NPGT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Nonprofit GAAP

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Interactive Self-study CPE

Companion to PPC's Guide to Nonprofit GAAP

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's Guide to Nonprofit GAAP consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Nonprofit GAAP* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

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

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

Obtaining CPE Credit

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

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of $79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

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COMPANION TO PPC'S GUIDE TO NONPROFIT GAAP

COURSE 1

SELECTED FINANCIAL STATEMENTS FOR NONPROFIT ENTITIES (NPGTG101)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides detailed how-to instructions for preparing financial statements and includes a section on reporting split-interest agreements. Lesson 1 includes the following major sections: the statement of activities, the statement of cash flows, fund accounting, financial statement presentation, and the statement of financial position. Lesson 2 includes the accounting and disclosure requirements for split-interest agreements.
PUBLICATION/REVISION DATE:	November 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Nonprofit GAAP*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting for nonprofit entities
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **November 30, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Nonprofit Financial Statements

Completion of this lesson will enable you to:

- Identify the accounting requirements of the statement of activities and list the components of the change in net assets.
- Outline a properly presented statement of activities and determine items that are separately presented.
- Classify transactions as extraordinary items or unusual or infrequent items.
- Summarize presentation and disclosure requirements.
- Determine when a cash flow statement should be presented, define cash and cash equivalents, and identify the basic elements of the statement.
- Outline a statement of cash flows by understanding the operating activities, investing activities, and financing activities sections.
- Describe the noncash investing and financing activities section of the cash flow statement, as well as properly present and disclose the cash flow statement.
- Summarize the accounting and disclosure requirements for fund accounting
- Summarize the accounting requirements for comparative financial statements, discontinued operations, assets classified as held for sale, and going concern issues.
- Outline disclosures for comparative financial statements, discontinued operations, and going concern issues.
- Summarize the accounting and disclosure requirements for the statement of financial position.

- Outline the current assets and current liabilities sections of the statement and determine the rules for offsetting assets and liabilities.

Lesson 2—Split-Interest Agreements

Completion of this lesson will enable you to:
- Identify the characteristics and the accounting requirements of split-interest agreements.
- Outline the general rules for recording split-interest agreements to charitable lead trusts, charitable remainder trusts, charitable gift annuities, and pooled income funds.

TO COMPLETE THIS LEARNING PROCESS:

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

Thomson Reuters
Tax & Accounting—R&G
NPGTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

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

Lesson 1: Nonprofit Financial Statements

INTRODUCTION

The objectives of financial reporting for nonprofit organizations differ from those of business enterprises. The primary objective of financial reporting for business enterprises is to provide information about an enterprise's performance, as measured by earnings. The objectives of external financial reporting for nonprofit organizations are to:

- Communicate the ways resources have been used to meet the organization's objectives and external requirements.
- Identify the organization's principal programs and their costs.
- Disclose the degree of control exercised by donors and funding sources over use of resources.
- Help the user evaluate the organization's ability to carry out its fiscal objectives.

This lesson provides detailed how-to instructions for preparing financial statements and includes the following major sections:

- The Statement of Activities
- The Statement of Cash Flows
- Fund Accounting
- Financial Statement Presentation
- The Statement of Financial Position

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the accounting requirements of the statement of activities and list the components of the change in net assets.
- Outline a properly presented statement of activities and determine items that are separately presented.
- Classify transactions as extraordinary items or unusual or infrequent items.
- Summarize presentation and disclosure requirements.
- Determine when a cash flow statement should be presented, define cash and cash equivalents, and identify the basic elements of the statement.
- Outline a statement of cash flows by understanding the operating activities, investing activities, and financing activities sections.
- Describe the noncash investing and financing activities section of the cash flow statement, as well as properly present and disclose the cash flow statement.
- Summarize the accounting and disclosure requirements for fund accounting
- Summarize the accounting requirements for comparative financial statements, discontinued operations, assets classified as held for sale, and going concern issues.
- Outline disclosures for comparative financial statements, discontinued operations, and going concern issues.
- Summarize the accounting and disclosure requirements for the statement of financial position.
- Outline the current assets and current liabilities sections of the statement and determine the rules for offsetting assets and liabilities.

ACTIVITIES STATEMENT

SOURCE: FASB ASC 225, 958-205 and 958-225

OVERVIEW

The statement of activities is one of the basic financial statements necessary to present a nonprofit organization's financial position and changes in net assets in conformity with generally accepted accounting principles. It should report the amount of the change in each class of net assets and the change in total net assets for the period for the organization as a whole.

The statement of activities should report information about the organization's revenues, gains, losses, expenses, and reclassifications. The statement should also apply the disclosure and display provisions related to extraordinary items, discontinued operations, and accounting changes, and present a subtotal for the change in each class of net assets before those items.

A nonprofit organization may choose how to classify business interruption insurance proceeds in the statement of activities as long as that classification is not contrary to existing GAAP. In addition, costs incurred and expenses generated from transactions with third parties in collaborative arrangements should be reported in each participant's separate statement of activities. Payments between participants should be presented in the statement of activities according to their nature.

Certain disclosures related to the statement of activities are also required.

ACCOUNTING REQUIREMENTS

The statement of activities should include all changes in net assets recognized during the period except for error corrections. The statement of activities (also referred to as the statement of changes in net assets) should provide financial statement users with relevant information about the effects of transactions and other events and circumstances that change the amount and nature of an organization's net assets. It also provides relevant information about the relationships of those transactions and events with each other and how the nonprofit organization's resources are being used to provide programs or services. (FASB ASC 958-225-05-2) (formerly SFAS 117, par. 17)

The statement of activities should focus on the organization as a whole and report the amount of change in each class of net assets (unrestricted, temporarily restricted, and permanently restricted) for the period. The change in net assets should be reported using a caption such as "Change in net assets," "change in equity," or "Increase (decrease) in net assets," and should correspond with the net assets reported on the statement of financial position. (FASB ASC 958-225-45-1 and 45-2) (formerly SFAS 117, paras. 18 and 19)

The authoritative literature provides guidance about how an organization should report information about how its revenues, gains, losses, expenses, and reclassifications increase or decrease net assets. (FASB ASC 958-225-45-3) (formerly SFAS 117, par. 19) The statement of activities should apply the disclosure and display provisions in GAAP that do not exempt nonprofit organizations, such as those related to extraordinary items, discontinued operations, and accounting changes. (FASB ASC 958-205-45-5) (formerly SFAS 117, par. 7) The implementation guidance at FASB ASC 958-225-55-7 illustrates how to present a subtotal for the change in each class of net assets before those items.

