audits using the 2016 supplement?

<u>ANSWER</u>:

The compliance supplement for the year is due out in the spring. It is effective for audits of periods ending June of that year. For example, the compliance supplement for 2017 will be used for audits beginning after June 30, 2016 (i.e., June 30, 2017 year-ends and after). However, it is generally not issued on a timely basis. Auditors may use the prior year compliance supplement understanding that there could be differences that affect an entity's major programs. Generally, there will be new programs added and changes to several programs. Sometimes programs are deleted. Although using the 2016 supplement can be helpful in planning, the auditor should obtain the final supplement when it is available and see if any changes have affected the entity's major programs.

Single Audit Assessment – Question 3

The Compliance Supplement:

A. ***Is always issued in March of the year for that year's June year ends***

B. ***Is often late so just use the PY if that's what's available at the time the audit begins***

C. ***Can be used for planning but the auditor must evaluate changes once the final is available***

D. ***Never changes***

****

QUESTION 4:

The AICPA has been focusing on independence recently and peer reviewers have reported problems in firm documentation.

What are the documentation requirements for independence?

ANSWER:

Independence is a very significant area and a focus point at this time. Auditors can count on extensive scrutiny of their documentation by peer reviewers. Independence is discussed in the Yellow Book, which is an authoritative source. These requirements are over and above the AICPA requirements.

There are two main threats of concern. One is the threat of the auditor making management decisions. The second is the threat of self-review.

The important components of documentation include:

- Discussion in the engagement letter of management's responsibilities.
- Identification of nonattest services.
- Documentation to support that management has the knowledge, skills and experience to take responsibility for the services (this should be more specific than a checkmark on a practice aid).
- Safeguards used when the threat to independence is significant and management's representations related to the responsibility they assumed for the nonattest services.
- Representations that management took responsibility for the nonattest services.

The author believes that it is good practice to include specific identification of the nonattest services in the engagement letter and in the representation letter. It is important that these identified services tie to the practice aid where management's skills, knowledge and experience are discussed.

Commercial practice aids include an independence assessment tool. In addition, the AICPA has an excellent practice aid for documenting the auditor's assessment of independence. It can be accessed at:

https://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/AuditPracticeToolsAids/DownloadableDocuments/2011YellowBookPracticeAid.pdf

Practice Point: The auditor must make a thoughtful, critical assessment of independence. Simply checking a box saying that independence was assessed is not enough. Documentation of SKE in the engagement letter and representation letter is not sufficient. If the SKE isn't there, then there is no way that the auditor can mitigate that threat to independence.

<u>QUESTION 5</u>:

A firm that I know quite well was recently referred to the AICPA Ethics Division for not properly testing the SEFA.

What are the important procedures to be performed in connection with the SEFA?

ANSWER:

There are two objectives when the auditor tests the SEFA. The first is to be able to issue an “in relation to” opinion. This is why the auditor reconciles the SEFA to the financial statements. If the auditor issues an adverse or disclaimer of opinion on the financial statements, the standard “in relation to” opinion cannot be issued. There are report forms that essentially say that due to the opinion on the financial statements, the auditor cannot issue an “in relation to” opinion on the SEFA.

EXAMPLE

One of the requirements in a single audit is to reconcile the information in the Schedule of Expenditures in Federal Awards (SEFA) to the entity’s financial statements. Commercial practice aids provide memory jogger questions such as – Did the firm reconcile the SEFA to the financial statements? A check mark indicating yes to this question may not be sufficient. In many cases, the reconciliation is not straightforward and would require additional documentation to illustrate how an experienced reviewer with knowledge of the subject matter could understand what the auditor did and reach a conclusion about the adequacy of the work performed.

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The second objective is to test the relevant assertions. The **assertions** that are relevant to the SEFA are similar to those used by the auditor in evaluating classes of transactions when auditing the financial statements.

- ***Occurrence*** – the transactions and events relate to that entity.
- ***Accuracy*** – the transactions and other events are recorded accurately.
- ***Cutoff*** – the expenditures are recorded in the proper period.
- ***Completeness*** – all expenditures that should have been included have been included.
- ***Classification and understandability*** – disclosures are clearly written and information is appropriately presented.

The auditor will want to ask a variety of questions of the client to test that the SEFA is complete.

- Are there any new grant programs this year that may have been left off the schedule because you believe that they are not federal?
- Did the client receive any noncash awards that may have been left off the schedule, including loan programs?
- Are all amounts on the schedule expended as opposed to received or awarded?
- Are the amounts on the schedule expended in the fiscal year under audit as opposed to the grant year?
- Have all indirect overhead costs and other program costs been allocated to the programs?
- Have amounts passed down to subrecipients been reflected as expenditures of federal awards?
- Were there any interpretations or assumptions underlying the measurement or presentation of the information?
- Have any clusters been identified using Part 5 of the Compliance Supplement?
- Have amounts expended under the American Recovery and Reinvestment Act been noted?

Procedures to be performed to test the assertions include:

1. Obtain an understanding of internal control over the preparation of the schedule including controls over completeness, accuracy and the classification of expenditures by CFDA No. **(COM, OCC, AC, C&U)**
2. **Obtain the SEFA from the client and perform the following:** a. Determine that the period covered by the SEFA corresponds with that of the financial statements. (**C&U)** b. Determine whether the client has identified all of the clusters that are noted in Part 5 of the Compliance Supplement. (**C&U, OC, AC, CT)** c. Reconcile to the underlying accounting records and grant records. (**COM, OC, AC, CT)** d. Compare the schedule to prior year schedules. (**COM, OC, AC)**
3. Using knowledge obtained during the financial statement audit or other work performed, evaluate consistency of the amounts and disclosures on the SEFA with that knowledge. (**COM, OC, AC)**

4.	Test the accuracy of the CFDA numbers and the awarding agencies. Also, note whether the awards are direct or pass through from another entity. Information may be obtained from the Compliance Supplement, Grant Agreement, Appendix 7, of the CFDA Historical Profile of Catalog Programs. (**AC, C&U)**
5.	Determine if the SEFA includes direct and indirect costs and excludes cost sharing or matching amounts. (**COM, OC, AC, C&U)**
6.	Determine if the SEFA measures items required by the UG such as loans, loan guarantees, endowment funds, and noncash assistance. (**COM, OC, AC)**
7.	Determine if the SEFA uses measurements that are different from prior periods and determine if any changes are reasonable. (**C&U, AC)**
8.	Determine if there have been any changes in assumptions or interpretations related to measurements or the presentation of amounts in the SEFA. (**C&U, CT, AC)**
9.	Determine if the minimum data elements required by the UG are included as well as appropriate notes to the SEFA. See disclosure requirements in Section 5. (**C&U)**
10.	Evaluate control weaknesses that were identified related to the preparation, completeness and accuracy of the SEFA and its disclosures. Conclude whether any deficiencies identified (individually or in combination) were significant deficiencies or material weaknesses in internal control over financial reporting, internal control over compliance or both.

Findings by Peer Reviewers and Agency Reviewers

SEFA presentation and disclosure is one area in the single audit that has had significant findings by peer reviewers and agency reviewers. These areas have been identified as frequently missed findings.

- Clusters are not properly disclosed.
- Subgrant award numbers assigned by pass-through entities were not included.
- Names of pass-through entities were missing.
- Grantor federal agency names were missing.
- Grantor federal agency subdivision names were missing.
- Multiple lines for CFDA number were shown but expenditures were not.
- The correct CFDA number was not identified.
- R&D programs were not identified as such.
- Notes to the SEFA were missing.

Disclosure Requirements

Following are the disclosure requirements for the SEFA.

- The federal programs listed individually by federal agency. Note that Recovery Act awards should be separately identified by including the prefix “ARRA” with the name of the federal program on the schedule.

- For research and development programs, the total federal awards expended must be shown by individual award or by federal agency and major subdivision within the agency. Example: National Institutes of Health is a subdivision in the Department of Health and Human Services, which is the federal agency.

- Each federal award within a cluster of programs should be listed individually. If it is not practical to list each individual federal award for research and development, the total awards expended should be shown by federal agency and major subdivision within the federal agency. Clusters must be totaled on the SEFA.

Practice Point: If an entity has one program that is included in a cluster, even if there are no other programs in a cluster present on the SEFA, the cluster should be named. In addition, if the SEFA has multiple lines with the same CFDA number they should be summed.

Practice Point: The Research and Development Cluster does not contain a list of programs by CFDA. Research or development can be a part of many grants. The compliance supplement provides the following discussion in Part 5, *Clusters.*

“Research” is a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. Development is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes. Research & Development (R&D) means all research activities, both basic and applied, and all development activities that are performed by nonfederal entities.

The term “research” also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other R&D activities and where such activities are not included in the instruction function. The absence of the words “research” and/or “development” in the title of the federal award does not indicate it should be excluded from the R&D cluster.

The substance of the federal award should be evaluated by the recipient and the auditor to determine the proper inclusion/exclusion in the R&D cluster.

EXAMPLE

An auditee had several grants with the same CFDA number. The grant administrator evaluated all of them carefully and concluded that three of them were related to research and development. The other two were not. She was confused because the grants all had the same CFDA number. After some research, she concluded that the three were to be included in the research and development cluster and the two other grants with the same CFDA were considered to be part of the same program, so they are combined.

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- The *Catalog of Federal Domestic Assistance* (CFDA) numbers or other identifying number when a CFDA number is not available.

- The total federal awards expended during the period for each program.

- For federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity. The AICPA illustrates this with the name of the federal agency and name of the pass-through entity.

- Notes to the schedule that describe the significant accounting policies used in preparing the schedule. It is permissible to include them directly on the schedule, but if there are several, then a separate page is preferable.

- Total amount provided **to** subrecipients from each federal program. This requirement is only applicable to pass-through entities. This information must be presented on the face of the schedule.

Practice Point: Note that the amount passed down to subrecipients is on the cash basis of accounting. The criteria for them to become expenditures is **when disbursed**.

- The value of the federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year-end. Examples of noncash assistance are free rent, interest subsidies, food stamps, food commodities, Women/Infant/Children (WIC) program vouchers, or donated property. These items may be shown in either the schedule or notes to the schedule.

- Noncash assistance is valued at fair market value at the time of receipt. WIC program vouchers may be valued at either maximum allowed redemption value or average redeemed value.

- If free rent is received by itself, it would not be considered an expenditure of federal awards; therefore, a single audit would not be required. But if free rent is received as part of an award to carry out a federal program, then it would be considered to be a federal award.

- Any interest subsidy or administrative cost allowance received by the audited entity under a federal loan or loan guarantee program should be included in the schedule or disclosed in a note to the schedule.

The **notes** to the SEFA should include:

- Balances of loan and loan guarantee programs outstanding at the end of the audit period for the loans where the government is at risk. Note that where there are no continuing compliance requirements, except to repay, the loan does not go on the SEFA. In addition, regarding Student Financial Aid, if the entity does not make the loan, no information is required to go in the notes to the SEFA.

- Significant accounting policies including **whether or not** the auditee elected to use the 10 percent de minimis indirect cost rate.

Following is an example of a SEFA.

EXAMPLE

Example Entity
Schedule of Expenditures of Federal Awards[1]
for the Year Ended June 20, 20X1

Federal Grantor/Pass-Through Grantor/Program or Cluster Title	**Federal CFDA Number[2]**	**Pass-Through Entity Identifying Number[3]**	**Passed Through to Subrecipients**	**Total Federal Expenditures**
Department of Agriculture Direct Programs				
Food distribution cluster				
Commodity Supplemental Food Program - *Total food distribution cluster*	10.565			$ 134,268
Total Department of Agriculture Direct Programs				134,268
Department of Housing and Urban Development Direct Programs				
Entitlement Grant Cluster				
Community Development Block - *Total Entitlement Grant Cluster* Grants - Entitlement Grants	14.218		$ 423,965	1,235,632
Housing Voucher Cluster				
Section 8 Housing Choice Vouchers - *Total Housing Voucher Cluster*	14.871			800,534
Total Department of Housing and Urban Development Direct Programs			423,965	2,036,166
Department of Education Direct Programs				
Impact Aid	84.041			372,555
Arts in Education	84.351			28,655
Subtotal Department of Education Direct Programs				401,210
Department of Education Pass-Through Programs				
From: State Department of Education - Title Grants to Local Educational Agencies	84.010	23-8345-7612		1,239,398
Total Department of Education				1,640,608
Total Expenditures of Federal Awards			$ 423,965	$ 3,811,042

The accompanying notes are an integral part of this schedule.

Serendipity Services
Notes to the Schedule of Expenditures of Federal Awards
for the Year Ended June 30, 20X1

Note 1. Basis of Presentation

The accompanying schedule of expenditures of federal awards (the "Schedule") includes the federal award activity of Serendipity Services under programs of the federal government for the year ended June 30, 20X1. The information in this Schedule is presented in accordance with the requirements of Title 2 U.S. Code of Federal Regulations Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Guidance). Because the Schedule presents only a selected portion of the operations of Serendipity Services, it is not intended to and does not present the financial position, changes in net assets, or cash flows of Serendipity Services.

Note 2. Summary of Significant Accounting Policies

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in the Uniform Guidance, wherein certain types of expenditures are not allowable or are limited as to reimbursement. Negative amounts shown on the Schedule represent adjustments or credits made in the normal course of business to amounts reported as expenditures in prior years. Serendipity Services has elected to use the 10-percent de minimis indirect cost rate as allowed under the Uniform Guidance.[1]

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[1] See information earlier in this section related to whether the auditee has awards that are before the effective date with no incremental funding.

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<u>QUESTION 6</u>:

The criteria for an entity to be a low risk auditee changed with the UG. I'm aware the percentage of coverage changed.

Is there anything else that I particularly need to be aware of?

<u>ANSWER</u>:

Low Risk Auditee

If a client meets the criteria outlined below, it will qualify as a low-risk auditee. As a low-risk auditee, the percentage of coverage of the total amount of **federal awards necessary in a single audit is 20% rather than 40%**. Therefore, generally, the amount of work to be performed will be considerably less if the client qualifies as a low-risk auditee.

Sometimes auditors fail to carefully read the criteria they need to use to make the determination of whether or not an auditee qualifies as low risk. Some of the criteria refer to findings in a **Type A** program. Type A programs are those that exceed a calculated threshold. For many[2] audits, this will be 3% of expenditures of federal awards, with the lowest possible threshold being $750,000. A major program is based on an evaluation using the risk-based approach that is discussed below. A major program can be Type A or Type B.

The entity must meet ALL of the following criteria for each of the **previous two years**.

Requirement	Discussion
• Single audits were performed on an annual basis in accordance with the UG/Circular A-133.[3]	An entity with biennial audits no longer qualifies as a low-risk auditee.
• Auditor's opinions on the financial statements and schedule of expenditures of federal awards were unmodified.	The UG incorporates language that the auditor's opinion must state whether the financial statements were prepared in accordance with GAAP or **a basis of accounting required by state law.**
• There were no deficiencies in internal control over financial reporting identified as material weaknesses under GAS.	There were no deficiencies in internal control over financial reporting identified as material weaknesses under GAS.
• Single audit reports were submitted to the FAC by the required deadline.	The OMB incorporated the guidance which was previously in M-10-14, stating that in order to meet the criteria for a low-risk auditee in the current year, the two prior year audits must have been submitted to the Federal Audit Clearinghouse by the due date, which is the earlier of nine months after year-end or 30 days after the receipt of the auditor's report.

[2] If expenditures of federal awards are less than $100 million, 3% will be the factor used.

[3] This will be true until the UG has been used for two years.

Requirement	Discussion
• None of the federal programs had audit findings for **Type A** programs from any of the following for the last two audit periods: a. Material weakness in internal control over compliance b. Known or likely questioned costs that exceed 5% of the total federal awards for a Type A program	The criteria that were deleted from the UG are related to material noncompliance. Formerly, under Circular A-133, if the entity had material noncompliance in a Type A program, then it could not be a low-risk auditee.
• The auditor did not report a substantial doubt about the auditee's ability to continue as a going concern.	

Practice Point: Neither the Uniform Guidance nor Single Audit Act requires the auditee's financial statements to be on GAAP. However, if the entity is on another basis of accounting, it will not be considered a low risk auditee. The exception as noted above is when the entity is required by state law to use a specific basis of accounting.

Peer reviewers and agency reviewers have found the following issues during their review.

- The data collection form was not filed or was filed late but the entity was still considered a low risk auditee.

- Material weaknesses over internal control over financial or compliance were noted but the auditee was assessed as low risk.

- Material noncompliance was reported but the auditee was assessed as low risk.

- Opinion on the financial statements or Schedule of Expenditures of Federal Awards was modified but the auditee was assessed as low risk.

Single Audit Assessment – Question 4

What is NOT TRUE about the low risk auditee determination?

A. If the entity is modified cash basis, it cannot be a low risk auditee

B. It is a two-year look back

C. It determines percentage of coverage

D. The auditor does not need to compute it if there is only one program

****

RISK-BASED APPROACH

QUESTION 7:

Prior to the UG, the criteria for assessing Type A programs for risk consisted of the general criteria and a few specific criteria. Now I am learning that there is more to this than I originally thought. I also learned that I could inadvertently cause more Type B programs to be audited than necessary.

Could you summarize the rules and tell me where I need to be careful?