COMPONENTS OF THE CHANGE IN NET ASSETS

According to Statement of Financial Accounting Concepts (SFAC) No. 6, *Elements of Financial Statements*, each item presented in the statement of activities may be categorized according to one of the following components:

- *Revenues*—actual or expected cash inflows (or the equivalent) from delivering or producing goods, rendering services, or other activities that have occurred or will eventuate as a result of an entity's major or central operations

- *Expenses*—outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations

- *Gains*—increases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues

- *Losses*—decreases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses

- *Reclassifications*—simultaneous increases to one net asset class and decreases to another as a result of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations (Reclassifications do not involve inflows, outflows, or other changes in assets or liabilities.)

Classifying amounts as revenues, expenses, gains, or losses varies among organizations depending on the nature of each entity's operations. Events or circumstances that are sources of revenues for one organization may be gains for another. The primary differences between revenues and gains and between expenses and losses are that (a) revenues and expenses result from an entity's ongoing major or central programs or activities such as producing or delivering goods or rendering services, while gains and losses result from incidental or peripheral events or circumstances and (b) revenues and expenses usually are recorded at their gross amounts while gains and losses may be recorded at net amounts.

Classifying Revenues, Expenses, Gains, and Losses

Revenues. Revenues are reported within the unrestricted net asset class unless use of the assets received is restricted for a specific use by the donor or by law. (FASB ASC 958-225-45-5) (formerly SFAS 117, par. 20)

<u>Revenues from Exchange Transactions.</u> Exchange transactions are reciprocal transfers in which each party gives or receives items of approximately equal value. The recognition principles for revenues from exchange transactions follow GAAP; that is, revenue from exchange transactions should be recorded in financial statements when the following conditions are met: (FASB ASC 605-10-25-1; 958-605-25-1) (formerly ARB 43, Ch. 1, par. 1 and 2008 Audit Guide, par. 12.04)

a. Amounts are realized or realizable; i.e., converted or convertible into cash or claims to cash.

b. Amounts are earned; i.e., activities that are prerequisite to obtaining benefits have been completed.

Thus, as a general rule, revenue from selling products is recognized at the date of sale, and revenue from rendering services is recognized when the services have been performed and are billable.

Revenues from exchange transactions should be reported only as increases in *unrestricted* net assets, even if resource providers place limitations on the use of the resources. That is because such limitations do not represent donor-imposed restrictions (which can *only* be placed on contributions). (FASB ASC 958-605-45-1) (formerly 2008 Audit Guide, par. 5.31) Revenues from exchange transactions generally should be reported gross of related expenses. If an organization regularly provides discounts that are not considered an expense (such as financial aid or free services), the revenues should be reported net of discounts. (FASB ASC 958-225-45-14; 958-605-45-2) (formerly SFAS 117, par. 24 and 2008 Audit Guide, par. 12.05)

<u>Revenues from Contributions.</u> Revenue recognition principles for contributions are different than those for revenues from exchange transactions. Unlike revenues from exchange transactions, contributions are voluntary, *nonreciprocal* transfers of assets to an entity. Generally, contribution revenue is recognized when a contribution is received or when an unconditional promise to give assets is received. Contributions may represent unrestricted, temporarily restricted, or permanently restricted support, depending on the presence or absence of donor-imposed restrictions. (FASB ASC 958-225-20; 958-225-45-6) (formerly SFAS 117, par. 21)

Expenses. The term "matching" sometimes is used to describe the process of recognizing expenses in the same accounting period as exchange transaction revenues associated with those costs. SFAC No. 5 describes the following broad expense recognition principles:

- Costs and revenues from exchange transactions that result directly and jointly from the same transaction or event are recognized in the same accounting period, such as sales revenue, cost of goods sold, and certain selling expenses.

- Costs that are incurred to obtain benefits that are exhausted in the period in which the costs are incurred are recognized in that period, for example, monthly salaries and utilities.

- Costs that provide benefits over several periods are allocated to those periods, for example, prepaid insurance and depreciation. Costs are generally allocated to accounting periods when no direct relationship between revenues and costs exists, and the costs cannot be identified with a particular accounting period.

Expenses are *always* reported as decreases in unrestricted net assets, including those expenses incurred to satisfy a donor's restriction. (FASB ASC 958-225-45-7) (formerly SFAS 117, par. 20)

Organizations must provide information about expenses by functional classification (the major classes of program services and supporting services) to assist users in assessing the organization's service efforts. Expenses by functional classification can be presented either on the face of the statement of activities or in the notes to financial statements. Voluntary health and welfare organizations also must report expenses by natural classification in a separate statement. GAAP encourages, but does not require, other nonprofit organizations to provide information about expenses by their natural classifications. (FASB ASC 958-205-45-6; 958-720-45-2; 958-720-45-15 and 45-16) (formerly SFAS No. 117, par. 26)

Gains and Losses. SFAC No. 6 indicates that gains and losses generally result from one of the following events or circumstances:

a. Netting costs and proceeds of incidental transactions, such as sales of investments in marketable securities or equipment

b. Nonreciprocal transfers, such as winning a lawsuit, thefts, or assessment of fines or damages by courts

c. Holding assets or liabilities while their values change, for example, causing inventory to be written down from cost to market

d. Environmental factors, such as damage or destruction of property by fire, flood, or earthquake

Recognized gains and losses on investments (and other assets or liabilities) should be reported as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by donor stipulation or by law. Investment revenues may be reported net of related expenses, provided the expenses are disclosed on the face of the statement or in the notes to financial statements. Gains and losses from other peripheral or incidental transactions may be reported as net amounts. (FASB ASC 958-225-45-8; 958-225-45-14 and 45-15; 958-320-45-4) (formerly SFAS No. 117, paras. 20 and 24-25; 2008 Audit Guide, par. 13.27)

Reclassifications

Expirations of donor restrictions, either time or purpose restrictions, are generally reported as simultaneous reclassifications between temporarily restricted net assets and unrestricted net assets. Reclassifications may also be necessary if a donor imposes a purpose restriction on unrestricted net assets. For example, a donor may stipulate that he or she will make a certain restricted contribution if the organization also restricts a stated amount of unrestricted net assets. If the restriction on these net assets cannot be reversed without the donor's consent, a reclassification of unrestricted to restricted net assets would be required. Reclassifications are required to be reported as separate items on the statement of activities. (FASB ASC 958-225-45-3; 958-225-45-13) (formerly SFAS 117, par. 19, and 2008 Audit Guide, par. 5.40)

SELF-STUDY QUIZ

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

1. Jones, CPA is preparing a statement of activities for his not-for-profit client. Which of the following will Jones include on this statement?

   a. Current assets.

   b. Change in net assets.

   c. Investing activities.

   d. Comprehensive income.

2. The Wish Organization reported a $20,000 increase in unrestricted net assets while simultaneously decreasing its temporarily restricted net assets by $20,000 because the organization fulfilled a donor-imposed stipulation. What is this component of the statement of activities called?

   a. Revenues.

   b. Gains.

   c. Reclassifications.

   d. Losses.

3. The State of the State Organization, a calendar year, not-for-profit organization, provides funding and activities for certain area residents in need. The organization also produces a quarterly magazine that includes research articles and current state topics. On December 1, 2010, Edna purchased a $60 magazine subscription for the 4 issues that will be produced in 2011. How will State of the State Organization report the subscription in its 2010 statement of activities?

   a. Net of related expenses.

   b. As an increase to temporarily restricted net assets.

   c. As a contribution.

   d. As deferred revenue.

4. Which of the following revenues earned by a not-for-profit organization can be reported net of related expenses?

   a. Revenue from investment activities.

   b. Revenue from ongoing activities.

   c. Revenue classified as temporarily unrestricted.

SELF-STUDY ANSWERS

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

1. Jones, CPA is preparing a statement of activities for his not-for-profit client. Which of the following will Jones include on this statement? **(Page 4)**

    a. Current assets. [This answer is incorrect. Current assets is a classification used if the organization chooses to present liquidity information on the statement of financial position.]

    b. Change in net assets. [This answer is correct. The statement of activities should report the amount of change in each class of net assets (unrestricted, temporarily restricted, and permanently restricted) for the period per FASB ASC 958-225-5-2 and 958-225-45-1 (formerly SFAS 117).]

    c. Investing activities. [This answer is incorrect. Investing activities is a section in the statement of cash flows.]

    d. Comprehensive income. [This answer is incorrect. The statement of comprehensive income is not prepared for not-for-profit organizations because it is a statement that reports certain changes in equity during a period.]

2. The Wish Organization reported a $20,000 increase in unrestricted net assets while simultaneously decreasing its temporarily restricted net assets by $20,000 because the organization fulfilled a donor-imposed stipulation. What is this component of the statement of activities called? **(Page 4)**

    a. Revenues. [This answer is incorrect. Revenues are the actual or expected inflows from delivering or producing goods, rendering services, or other activities that have occurred or will eventuate as a result of an entity's major or central operations per SFAC No.6.]

    b. Gains. [This answer is incorrect. Gains are increases in net assets from peripheral or incidental transactions an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues per SFAC No.6.]

    c. Reclassifications. [This answer is correct. Reclassifications are simultaneous increases to one net asset class and decreases to another as a result of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations per SFAC No.6.]

    d. Losses. [This answer is incorrect. Losses are decreases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses per SFAC No.6.]

3. The State of the State Organization, a calendar year, not-for-profit organization, provides funding and activities for certain area residents in need. The organization also produces a quarterly magazine that includes research articles and current state topics. On December 1, 2010, Edna purchased a $60 magazine subscription for the 4 issues that will be produced in 2011. How will State of the State Organization report the subscription in its 2010 statement of activities? **(Page 5)**

    a. Net of related expenses. [This answer is incorrect. Revenues from exchange transactions should be reported gross of related expenses.]

    b. As an increase to temporarily restricted net assets. [This answer is incorrect. Revenues from exchange transactions should be reported only as increases in unrestricted net assets.]

    c. As a contribution. [This answer is incorrect. This transaction is an exchange transaction because it is a reciprocal transaction where each party gives or receives items of approximate equal value. Accounting for contributions differs from accounting for exchange transactions.]

    d. As deferred revenue. [This statement is correct. Since the State of the State has not yet earned the revenue for the magazine, the amount should be reported as deferred revenue. Revenue from

exchange transactions should be recorded in financial statements when amounts are realized or realizable and when amounts are earned. The organization can recognize all of the revenue in its 2011 financial statements.]

4. Which of the following revenues earned by a not-for-profit organization can be reported net of related expenses? **(Page 6)**

   a. **Revenue from investment activities. [This answer is correct. Investment revenues may be reported net of related expenses, provided the expenses are disclosed on the face of the statement or in the notes to financial statements per FASB ASC 958-225-45-14 (formerly SFAS 117).]**

   b. Revenue from ongoing activities. [This answer is incorrect. Netting costs and proceeds of incidental transactions are allowed, but proceeds from ongoing activities such as an annual gala must be reported gross.]

   c. Revenue classified as temporarily unrestricted. [This answer is incorrect. The net asset classification does not dictate whether the revenue can be reported net of expenses, or must be reported as gross, rather it is the nature of the revenue (i.e. ongoing activity, special event, lawsuit winning, etc.) that will determine how it may be reported.]