<u>ANSWER</u>:

Type A Program Assessment

The auditor will use the risk-based approach in order to choose the major programs to audit. A calculation is made to separate the program into Type A programs and Type B programs. Unless expenditures exceed $100 million, the factor used to multiply the total program expenditures will be three percent. The minimum threshold is now $750,000.

The next step is to evaluate the Type A programs for risk. The criteria for Type A program evaluations are very specific.

One of the most important criteria in determining risk is that the program must be audited every three years. If the program has not been audited in one of the two most recent audit periods, then it is considered to be a major program.

Other Type A criteria involve looking back at the most recent audit period.

Criteria
In the most recent audit period, the Type A program may not have had: • **Material weaknesses** over major programs • A modified opinion on compliance • Known or likely questioned costs that exceed 5% of the total federal awards expended under that program

Section 200.51 states that the auditor **must consider** whether the requirements in 200.519 paragraph (c) are met. These criteria state that the results of audit follow-up or any changes in personnel or systems affecting the program indicate a significant increase in risk.

<u>EXAMPLE FROM AUDIT GUIDE</u>

An auditor of a city was assessing the risk of the entity's Type A and Type B programs. In accordance with the UG, she separated the programs into A and B with the threshold she counted according to the Guidance.

In evaluating the Type A programs, the auditor looked at the specific Type A criteria (in section 200.518). One of the largest programs was due to be rotated because it was audited in the prior year with no issues identified that would cause it to be considered not low risk. Then she evaluated the program using the general criteria for risk (200.519c), results of audit follow-up and results of changes in personnel or systems affecting the program.

While discussing the programs with the client, she learned that the person that had administered this large A program for the past 15 years retired. The program was closed out in the year under audit. The client casually mentioned that the person who took over the role on that grant was not as experienced and had a lot to learn; that she had to correct numerous errors.

The auditor took this into consideration when assessing risk and since the grant was so large and was closed out during the year under audit, she decided that this heightened the risk. The program was evaluated as a ***not-low-risk A program*** *and audited as major.*

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The UG does not specifically come out and state that the auditor should not consider the concept of inherent risk (200.519 item d) when determining the risk of a Type A program. Rather, it specifically notes that the auditor should use section 200.518 (item c) when considering risk. To clarify the intent of the OMB, the Audit Guide (paragraphs 8.10 to 8.12) notes that there are three criteria in the General Criteria (200.518) that may be considered when assessing the risk of Type A programs:

1. Oversight exercised by federal agencies and pass-through entities (.519c)

2. Results of audit follow-up

3. Changes in personnel or systems affecting the program

In addition, the Audit Guide specifically mentions that the auditor is **not** to use inherent risk to determine whether there is significantly increased risk in a Type A program. This is a significant change from Circular A-133 and could result in additional Type A programs being considered major programs.

AICPA EXAMPLE

The AICPA's Audit Guide uses an example in paragraph 8.12 related to a Type A program where the program was audited as a major program in one of the two prior audit periods with no findings that would otherwise require it to be identified as not low risk. The auditor evaluated two of the permissible general criteria (oversight exercised by federal agencies and pass-through entities, the results of audit follow-up and changes in personnel or systems affecting the program). The question addressed was: ***Can the auditor use judgment to override the low-risk conclusion?***

The answer in the guide was – NO, the auditor cannot use judgment to override the low-risk Type A conclusion based on the inherent risk of the federal program. This is a change in the Uniform Guidance that could potentially increase the number of high-risk Type B programs to be audited.

One question auditors could ask is, if there is significant oversight by the Department of Education that leads the auditor to believe the program is really not low risk, would that be permissible? The author believes the Department of Education could identify this program as one of higher risk in the compliance supplement, similar to the Medicaid program.

One of the common deficiencies noted in peer reviews, ethics investigations and federal OIG QCRS was failure to audit Type A programs as major programs, if they did not qualify as low risk. The major reason for this deficiency appears to be related to the historical look-back criterion that requires Type A programs to be audited in one of the two most recent audit periods (effectively a three-year cycle). Many auditors failed to audit programs in the first year they became Type A programs. There is no leeway in this criterion

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Practice Point: Auditors should also be careful to read the compliance supplement to see if a program has been identified as high risk by the federal agency.

Type B Program Assessment

Type B programs are assessed next. The auditor will evaluate Type B programs for risk to the extent that there are Type A programs that are considered low risk. The auditor is **not required** to identify more high-risk Type B programs than at least **one-fourth** the number of low-risk Type A programs. This means that if there are no low-risk A programs, Type B programs do not need to be assessed for risk.

The auditor is not expected to perform risk assessments on small federal programs. This is defined in §200.518 as those that do not exceed 25% of the Type A/B threshold. This is larger than in Circular A-133 where the threshold for audits of federal awards totaling less than $100 million was $100,000. Since the minimum Type A/B threshold is $750,000, the starting point for evaluation of Type B programs for risk is those exceeding $187,500.

Note that the auditor is not required to identify more high-risk Type B programs than at least 25% of the low-risk Type A programs. However, if the auditor assesses a Type B program as high risk, then it must be audited as a major program. All high-risk B programs must be audited.

When considering risk for Type B programs, the auditor would consider the following:

1. Current and prior audit experience:
    - Weaknesses in internal control over compliance
    - Federal programs administered under multiple internal control structures
    - Weak system for monitoring subrecipients (when that is a significant part of the program)
    - Prior audit findings
    - Federal programs not recently audited as major programs
2. Oversight exercised by federal agencies and pass-through entities
3. Inherent risk of the federal program:
    - The phase of the federal program in its life cycle **with the federal agency**
    - The phase of the federal program in its life cycle **at the auditee**
    - The amount of dollars expended

Single Audit Assessment – Question 5

What is TRUE about the risk-based approach?

- ***A. The auditor will always audit at least one A and one B program***
- ***B. The auditor cannot consider inherent risk when assessing the risk of Type A programs***
- ***C. The auditor should use all of the general criteria when assessing risks for all programs***
- ***D. The auditor will audit B programs that are high risk no matter how large they are***

****

Single Audit Assessment – Question 6

Note that the entity is a low risk auditee.

Program 1		*$5,000,000*	*Audited in prior year, no findings, no questioned costs or other risk factors*
Program 2		*250,000*	*New program director and known compliance issues identified by pass-through entity*
Program 3		*800,000*	*Not audited in the prior 2 years*
Program 4		*35,000*	*New program*
		$6,085,000	

Step 1: Calculate threshold.

Step 2: Separate programs into Type A and Type B programs.

Step 3: Evaluate Type A programs for risk.

Step 4: Evaluate Type B programs for risk.

How many major programs does this entity have?

- ***A. 1 program – $800,000***
- ***B. 2 programs – $800,000 and $250,000***
- ***C. 2 programs – $800,000 and $5,000,000***
- ***D. 3 programs – $800,000, $250,000 and $5,000,000***

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Once the auditor has assessed the risk of Type A and Type B programs and made program selections based on the risk-based approach, he/she will determine whether the percentage of coverage has been met. The auditor will determine if the auditee is a low risk auditee or not low risk. The assessment determines whether the percentage of coverage is 20% (low risk) or 40% (not low risk).

Practice Points: Take care in making this calculation. **Never** round up. This is easily picked up in federal agency desk reviews and has caused referrals to the AICPA ethics division.

CONSIDERATION OF RISK IN A MAJOR PROGRAM

QUESTION 8:

After the auditor completes the assessment of major programs, he/she should assess risk in each major program to determine the level of audit work needed. It seems like a lot of work to the assessment for each program.

Can I assess the programs all together?

ANSWER:

The auditor will be issuing an opinion on each major program. Therefore, to ensure the appropriate level of audit evidence will be obtained for each program, the auditor must assess risk for each program independently.

Part of the issue with assessing risk is that until testing is performed the auditor will not be able to finalize the risk assessment. The auditor will make a preliminary assessment of risk. In order to do this, he/she will need to obtain an understanding of the risk inherent in the major programs and an understanding of internal controls. The auditor may decide that it is efficient to test some of the controls at the time of the understanding. This is particularly true with entity level controls where sampling is either not involved or sample sizes are small due to the infrequent operation of the control.

The **components of audit risk** as they relate to audits of federal awards, as outlined in the Audit Guide, are as follows:

- **Inherent risk** – The risk that material noncompliance with a major program's compliance requirements could occur, assuming there is no related internal control. The auditor should consider complexity of the compliance requirements, length of time the entity has been subject to the requirements, prior experience with the entity, and the potential impact of noncompliance.
- **Control risk** – The risk that material noncompliance that could occur will not be prevented or detected on a timely basis by an entity's internal control.
- **Fraud risk** – The risk that intentional material noncompliance with a major program's noncompliance could occur.
- **Detection risk** – The risk that the auditor's procedures will lead him/her to conclude that noncompliance that could be material to a major program does not exist when, in fact, it does.

The auditor should follow up on prior audit findings in order to add this knowledge to the risk assessment. He/she should perform procedures to assess the reasonableness of the summary schedule of prior audit findings. If the auditor finds that the client misrepresents the status of a prior audit finding, that fact is considered an audit finding. **Procedures an auditor might perform in follow-up on prior audit findings are:**

- Inquiry of management and other client personnel.
- Review of the management decisions issued by federal awarding agencies and pass-through entities.
- Observation that the process or area has been redesigned.
- Testing similar transactions.

Practice Point: The auditor should take care to document his/her follow up on prior audit findings. The report will include a section on this follow-up. The auditor should perform this assessment during the risk assessment period and make sure to include evidence in the workpapers that this was performed.

It is very important for the auditor to remember to evaluate the **risk of fraud at the major program level**. Often this step is performed only in connection with the audit of the financial statements. AU-C 935 makes it very clear that the risk assessment process for compliance audits includes the same evaluations of risk as the financial statement audit, only directed at the major programs.

Fraud risk factors are classified based on the three conditions generally present when material noncompliance due to fraud occurs:

1. Incentives or pressures

2. Opportunities

3. Attitudes or rationalizations

A list of fraud risks relevant to a compliance audit follows.

Risk Factors Related to Incentives or Pressures

- Substantial political pressure on management creates an undue concern about federal award program accomplishments.

- Imminent or anticipated adverse changes in program legislation or regulations that could impair the financial stability of profitability of the entity.

- High degree of competition for federal awards, especially when accompanied by declining availability of federal awards nationally or regionally.

- A stagnant tax or revenue base or declining federal funding, enrollments, or eligible participants.

- Complex or frequently revised compliance requirements or participant requirements (such as cost sharing or matching requirements) that create incentives to shift costs or incorrectly value transactions.

- A significant portion of program management's compensation or performance appraisal is linked to federal award budgetary or program accomplishments or other incentives, the value or results of which are contingent upon the entity achieving unduly aggressive targets for budgetary or programmatic results.

- Unrealistically aggressive budget or program goals.

- A mix of fixed price and cost reimbursable program types that create incentives to shift costs or otherwise manipulate accounting transactions.

- Financial pressure due to declining revenues or increasing expenses, creating incentive to apply non-program costs to federal awards.

- Significant pressure to obtain additional funding necessary to stay viable and maintain levels of service considering the financial or budgetary position of the entity or of specific federal award programs, including need for funds to finance major research and development or capital expenditures.

- Threat of imminent program termination or significant reduction in scope, the effect of which could have a material financial impact on the entity.

Risk Factors Related to Opportunities

- The nature of the entity's operations provides opportunities to engage in fraud.

- An organizational structure that is unstable or unnecessarily complex.

- Rapid growth due to significant increases in funds without the organizational structure to support it.

- Inadequate internal control due to outdated or ineffective accounting or information systems.

- Inadequate oversight by those charged with governance over the financial reporting process and management activities.

- Inadequate monitoring by management for compliance with policies, laws and regulations.

- Lack of appropriate segregation of duties or independent checks, especially in areas such as eligibility determination and benefit awards.

- Lack of appropriate system of authorization and approval of transactions, such as purchasing, contracting, benefit determinations and eligibility due to either poorly designed or outdated controls.

- Lack of timely and appropriate documentation for transactions, such as eligibility and benefit determinations.

- Lack of asset accountability or safeguarding procedures.

- Rapid changes in federal award programs, such as significant centralization or decentralization initiatives, funding shifts from federal to state or local levels, increases or decreases in participant populations, high vulnerability to significant changes in compliance requirements, or pending program elimination.

- High turnover rates or employment of accounting, internal audit or IT staff.

Risk Factors Related to Attitudes or Rationalizations

- An ineffective or nonexistent means of communicating and supporting the entity's values or ethics, especially regarding such matters as acceptable business practices, conflicts of interests and codes of conduct.

- Significant subrecipient or subcontract relationships for which there appears to be no clear programmatic or business justification (for example, a subrecipient providing services it does not appear qualified to provide or a contractor geographically distant from the entity when nearby contractors are available).

- Management displaying or conveying an attitude of disinterest regarding strict adherence to federal award rules and regulations such as those related to participant eligibility, benefit determinations or eligibility.

- An individual or individuals with no apparent executive position(s) within the entity appearing to exercise substantial influence over its affairs or over individual federal award programs (for example, a major donor, fundraiser, or politician).

- An attitude among program personnel that given their position they, or parties related to them, are due benefits from the program, such as expenses reimbursed by the federal award or participation in the program, to which they would otherwise not be entitled, resulting in questioned costs.

EXAMPLE

The auditor of a major program that provides assistance to families with children that meet specified eligibility criteria was evaluating the risk of fraud. In making inquiries of grant personnel and their attitudes toward the program, the auditor learned that some personnel dealing with eligibility thought that the economic guidelines were too stringent and that too many needy people were being refused assistance. The auditor remembered reading a notice on the U.S. Department of Health and Human Services website which said that audits revealed that eligibility criteria were often violated by agency personnel. Accordingly, the auditor assessed the risk that program personnel would have personal bias and provide service to ineligible families as a risk of fraud for that major program.

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Practice Point: Auditors may believe that they are evaluating the risk of fraud over compliance when they perform the assessment for the financial statement audit. This may not be true. The auditor needs to perform this action for each major program.

The following template could be used to make a preliminary assessment of risk. Note that the AICPA has also created a practice aid that could be used. It is on the GACQ portion of the AICPA website.

Template

Single Audit Risk Assessment Grid

Auditors should complete one per major program. Note that the assessment from the inherent risk template (H, M, L) should agree to the value in the assessment template. The assessment of control risk should be based on the evidence obtained from testing controls.

Major Program:
Expenditures:
Materiality:

Compliance Requirement	Applicable?	Direct & Material Effect?	Significant Risk?	Fraud Risk?	Inherent Risk	Control Risk	Remaining Risk of Material Noncompliance
Activities allowed or unallowed							
Allowable costs							
Cash management							
Eligibility							
Equipment, real property management							
Matching, Level of Effort and Earmarking							
Period of Performance							
Procurement, suspension and debarment							
Program income							
Reporting							
Subrecipient monitoring							
Special tests and provisions							

Document the Auditor's Consideration of the Risk of Fraud for this Program

Evaluation of Inherent Risk

	Length of time client has worked with the program	Complexity of the processing	Significant deficiencies or material weaknesses in internal control identified in the past	Notification from program officials that indicates there are potential problems	Lack of compliance in the prior year	High volume of activity	Substantial change in policies, processes or personnel associated with the requirement	High client turnover in grant programs	Program has been identified as higher risk by the OMB in the Compliance Supplement	**Overall assessment of inherent risk – Note that this should tie to the grid above for inherent risk. Also remember that this should be included as the inherent risk assessed when sample sizes for controls are considered for each compliance requirement**
Activities allowed or unallowed										
Allowable Costs										
Cash Management										
Davis Bacon										
Eligibility										
Equipment, Real Property Management										
Matching, Level of Effort and Earmarking										
Period of Performance										
Procurement, suspension and debarment										
Program Income										
Real property acquisition and relocation assistance										
Reporting										
Subrecipient monitoring										
Special tests and provisions										

Practice Point: The auditor should take care to ensure that if he/she indicates that an applicable compliance requirement would not have a direct and material effect on a major program, that the reasons are documented.

Auditors will also want to take care that they do not perform blanket risk assessments on groups of programs.

Single Audit Assessment – Question 7

Which of the following is TRUE about risk in a major program?

A. ***The auditor only has to identify inherent risk and assess control risk***

B. ***Controls have to be tested so control risk will always be low***

C. ***The auditor is required to assess the risk of fraud of the major program***

D. ***Inherent risk, control risk and fraud risk are only assessed at the beginning of the audit***

E. ***All programs are considered high risk because it's safer that way***

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INTERNAL CONTROL, COMPLIANCE & SAMPLING CONSIDERATIONS

QUESTION 9:

I know that peer reviewers and agency reviewers continue to note deficiencies in the auditor's tests of internal control and compliance many of which relate to sampling.

What do I need to consider?

ANSWER:

Peer reviewers and agency reviewers have noted several deficiencies in the auditor's testing of internal control as follows:

- Audit documentation did not contain sufficient evidence of the auditor's **understanding** of the **five elements of internal control** and testing of internal control for many or all of the applicable compliance requirements.

- Audit documentation did not contain evidence of **internal control testing for several compliance requirements.** Although testing is not required if the requirements are not applicable, this was not noted in the audit documentation.

- Control weaknesses identified during the internal control assessment and testing were not evaluated to determine whether they were significant deficiencies or material weaknesses.

- Controls tested did not link back to controls identified in the risk assessment process.

Audit deficiencies frequently noted in agency and peer reviews related to compliance testing follow:

- Audit documentation did not contain evidence of compliance testing for several compliance requirements. Although testing is not required if the requirements are not applicable, this was not noted in the audit documentation.

- Audit documentation did not include evidence to support that audit programs were used for auditing compliance and/or the schedule of expenditures of federal awards.

- Changes in state/federal eligibility requirements made during the year were not incorporated in the auditor's tests. This is important to ensure that the persons were properly eligible at the time of service.

- Certain programs such as Medicaid are identified as higher-risk programs in the compliance supplement, yet some auditors only test 25 or 40 compliance selections with no explanation as to how they were able to test compliance, as if this was a lower-risk program.

- No additional procedures performed in response to actual fraud that was found.

In addition, sampling techniques are often misunderstood by auditors. However, appropriate sampling is extremely important because it is one of the keys to addressing risk at the major program level. In discussion with auditors, it appears that they tend to choose 40 items to test because it's the midpoint of the usual sampling range (25, 40, 60). This is not sufficient reason to choose a sample.

Sampling for Internal Control Testing

The **guidance has become more specific in Chapter 11 of the Audit Guide**. The first thing the auditor does when selecting a sample for attribute testing is to determine the **significance of the control** and the **inherent risk** of the compliance requirement.

If the auditor has decided that a control must be tested, then it is a significant control. However, some may have more significance than others. The significance of the control really hinges on the magnitude of the noncompliance that could result if the control failed. This is both a qualitative and a quantitative evaluation. For example, the initial approval by the principal investigator or lead on the grant indicating the cost is allowable is a significant control. However, it is also backed up by the monitoring control where the manager monitors to see if he/she agrees.

If the auditor believes that the activity control is more precise than the monitoring control because of the knowledge and experience of the person performing the control and that the person monitoring relies on their judgment, the quality of the monitoring may not be as precise. Then the activity control may be **very significant** and the monitoring control **moderately significant.** However, the reverse could also be true. If the monitoring control catches numerous errors, it may be the more significant control. This is an example of why the auditor has to be careful in assessing risk. Every client has its differences.

In determining sample size, the auditor also has to evaluate the inherent risk of noncompliance over that compliance requirement. **Inherent risk factors follow:**

- Length of time client has worked with the program.
- Complexity of the processing (routine transactions vs. nonroutine, systematic vs. nonsystematic, manual vs. programmed) or judgment involved.
- Significant deficiencies or material weaknesses in internal control identified in the past.
- Notification from program officials that indicates there are potential problems.
- Lack of compliance in the prior year.
- High volume of activity.
- Substantial change in policies, processes or personnel associated with the requirement.

- High client turnover in grant programs.
- Program has been identified as higher risk by the OMB in the Compliance Supplement.

The size of the program is not the determining factor. Samples may be selected using haphazard, random or systematic sampling. However, the sample should be representative of the population.

Sampling Unit & Sampling Tables

The sampling unit for a test of controls for allowable costs may be a payment voucher if the cost is related to goods or services. If it is related to payroll, the sampling unit could be the monthly time reporting. The auditor needs to determine how the client maintains its records in order to define the sampling unit.

The sampling tables included in the Audit Guide are designed to achieve a 90%-95% confidence level. There are two charts provided. One table is for instances where there are 250 or more items and one where there are less than 52 items. For 52–249 items, the AAG-SLA suggests using 10%. However, this is a matter of professional judgment. It is important to remember that unless populations are very small, the sample size of an attribute test does not correlate with the population.

The table from the Audit Guide was constructed to plan for a high level of assurance (90%-95% confidence level). It has three different sample sizes depending on the significance of the control and inherent risk. The significance of the control is another way of expressing the concept of tolerable deviation rate. The higher the tolerable deviation rate, the less assurance is needed from the control. If the auditor needs more assurance from the control (i.e., it is very significant), this means that he/she needs an increased sample size. Note that this table anticipates there will be zero deviations.

Sampling Table from the GAS/Single Audit Guide

Control Testing Sample Size Table – Population 250 or More Items	
Significance of Control and Inherent Risk of Compliance Requirement	**Minimum Sample Size with 0 Deviations Expected**
Very significant and higher inherent risk	60
Very significant and limited inherent risk **or** Moderately significant and higher inherent risk	40
Moderately significant and limited inherent risk	25

A rule of thumb noted in the Audit Guide for populations where the element is performed more often and the sample is between 52 and 250 is to take 10% of the population. The auditor would also determine whether, for qualitative reasons, that was sufficient.

When controls are performed 52 or fewer times or on a quarterly, monthly, semi-monthly or weekly basis, the following table is appropriate.

Small Population Sample Size Table	
Frequency and Population Size	**Sample Size**
Quarterly (4)	2
Monthly (12)	2-4
Semi-monthly (24)	3-8
Weekly (52)	5-9

The auditor will typically begin with an expectation of zero control deviations. If there are more than zero deviations, then it is possible to select additional samples if the auditor believes the results will be different.

The auditor should also document: 1) the sampling unit, 2) how he/she believes that the population is complete, and 3) the method of sampling (haphazard, random, systematic).

Evaluating the Results of the Test

In an audit under the UG, the auditor designs the control test to provide a high level of assurance. When the auditor performs the control testing and finds no deviations, then the objective of the test is met and a high degree of assurance is achieved that the control is performed well enough to be acceptable so control risk is low. However, if the deviations are higher than zero, then the control is not being performed well enough to be considered acceptably effective and risk is greater than low. This does not necessarily mean that noncompliance will result, just that the control is not operating at the necessary level for risk to be considered low.

The auditor needs to investigate all deviations to determine the potential impact on the program. Not all deviations may lead to a finding but understanding the potential impact on the program will help the auditor determine whether sufficient evidence has been obtained to support the compliance opinion and whether an internal control finding needs to be reported.

In evaluating deviations, the auditor should consider:

- Systemic nature of the deviation – If the control deviation is systemic, then it is more likely to lead to a finding.

- Intentional deviation – If the control deviation is the result of what the auditor believes may be fraud, then this requires more consideration than if it were clearly a mistake or lack of understanding.

- Pattern of deviation – If the deviation is similar to those the auditor has seen in the past, then this increases the likelihood that the deviation will need to be reported or that there is material noncompliance. The auditor may wish to perform additional tests to determine the effect of the deviation. In addition, if the client has not corrected a previously identified control deficiency, this also needs to be considered.

Auditors should be aware that a sample is only representative with respect to the **occurrence rate** or incidence of deviations but not to their cause. It is possible that where there are one or more deviations in a sample, there may be more in the population. If the auditor believes that the deviation found in the sample is not representative, he/she may wish to extend the sample.

Using AICPA sampling tables (90% confidence interval), if the auditor wants to achieve control risk of low, he/she would plan to test somewhere between 38 and 114 items with **no deviations**.

Acceptable Errors	**LOW**					**MODERATE**			**HIGH**		
	2%	**3%**	**4%**	**5%**	**6%**	**7%**	**8%**	**9%**	**10%**	**15%**	**20%**
0	**114**	**76**	**57**	**45**	**38**	**32**	**28**	**25**	**22**	**15**	**11**
1	194	129	96	77	64	55	48	42	38	25	18
2	265	176	132	105	88	75	65	58	52	34	25
3	331	221	166	132	110	94	82	73	65	43	32

<u>EXAMPLE</u>

If the auditor selected a sample of 40 and had zero deviations, then he/she could be 90% confident that the deviation from controls in that population was no more than 5.5% (interpolated). Control reliance would be assessed as low for that control.

Auditors should also remember that the selection of 25, 40 or 60 is based on the inherent risk and the significance of the control. Therefore, if a sample of 40 was selected, it was because inherent risk is higher and the control is moderately significant or inherent risk is lower and the control is very significant.

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Overall Conclusion on Controls

The auditor will form a conclusion on the controls over a compliance requirement considering **all** of the evidence supporting his/her tests of controls. Only some of the controls are tested by attributes. Others may be tested by corroborative inquiry, observation and review of documents.

If the auditor believes that controls are not likely to be reliable, then he/she does not have to continue to test controls. In that case, he/she would:

- Report the control deficiency as a significant deficiency or material weakness.
- Assess control risk related to requirements for the compliance requirement as high.
- Consider the lack of effective controls when designing the compliance sample.

Compliance Testing vs. Control Testing

It is important to understand that Parts 3 and 4 of the compliance supplement were written in order to identify and test compliance requirements, not internal controls. Controls are related to the actions taken by client personnel to ensure that compliance objectives, e.g., only eligible individuals receive service, are met. They are evaluated before the testing of compliance to give the auditor information about how large a compliance sample needs to be. By testing the controls, auditors are testing that the entity is following its procedures to meet the control objective, e.g., only eligible individuals receive service. The results of the tests of controls over compliance provide the auditor with a basis for computing the compliance sample size.

Procedures detailed in the Compliance Supplement are audit procedures to be performed to test whether the entity is in compliance. The auditor does that by answering the question “Is the entity in compliance with the requirement?” The answer will be “yes” or “no”. In addition, while performing this testing, the auditor will also note any questioned costs. It follows then that tests of compliance are similar to substantive tests in a financial statement audit. For eligibility, the auditor would then test compliance with the specific requirements in the supplement to see if they have been met or if there is noncompliance.

The auditor wants to gain efficiencies where possible and so he/she may want to use the same selections to test internal control and compliance. There are several considerations the auditor needs to make when doing this. It is important to document the fact that the test performed on a particular item is a test of controls as well as a test of compliance.

EXAMPLE

An auditor wanted to perform a multi-purpose test combining a test of controls with a test of compliance over allowable costs. One of the controls that the auditor identified as a key control over compliance related to control activities was that:

> ***Supporting documentation is compared to a list of allowable and unallowable expenditures.***

The auditor believed that it would be possible to also test the following compliance requirement at the same time:

> ***When allowability is determined based upon individual transactions, select a sample of transactions and perform procedures to verify that the transaction was for an allowable activity.***

The auditor was required to test the compliance requirement by attribute testing or reperformance and thought it might be possible to test internal control in that manner as well. She obtained a sample of transactions. She was able to test to see if the transactions were allowable under the terms of the grant and cost circular so she was able to complete the compliance test. She was also able to complete the test of the internal controls because there was evidentiary support on the invoice. To evidence performance of the control, the grant accountant recorded a code (that corresponded to the grant number) to indicate that she compared the supporting documentation to a list of allowable and unallowable costs. Therefore, she was able to use the selection for both purposes. She documented that "Attribute A" tested internal controls and "Attribute B" tested compliance.

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Note that if a sample is used as a multi-purpose sample, the number of selections should be the larger of the two samples that would have otherwise been chosen. The auditor may test a subset of the larger sample for the particular test requiring a smaller sample.

Documentation

One of the issues raised by reviewers (peer reviewers, government agencies and state auditors) is that internal controls are not appropriately documented. There is no one correct way to document internal controls. However, professional standards require the following elements to be documented:

1. Description of the control or compliance requirement being tested.

2. Definition of the population and sampling unit as well as how the auditor considered the completeness of the population.

3. Definition of what constitutes a deviation or exception.

4. Desired confidence level, tolerable deviation or exception rate and the expected population deviation or exception rate.

5. Sample size.

6. Sample selection method (random, haphazard, systematic).

7. Sample items selected along with sufficient characteristics to support the control or compliance testing if used for a dual-purpose sample.

8. Evaluation of the sample.

   a) Deviation/exceptions.

   b) Important qualitative aspects of the deviation/exception.

   c) Projected population deviation or exception rate.

   d) Determination of whether the results support the test objective.

   e) Effect of the evaluation on other audit procedures, e.g., if control risk is other than low.

   f) Determination of known questioned costs and estimation of likely questioned costs.

   g) Determination on whether the auditor's opinion on compliance will need to be modified or if the deviations will result in a finding and if not, how the auditor considered sampling risk.

9. Any qualitative factors considered significant when making sample selections, assessments and judgments including multiple major programs, clusters, multiple components or other factors.

10. Summary conclusion if not evident.

A narrative may be the most expedient method to document the entity level controls while a matrix form may be the best way to document the control activities. The auditor may want to perform a dual-purpose test with the control activities and compliance requirements. As noted above, the auditor should distinguish which attributes relate to compliance and which relate to internal controls. Otherwise, a reviewer might conclude that controls were not tested.

Following is an example of the testing of control activities over allowable cost as it relates to items purchased. Note that the controls over personnel costs are not included as they are processed with a different system.

EXAMPLE WORKPAPER

Controls over Allowable Costs

Objective of Controls – *To provide reasonable assurance that federal awards are expended only for allowable activities and that the costs of goods and services charged to federal awards are allowable and in accordance with the applicable cost principles. We selected the key entity level and activity level controls over allowable costs to test.*

Control Activities

Following is the process used by the client to process grant expenditures. The controls are inserted in the process in parentheses. We have identified the key controls to test. For efficiency, we will conduct a dual-purpose test of controls and compliance. Our sample size will be the larger of the two samples that would have been selected separately.

Process narrative (note that controls are bolded). The walk through to confirm whether the control has been implemented is our first selection in the testing that follows.[4]

Grants personnel order supplies, other necessary items, and the purchase orders are approved by the grants manager. When invoices are received, they are approved by grants accounting personnel. First, the computations are checked for accuracy ***(control 1 – accuracy, existence)*** *and then supporting documentation is compared to list of allowable and unallowable expenditures* ***(control 2 – existence, allocation)****. The grants manager reviews costs allocated to each grant and makes adjustments to unallowable costs made where appropriate. Follow-up action is taken to determine the cause when this happens* ***(control 3 – valuation, completeness)****. Grants management ensures that the grants personnel are provided an updated list of changes in activities allowed and cost principles when these things occur* ***(control 4 – accuracy)****. Accountability for authorization is fixed in an individual who is knowledgeable of the requirements for determining activities allowed and allowable costs* ***(control 5 – accuracy)****.*

Testing:

Control 1 *– Client personnel check computations for accuracy.* ***A deviation is lack of a checkmark on the computation. This is tested by attribute in the worksheet below.***

Control 2 *– Supporting documentation compared to a list of allowable costs. Grants personnel have been trained and understands the requirements of the UG related to allowable costs as summarized in the entity's policy document.* ***A deficiency is a lack of initials on the documentation. This is tested by attribute in the worksheet below.***

[4] Although this process narrative is helpful, it is not required. However, a process narrative without the controls and assertions identified would not be sufficient.

Control 3 *– Grants manager reviews costs allocated to each grant and makes adjustments to unallowable costs where appropriate. Follow-up action is taken to determine the cause when this happens.* ***This is tested by observation and corroborative inquiry (not illustrated here). Note that if there is no signoff evidencing the work performed, it will not make a good attribute test. It would be documented in the form of a paragraph.***

Control 4 *– Grants management ensures that the grants personnel are provided an updated list of changes in activities allowed and cost principles when these things occur.* ***This is tested by observation and corroborative inquiry (not illustrated here). Note that if there is no signoff evidencing the work performed, it will not make a good attribute test. It would be documented in the form of a paragraph.***

Control 5 *– Accountability for authorization is fixed in an individual who is knowledgeable of the requirements for determining activities allowed and allowable costs.* ***This is tested by observation and corroborative inquiry (not illustrated here). Note that if there is no signoff evidencing the work performed, it will not make a good attribute test. It would be documented in the form of a paragraph.***

Compliance 1 *– Test of allowable cost.* ***This is tested by attribute testing. The auditor's conclusion is either that the cost is allowable under the terms of the applicable cost circular and grant agreement or it is not.***

Compliance 2 *– Costs were given consistent treatment through application of those generally accepted accounting principles.* ***This is tested by attribute testing. The auditor's conclusion is either that the cost was given consistent treatment or it was not.***

Compliance 3 *– Cost conforms to limitations or exclusions set forth in the circulars, federal, state or local laws (if any) and is net of all applicable credits such as purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments for overpayments.* ***This is tested by attribute testing. The auditor's conclusion is either that the cost conforms to limitations or exclusions or it does not.***

Sample Size

Control Testing Sample Size Table – Population 250 or More Items		
Significance of Control and Inherent Risk of Compliance Requirement	***Minimum Sample Size with 0 Deviations Expected***	***Tolerable Rate***
Very significant and higher inherent risk	*60*	*3%-4%*
Very significant and limited inherent risk ***or*** *Moderately significant and higher inherent risk*	*40*	*5%-7%*
Moderately significant and limited inherent risk	*25*	*8%-10%*

Selection method for testing control activities by attributes: *haphazard.*

Population: *All of the grant expenditures for this grant were considered for testing. Payroll expenditures were tested separately since payroll approval and reporting is separate from expenditures other than payroll. In addition, we determined that there were no items that were capitalized that should have been part of this population. Cutoff testing was performed to ensure that the population **was complete**.*

The controls tested below are moderately significant with limited inherent risk. Therefore, a sample size of 25 would be appropriate with zero deviations. However, we found one deviation in controls that we believed was an isolated incident that caused us to select additional items to test for a total of 43. We used these for compliance even though with no additional control deviations a sample size of 25 would have been all that was necessary since it is the larger of the two sample sizes.