FINANCIAL STATEMENT PRESENTATION

GAAP allows organizations a great deal of latitude in determining the most meaningful presentation formats for their statements of activities. GAAP does not require any particular format for the statement of activities as long as revenues, expenses, gains, losses, and reclassifications are properly classified by net asset class, and the change in net assets is presented both by net asset class and in total. (FASB ASC 958-225-45-1 and 45-3) (formerly SFAS 117, paras. 18–19)

Exhibit 1-1

Illustrative Example Statement of Activities—Single-column Format

HABITAT HOUSE, INC.
STATEMENTS OF ACTIVITIES
Years Ended June 30, 20X6 and 20X5

	20X6	20X5
UNRESTRICTED NET ASSETS		
Revenues and gains		
Business organizations	$ 5,324	$ 18,516
Churches	36,040	39,043
Federal financial assistance	43,473	38,547
Foundations	17,179	13,162
Individuals	31,193	21,495
Special events and other	2,777	16,082
Investment return	5,766	16,015
TOTAL UNRESTRICTED REVENUES AND GAINS	141,752	162,860
Net assets released from restrictions		
United Way Services funding for the year	146,465	140,544
Restrictions satisfied by payments	11,878	540,841
TOTAL UNRESTRICTED REVENUES, GAINS, AND OTHER SUPPORT	300,095	844,245
Expenses		
Program services		
Women and children	134,051	132,569
Men	94,231	88,439
Supporting services		
Management and general	55,629	54,886
Fund-raising	13,541	15,960
TOTAL EXPENSES	297,452	291,854
INCREASE IN UNRESTRICTED NET ASSETS	2,643	552,391
TEMPORARILY RESTRICTED NET ASSETS		
United Way Services funding for the next year	156,275	146,465
Contributions—new men's shelter	46,193	—
Contributions—Capital Campaign	4,771	195,744
Investment return	497	352
Net assets released from restrictions		
Expiration of time restrictions on United Way Services funding	(146,465)	(140,544)
Restrictions satisfied by payments	(11,878)	(540,841)
INCREASE (DECREASE) IN TEMPORARY RESTRICTED NET ASSETS	49,393	(338,824)

	20X6	20X5
PERMANENTLY RESTRICTED NET ASSETS		
Endowment fund contributions	2,704	4,165
INCREASE IN PERMANENTLY RESTRICTED NET ASSETS	2,704	4,165
INCREASE IN NET ASSETS	54,740	217,732
NET ASSETS AT BEGINNING OF YEAR	808,972	591,240
NET ASSETS AT END OF YEAR	$ 863,712	$ 808,972

* * *

Exhibit 1-2

Illustrative Example Statement of Activities—Multicolumn Format

HABITAT HOUSE, INC.
STATEMENT OF ACTIVITIES
Year Ended June 30, 20X6

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES, GAINS, AND OTHER SUPPORT				
United Way Services funding for the next year	$ —	$ 156,275	$ —	$ 156,275
Other contributions	133,209	50,964	2,704	186,877
Investment return	5,766	497	—	6,263
Special events and other	2,777	—	—	2,777
Net assets released from restrictions				
Expiration of time restrictions on United Way Services funding	146,465	(146,465)	—	—
Restrictions satisfied by payments	11,878	(11,878)	—	—
TOTAL REVENUES, GAINS, AND OTHER SUPPORT	300,095	49,393	2,704	352,192
EXPENSES				
Program services				
Women and children	134,051	—	—	134,051
Men	94,231	—	—	94,231
Supporting services				
Management and general	55,629	—	—	55,629
Fund-raising	13,541	—	—	13,541
TOTAL EXPENSES	297,452	—	—	297,452
CHANGE IN NET ASSETS	2,643	49,393	2,704	54,740
NET ASSETS AT BEGINNING OF YEAR	598,875	205,932	4,165	808,972
NET ASSETS AT END OF YEAR	$ 601,518	$ 255,325	$ 6,869	$ 863,712

* * *

Exhibit 1-3

Illustrative Example Two-statement Format

HABITAT HOUSE, INC.
STATEMENTS OF UNRESTRICTED REVENUES, EXPENSES, AND OTHER CHANGES IN UNRESTRICTED NET ASSETS
Years Ended June 30, 20X6 and 20X5

	20X6	20X5
UNRESTRICTED REVENUES, GAINS, AND OTHER SUPPORT		
Revenues and gains		
Business organizations	$ 5,324	$ 18,516
Churches	36,040	39,043
Federal financial assistance	43,473	38,547
Foundations	17,179	13,162
Individuals	31,193	21,495
Special events and other	2,777	16,082
Investment return	5,766	16,015
TOTAL UNRESTRICTED REVENUES AND GAINS	141,752	162,860
Net assets released from restrictions		
Expiration of time restrictions on United Way Services funding	146,465	140,544
Restrictions satisfied by payments	11,878	540,841
TOTAL NET ASSETS RELEASED FROM RESTRICTIONS	158,343	681,385
TOTAL UNRESTRICTED REVENUES, GAINS, AND OTHER SUPPORT	300,095	844,245
Expenses		
Program services		
Women and children	134,051	132,569
Men	94,231	88,439
Supporting services		
Management and general	55,629	54,886
Fund-raising	13,541	15,960
TOTAL EXPENSES	297,452	291,854
INCREASE IN UNRESTRICTED NET ASSETS	$ 2,643	$ 552,391

HABITAT HOUSE, INC.
STATEMENTS OF CHANGES IN NET ASSETS
Years Ended June 30, 20X6 and 20X5

	20X6	20X5
UNRESTRICTED NET ASSETS		
Total unrestricted revenues and gains	$ 141,752	$ 162,860
Total net assets released from restrictions	158,343	681,385
Total expenses	(297,452)	(291,854)
INCREASE IN UNRESTRICTED NET ASSETS	2,643	552,391
TEMPORARILY RESTRICTED NET ASSETS		
United Way Services funding for the next year	156,275	146,465
Contributions—new men's shelter	46,193	195,744

	20X6	20X5
Contributions—Capital Campaign	4,771	—
Interest income on Capital Campaign assets	497	352
Net assets released from restrictions	(158,343)	(681,385)
INCREASE (DECREASE) IN TEMPORARY RESTRICTED NET ASSETS	49,393	(338,824)
PERMANENTLY RESTRICTED NET ASSETS		
Endowment fund contributions	2,704	4,165
INCREASE IN PERMANENTLY RESTRICTED NET ASSETS	2,704	4,165
INCREASE IN NET ASSETS	54,740	217,732
NET ASSETS AT BEGINNING OF YEAR	808,972	591,240
NET ASSETS AT END OF YEAR	$ 863,712	$ 808,972