Example of attribute testing (only four selections out of the sample of 40 shown)

This example shows a dual-purpose test where internal control and compliance are tested with the same sample. The two controls (attributes A & B) are tested by reperformance. The remainder of the attributes represents tests of compliance and substantive testing. Note that only the documentation of the control testing is evaluated here. Compliance testing will be addressed in another section.

				IC	***IC***	***C***	***C***	***C***
	Invoice/Vendor #	*Date*	*Amount*	*A*	*B*	*C*	*D*	*E*
1	*03023 – Contract Labor*	*1/12/X3*	*$8,425*	*X*	*X*	*X*	*X*	*X*
2	*111995/ 003 – Kaiser Permanente*	*4/18/X3*	*$825*	*X*	*X*	*X*	*X*	*X*
3	*752052 – Amazon.com*	*12/1/X3*	*$1,225*	*X*	*X*	*X*	*X*	*X*
4	*35211 – Delta Airlines*	*6/25/X3*	*$1,350*	*X*	*X*	*X*	*X*	*X*

Attributes

A. *Client personnel checked computations for accuracy, evidenced by a checkmark.*

B. *Grants personnel reviewed the cost to ensure it was supported by an invoice, receiving document and is allowable under the terms of Circular A-122. This was evidenced by the reviewer's initials and the associated grant number.*

C. *Per review of the supporting documents, the cost is allowable under the terms of the grant agreement and is reasonable and necessary for the performance and administration of federal awards.*

D. *Costs were given consistent treatment through application of generally accepted accounting principles. (A cost may not be assigned to a federal award as a direct cost if any other cost incurred for the same purpose in like circumstances was allocated to the federal award as an indirect cost.)*

E. Cost conforms to limitations or exclusions set forth in the circulars, federal, state or local laws (if any) and is net of all applicable credits such as purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments for overpayments.

IC = Internal control test
C = Compliance test
X = Attribute met without exception

****

The auditor will want to be careful when performing dual purpose testing. It is possible that control deviations could cause the auditor to conclude that the controls are not effective but a sample of 40 was used for the dual-purpose test. The auditor needs to determine if there are mitigating controls that would cause the sample size of 40 to be appropriate for compliance testing.

The compliance testing sampling table is below. Note that the AICPA mentions that when populations are between 52 and 250 items, a rule of thumb some auditors follow is to test a sample size of approximately 10 percent of the population. That being said, the auditor should always adjust the sample size for risk.

Remaining Risk of Material Noncompliance	Minimum Sample Size
High	60
Moderate	40
Low	25

The remaining risk of material noncompliance is the amount of assurance needed after inherent risk and control risk have been assessed. In the example above, if the controls were deemed ineffective the sample size may be larger (e.g., 60).

The Audit Guide speaks to internal control and compliance testing that spans over several grants. With internal control testing, the auditor determines the number of systems present. If the controls span over multiple programs, then it is appropriate to test internal control for multiple programs together. It is important to remember that when testing internal control the controls must be responsive to the attributes tested. Therefore, if the attributes tested for the personnel component of allowable cost are not the same as those over the items purchased for the program, indirect cost allocation or amounts passed down to subrecipients, there may be multiple systems to test.

As it relates to compliance testing, the Audit Guide is clear that the minimum samples in the table are applied for **each direct and material compliance requirement for each major program.** This may mean that dual purpose testing is not as efficient as it appears to be at first.

Practice Point: Auditors need to consider the concept of sampling with replacement. If a selection yields a result that the attribute is not applicable, it should be replaced or else the sample is not adequate.

Practice Point: The auditor needs to take care of the compliance requirements that are tested together. In the past, auditors have tested allowable cost, cash management and period of performance (previously called period of availability of federal funds) together. In the 2016 compliance supplement, the reference to it being permissible to test period of performance with allowable costs was removed. The AICPA has warned auditors that it is not appropriate to test these two requirements together.

Single Audit Assessment – Question 8

Which of the following is TRUE about sampling?

- ***A. The auditor is required to use statistical sampling***
- ***B. Always choose at least 40 selections***
- ***C. Number of selections for IC testing depends only on pop. size***
- ***D. Samples of 25, 40 and 60 assume zero deviations***

******

Single Audit Assessment – Question 9

Which of the following is TRUE about testing internal control?

- ***A. The auditor only tests control activities***
- ***B. Attribute testing is used for all internal control tests***
- ***C. Finding a deviation, auditor must choose more selections***
- ***D. When testing internal control, the auditor can combine programs***

******

Single Audit Assessment – Question 10

Which of the following is NOT TRUE about testing internal control and compliance?

A. ***Dual purpose testing (DPT) is permitted***

B. ***The auditor must use the larger of the two samples for DPT***

C. ***Compliance samples must be per major program & compliance requirement***

D. ***"Agreed invoice amt. to the GL" is a test of internal control***

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EVALUATING AND REPORTING COMPLIANCE DEFICIENCIES

QUESTION 10:

One of the problems I have with my single audits is deciding when my compliance testing has identified enough deficiencies to warrant reporting due to material noncompliance.

What criteria should I use to tell when material noncompliance has occurred?

<u>ANSWER</u>:

Evaluating the results of compliance tests can be confusing. The auditor must use quantitative and qualitative methods to make those determinations.

Compliance attributes may be monetary or nonmonetary. If the attributes are nonmonetary, such as for the compliance requirement eligibility, the auditor would use the approach outlined below when evaluating the results of the test to determine the exception or deviation rate. If the attributes are monetary, such as for allowable costs, the auditor may extract the large or more risky items and then lower the sample based on reduced risk. When evaluating the results, the auditor evaluates the deviation rate along with the dollar value of questioned costs.

Deviation Rate – Qualitative & Quantitative Evaluation

Compliance testing in a compliance audit often involves monetary amounts (i.e., testing allowable costs); the focus of the tests is on whether the entity complied with the requirements. Therefore, it is important to understand the deviation rate.

The AICPA tables show the following as it relates to a 90% confidence level. This assumes statistical sampling.

Sample Size = 25		**Sample Size = 40**		**Sample Size = 60**	
Deviations	Deviation Rate	Deviations	Deviation Rate	Deviations	Deviation Rate
0	8.8%	0	5.6%	0	3.8%
1	14.7%	1	9.4%	1	6.4%
2	20.2%	2	12.8%	2	8.7%
3	24.9%	3	16.0%	3	10.8%
4	29.9%	4	19.0%	4	12.9%

It may be surprising that with a statistical sample there is a deviation rate associated with zero deviations. This is because the auditor is selecting a sample. This would be the **upper limit** of the deviation because it incorporates sampling risk.

Note that there is no requirement that the auditor use a statistical sample.

A less precise way of calculating a deviation rate might be to use a mathematical calculation as shown below. In this table, the auditor would divide the number of deviations by the sample size to calculate the deviation rate. This would be a **lower limit**.

Sample Size = 25		Sample Size = 40		Sample Size = 60	
Deviations	Deviation Rate	Deviations	Deviation Rate	Deviations	Deviation Rate
0	0%	0	0%	0	0%
1	4.0%	1	2.5%	1	1.6%
2	8.0%	2	5.0%	2	3.3%
3	12.0%	3	7.5%	3	5.0%
4	16.0%	4	10.0%	4	6.6%

The measurement of deviations is important to the auditor's evaluation as to whether there is material noncompliance in relation to the compliance requirement. The tolerable exception rate for a compliance test is the maximum rate of compliance exceptions that auditors are willing to accept.

The **quantitative** threshold used to determine if an exception is an audit finding related to a major program is lower than the materiality (generally 5%) used for planning and expressing an opinion on compliance.

Materiality is a matter of auditor's judgment but the tolerable exception rate would be equal or less than materiality. Therefore, if materiality was set at 5%, then the tolerable exception rate would be 5% or less. Auditors need to use judgment to determine whether or not there is material noncompliance.

In addition to material noncompliance, the auditor is required to report known questioned costs when likely questioned costs are **greater** than $25,000 for a type of compliance requirement. In making the evaluation, the UG requires the auditor to evaluate the known questioned costs and project the likely questioned costs. In order to determine likely questioned costs, the auditor has to extrapolate the amount of known questioned costs to the population. There are two approaches the auditor can use:

Approach 1: If the transactions with noncompliance are approximately the same size, the auditor could take the exception rate and multiply it by the total population to get the likely questioned costs.

EXAMPLE

The auditor uses a sample of 60 and identifies four questioned costs. The errors are 100% of the sampling unit and the sample is homogeneous. That is, the sampling unit is one invoice and it is deemed unallowable. The deviation rate is 6.6%. The population is $600,000. The auditor calculates 3.3% of $600,000, which is $39,600. The auditor would report the known questioned cost.

****

Approach 2: In this approach, the auditor projects the dollar value of the error to the population. This is appropriate when only a portion of the sampling unit is found to be incorrect.

EXAMPLE

The population is $600,000. The sample is $200,000 of the population. The auditor identifies known questioned costs in the sample of $7,500. She divides the known questioned costs ($7,500) by the sample ($200,000) and gets a 3.75% rate. She multiplies 3.75% times $600,000 and the likely questioned costs are $22,500. This amount does not exceed $25,000 so the amount is not required to be reported as a finding.

****

If the auditor identifies known questioned costs of $25,000 or more, they are reported as known questioned costs. If the questioned costs are less than $25,000, then the extrapolation discussed above occurs to perform the evaluation. However, the auditor still reports only the known questioned costs.

The auditor is not required to expand his/her test work to definitively determine the total questioned costs.

If exceptions are found and the likely questioned costs are close to the audit materiality level or is over $25,000, then the auditor may need to conduct additional tests. This is important where an area of the major program may have particular risk. Making additional sample selections would also help the auditor assess the effect of money that may need to be paid back to a federal agency and the effect on the financial statement opinion. However, the Audit Guide states that the auditor may decide just to report the exceptions as a finding and evaluate the effect that the sample results has on the assessed level of material noncompliance and the overall compliance opinion. The UG does not require the auditor to expand his/her sample in the case of exceptions.

Documentation

Documentation is very important in any audit. AU-C 230, *Audit Documentation*, provides general guidance on documentation, and the Audit Guide provides guidance on documenting samples and the evaluation of the results of testing. Poor documentation is the root cause of many deficiencies noted by peer reviewers, IGs and in the statistical sample of audits. As noted earlier, the peer reviewer is not permitted to accept oral explanations for procedures performed in the workpapers. Elements of documentation are also listed below. Note that the testing workpaper only needs to be included once if a dual purpose test is used. Documentation requirements were identified earlier in this section.

EXAMPLE

Following is an example compliance testing documentation, using the compliance requirement of eligibility for the Section 8 grant.

The control activities tested were:

- *Grants personnel verify eligibility. Criteria are listed on a worksheet and grants personnel completed the worksheet after performing the required verifications.*

- *Grants personnel have a list of reverifications that need to be performed monthly. This sheet is consulted the month before the 12-month period ends.*

The auditor selected 60 items for Control A based on the controls being very significant and inherent risk being higher. The population for Control B was smaller, only 75 redeterminations during the year. Inherent risk was lower and control was deemed very significant. The auditor performed a dual-purpose test by testing internal control and compliance for eligibility with the same sample selections. Based on results of testing, the sample for internal controls, control risk was assessed as high.

Documentation

Dual-Purpose Eligibility Internal Control (activity controls only) & Compliance Testing

Compliance Testing

Audit Objective: T*o ensure that only eligible persons receive housing, rent calculations where appropriate, and the waiting list is being properly used.*

Compliance requirements tested:

1. *Reexamined family income and composition at least once every 12 months and adjust the total rent payment and housing assistance payment, as necessary.*

2. *Verified the eligibility of applicants by: (a) obtaining signed applications that contain the information needed to determine eligibility (including designation as elderly, disabled, or homeless, if applicable), income, rent, and order of selection; (b) conducting verifications of family income and other pertinent information (such as assets, full time student and immigration status, and unusual medical expenses) through third parties; (c) documenting inspections and tenant certifications, as appropriate; and (d) determining that tenant income did not exceed the maximum limit set by HUD for the PHA's jurisdiction.*

3. *Determined the total tenant rent payment in accordance with 24 CFR Section 5.613.*

4. *Selected participants from the waiting list in accordance with the admission policies in its administrative plan and maintained documentation that shows that, at the time of admission, the family actually met the preference criteria that determined the family's place on the waiting list.*

Selection method for testing compliance by attributes: *haphazard.*

Population: *The number of applications approved or up for redetermination during the year was identified as the population. Cutoff testing was performed to ensure that the population was complete.*

- *There were greater than 250 redeterminations during the year (compliance element 4).*
- *There were only 75 approvals during the year (compliance elements 1-3).*

90%-95% Confidence Interval – 4% Tolerable Deviation Rate	
Expected Population Deviation Rate	***Sample Size***
0	***60***
1	*91*
2	*120*

Small Population Sample Size Table	
Frequency and Population Size	***Sample Size***
Quarterly (4)	*2*
Monthly (12)	*2-4*
Semi-monthly (24)	*3-8*
Weekly (52)	*5-9*

Although this table is for a small sample size, the compliance requirement tested is not suitable for this table since there is not a frequency associated with the element. Accordingly, the audit guide permits 10% of the population to be tested. Since the remaining risk of material noncompliance is high, we have elected to test 20 items (27% of the population) for approvals.

For redeterminations, we will use a sample size of 60 as noted above.

Results of Internal Control Testing & Compliance Testing:

Internal Control and Compliance Test Attributes

A. *Grants personnel have a list of re-verifications that need to be performed monthly. This sheet is consulted the month before the 12-month period ends. Personnel complete appropriate worksheet* ***(internal control attribute)****.*

B. *Reexamined family income and composition at least once every 12 months and adjusted the total rent payment and housing assistance payment, as necessary* ***(compliance attribute)****.*

	Individual/Family	***Month***	***A***	***B***
1	*E. Baum*	*2/1/09*	†	†
2	*E. Odeye*	*2/1/09*	†	†
3	*M. Trudgeon*	*3/1/09*	†	†
4	*G. Clark*	*4/1/09*	***x***	***x***

Selections 5-57 not shown.

58	*A. Sea*	*10/1/09*	†	†
59	*S. Curtis*	*11/1//09*	***x***	***x***
60	*J. Baker*	*12/1/09*	***x***	***x***
	Total Deviations		***3/60***	***3/60***

Tickmark Legend

† *Selected from sheet of redeterminations needed for month, redetermination correctly made.*

x *Improper redetermination made, compliance deviation.*

C. *Grants personnel verify eligibility. Criteria are listed on a worksheet and grants personnel completed the worksheet after performing the required verifications* ***(internal control attribute)****.*

D. *Verified the eligibility of applicants by: (a) obtaining signed applications that contain the information needed to determine eligibility (including designation as elderly, disabled, or homeless, if applicable), income, rent, and order of selection; (b) conducting verifications of family income and other pertinent information (such as assets, full-time student, immigration status, and unusual medical expenses) through third parties; (c) documenting inspections and tenant certifications, as appropriate; and (d) determining that tenant income did not exceed the maximum limit set by HUD for the PHA's jurisdiction* ***(compliance attribute)****.*

E. *Determined the total tenant rent payment in accordance with 24 CFR Section 5.613* ***(compliance attribute)****.*

F. *Selected participants from the waiting list in accordance with the admission policies in its administrative plan and examined documentation which shows that, at the time of admission, the family actually met the preference criteria that determined the family's place on the waiting list* ***(compliance attribute)****.*

	Individual/Family	***Date***	***C***	***D***	***E***	***F***
1	*G. Truman*	*1/13/09*	†	†	†	†
2	*F. Gonzales*	*1/28/09*	†	†	†	†
3	*Z. Frank*	*2/3/09*	∗	†	†	†
4	*J. Auralias*	*2/25/09*	∗	†	†	†
5	*B. Walker*	*3/16/09*	***x***	***x***	***x***	***x***

Selections 6–18 not shown.

19	*L. Oslo*	*12/10/09*	***x***	***x***	***x***	***x***
20	*S. Young*	*10/14/09*	∗	***x***	***x***	***x***
	Total exceptions		***2/10***	***3/60***	***3/60***	***3/60***

Tickmark Legend

† *Employee performed control.*

x *Employee failed to perform control.*

∗ *Selection not tested for control. Compliance sample was larger than control.*

Results of Compliance Tests:

Test	***Sample Size***	***Conclusion***
Compliance test	***Requirement B:*** *60 tested* *3 deviations (redeterminations)*	*5% deviation rate* ***Material noncompliance due to the fact that the original applications have 15% noncompliance. This is significant in that it supports the pattern of lack of care which appears to be the cause with the original applications***
	Requirements D-F: *60 tested* *3 deviations (original applicants)*	*5% deviation rate* ***Material noncompliance due to the fact that the original applications have 15% noncompliance***

******

Single Audit Assessment – Question 11

If the auditor tests 40 items in a dual-purpose test and finds several compliance findings, then:

A. Controls – not effective, sample size for compliance S/B larger

B. The auditor needs to report the deviation rate as is

C. The auditor should write up a control and compliance finding

D. Both A and C

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DEVIATIONS, WRITING FINDINGS & REPORTING

QUESTION 11:

Writing findings has become a little more challenging under the UG. There are several more items that must be included.

Can you summarize what needs to be reported under Government Auditing Standards and the Uniform Guidance and review the elements of a finding?

<u>ANSWER</u>:

The auditor reports deviations in the Schedule of Findings and Questioned Costs. This includes internal control and compliance findings under Government Auditing Standards (GAS) and internal control and compliance findings under the Uniform Guidance as discussed below.

GAS requires the following to be reported:

- Significant deficiencies (which includes material weaknesses) in the internal control over financial reporting.

- All but clearly inconsequential fraud and illegal acts that the auditor concludes either occurred or are likely to have occurred.

- Significant violations of provisions of contracts or grant agreements and abuse.

- The status of uncorrected material findings and recommendations from prior years that affect the financial statement audit.

The evaluation point for these findings is financial statement materiality – both from a quantitative and qualitative standpoint.

Section 200.516 of the Uniform Guidance requires the auditor to report the following:

- Significant deficiencies in the internal control over major programs and ***significant instances of abuse***. If a significant deficiency is deemed a material weakness, this should be identified. Note that the auditor's determination of whether a deficiency in internal control is a significant deficiency is based on its relation to a type of compliance requirement or an audit objective identified in the compliance supplement.

- Material noncompliance with provisions of federal statutes, regulations or the terms and conditions of federal awards. The auditor's determination of whether noncompliance is material is in relation to the type of compliance requirement or an audit objective identified in the compliance supplement.

- Known questioned costs that are greater than $25,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. The auditor reports known questioned costs when likely questioned costs are greater than $25,000 for a type of compliance requirement for a major program. The auditor is required to put this information into perspective.

- Known questioned costs that are greater than $25,000 for a federal program that is not audited as a major program. Except for audit follow-up, the auditor is not required (under this part) to perform audit procedures for such a federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a federal program which is not audited as a major program (for example as part of audit follow-up or other audit procedures) and the known questioned costs are greater than $25,000, then the auditor must report this as an audit finding. These are not extrapolated.

- Circumstances where the auditor's report on compliance for major programs is other than unmodified, if this has not already been reported in the schedule. An example where this might occur is a scope limitation.

- Known fraud affecting a federal award, unless this is already reported in the schedule of findings and questioned costs or if the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAS.

- Significant instances of abuse relating to major programs that are quantitatively or qualitatively material to a major program.

- Instances where the audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the client misrepresented the status of a prior audit finding.

If a finding relates to both the financial statements and federal awards, then it should be reported in both sections. However, it should be reported in detail in one section and referenced in the other.

Audit deficiencies frequently noted in agency and peer reviews follow:

- Audit findings were identified but not reported.

- All findings should include the required elements, as applicable, in order for the awarding agency to understand the issue. This includes condition, context, criteria, and effect or potential effect.

- There should be a questioned cost or an explanation of why there is no questioned cost for all findings related to the noncompliance of federal programs.

- There should be a corrective action plan for all findings (including deficiencies and noncompliance) that is reportable under Government Auditing Standards. Note that this also applies if there is a Yellow Book finding but no single audit was performed.

- Audit findings are not written in sufficient detail. They should be presented in such a way that the auditee has enough information to prepare a corrective action plan and government reviewers can form their ideas on the severity of the finding and whether it needs further follow-up.

Findings. More detail is required to be included in the auditor's findings as a result of the Uniform Guidance:

The UG states that audit findings should be presented in enough detail that the auditee has enough information to prepare a corrective action plan and government reviewers can form their ideas on the severity of the finding and whether it needs further follow-up. **Specific information** that must be included in a finding is as follows:

- Federal program name, CFDA title and number, federal award number and year, name of the federal agency and pass-through agency. Note that sometimes this information is not available. In those cases, the auditor would provide whatever information they have available to describe the federal award.

- **Criteria** – The criteria is what should be. This section could state the applicable law, regulation or provision of the contract and grant. If the finding relates to internal control, it could refer to the desired control state.

- **Condition** – The condition is a description of the situation, as it existed at the time. Note that even if the client corrects a situation during the period, it is still considered a finding if it occurred during the period.

- **Cause** – Root cause of the condition on which the finding is based.

- **Possible Asserted Effects** – The effects are the result of the deficiency. The effect could also be the difference between what is (the condition) and what should be (the criteria). These could be possible effects as well. This information should be sufficient to facilitate prompt, corrective action and provide a clear link to establish the impact or potential impact of the difference between the cause and criteria.

- **Perspective/Context** – The condition should be put into perspective; that is, there should be a description of the prevalence of the finding and/or questioned cost. This would include how many deficiencies were noted out of how many items selected and the dollar amount of both the deficiencies and the sample. Perspective should be qualitative as well, including whether the audit finding represents an isolated instance or a systemic problem. Where appropriate, instances identified should be related to the universe and the number of cases examined and be quantified in terms of dollar value. The auditor should report whether or not the sample was a statistically valid sample.

Practice Point: The guidance further says that the auditor should quantify the effects in terms of dollar value. The AICPA interprets this to mean for every compliance requirement. For example, although it is simple to extrapolate questioned costs found while testing allowable costs/activities allowed, it is not as easy to quantify the effects of eligibility findings. If an auditor sampled 40 individuals eligible for service out of a population of 400 and there was a deviation rate where someone receiving service was not eligible 4 times, the deviation rate would be 10%. If the costs of the program were $800,000 then it is possible that the dollar value of that deviation is $80,000. This would be very difficult to substantiate in fact. Since there is no known questioned cost to extrapolate it would be better to include this in the perspective section of the finding. That is where the discussion is found in the UG.

Practice Point: Findings cannot always be quantified. For example, an auditor might find that a pass-through entity is not monitoring the subrecipients as required. Although this is most likely material noncompliance, there is no monetary effect. It should be reported as a finding and the auditor should consider whether it is the result of a control deficiency that would be classified as a significant deficiency or material weakness.

- **Questioned Costs** – Identification of questioned costs and how they were computed. The known questioned costs must be identified by CFDA number.

- **Identification as to whether the finding was a repeat** of a finding in the immediately prior audit and if so, any applicable prior-year audit finding numbers.

- **Recommendations** – The auditor should recommend a way to prevent future occurrences.

- **Views of responsible officials of the auditee**. Note that this does not serve as the client's corrective action plan, which is a separate document.

Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up (20X1-001).

All single audit reports will be published online with safeguards for PII. Subrecipients are only required to submit reports to the FAC and not to the pass-through entity.

Single Audit Assessment – Question 12

Which of the following is NOT TRUE about findings?

A. ***The auditor reports significant deficiency and material weakness under GAS and the Uniform Guidance***

B. ***The auditor reports all instances of abuse***

C. ***Auditor reports fraud if material and has not been reported to authorities***

D. ***The audit reports instances of material noncompliance***

******

Single Audit Assessment – Question 13

Which of the following is NOT an element of a finding?

A. ***Cause***

B. ***Criteria***

C. ***Client's corrective action plan***

D. ***Questioned costs***

******

Single Audit Assessment – Question 14

Which of the following is NOT TRUE about writing findings? The auditor must:

A. ***Include the perspective (e.g., 5/60 instances)***

B. ***Extrapolate questioned costs to evaluate the effect of the finding on opinion***

C. ***Include whether or not the sample is statistically valid***

D. ***Try to quantify the impact of all findings***

E. ***None of the above***

The Auditor's Opinion

AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, states that when the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with the requirements, the auditor should express a qualified or adverse opinion on compliance in the report on compliance with requirements that could have a direct and material effect on each major program and on internal control over compliance. AU-C 935, *Compliance Audits*, provides additional guidance.

AU-C 935 states that the auditor must report on compliance for **each** major program. The auditor will express an unmodified, qualified, adverse or disclaimer of opinion. In addition, the auditor will prepare schedule of findings and questioned costs.

The unmodified opinion provides that the entity complied in ***all material respects with the types of requirements that could have direct and material effect to the major program.***

To determine the type of opinion, the auditor aggregates the findings applicable to the program as illustrated above and considers the following factors:

- Frequency of noncompliance with the direct and material compliance requirements identified in the audit.
- Nature of the noncompliance with the direct and material compliance requirements.
- Adequacy of the entity's system for monitoring compliance with the requirements and the possible effect of any noncompliance.
- Whether any identified noncompliance resulted in likely questioned costs that are material to the federal program.

The auditor will also need to assess the effect of questioned costs and other noncompliance on the audit of the financial statements as there could be contingent liabilities. Note that when there is material noncompliance, there is a high probability that there is also a material weakness or at least significant deficiency. It may be beneficial to use a tool to aggregate the findings and questioned costs for **each** major program.

The AICPA believes that when material noncompliance is identified in test work, the auditor should decide whether the discovered noncompliance is material, either individually or aggregated with other noncompliance in relation to the particular major program as a whole. If so, the auditor would express a qualified or an adverse opinion on the program.

Single Audit Assessment – Question 15

Which of the following is NOT true of reporting?

- ***A. Opinion is on each major program***
- ***B. The opinion is always modified when there is a finding***
- ***C. Documentation – critical when evaluating the auditor's opinion***
- ***D. The UG reports changed slightly but GAS reports did not change***

****

ANSWERS TO SINGLE AUDIT ASSESSMENT QUESTIONS

1. A
2. A
3. C
4. D
5. B
6. D
7. C
8. D
9. D
10. D
11. D
12. B
13. C
14. E
15. B

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SECTION THREE

NOT-FOR-PROFIT AUDITING ISSUES

CLARITY STANDARDS

QUESTION 1:

In 2014, the FASB issued an accounting pronouncement on an entity's ability to remain a going concern. At the time, the AICPA issued a technical practice aid to aid auditors in reconciling the current auditing standard with the FASB standard. SAS 132, an auditing standard, was issued in 2017 by the Auditing Standards Board to revise the current standard (SAS 126) to accommodate not only the new FASB standard but the GASB standard on going concern as well.

What are the important points that auditors need to know?

ANSWER:

The Auditing Standards Board (ASB) issued its Statement on Auditing Standards (SAS 132, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*) in February 2017. It supersedes SAS 126 and is effective for audits of financial statements for periods ending on or after December 15, 2017 and reviews of interim financial information for interim periods beginning after fiscal years ending on or after December 15, 2017. The AICPA undertook this project to consider the accounting provision of the FASB standard issued in 2014 (ASU 2014-15) as well as GASB 56. SAS 132 was written to be neutral regarding accounting frameworks.

The ASB retained most of the requirements of SAS 126. Following is a list of things that changed.

Auditor's Objectives and Related Conclusions

The standard clarifies that the auditor's objectives include separate determinations and conclusions related to the appropriateness of management's use of the going concern basis of accounting to prepare financial statements and whether a substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period for time.

Practice Point: The FASB requires management to evaluate conditions and events, considered in the aggregate, that raise substantial doubt about an entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued). The GASB requires financial statement preparers to evaluate whether there is substantial doubt about a governmental entity's ability to continue as a going concern for 12 months beyond the date of the financial statements. In addition, the GASB requires that if information is currently known to the governmental entity that may raise substantial doubt shortly thereafter (for example, within an additional three months), such information should also be considered. The SAS remains neutral on the time frame.

Financial support by third parties or the entity's owner – SAS 132 includes a new requirement related to financial support by third parties or the entity's owner/manager. When management's plans include financial support, the auditor must obtain evidence about the intent and ability of the parties to provide it. The SAS mentions that evidence related to intent may be obtained from management or confirming directly with a supporting party. If the owner/manager will provide the support, evidence may be in the form of a support letter or written representation.

Period beyond management's assessment – The auditor must ask management about conditions or events beyond the period of management's evaluation that might have an impact on the entity's ability to continue as a going concern. This is not intended to require management to extend the evaluation period but may affect other disclosure requirements or consideration about the fair presentation of the financial statements.

Emphasis paragraphs when substantial doubt is alleviated – The standard contains language that can be used when an auditor determines that it is necessary to highlight liquidity issues once he/she has concluded that substantial doubt has been alleviated by management's plans (also referred to as close call).

> ***Emphasis of Matter Regarding Going Concern***
>
> As discussed in Note X to the financial statements, the Agency has suffered recurring decreases in net assets and has violated restrictive covenants. Management's evaluation of the events and conditions and management's plans to mitigate these matters are also described in Note X. Our opinion is not modified with respect to this matter.

Interim financial information – The auditor is required to perform inquiries and consider the adequacy of disclosures to address the issue of substantial doubt about the entity's ability to continue as a going concern if:

- Conditions or events indicate that the substantial doubt existed at the date of the prior period financial statements even if the substantial doubt was alleviated by management's plans.
- In the course of performing review procedures on the current period interim financial information, the auditor becomes aware of conditions or events that might indicate the entity's inability to continue as a going concern.

The auditor may include an emphasis paragraph when management's disclosures are adequate.

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QUESTION 2:

One of my clients recently experienced a fraud. The woman who committed the fraud was with them for over 20 years. She created fictitious invoices and although they were approved by the CFO and a person on the board reviewed the support and was a second signer on checks, the fraud was not detected for 10 years. The entity knew that there was lack of segregation of duties. The woman initiated payment, processed the invoices, mailed the checks and reconciled the bank statements. But the organization was small and the board felt secure in that they reviewed all expenses. Analytically there were no anomalies; the woman did not significantly increase the amount she stole over that period. And when the board analyzed budget to actual, nothing was detected. Eventually a vendor who came to make a presentation and sat through the budget to actual discussion asked why the items cost so much and suggested that the organization go out for bid.

We mentioned lack of segregation of duties in a management letter at the beginning of our audit relationship with the organization but after seeing that management was not going to invest in more people, eventually stopped believing that the board's review of the invoices and budget to actual discussion was sufficient to detect a material fraud or error.

Unfortunately, the amount stolen per year was material and now we are being sued. Lack of segregation of duties is common in most of our small clients.

Is there anything we can do to protect ourselves as a firm?

ANSWER:

When participants around the country are asked what they believe is the most important internal control, the answer that is most frequently given is segregation of duties. And it is certainly one of the most important activity controls used to ensure that no one person has control over two or more phases of a transaction or operation. This important control reduces the opportunity to perpetrate and conceal errors or fraud in the normal course of employee's assigned functions.

But segregation of duties is costly to a small nonprofit. In the mind of the manager of a small not-for-profit organization, adding additional personnel in a support function takes away resources from program activities. It is important to remember that if assets are misappropriated, this situation may also take away from resources that can be devoted to programs. Moreover, a scandal in a not-for-profit that results from theft can also hurt the entity's fundraising ability.

In segregating duties, an entity may utilize people in and out of the accounting and financial reporting area, as well as people on the board of directors. Some not-for-profits use volunteers. This may be risky in that volunteers may not really know what to look for or may not use the same care in performing duties as employees would. In many instances the trust factor may cause board members not to challenge as much. And today anyone can make invoices that look just like the real thing.

One possible remedy to the lack of segregation of duties could be bonding employees. In addition, on the cash receipts side, a lockbox could be used for incoming payments. On the cash disbursements side, monitoring for unusual or unexpected vendors, scanning expenditures to ensure that they are reasonable for the entity and the use of positive pay are all very good controls.

Other controls that help to support the entity when they don't have sufficient resources to segregate duties very well are:

- Conflict of interest/codes of conduct – this only works if taken seriously by management and employees understand the policy

- Whistleblower policy and the use of some type of anonymous reporting mechanism such as a hotline or access to a board member, etc. This type of mechanism sends a message to employees that stealing is not only inappropriate, it's not tolerated. And the Association of Certified Fraud Examiners says that the way most frauds are caught is through a tip – either from an employee, vendor, customer or donor.

- Independent challenge of vendors to ensure they are bona fide and a periodic check of the value the entity is getting from their vendors.

These controls notwithstanding, management should segregate duties, to the best of their ability, given the personnel at hand.

One way for a firm to address this issue is to use a practice aid such as the one following to identify where the lack of segregation of duties lies. Once a lack of segregation of duties is identified it should be communicated in writing to the board. This may continue to occur but it is also a protection for the firm.

The other thing a firm can do is to ensure that the audit team has followed professional standards related to understanding the risk of fraud and ensure that the documentation relating to the entity and its environment has been updated and appropriate consideration has been given to internal controls.

Segregation of Duties Diagnostic
Fill in the names of the people who perform the following functions:
Expenses and Cash Disbursements

Initiating transaction	Cash handling	Bank reconciliation	Authorizing transactions	Posting transaction	Supervision and monitoring

Vendor Master File
Vendor Refunds
Wire Transfers and Other Electronic Payments

Authorizing transactions	Initiating transaction	Confirming transaction	Posting transaction	Bank reconciliation	Supervision and monitoring

Revenue and Cash Receipts: include information by revenue source

Initiating transaction - billing	Cash handling	Bank reconciliation	Access to cash for electronic transactions	Posting transactions	Supervision and monitoring

Payroll

Initiating transaction	Payroll master file	Authoriza-tions	Changes in pay rates, withholdings, benefits, etc.	Posting transactions	Supervision and monitoring including output of service provider

Initiation of Journal Entries

Approval of Journal Entries

QUESTION 3:

I have never understood what we were supposed to do to audit alternative investments. Right now all we do is get a confirmation.

How do you audit alternative investments? What is the level for them? What disclosures do you need?