* * *

Intermediate Measure of Operations

In addition to classifying revenues, expenses, gains, losses, and reclassifications within the three classes of net assets, an organization may also choose to further classify items within a net asset class in a variety of different ways, including: (FASB ASC 958-225-45-9) (formerly SFAS 117, par. 23)

- Operating and nonoperating
- Expendable and nonexpendable
- Earned and unearned
- Recurring and nonrecurring
- Other

If an intermediate measure of operations is reported, at a minimum the statement should report the change in unrestricted net assets for the period. As discussed later in this section, if the meaning of the term *operations* within the statement is not apparent, an organization should disclose the nature of the reported measure of operations or the items excluded from operations. (FASB ASC 958-225-45-10; 958-225-45-12) (formerly SFAS 117, par. 23) Exhibit 1-4 presents an example of a statement of activities with an intermediate measure of operations.

GAAP may place some limitations on an organization's use of an intermediate measure of operations. For example, if a subtotal such as "change in unrestricted net assets from operations" or "income from operations" is used, it must include any: (FASB ASC 958-225-45-11) (formerly SFAS 144, paras. 25 and 45; SFAS 146, par. 18)

- Impairment losses recognized on long-lived assets to be held and used
- Gains or losses recognized on the sale of a long-lived asset that is not a component of the organization
- Costs associated with exit or disposal activities that do not involve discontinued operations

Exhibit 1-4

Illustrative Example Intermediate Measure of Operations Format[a]

HABITAT HOUSE, INC.
STATEMENTS OF UNRESTRICTED REVENUES, EXPENSES, AND OTHER CHANGES IN UNRESTRICTED NET ASSETS
Years Ended June 30, 20X6 and 20X5

	20X6	20X5
OPERATING REVENUES, GAINS, AND OTHER SUPPORT		
Federal financial assistance	$ 43,473	$ 38,547
Special events and other	2,777	16,082
Net assets released from restrictions		
United Way Services funding for the year	146,465	140,544
Restrictions satisfied by payments	11,878	540,841
TOTAL OPERATING REVENUES, GAINS, AND OTHER SUPPORT	204,593	736,014
OPERATING EXPENSES		
Program services		
Women and children	134,051	132,569
Men	94,231	88,439
Supporting services		
Management and general	55,629	54,886
Fund-raising	13,541	15,960
	297,452	291,854
CHANGE IN UNRESTRICTED NET ASSETS FROM OPERATIONS	(92,859)	444,160
OTHER CHANGES		
Nonoperating contributions		
Business organizations	5,324	18,516
Churches	36,040	39,043
Foundations	17,179	13,162
Individuals	31,193	21,495
Investment return	5,766	16,015
TOTAL OTHER CHANGES	95,502	108,231
INCREASE IN UNRESTRICTED NET ASSETS	$ 2,643	$ 552,391

Note:

[a] This example statement presents only the change in unrestricted net assets. A second statement presenting the changes in other net assets would be the same as the example second statement at Exhibit 1-3.

* * *

Sequencing of Components

Organizations are not required to present revenues, expenses, gains, losses, and reclassifications in any particular order or sequence in their statements of activities, nor are they required to present totals for those components. The statement of activities can be prepared with the different components disaggregated from each other if the organization determines that approach is relevant and understandable. (Transactions should be properly classified among those components, however.) (FASB ASC 958-225-55-3) (formerly SFAS 117, par. 118)

Items Presented Separately

Nonprofit organizations must follow the financial statement disclosure and display provisions in GAAP that do not specifically exempt them. (FASB ASC 958-205-45-5) (formerly SFAS 117, par. 7) Thus, a nonprofit organization's statement of activities should present the following items separately:

- Extraordinary items
- Unusual or infrequent items
- Discontinued operations of a component of an entity
- Cumulative effects of accounting changes
- Equity in operations of investees
- Agency transactions involving financially interrelated organizations
- Collections that are not capitalized
- Increase or decrease in the appropriate class of net assets attributable to noncontrolling interests.

GAAP may also require other items such as business interruption insurance and activities related to collaborative arrangements to be reported separately.

Although all of the items listed above should be reported separately in the activities statement, the effects of discontinued operating segments and extraordinary items are the only items that are required to be reported after an appropriately labeled subtotal (for example, change in net assets before the effects of extraordinary item; or change in net assets before discontinuance of XYZ Program). These items should be presented in the statement of activities in the following order:

a. Change in net assets from continuing operations

b. Discontinued operations of a component of an entity

c. Extraordinary items

The following sections provide guidance on extraordinary items, unusual or infrequent items, business interruption insurance, and collaborative arrangements.

SELF-STUDY QUIZ

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

5. Your client, a not-for-profit organization, is issuing its first set of financial statements. The organization would like to present separate columns for each class of net assets on its statement of activities. Which presentation would you recommend to your client?

    a. Single-column format.

    b. Multicolumn format.

    c. Two separate statements.

    d. Intermediate measure of operations.

6. Which of the following is an optional presentation item on the statement of activities?

    a. Classifications by net asset class.

    b. Change in net assets.

    c. Classification by liquidity.

    d. Classification of operating and nonoperating items.

SELF-STUDY ANSWERS

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

5. Your client, a not-for-profit organization, is issuing its first set of financial statements. The organization would like to present separate columns for each class of net assets on its statement of activities. Which presentation would you recommend to your client? **(Page 11)**

   a. Single-column format. [This answer is incorrect. The single column format shows the changes in the three net asset classes, one after the other. This is a good way to present comparative information. This format is illustrated in FASB ASC 958-205-55 (formerly SFAS No. 117).]

   b. Multicolumn format. [This answer is correct. The multicolumn format presents separate columns for each class of net assets with an optional total column. The statement must present the total change in net assets for the organization, as well as the changes in unrestricted, temporarily restricted, and permanently restricted net assets. This format is illustrated in FASB ASC 958-205-55 (formerly SFAS No. 117).]

   c. Two separate statements. [This answer is incorrect. This format presents two statements, the "statement of unrestricted revenues, expenses, and other changes in unrestricted net assets" and a "statement of changes in net assets." This format is illustrated in FASB ASC 958-205-55 (formerly SFAS No. 117).]

   d. Intermediate measure of operations. [This answer is incorrect. With the intermediate measure of operations format, an organization further classifies items within a net asset class in a variety of different ways.]