ANSWER:

Alternative investments are securities where a readily determinable value does not exist. This means that they are not marketable securities. Therefore, since there are no readily determinable values, there is more audit risk. Auditors find them in their client's portfolios in the form of investment funds that are not typical mutual funds but are sponsored by a financial institution, investment firm or venture capital firm. These can be venture funds, real estate funds, private equity funds, hedge funds, funds of funds and some bank common and collective trust funds.

Alternative Investments – Existence

Existence is not generally the issue auditors find challenging with alternative investments. It is fairly easy to receive a confirmation from the investment fund manager. This covers existence but does not cover valuation. However, to take the value on the confirmation as it is without auditing it would be like taking the client's word that the investments are appropriately valued when they managed them in-house without testing it.

Alternative Investments – Valuation

Some alternative investments are measured at the practical expedient of net asset value per share (NAV). Many types of entities invest in these vehicles in order to increase the total return of their portfolios, but there is more risk. The appropriate valuation unit is the interest in the fund itself, but not the underlying investments in the fund. That is because the reporting entity owns an undivided interest in the funds and is not able to dispose of any of the individual assets in the fund.

The reporting entity (the client) is responsible for the valuation assertions in its financial statements; therefore, it is not appropriate for management to simply rely on the fund manager to provide information. Management should perform an independent valuation. This does not mean that they need to recalculate the NAV, but they should:

- Determine that the investee fund manager is competent by considering the professional reputation and standing of the fund manager and even its auditor

- Understand the process in place to calculate the NAV, including understanding the inputs

- Perform due diligence

- Perform ongoing monitoring

Management should evaluate the fund manager's estimation processes in hindsight and understand any changes in those processes; if necessary, use a third party valuation expert to assist in the valuation. This includes determining whether there have been significant adjustments to the NAV from prior periods.

One other issue to consider is that the investments may be listed in an investment confirmation from the custodian. However, they generally fall outside the SOC 1 report that the custodian has for its investment processing. This could mean that the values are not updated in the system until the client or external investment advisor notifies them. Auditors should be alert for this possibility.

Audit Implications

The auditor should test to ensure management has performed the necessary steps. If they have not, consider whether this is a significant deficiency or a material weakness in internal control. The auditor will need to perform the steps if management did not challenge the valuation assertion.

It is possible that the NAV may not be reported as of the measurement date. This could be due to late reporting by the fund given that their auditors may not have finished the audit, and the fund may not have the same year-end as the reporting entity; therefore, unaudited balances may need to be used. Even then, there is often a three-month lag just because it takes time for the fund to close down and report the quarter end numbers.

When the audited balances are not available, the auditor should obtain the most recent audit report and consider changes that may have occurred since year-end when evaluating the quarter end reported but unaudited balances.

EXAMPLE

A historical society used alternative investments to increase the return on its endowment assets. The auditor performed the following:

- *Obtained the statements from the fund managers (confirmed) to evidence existence. The statements showed the proportionate ownership in the funds*
- *Performed research on the fund managers and the quality of the fund auditors*
- *Evaluated the client's controls over evaluation of the funds in due diligence. The auditor learned that the chair of the investment committee had significant experience in investments and that the fund managers were contacted at least once a year to discuss the fund, the fund's return, the funds challenges and any other topics deemed necessary by the investment committee.*

- *The auditor read the minutes of the investment committee where the alternative investments and valuation were discussed finding them to be very thorough.*

- *The auditor discussed the next quarter with the fund manager since the audited statements were not as of the reporting entity's measurement (financial statement) date. This included reviewing a rollforward of activity and adjusting for activity since the last reported NAV.*

The rollforward of the NAV follows:

Last reported NAV	*X,XXX*
Add capital contributions/subscriptions	*XXX*
Subtract distributions/redemptions/withdrawals	*(XXX)*
Adjust for changes in valuation	*XXX*
NAV at the reporting entity's measurement date	*X,XXX*

****

Note that the changes in valuation refer to market fluctuations between the date of the reported NAV and the reporting entity's measurement date. There may be other economic conditions or other occurrences that will impact the valuation such as bankruptcy, going public, etc.

Disclosure

ASU 2015-07 is effective for years beginning December 15, 2016 for public entities and for years beginning after December 15, 2017 for all others. It may be implemented early. Until it is implemented, the auditor will also need to challenge the hierarchy level of alternative investments. When the practical expedient is used, the auditor would look to the ability of the entity to redeem the investment. If the period falls within 60 days, then the investment could be classified as Level II. If a longer redemption period is specified or there is no ability to redeem, then the investment would be classified as Level III.

If the investment is not reported using the practical expedient, the auditor would challenge the inputs and valuation techniques used. Some valuations are performed using the market approach and some using the income approach. It also may be necessary to obtain audited financial statements, talk with the investee company's management or involve a valuation specialist.

Don't forget that the inputs and valuation techniques must be disclosed. Use the NAV footnote format included in all of our client's statements. When there are Level III investments, it is important to talk about the process used by management and the board and to challenge the value of those Level III assets (liabilities).

ASU 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*

The purpose of this ASU is to eliminate diversity in practice for the fair value hierarchy level attributed to investments carried at net asset value (NAV) as a practical expedient to fair value.

When an investor holds units in a fund that combines various securities based on a certain investment objective, the units are valued by taking the total fair value of securities held and dividing by the number of units held, resulting in NAV. Not-for-profits see this in their alternative investments, typically hedge funds, funds of funds, etc.

ASC 820, *Fair Value*, includes a "practical expedient" that permits the use of NAV in place of fair value, but this option impacts the level in the fair value hierarchy.

NAV is actually a step removed from a Level 1 fair value because it combines Level 1 fair values (for the underlying investments) with the number of units assigned by a fund manager. As a result, if units are redeemable at their NAV at the measurement (financial statement) date, the NAV is treated as a Level 2 fair value. (This would be the case for units that can be redeemed any time.)

However, investments accounted for using NAVs often include restrictions on redemptions, such as hedge funds or real estate funds. The effects of restrictions are:

- If redemptions will *never* occur at NAV, the NAV is treated as a Level 3 fair value.
- If redemptions at NAV can occur at some point in the future, judgment is required to determine whether the NAV should be treated as a Level 2 or Level 3 fair value, based largely on how much time must pass before redemption. *This is where the diversity in practice occurs.*

The update helps to conform practice by stating that investments carried at NAV as a practical expedient will **no longer be assigned a fair value hierarchy level.**

As a result, the typical table breaking down assets and liabilities carried at fair value by hierarchy level will include line items for investments carried at NAV that are not assigned a level, so that the table ties into the Balance Sheet. (This example is abbreviated; asset classes would be broken down further into market sector, industry type, etc.)

EXAMPLE BEFORE ASU 2015-07

Asset Class	*Fair Value*	*Level 1*	*Level 2*	*Level 3*
U.S. equities	*$45,200*	*$39,000*	*$6,200*	--
International equities	*29,000*	*20,000*	*4,000*	*$5,000*
Mortgage-backed securities	*14,000*	--	*12,000*	*2,000*
Hedge fund investments measured at NAV	***12,000***	--	--	--
Total fair values	*$100,200*	*$59,000*	*$22,200*	*$7,000*

******

EXAMPLE AFTER ASU 2015-07

Asset Class	*Total*	*Level 1 Prices in Active Markets for Identical Assets*	*Level 2 Significant Observable Inputs*	*Level 3 Significant Unobservable Inputs*	*Investments Measured at NAV*
U.S. equities	*$45,200*	*$39,000*	*$6,200*	--	
International equities	*29,000*	*20,000*	*4,000*	*$5,000*	
Mortgage-backed securities	*14,000*	--	*12,000*	*2,000*	
Hedge fund investments measured at NAV	***12,000***	--	--	--	***12,000***
Total fair values	*$100,200*	*$59,000*	*$22,200*	*$7,000*	*$12,000*

******

In addition, a previous disclosure requirement describing *all* investments eligible for this practical expedient (whether used or not) is eliminated. Instead, relevant disclosures will only be required for investments where the NAV *is* used. These include a description of the nature, characteristics, and risks of these investments, as well as information explaining the restrictions on redemption, and whether the investments are likely to be sold at values different from NAV.

The following table illustrates how the redemption information might be presented. Note that this information stays the same after ASU 2015-07 is implemented.

EXAMPLE

	Fair Value	*Unfunded Commitments*	*Redemption Frequency (if Currently Eligible)*	*Redemption Notice Period*
Equity long/short hedge funds (a)	*$ 87,000*		*quarterly*	*30-60 days*
Event driven hedge funds (b)	*65,000*		*quarterly, annually*	*30-60 days*
Real estate funds (c)	*47,000*	*$10,000*		
Total	*$199,000*	*$10,000*		

Explanatory notes (a), (b), and (c) would describe the investment's nature, characteristics, risks, redemption restrictions, and valuation at NAV, as well as whether any future sale would be at amounts different from NAV.

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The ASU is effective for public entities for years beginning after December 15, 2015, including interim periods. There is a one-year delay for nonpublic entities. Implementation is retrospective, which means that assets measured at NAV will be removed from the hierarchy level disclosures for all years presented. Early adoption is permitted.

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SECTION FOUR

GOVERNANCE ISSUES IN NOT-FOR-PROFITS

Governance, risk assessment and a focus on how controls change as technology changes are three of the most important improvements in the 2013 COSO framework. Based on CohnReznick's 2015 Governance Survey Report,[1] a report focused on not-for-profit entities, 87% of the 470 entities who responded to the survey report that they have implemented key governance initiatives. However, approximately 40% do not feel very confident about their governance practices. Based on the findings in the report, it appears that only about one third of the entities responding had performed an enterprise risk assessment.

Not-for-profits are making shifts to the way they conduct their business. Approximately 38% implemented a new strategic plan, 25% hired a new CEO and 21% hired a new CFO. Approximately 25% are pursuing additional government funding. In terms of cutting expenses, approximately 39% either cut staff or froze salaries.

Some of the key governance initiatives conducted by not-for-profits were:

- Implementation of a social media policy (67%)
- Implementation of an information technology strategic plan (50%)
- Whistleblower complaint resolution process (77%)
- Whistleblower policy (84%)
- Record retention policy (90%)
- Gift acceptance policy (62%)
- Annual disclosure of conflicts of interest/written policy (92%)
- Disaster recovery plan (63%)

[1] https://www.cohnreznick.com/sites/default/files/pdfs/2015_GovernanceSurveyReport.pdf.

The COSO 2013 framework stresses the need to assess risk and in this changing environment it is even more important. However, only 30% of the respondents conducted an enterprise risk assessment. A risk assessment might yield valuable information about risks associated with information technology, record retention and cybersecurity risk as well as the risk associated with Baby Boomers leaving the workforce, generational issues in giving to not-for-profits and cutbacks in certain governmental funding.

Of the respondents, 19% were not concerned about cybersecurity risk, 57% put it among the top 10 risks and 24% put it in their top 3 risks. Nearly half the respondents reported that they thought that they would spend from 1%-10% more on data security in the coming year.

These responses may indicate that those charged with governance have given some thought to assessing risk although the assessment was not formal.

Of the respondents, 13 of them indicated that board turnover exceeded 25% in 2014. Even so, the number of respondents with 20 or more board members stayed at approximately 36% in the 2015 survey. The number with 15-20 board members decreased about 4% to 18%. The number with 10-15 members increased from 24% to 33%.

Almost 75% of boards have term limits, with three years being the most prevalent term.

In terms of committees:

- 64% have an audit committee
- 83% have an executive committee
- 86% have a finance committee
- 38% have an investment committee
- 51% have a development/advancement committee
- 55% have a nominating committee
- 7% have an information technology committee
- 4% have a risk committee

Audit committees meet infrequently with 32% meeting quarterly, 22% semiannually, and 19% annually. Only 12% meet monthly. Audit committees tend to have between 2-6 members and 82% have a financial expert.

Most boards require no annual contribution. 6% of respondent entities require between $1,000 to $2,500. Only about 2% of boards require a significant contribution of $10,000 to $25,000.

Not surprisingly, CohnReznick recommends that a dedicated board committee be formed to oversee risk management. Generally, this has been an audit committee function. A committee of the board should be charged with monitoring information technology. Where board members do not have this expertise, the board may have to hire a competent entity to fill that advisory role.

The not-for-profit should consider performing an enterprise risk assessment along with an assessment of cybersecurity policies and procedures. In addition, the board should assess how effective its governance is by comparing the current situation with state laws and best practices. Educational programs should be provided for the board with an emphasis currently on the latest developments in risk management and cybersecurity.

CohnReznick's findings are consistent with the best practices laid out in the AICPA's not-for-profit toolkit for audit committees. It states that the audit committee should:

- Take responsibility for oversight and response to risk management activities
- Periodically reassess top risks
- Determine who in management is responsible for each risk

VOLUNTEERISM

Salaries and wages along with other personnel costs like health insurance have continued to rise. One way to minimize the impact is to have an effective volunteer program. Studies show that Baby Boomers and Generation Y (millennials) are eager to volunteer if they believe that they are adding value.

In the face of this need, it is sad to note that the U.S. Department of Labor's Current Population Survey and American Time Use Survey reported that the number of volunteers and volunteer hours has decreased. An estimated 62.8 million adults volunteered at least once in 2014 representing 25.3% of the population, the number is down from 28.8% when the U.S. Department of Labor began keeping statistics in 2002. It also represents a small decline from 2013 when the number of adults volunteering was 25.4%. Although statistically insignificant, the decline is indicative of a negative trend that continues. However, the number of hours volunteered are increasing. Volunteer hours in 2014 were 8.7 billion compared with 8.3 billion in 2013. The number of volunteer hours per volunteer was 139 in 2014 up from 132 in 2014. Volunteer hours are critical to not-for-profit organizations. The Urban Institute projects the total amount of volunteer time to be $179.2 billion.

The sectors where volunteers spent their time follows:

Social service and care	23.8%
Administrative and support	23.5%
Other	17.8%
Travel	11.5%
Meetings and conferences	12.9%
Performing and cultural activities	6.7%
Maintenance, building and clean up	3.2%
Public health and safety	0.4%
Waiting	0.1%

Volunteer time and effort saves not-for-profits billions of dollars. The time that volunteers spent working with not-for-profits is estimated at $179.2 billion. Combined with the fact that volunteers typically give, the full impact was $537.6 billion. The publication presents a chart that shows how these estimates were derived. The wage amount estimated per volunteer hour was $20.59 in 2014.

TRENDS IN GIVING

Generational differences are making themselves felt whether we acknowledge it or not. And the not-for-profit organizations that embrace these differences can find themselves in a better position than those that do not. Where it is true that the Silent Generation (Silents) and the Baby Boomers (Boomers) will continue to be with us for a while, those not-for-profits that begin to be responsive to Generation X and Generation Y (millennials) will be prepared when they become the majority of donors. The following table presents pertinent generational information on giving.[2]

Characteristic	Generation Y	Generation X	Boomers	Silent Generation
Born	1981-1995	1965-1980	1946-1964	1945 and earlier
Age now	18-32	33-48	49-67	68+
% total giving	11%	20%	43%	26%
% that give	60%	59%	72%	88%
Average annual gift	$481	$732	$1,212	$1,367
Number of charities supported	3.3	3.9	4.5	6.2

These trends will not change dramatically over the next few years because the youngest of the Baby Boomers are in their early 50s. Younger donors interviewed for the study are more likely to say that they plan to give more in the coming year where the silent generation is giving less. But overall, since silent give much more than either Generation X or Y, the giving is likely to remain constant.

Generation Y tends to be more multicultural, more internationalist in outlook, more socially tolerant than other cohorts. They have grown up in an era of economic, political and social uncertainty. This causes them to make more demands on not-for-profits and other institutions for transparency, accountability and fairness. These views affect their charitable giving.

[2] https://www.blackbaud.com/nonprofit-resources/generational-giving-report.

Here are some other items of note:

- Generation Y is less likely to support local social services
- Younger donors (X and Y) are more likely to donate to children's charities
- Older donors (Boomers and Silent) are more likely to donate to veteran's causes
- Generation Y is more likely to donate to environmental causes
- Younger donors (X and Y) are more likely to say they support human rights and international development

Not-for-profits count on support in the form of donations, volunteering, advocacy, word-of-mouth endorsement and fundraising for their causes. Based on the study, it appears the Silents (48%) and Boomers (45%) believe that support in the form of donations is the most important. The focus on other forms of support increases with age. Generation X (36%) and Generation Y (25%) feel this way.

On the other hand, 30% of Generation Y believe volunteering make the most difference to a not-for-profit, followed by spreading the word about it (18%). It is interesting because Generation Y members are less likely than the Silent Generation to actually volunteer.

Younger people want to be able to see how their donations are making a difference. Almost 60% of Generation Y and 50% of Generation X believe this is very important, as opposed to approximately 33% of Silents and 37% of Boomers. This has significance in messaging and other implications. Not-for-profits would do well to take more care in providing information about service efforts and accomplishments. Older people are more concerned with the charity's reputation and respond to the emotional appeal.

Most donors do not believe that premiums such as coffee mugs, tee shirts or other items that not-for-profits provide to say thank you are important.

Direct Mail

Direct marketers used to be able to tie donations to fundraising pieces sent by mail. It now appears that donors may pay attention to the mailing but decide to give via the internet.

According to the survey, younger donors (Gen Y and Gen X) believe that direct mail is acceptable, but they are not giving through that medium. The first reason cited was that direct mail is easy to ignore; therefore, the younger donors do not find it to be intrusive. It may also be that since those cohorts are younger, they do not receive much direct mail. Target Analytics Index of National Fundraising performance reported that a significant percentage of Silents gave a donation in response to a direct mail appeal (52%) as opposed to Generation Y (10%) or Generation X (22%). 22% of Boomers gave in response to a direct mail appeal.

Engagement Channels

Engagement channels may not be transaction channels but both play a role in obtaining donations. Studies of Facebook and Twitter users suggest a large percentage of individuals are committed to causes. Some other findings from the study:

- More members of Generation X and Generation Y report giving online than through the mail. What may also be surprising is that 42% of Boomers and Silents now do too. This is a change for Boomers and Silents who in 2010 gave predominantly by mail.

- Only 6% and 7% of Generation Y and Generation X, respectively, respond to telemarketing, where 19% of the Silents do.

The following table illustrates the way respondents donated (2012 and 2013):

Giving Channel/Method	% Used Channel	Most Used by Cohort
Checkout donations	50%	Boomers
Purchase of Proceeds	40%	Gen X
Online donation	39%	Gen Y
Pledge	35%	Gen X/Boomer
Mailed Check/Credit Card	32%	Silent
Honor/Tribute Gift	32%	Boomer/Silent
Street Canvassing	25%	Gen X
Third Party Vendor	21%	Gen Y
Email	15%	Silent
Phone	11%	Silent
Door to Door	8%	Gen X/Silent
Mobile Text	8%	Gen Y
Social Networking Site	6%	Gen X
Online Ad	6%	Gen Y
Planned giving/will	5%	Gen X
Radio/TV	5%	Silent
Stocks, Bonds Property	2%	Gen Y

According to the Blackbaud Charitable Giving Report,[3] online giving increased 8.9% in 2014 as more donors use mobile devices and the Internet to make donations, but online contributions still account for less than 10% of all charitable giving. While small organizations had the greatest increase in overall fundraising, higher education institutions had the greatest increase in online giving in 2014.

Following is a chart depicting the percentage of each of the cohorts that gave online through the organization's website.

Cohort	2013	2010	Give by Mobile Device?
Gen Y	47%	29%	62%
Gen X	40%	35%	47%
Boomers	42%	31%	20%
Silents	27%	25%	11%

[3] https://www.blackbaudhq.com/corpmar/cgr/how-nonprofit-fundraising-performed-in-2014.pdf.

Dealing with Reputational Risk

The reputational risk management area (an important area to watch) is monitoring the level of functional expenses and the methodology. According to the Grant Thornton Board Governance survey, only 56% of the entities surveyed reviewed their methodology. Charity Navigator and others carefully evaluate functional expense allocations. Those with higher program ratios are more competitive when looking for funding. Although there are no clear guidelines for the "right" percentage, Charity Navigator[4] would like to see between 0% and 15% spent on administrative expenses and 0% to 10% spent on fundraising. These are the percentages for most not-for-profits. Charity Navigator assigns scores from 1-10, but the percentage levels change depending on whether the entity is a general not-for-profit, a fundraising entity, a community foundation, a museum or a food bank.

Other elements that help to mitigate reputational risk are:

- Board independence
- Conflict of interest policies and surveys
- Form 990 approval
- Internal audit function (although only 39% of entities responding to the survey had them)

The questions in this section address the following aspects of governance:

- Board roles and responsibilities and recent statistics on board size, composition, committee structure, etc.
- Assessing risk
- Board self-assessment
- Evaluation of record retention policies
- Give/get policies

[4] http://www.charitynavigator.org.

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BOARD ROLES AND RESPONSIBILITIES AND BOARD STATISTICS

QUESTION 1:

Accounting literature uses the term “those charged with governance.”

What does governance really mean? I work with a not-for-profit where the board assumes management responsibilities. Does this make a difference?

ANSWER:

Governance is defined by the Certified Institute of Management Accountants and the Institute of Financial Accountants in the publication *Enterprise Governance: Getting the Balance Right* (2004) as a "set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organization's resources are used responsibly."

Governance is a shared responsibility between management and the board. However, the board's role is to set strategy and parameters for the organization and delegate the responsibility for execution to the chief executive. When board members become those that carry out the day to day activities of the organization, it is difficult for them to step back and perform the monitoring activities. If the board becomes management or performs those functions, then where are the checks and balances?

When the division of responsibility is not possible due to size, then it falls to the chair of the board to oversee those that are performing management functions. The principle is the same.

Governance can be effective even when this occurs. And there is no "one size fits all" for not-for-profit organizations.

QUESTION 2:

I am a new board member and after watching what goes on in the meetings, it is apparent that the executive director reports to the board on activities that have occurred or are about to occur. Sometimes she discusses her plans for the organization. Generally the board congratulates her on her accomplishments and tries to offer suggestions. I thought that the board was supposed set the strategy.

How does the role of the board differ from the role of management?

<u>ANSWER</u>:

What you describe happens because the members of the board are often unaware of the board's function. Many times they are well meaning people who care about the mission but have never been provided any board education.

The board's role is to lead the organization and support the chief executive as he/she carries out the board's directives. It also:

- Assumes responsibility for the organization's compliance with laws and regulations and with provisions of funding source agreements
- Sets strategic objectives to be accomplished
- Creates policies to guide the implementation of activities designed to assist the organization in meeting its strategic objectives
- Serves as content matter experts and a sounding board for the chief executive
- Hires the chief executive and monitors his/her progress towards meeting strategic objectives
- Sets its own governance processes and assess its performance in meeting its objectives

The board delegates to the chief executive but the directives must be clear or it will be hard to hold him/her accountable for results. John Carver's policy model calls for the board to delegate the objectives or goals to the chief executive. This is referred to in his model as the "ends." The chief executive delegates to other management personnel who are charged with execution. This is referred to in his model as the "means." Parameters are set and the board monitors the results against the objectives or goals on a predetermined schedule. If the organization is not meeting its objectives, then the monitoring becomes more frequent until the issue is corrected. This may or may not be controllable by the chief executive.

EXAMPLE

The board of a not-for-profit social service organization wanted to grow in its market. The board established two goals (1) to raise 20% more in contributions than the previous year and (2) to decrease the variable cost of providing service by 10% so that more people could be served. These goals were important, so progress was to be evaluated once a quarter. The Executive Director met with the rest of the executive team to discuss what changes could be implemented to achieve the goal. After the brainstorming session, the development director and the director of operations went back to their staff to discuss the changes that would be necessary and developed a plan to implement them.

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Other issues can arise when board members feel that they should be involved in day to day issues.

EXAMPLE

The board of a small independent school and the head of school (chief executive) did not agree on the level of board involvement. One of the members of the board was a human resources executive of a large company and thought it would be a good idea if the board was involved in hiring new teachers for the school. A board consultant was called in to assess the situation and told the board that its responsibility was to delegate within parameters to the head of school who would execute strategic directives. If the strategy was to hire only teachers that met a certain level of qualification (degrees, certificates, experience) then meeting that goal should be delegated to the head of school. If the goal was not met then the board should discuss corrective action with the head of school.

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A highly effective board is one that is aware of its roles and responsibilities and board training is an important part of helping the members to be effective.

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QUESTION 3:

I heard that as a board member I have a fiduciary responsibility for the organization. It sounds like a legal responsibility.

Can I get sued?

ANSWER:

A **fiduciary** is one to whom property or power is entrusted for the benefit of another. The other in this case is the public. A not-for-profit organization is not owned by any person or company. The only exception would be when it is controlled by another not-for-profit.

Although you could get sued and there would be defense costs, it is less likely that you would be found guilty unless gross negligence was involved. It is always wise, however, to ask if the not-for-profit carries director's and officer's (D&O) liability insurance. This is an important protection for board members.

Legal Responsibilities of the Board

Nonprofits serve the public and, as a result of their tax-exempt status, derive a benefit by relief from taxes or the ability to issue tax-exempt debt. In addition, many not-for-profits receive support in the form of grants from federal, state and local governments and foundations. Other support comes from corporate and individual donors. So regardless of the type of activities conducted by the not-for-profit, the public benefit is there. Those exercising the governance function are designated by law to protect the organization by assuming overall responsibility and liability for it. The legal responsibilities of the members of the governing board are often referred to as the Duty of Care, Duty of Loyalty and the Duty of Obedience.[5]

The Duty of Care instructs the board to conduct the affairs of the not-for-profit in the way that a prudent person would.

The Duty of Loyalty instructs the board to be loyal in its dealings with the not-for-profit and to put the organization's needs above their own. The board should not have any conflicts of interest and the members should keep all the information they learn about the organization or its stakeholders and constituents confidential and not use it for private gain.

The Duty of Obedience instructs the board that it should be faithful to the mission of the organization. This means that the actions taken by the board should support the mission, and this extends to the purposes identified by donors for which their restricted contributions are to be used.

[5] Bruce R. Hopkins, Legal Responsibilities of Nonprofit Boards (BoardSource 2003).

In October 2007 the Panel on the Nonprofit Sector published a paper entitled "Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations." The paper identifies 33 principles of good governance recommended by the Panel. The spirit of the principles codified in the requirements of the Sarbanes-Oxley Act (2002) was assumed to apply to not-for-profits even though most of the provisions of the law did not. The Panel on the Nonprofit Sector was created in 2004 to try to find ways to strengthen governance, transparency and ethical standards.

Of the 33 principles outlined in the paper, only six of them are legally required:

1. Must have a governing body responsible for reviewing and approving the organization's mission, strategic direction, annual budget, key financial transactions, compensation practices, policies and fiscal and governance policies

2. Must abide by federal, state and if applicable, international laws and regulations

3. Must maintain complete, current and accurate financial records

4. Must institute policies and procedures to ensure the appropriate investment and management of institutional funds

5. Must use contributions for purposes consistent with donor intent

6. Must provide donors with acknowledgements of donations consistent with IRS requirements

The board has the responsibility for ensuring that these duties and responsibilities are met by setting the appropriate tone for their organization, periodically assessing risk and monitoring the chief executive.

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QUESTION 4:

I work almost exclusively with not-for-profit clients. One of them has 38 board members and some of them have been on the board over 10 years. At the other end of the spectrum, I have some clients that have a very hard time getting people with accounting and other business skills to join the board. One of them only has six members.

Is there any rule of thumb about how many board members a not-for-profit should have and how long the terms should be? What is an ideal mix of characteristics and skills for the board?

ANSWER:

There is wide diversity in not-for-profit organizations. Some are required by their by-laws to have members that meet a prescribed formula. For example, some organizations are required to have at least one board member from each district and sometimes the number of districts can be quite large. There are others that have no requirements or very loose requirements in their by-laws. As a result the board may have grown over time to an unwieldy number with some board members having served 10 or more years. In some cases the board may grow large because when people donate significant amounts, many expect a seat on the board. And as you point out, there are other organizations that struggle to get board members because they are small and not well funded. This can cause potential board members to shy away from them.

Board members should have a good mix of people with different skills. Diversity in terms of age, sex, race and background is important to try to bring different points of view to the table. **Other characteristics** that are important for board members are:

- Leadership skills
- Systems thinking
- Professional business achievement
- Specialized skills (accounting, law, information technology, knowledge related to program needs)
- Reputation
- Mix of gender, age, race, nationality, especially relevant to constituents served
- Willingness to serve
- Time to serve
- Influence and ability to fundraise

If a board is too large, it is unwieldy and often people do not feel engaged. Therefore, the participation is not there. It is important to have the right mix of skills as well as diversity so that there is less chance of “group think” getting in the way of good decision making.

BOARD'S ROLE IN ASSESSING RISK

<u>QUESTION 5</u>:

I have a client that is a trade association. The economy has been difficult for similar associations around the country and the board is concerned that the organization may be losing its relevance. About 20% of the membership has not renewed for the coming year. And although it is in a better financial position than many similar associations, the board is seeing lower attendance in professional education events. Since these are its two major sources of revenue, I am also concerned.

How can I help the Association through this uncertain period?

ANSWER:

It is always good for an organization to be forward thinking. However, it is also true that addressing symptoms such as lack of membership renewal and declining attendance at educational events may be shortsighted without a more methodical approach to try to understand the root cause.

John Carver, a noted author on leadership and board governance, developed a model based on the concept of servant leadership. His premise is that the board cannot lead until it is a servant. And this means that the board needs to understand its constituents, in this case, the members, and determine their needs. A needs assessment or membership survey along with understanding the external environment and the organization's internal capabilities and constraints is very important. Demographics, trends, technological developments, changes in laws and regulations and member preferences all play a significant role in strategy development.

It is the board's responsibility to evaluate risks to the organization and to use this information to guide the development of and changes to the strategic plan. Otherwise, the strategic direction may not accomplish the objectives that the board had in mind. All organizations experience change and the uncertainty that is inherent in any business is its risk. It is a by-product of the environment in which the organization does business. Some risks are global risks that affect all industries. Some risks are particular to an industry, such as higher education, healthcare or others. And some risks are inherent in the programs and services provided by the organization such as working with children, shifting demographics or consumer preferences. Risks can also be turned into opportunities if the response is targeted and focused.

The board's role is to:

- Identify the possibility of risk
- Understand the likelihood that the risk could occur and the magnitude of effect it would have on the organization (both quantitative and qualitative)
- Plan for a response to the risk in advance
- Evaluate and implement mechanisms to mitigate risk as necessary

A wise board will determine the portfolio of risks to the organization in several domains:

- Physical assets such as the property and equipment
- Financial assets such as investments, receivables (and also liabilities such as debt – interest rate risk)
- Viability and sustainability of funding sources such as donors, grantors, program participants
- Risk arising from employees, continuity of personnel, joint venture partners, affiliates and volunteers
- Organizational assets such as reputation, strategy, knowledge (databases), processes and systems
- Risks inherent in various programs the organization offers

Accumulating the Information to Perform the Assessment

A useful way to begin is to accumulate risks in the above domains either using a top down or a bottom up approach. With a top down approach, management identifies the risks and then asks the staff to provide input on them. With a bottom up approach the staff identifies risks and brings them to management for evaluation. Depending on the size and complexity of the organization, management and staff may bring their ideas to a meeting designed to evaluate risks. There are pros and cons to each method. If the organization is too large, input from numerous people slows the process down and can become unwieldy. With only management involved, important risks could be missed. A collaborative approach can ensure a better product.

The board is the ultimate strategy setter, so after the legwork is performed, it is important for them to understand the risks as presented by the staff, discuss them to get all sides of the issue and then prioritize them. The discussion is a key part of the risk assessment. A person who works primarily in finance will tend to evaluate those risks as the highest and those who do not have as deep an understanding may discount them if not properly explained. The same is true with program personnel.

EXAMPLE

A trade association wanted to perform a risk assessment. The association had several programs:

- *Lobbying on behalf of the members for favorable legislation*
- *Continuing education for members*
- *Programs to bring new people into the profession*
- *New information technology which it just implemented to create a better web presence and to help members manage their continuing education*
- *Continuing education on college campuses*

It also wanted to evaluate its other assets over the domains listed above:

- *Physical assets (outdated facilities)*
- *Information technology (new registration system has just been implemented)*
- *Investments*
- *Viability and sustainability of membership*
- *Risk arising from acts of employees and volunteers*
- *Continuity of key personnel and succession planning for executives and management*
- *Organizational assets (reputation, databases)*

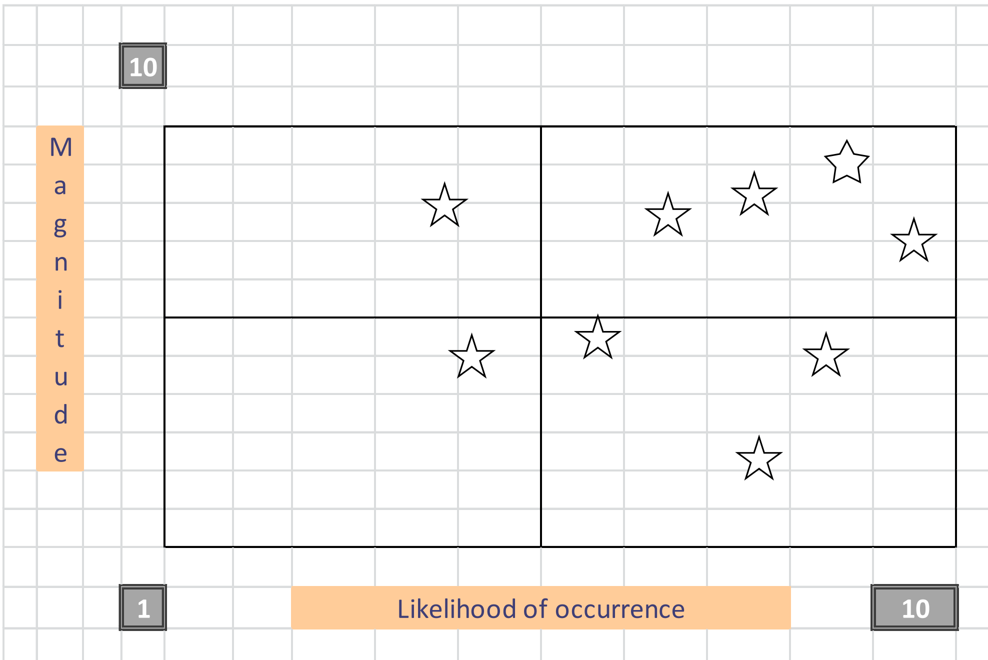
The executive director and chief operating officer asked the managerial personnel who headed the programs, information technology and finance to prepare a list of where the organization is currently headed in terms of trends, and also to make a list of the top 5-10 risks that they saw to the organization. The entire team met for a facilitated session and discussed the risks. Each was presented by the person who raised the risk and there was time for questions and discussion. Some were taken off the table because the likelihood of them happening given the controls and environment was not high or because the magnitude of effect on the Association would not be large.