6. Which of the following is an optional presentation item on the statement of activities? **(Page 13)**

   a. Classifications by net asset class. [This answer is incorrect. The statement of activities must present revenues, expenses, gains, losses, and reclassifications by net asset class.]

   b. Change in net assets. [This answer is incorrect. The statement of activities must present the change in net assets both by net asset class and in total.]

   c. Classification by liquidity. [This answer is incorrect. A statement of financial position may be classified by order of liquidity.]

   d. Classification of operating and nonoperating items. [This answer is correct. In addition to classifying revenues, expenses, gains, losses, and reclassifications within the three classes of net assets on the statement of activities, an organization may also choose to further classify items within a net asset class in a variety of different ways, including operating and nonoperating, expendable and nonexpendable, and earned and unearned (FASB ASC 958-225-45-9) (formerly SFAS 117, par. 23).]

EXTRAORDINARY ITEMS

Extraordinary items are events or transactions that meet *both* of the following criteria: (FASB ASC 225-20-20; 225-20-45-2) (formerly APB 30, par. 20)

a. *Unusual nature.* The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates. (An event or transaction is not considered to be unusual merely because it is beyond the control of management.)

b. *Infrequency of occurrence.* The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

An event or transaction should be classified as extraordinary only in rare circumstances. A presumption underlying the definition of extraordinary items is that an event or transaction should be considered ordinary and usual unless evidence clearly supports its classification as extraordinary. (FASB ASC 225-20-45-1) (formerly APB 30, par. 19) The environment in which an entity operates, including the characteristics of its industry, the geographical location of its programs and activities, and the nature and extent of governmental regulation, should be a primary consideration when determining whether an event or transaction is extraordinary. (FASB ASC 225-20-55-1) (formerly APB 30, par. 21) Thus, as a general rule, particular events or transactions do not, of themselves, require classification as extraordinary items, and an event or transaction considered an extraordinary item for one entity may not be considered an extraordinary item for another.

Although the definition of an extraordinary item embodies infrequency of occurrence, infrequency alone does not imply that an event or transaction should be classified as extraordinary. The past occurrence of an event for a particular entity provides evidence to assess the probability of recurrence in the foreseeable future. The probability of recurrence should take into account the environment in which the particular entity operates. (FASB ASC 225-20-55-2) (formerly APB 30, par. 22)

The materiality of an event or transaction should be considered when deciding whether to present it as an extraordinary item. Materiality should be considered as it relates to individual items, except that the effects of a series of related transactions from a single specific and identifiable event or plan of action should be considered in the aggregate. (FASB ASC 225-20-45-3) (formerly APB 30, par. 24)

Examples of Items That Are Not Extraordinary Items

Some events or transactions may either be unusual in nature or occur infrequently but not both, and thus do not meet the criteria for classification as extraordinary items. Examples of such items generally include the following: (FASB ASC 225-20-45-4) (formerly APB 30, par. 23)

- Writedown or writeoff of receivables, inventories, equipment leased to others, or intangible assets
- Gains or losses from sale or abandonment of property, plant, or equipment used in programs or activities
- Gains or losses from exchange or translation of foreign currencies, including those relating to major devaluations and revaluations
- Effects of a strike, including those against competitors and major suppliers
- Adjustments of accruals on long-term contracts
- Gains or losses from disposals of part of a component of an entity

Examples of Extraordinary Items

Profit or loss on disposition of assets when a business combination is accounted for using the pooling of interests method provided (a) the profit or loss is material in relation to the change in net assets of the combined entity and

(b) the disposition is within two years after the combination is consummated has been designated by authoritative pronouncements as an extraordinary item even though it may not meet the criteria. (APB 16, par. 60)

Statement of Activities Presentation

Extraordinary items should be separately presented in the statement of activities, net of related income tax effect (if any). Individual extraordinary items should be presented using descriptive captions following changes in net assets from continuing operations. If the statement of activities includes discontinued operations, extraordinary items should be presented following discontinued operations. (FASB ASC 225-20-45-10 and 45-11) (formerly APB 30, par. 11) Exhibit 1-5 illustrates presenting extraordinary items in the statement of activities.

Exhibit 1-5

Illustrative Example Statement of Activities Presentation of Extraordinary Items and Discontinued Operations

INCREASE IN UNRESTRICTED NET ASSETS FROM CONTINUING OPERATIONS	98,800
Discontinued operations—loss on disposal of performing arts activities	(24,000)
Extraordinary item—loss on expropriation of assets by foreign government	(71,400)
INCREASE IN UNRESTRICTED NET ASSETS	$ 3,400

* * *

Adjustment of Prior Period Extraordinary Items

In many circumstances, amounts reported as extraordinary items are based on estimates and require adjustments in subsequent periods. In those cases, unless the adjustments meet the criteria for prior period adjustments, they also should be reported as extraordinary items. (FASB ASC 225-20-45-13 and 45-14) (formerly APB 30, par. 25)

UNUSUAL OR INFREQUENT ITEMS

Events or transactions that are either unusual or infrequent, but not both (and therefore, do not meet the criteria for extraordinary items), should be presented in the statement of activities as separate elements of the change in net assets from continuing operations. The statement of activities presentation should not imply that the amounts are extraordinary items; for example, they should not be presented net of tax (if any) or as separate line items following the captions, "Change in net assets" or "Increase (decrease) in net assets." The nature and effects of the events or transactions should be disclosed on the face of the statement of activities or in the notes to the financial statements. (FASB ASC 225-20-45-16) (formerly APB 30, par. 26)

Captions such as "Nonrecurring items" or "Unusual items" may be used if the unusual or infrequent event or transaction is disclosed in the notes to the financial statements.

BUSINESS INTERRUPTION INSURANCE

Business interruption insurance provides coverage if an entity's business operations are suspended due to the loss of use of property and equipment resulting from a covered loss. Such insurance coverage generally reimburses certain costs and losses incurred during the period required to rebuild, repair, or replace the damaged property, such as the following: (FASB ASC 225-30-20; 225-30-05-2) (formerly EITF 01-13, par. 4)

- The excess of sales over cost of goods sold, lost, or not earned because normal operations were suspended
- A portion of fixed charges and expenses relating to the lost profit
- Other expenses, such as the rent of temporary facilities and equipment, which are incurred to reduce the loss from business interruption

An entity may choose how to classify business interruption insurance proceeds in the statement of activities, as long as that classification is not contrary to existing GAAP. For example, business insurance proceeds must meet the requirements for an extraordinary item if they are to be classified as such in the statement of activities. (FASB ASC 225-30-45-1) (formerly EITF 01-13, par. 7)

COLLABORATIVE ARRANGEMENTS

A collaborative arrangement is a contractual arrangement for a joint operating activity (not primarily conducted through a separate legal entity) that involves two or more parties who are both: (FASB ASC 808-10-15-4; 808-10-20) (formerly EITF 07-1, paras. 5 and 6)

a. Active participants in the activity, and

b. Exposed to significant risks and rewards dependent on the commercial success of the activity

In a collaborative arrangement, costs incurred and revenues generated from transactions with third parties should be reported in each entity's separate activities statement. The collaborative arrangement participant that is the principal participant for a transaction should record the transaction on a gross basis; other participants may record the transaction on a net basis. Payments between participants should be presented in the statement of activities according to their nature. The equity method of accounting should not be applied to activities of collaborative arrangements. (FASB ASC 808-10-45-1 through 45-3) (formerly EITF 07-1, paras. 16–19)

SELF-STUDY QUIZ

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

7. The headquarters of a not-for-profit organization that shelters and feeds the homeless was partially destroyed due to a hurricane. Which of the following characteristics does **not** determine whether this disaster should be classified as extraordinary?

   a. Whether the disaster is material.

   b. Whether the headquarters are located in a hurricane vulnerable area.

   c. Whether hurricanes are listed as extraordinary in GAAP.

   d. Whether evidence clearly supports the hurricane was extraordinary.

8. In 2010, World Organization estimated a $100,000 loss which it reported as an extraordinary item. In 2011, the organization realized the actual loss was $125,000. What should the organization do regarding the additional $25,000 of loss?

   a. Report it as extraordinary in 2011.

   b. Report a prior period adjustment.

   c. Report it as ordinary in 2011.

   d. Report a change in accounting estimate.

9. The Toys for Kids Organization had to evacuate from its headquarters because mold was discovered in the building and had to be removed. The organization rented a temporary facility to reduce the loss from this interruption. The business interruption insurance policy taken out by the organization covered these expenses. Toys for Kids must classify the business insurance proceeds as an extraordinary item.

   a. True.

   b. False.

SELF-STUDY ANSWERS

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

7. The headquarters of a not-for-profit organization that shelters and feeds the homeless was partially destroyed due to a hurricane. Which of the following characteristics does **not** determine whether this disaster should be classified as extraordinary? **(Page 19)**

   a. Whether the disaster is material. [This answer is incorrect. The materiality of an event or transaction should be considered when deciding whether to present it as an extraordinary item. Materiality should be considered as it relates to individual items per FASB ASC 225-20-45-3 (formerly APB 30, par. 24).]

   b. Whether the headquarters are located in a hurricane vulnerable area. [This answer is incorrect. An item may be considered extraordinary if it is unusual in nature and infrequent in occurrence per FASB ASC 225-20-45-2 (formerly APB 30, par. 20).]

   c. Whether hurricanes are listed as extraordinary in GAAP. [This statement is correct. As a general rule, particular events or transactions do not, of themselves, require classification as extraordinary items, and an event or transaction considered an extraordinary item for one entity may not be considered an extraordinary item for another per FASB ASC 225-20-55-1 (formerly APB 30, par. 21).]

   d. Whether evidence clearly supports the hurricane was extraordinary. [This answer is incorrect. A presumption underlying the definition of extraordinary items is that an event or transaction should be considered ordinary and usual unless evidence clearly supports its classification as extraordinary per FASB ASC 225-20-45-1 (formerly APB 30, par. 19).]

8. In 2010, World Organization estimated a $100,000 loss which it reported as an extraordinary item. In 2011, the organization realized the actual loss was $125,000. What should the organization do regarding the additional $25,000 of loss? **(Page 20)**

   a. Report it as extraordinary in 2011. [This answer is correct. In the case where an organization requires an adjustment to its prior reported extraordinary item because it was based on an estimate, the adjustment should be reported as an extraordinary item per FASB ASC 225-20-45-13 and 45-14 (formerly APB 30, par. 25). Prior period adjustments are not usually made to adjustments of estimates.]

   b. Report a prior period adjustment. [This answer is incorrect. Prior period adjustments should not be applied to the normal, recurring corrections and adjustments which are the natural result of the use of estimates inherent in the accounting process.]

   c. Report it as ordinary in 2011. [This answer is incorrect. If the item was considered extraordinary in 2010, the item, or an adjustment to its estimate, will not be classified as ordinary in future years.]

   d. Report a change in accounting estimate. [This answer is incorrect. FASB defines a change in accounting estimate as "a change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing or future assets or liabilities". A difference between an estimate made and the actual cost realized does not meet the definition of a change in accounting estimate.]

9. The Toys for Kids Organization had to evacuate from its headquarters because mold was discovered in the building and had to be removed. The organization rented a temporary facility to reduce the loss from this interruption. The business interruption insurance policy taken out by the organization covered these expenses. Toys for Kids must classify the business insurance proceeds as an extraordinary item. **(Page 21)**

   a. True. [This answer is incorrect. The business insurance proceeds must meet the requirements for an extraordinary item in order for it to be classified as an extraordinary item in the statement of activities.]

   b. False. [This answer is correct. An entity may choose how to classify business interruption insurance proceeds in the statement of activities, as long as that classification is not contrary to existing GAAP. (FASB ASC 225-30-45-1) (formerly EITF 01-13, par. 7).]