The remaining risks were evaluated and prioritized so that only the top 15-20 out of the approximately 50 raised would be brought to the board for discussion. In addition, a member survey was completed and the results shared so that the board would have additional information related to risk.

Assessment of Risk, Prioritization and Action Plans

The board session took place on a weekend and was productive in that all of the board was engaged in areas they had never previously considered. They prioritized the risks in terms of likelihood and magnitude and presented them on a 4X4 matrix.

Results of the Risk Assessment



To do this each person evaluated the likelihood of occurrence on a scale from 1-10 with 10 being the most likely. And they evaluated the magnitude of the occurrence on a scale of 1 to 10 with 10 being the highest impact. The magnitude of the impact is directional and represented their assessment of both qualitative and quantitative factors.

The stars in the graphic above represent the assessment of the board members collectively. The ones in the upper right hand quadrant are those that would take top priority.

The risks that were deemed highest priority follow:

1. *Younger members of the Association want to be engaged electronically and value community service. They want to have educational and career information available to them when they need it. This is a higher priority to them than the ability to obtain continuing education programs at a reduced rate which was historically one of the main reasons to join the Association. Since continuing education is the Association's top priority, these younger people may not see its relevance. The move to information when you need it "now" will require significant investment in people and technology.* ***(9 likelihood, 7 magnitude)***

2. *The profession is experiencing an unprecedented wave of new professional literature, making it difficult for the members to remain current in all of the fields in which they practice. It is difficult to adhere to all of the standards at the rates that clients are willing to pay for the service and often problems with service quality result. This is causing difficulties for the Association since its reputation is, in many ways, based on the reputation of its members.* ***(8 likelihood, 6 magnitude)***

3. *The evolving delivery methods for continuing education will continue to change, perhaps making their current products obsolete.* ***(9 likelihood, 9 magnitude)***

4. *Demographic studies show that the number of older members in the Association will increase as the population ages and people who might have retired at 65 in the past are working longer. This could cause an increasing diversity in what members want. And the Association, with its limited resources, must find a way to stay relevant to both the younger members and the older members.* ***(8 likelihood, 8 magnitude)***

The Association board voted to place priority on the four issues identified above as the highest risk and develop action plans to address them. Other items that were less urgent in priority but still important to consider were:

- *Succession planning for executive management*
- *Needed investment in facilities*
- *Rising healthcare costs for employees and need to balance benefits with retention needs*
- *Disaster recovery planning is not adequate*
- *Lack of diversity in revenue sources*

This information was useful in updating the Association's strategic plan.

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QUESTION 6:

I am the chair of the board of directors of a charitable organization. We have just learned that the national office has set down new rules for affiliation so that affiliates that do not meet the new financial and service requirements will either be acquired by stronger affiliates or will be asked to disaffiliate from the organization. In order to remain an affiliate, our organization will need to improve. I worry, though, about the level of board commitment. Some of the members are involved but many of them are not. It wasn't always like this. There was a time when most of the members were very engaged.

How can I re-energize the board?

ANSWER:

Growth is difficult even when the board is committed and active. It is practically impossible when the board is not. There are many reasons why this happens. Board members that have served for many years could be burned out. This is one good reason for creating and then enforcing term limits and recruiting new members with fresh ideas to the board. Succession planning is a board responsibility.

It is also possible that the members are unsure of their role or do not feel as if they have a meaningful role to play. New board members should participate in an on-boarding process that provides them with the basic knowledge that they need in order to carry out their responsibilities. The orientation should clearly outline the board's expectations of members. It is the chair's responsibility to ensure that new members are assimilated into the group. Some people have a harder time entering a new situation than others and the chair should assist or assign someone to help them.

Often management does the work of the board and the board reacts to management's input, therefore appearing to be a rubber stamp on management's strategy and action plans. This can make board members feel like they are not making a contribution.

One way to determine the root cause is to have the members perform a board self-assessment. This tool can be very helpful in not only assessing board performance but in beginning the dialog on how things could be done differently so that the board assumes the role it was meant to perform and members feel that their contributions are valued. After the initial assessment, some boards assess their progress each year. And while this is a good practice, others will perform the assessment every two to three years.

EXAMPLE

The board of a charitable organization wanted to perform a self-assessment. There were 15 members on the board. The chair was concerned that people would not give honest feedback if the surveys were not anonymous. She decided to use survey monkey to be able to provide the assurance to the members that they could register their opinions freely.

The survey was constructed so that it asked 25 questions in two categories:

- *Composition and logistics of the board*
- *Board responsibilities*

The following Self-Assessment Questionnaire was adapted from the book The Best of Boards: Sound Governance and Leadership for Nonprofit Organizations.

Sample Board Self-Assessment Document

Purpose:	*To assist the board in evaluating its performance during the year. Evaluate your perception of the board's performance by selecting 1-5 as follows:* *1. Board does not perform well in the area* *2. Board is inconsistent in its performance* *3. Board does an acceptable job in this area* *4. Board does a good job in this area* *5. Board does an exceptional job in this area*

Category 1: Composition					
	1	***2***	***3***	***4***	***5***
Board has an appropriate number of members to perform the work of the organization but is not too large so that people all feel like they can make a contribution.					
The board has sufficient diversity in its members and it matches, or closely matches the demographic makeup of its constituents it serves.					
Board has the right skills and sufficient skilled members on it to facilitate good governance.					
Board has sufficient independent members (recommendation 2/3).					
Board is able to answer "yes" to 990 governance questions.					
Board performs its monitoring activities (financial, program, regulatory compliance) on a timely basis. Sufficient care is taken to perform them at a high level.					
Meetings are productive and members contribute and challenge the issues discussed.					
Board agenda and package is sent sufficiently in advance so members can prepare for the meeting.					
Board package contains the right amount of information at the right level of detail.					
There is an atmosphere of trust and cohesiveness among the board members.					

Category 2: Board Responsibilities					
	1	***2***	***3***	***4***	***5***
Board members set the tone for the organization as it relates to integrity and ethical values. It demonstrates moral courage by considering the ethical ramifications of each decision.					
Board members act as servants to the constituents they serve. They conduct community needs assessments to build awareness for the mission of the organization and solicit input.					
Board understands the potential areas of risk and considers plans to mitigate them.					
Board shows concern for the organization's internal control structure and periodically assesses the risk of fraud in the organization.					
Board understands its obligations as it relates to the duties of care, loyalty and obedience as well as its other legal responsibilities.					
Board views itself as accountable to the community and regulatory bodies for the actions of the organization.					
Board annually reviews the performance and compensation of the chief executive. Compensation is approved by the board and appropriate documentation maintained.					
Monitoring of compliance with laws and regulations is performed periodically.					
Board annually approves the budget for the year and sets effective parameters for the chief executive to follow relating to revenue, expenditures, investments and other important financial aspects of the organization.					
Board annually reviews Form 990.					
Board annually reviews its financial statements.					
Board meets at least annually with the independent auditors.					
Board adopts and then annually reviews the strategic plan.					
Board chair ensures that individual directors are evaluated, by each other or by the board chair.					
Board chair ensures that conflict of interest statements are signed.					
Board monitors its own performance by completing and discussing the results of the self-assessment.					
Board members all contribute to the organization as set forth in the orientation materials. This includes financial contribution, and attendance and participation at meetings and committee service.					

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QUESTION 7:

This year a tornado struck the building of one of my independent school clients. Although the school had its electronic information backed up, some of the other records were in paper form in a fireproof cabinet. The hardest part for this client was that although the records were probably not damaged, the building was condemned and the organization was not permitted to retrieve the cabinet. All of those records were lost. This made me think not only about electronic records but also about record retention in general. As the client rebuilds its files, I would like to help management put policies in place about record retention and destruction.

But where do I find this information?

<u>ANSWER</u>:

The purpose of a document retention/destruction policy is to provide management and others in the organization with a document that can be followed consistently. This document would contain provisions for managing, retaining, storing and disposing of documents no matter where they are stored. As required by the Sarbanes-Oxley Act of 2002, any documents that are relevant to a legal action or government investigation should be retained. So this policy would also address what to do in the event of reasonably foreseeable or contemplated legal action or government investigation, such as a lawsuit or IRS audit.

A document retention/destruction policy is helpful because it can provide guidance on when to destroy documents that are no longer needed to avoid storage costs (electronic or otherwise). It is important to remember that the organization will need to take extra care when destroying certain documents due to their confidential nature.

Another important facet of the policy is access. This includes not only limiting access electronically and otherwise by means of locked cabinets, but also taking due care that important information such as credit card numbers of parents, donors, etc., are secured. All too often this information is not properly secured by employees, making identity theft a real possibility.

It is helpful to have one person take the role of record coordinator. In some institutions it may take more than one. This person would be responsible for ensuring compliance with the policy, training employees on the record retention policy and conducting annual record reviews.

Following are steps that could be used to implement a record retention system:

1. Identify the documents that are routinely created both electronically and on paper. Depending on the organization, this accumulation may need to be assigned to department heads.

2. Determine from information technology personnel who currently have access, how the documents are preserved (back-up and recovery), how long they are retained and the cost involved.

3. Determine the statute of limitations for various records for the state in which the entity operates. An attorney may need to be consulted.

4. Discuss record retention with the independent auditor or internal auditor

5. Appoint record retention coordinator(s)

6. Create a process so that the coordinator(s) are aware of important documents flowing through the organization as well as are they notified of any potential litigation or government investigation

7. Create a process where the coordinator must approve all document destruction to ensure it occurs in the appropriate manner

8. Train staff on record retention policy

9. Establish a monitoring schedule. This would include determining whether there are any new records to be considered, whether the form of records have been changed and whether there have been any changes in laws or retention regulations.

The National Association of Independent Schools (NAIS) published an article that speaks to the period of time that records should be retained. It can be obtained at: www.nysais.org/uploaded/heads_back_page/records_in_independent_schools07.pdf. Since a significant aspect of record retention is governed by state law, we will not discuss specific time periods. However, the NAIS document provides statutory limitations for bodily injury, property damage, unwritten and written contracts at the time it was written. This should be updated since legislation is always subject to change.

The article makes recommendations, which NAIS follows. They are, in part, based on IRS and other agency guidelines. It goes without saying that there are certain items such as the IRS filing for tax-exempt status, bylaws, charter and other corporate documents that must be retained permanently.

Some of the documents listed below are generally maintained in electronic form. Storage for electronic documents is less expensive than paper but is not without cost. The rule of thumb is to maintain the electronic documents as long as the institution would keep the paper ones. In December 2006 new rules were issued on electronic discovery. The rules require that parties to a lawsuit meet early to determine the records that will be shared as well as a discovery timetable. This includes electronic and paper records. More information can be obtained at: www.duanemorris.com/servlet/SearchServlet?query=electronic+discovery&col=1&col=9&col=8&col=2&col=7&col=3&col=10&col=6&col=5.

The sample record retention schedule below provides a good start to identifying the types of records most not-for-profits have. However, the NAIS recommendations should be compared to state law to ensure there are no superseding requirements.

EXAMPLE

Record	***Retention period – NAIS***	***Retention period – Our organization***	***Person responsible***	***Date last evaluated***
Accident reports/claims	*7 years*			
Financial records – general ledger	*Permanently*			
Subsidiary ledgers and related schedules and documents	*7 years*			
Financial Statements	*Permanently*			
Budgets	*3 years*			
Chart of accounts	*Permanently*			
Checks (cancelled)	*7 years*			
Cancelled checks or evidence of payment for important purchases, contracts, taxes	*Permanently*			
Deposit slips	*3 years*			
Cash receipts and disbursement journals	*Permanently*			
Insurance policies (current and expired)	*Permanently*			
Income tax returns and evidence of payment	*Permanently*			
Government reports	*6 years*			
Leases, loans, contracts still in effect	*Permanently*			
Leases, loans, contracts not still in effect	*10 additional years*			
Continuing education records	*2 years*			
Claims and litigation files	*10 years*			
Medical records	*30 years*			
Membership records	*3 years*			
Constitution and bylaws	*Permanently*			
Copyright, patent, trademark registrations	*Permanently*			
General correspondence	*3 years*			
Legal correspondence	*Permanently*			
Payroll tax returns	*4 years*			
Pension & profit sharing plan records	*Permanently*			
Minutes of the board and committees with board authority	*Permanently*			
Minutes of committees (no board authority)	*5 years*			
Inventory list	*Permanently*			
Mortgages, deeds, bills of sale	*Permanently*			
Vendor correspondence	*3 years*			
Employee contracts	*10 years*			
Employee expense reports	*7 years*			
Employee records (terminated)	*7 years*			
Employee payroll records	*6 years*			
Employment applications	*4 years*			
Withholding tax statements	*7 years*			
Sales and use tax records	*10 years*			
Sales records	*7 years*			

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QUESTION 8:

I have just come on as board chair to a not-for-profit that really counts on donations to fund its operations. It has a few small grants and no fee for service income. Unfortunately, it does not have a development /advancement department and although the executive director tries, she hasn't been able to increase the amount of donations in the three years she has been with the organization. This leaves the board. Each board member is required to make a contribution so that we can say we have 100% board participation. But no amount is stated in our charter or any of our documents. The contributions range from $150 to $1,000 per board member. The organization's expenses continue to rise.

Is it unrealistic to ask the board to give more money or to at least go out and raise a certain amount?

ANSWER:

Board giving is a difficult subject. When I have asked the question of board members, some of the responses I have heard are:

- We give our time and talent and that should be enough. We should only give what we feel we can afford.
- Setting an amount for a board member to give would limit the diversity that is important on boards.
- The management of the not-for-profit is responsible for raising funds. That is what they are paid to do.
- Giving is important because it sets the tone for the entire organization and others will give only if the board is willing to do it.
- Don't join a board if you can't give money to the organization.

Another touchy issue is give/get. This is where the board member is responsible for a certain sum and they can either give it or get others to give it. This may make board members uncomfortable as many are reluctant to ask their friends and family to donate to a cause that means a lot to them. It is likely that their friends and family may ask for a reciprocal donation to a cause that is important to them.

Then there is the issue as to what is considered "get." If a board member can cause a company to donate noncash assets to the organization, then should that be considered a "get"? Some organizations will count that toward the "get" goal and some consider only cash donations.

Grant Thornton conducted a survey of 403 charitable organizations in the United States in 2012 and found that most do not have a policy requiring board members to contribute. 4% required board members to give/get but did not set a specific sum. Of those that required board members to give or get, 28% of them required a donation of more than $10,000. 20% required a donation of $5,000 to $9,999 and 35% required a donation of less than $5,000.

The Board Source Governance Index identified interesting trends in fundraising expectations.

Requirement	2012	2010	2007
Personal contribution	75%	70%	68%
Attending fundraising events	62%	60%	60%
Identifying donors	62%	58%	62%
Soliciting funds	42%	42%	51%

For 2012, 40% of the CEOs reported that even though there may be expectations around fundraising, board members are more likely to attend fundraising events and make personal contributions. They are reluctant to identify donors and solicit funds, even though CEOs identify fundraising as a pressing need. Providing board members with clear expectations around fundraising is important. 75% of CEOs reported they felt like the expectations were explained; however, board members still had challenges in fulfilling the expectations.

While the main consideration here is that the board is involved in the organization at a meaningful level, a financial contribution helps to set a tone for others to give. In times when many organizations are having difficulty keeping up with expenses due to cuts in most forms of funding, it might be wise to consider whether a give/get policy would be helpful.

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<u>QUESTION 9</u>:

My clients do not all have formal cash reserve policies.

What is a good rule of thumb for reserves?

<u>ANSWER</u>:

Cash reserves are very important to a not-for-profit. Grant Thornton's 2013 survey and white paper on reserves planning is very helpful when understanding an appropriate benchmark for not-for-profits.

Most of the respondents had a cash reserve policy and could use those reserves if needed to fill shortfalls without cutting programs or services.

Months of Reserves on Hand	Percentage 2014	Percentage 2015
None	0%	3%
1 month or less	7%	13%
2-3 months	23%	13%
4-6 months	33%	37%
More than 6 months	37%	35%

Approximately 35% of respondents saw employment as a major challenge. 89% of respondents expect wages and other employment costs to increase.

Impact on Expenses	Percent/ Wage Rates
Increase by 4% to 6%	10%
Increase by 2% to 4%	76%
Increase by more than 6%	3%
Decrease	2%
Neutral	10%

Approximately 72% of respondents expect healthcare benefits to increase, 29% expect retirement benefits to increase and 24% expect other benefits to increase. High-growth not-for-profits contribute more than 5% to retirement. 56% of high-growth not-for-profits use incentive compensation as recruitment and retention mechanisms.

The National Council on Nonprofits has a very helpful tool that can be used to assess reserves. It can be accessed at https://www.councilofnonprofits.org/tools-resources/operating-reserves-nonprofits.