DISCLOSURE REQUIREMENTS

The following are required disclosures related to the statement of activities. (Many of the listed requirements are presentation rather than disclosure requirements and are discussed in the Accounting Requirements section. Presentation requirements are summarized in this section, however, so that the primary considerations for statements of activities may be easily identified.)

FINANCIAL STATEMENT PRESENTATION

The statement of activities should report the following:

a. The amount of the change in net assets for the period for the organization as a whole (using a descriptive term such as "change in net assets"), which should reconcile to the net assets reported in the statement of financial position (FASB ASC 958-225-45-1 and 45-2) (formerly SFAS 117, paras. 18 and 19)

b. The amount of the change in unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets for the period (FASB ASC 958-225-45-1) (formerly SFAS 117, paras. 18 and 19)

c. A subtotal for the change in each net asset class before the effects of extraordinary items, discontinued operations, or accounting changes (FASB ASC 958-205-45-5; 958-225-55-7) (formerly SFAS 117, paras. 7 and 114)

d. The components of the change in net assets as follows:

   (1) Revenues as increases in unrestricted net assets unless there are donor-imposed restrictions limiting the use of the assets received (FASB ASC 958-225-45-5) (formerly SFAS 117, par. 20)

   (2) Expenses as decreases in unrestricted net assets (FASB ASC 958-225-45-7) (formerly SFAS 117, par. 20)

   (3) Gains and losses as increases or decreases in unrestricted net assets unless donor or law temporarily or permanently restricts their use (FASB ASC 958-225-45-8) (formerly SFAS 117, par. 22)

   (4) Reclassifications as simultaneous increases in one class of net assets and decreases in another (FASB ASC 958-225-45-3 and 45-13) (formerly SFAS 117, par. 19)

e. Material events or transactions that are either unusual in nature or of infrequent occurrence (but not both) as a separate component of the change in net assets (FASB ASC 225-20-45-16) (formerly APB 30, par. 26)

f. If the organization reports an intermediate measure of operations, the total change in unrestricted net assets for the period, at a minimum (If the meaning of the term *operations* is not apparent on the face of the statement, the notes should describe the nature of the reported measure of operations or the items excluded from operations) (FASB ASC 958-225-45-10; 958-225-45-12; 958-225-50-1) (formerly SFAS 117, par. 23)

g. Support and revenue as follows:

   (1) Sales revenues and cost of goods sold net of estimated returns (FASB ASC 605-15-45-1) (formerly SFAS 48, par. 7)

   (2) For investment revenues reported net of related expenses, the amount of those expenses should be disclosed on the face of the statement or in the notes to financial statements (FASB ASC 958-225-45-14) (formerly SFAS 117, par. 24)

   (3) For revenues from goods or services revenues for which discounts are provided on a regular basis and not accounted for as expenses, the discounts should be netted against the related revenues. Net

revenue may be presented as a single line item or the gross revenue less the related discounts may be presented if the discount is displayed immediately beneath the gross revenue in the statement of activities. (FASB ASC 958-605-45-2) (formerly 2008 Audit Guide, par. 12.05)

h. Expenses, gains, and losses as follows:

(1) Expenses by their functional classification (such as major classes of program services and supporting services) either on the face of the statement or in the notes to financial statements (FASB ASC 958-720-45-2) (formerly SFAS 117, par. 26)

(2) Discounts given in exchange for goods or services provided reported in the same functional category as the cost of the goods or services provided (FASB ASC 958-720-45-23) (formerly 2008 Audit Guide, par. 13.07)

(3) Cost of goods sold and expenses shown net of purchase discounts (Generally accepted)

(4) Gains and losses resulting from involuntary conversions on nonmonetary assets to monetary assets reported as extraordinary items or unusual or infrequent items, as appropriate (FASB ASC 605-40-45-1) (formerly FIN 30, par. 4)

(5) Payments made to local or national organizations that cannot be allocated to functional expense classifications reported as a separate supporting services line item captioned "Unallocated payments to local or national organizations" (FASB ASC 958-720-45-26) (formerly 2008 Audit Guide, par. 13.57)

EXTRAORDINARY ITEMS

In addition to the presentation requirements previously discussed, the following disclosures about extraordinary items are required:

- The nature of the event or transaction and the principal items entering into determination of the extraordinary gain or loss (FASB ASC 225-20-45-11) (formerly APB 30, par. 11)
- The year of origin, nature, and amount of each adjustment in the current period of an element of an extraordinary item that was reported in a prior period (The adjustment should be presented separately in the current period statement of activities as an extraordinary item.) (FASB ASC 225-20-50-2) (formerly APB 30, par. 25)

UNUSUAL OR INFREQUENT ITEMS

As discussed, the gain or loss from events or transactions that are either unusual or infrequent, but not both, should be presented as a separate component of the change in net assets from continuing operations. In addition, the nature and financial effects of each event should be disclosed on the face of the financial statements or in the notes. (FASB ASC 225-20-50-3) (formerly APB 30, par. 26)

BUSINESS INTERRUPTION INSURANCE

The following information should be disclosed in the period in which business interruption insurance recoveries are recognized: (FASB ASC 225-30-50-1) (formerly EITF 01-13, par. 7)

a. The nature of the event resulting in business interruption losses

b. The aggregate amount of business interruption insurance recoveries recognized during the period and the line items in the statement of activities in which those recoveries are reported

COLLABORATIVE ARRANGEMENTS

Participants to collaborative arrangements should disclose the following for the initial period and all annual periods thereafter, with amounts for individually significant collaborative arrangements disclosed separately: (FASB ASC 808-10-50-1) (formerly EITF 07-1, par. 21)

a. Accounting policy for collaborative arrangements

b. Information about the nature and purpose of collaborative arrangements

c. The participant's rights and obligations under the arrangement

d. The classification in the statement of activities and amounts attributable to transactions between the participants under the arrangements for each period a statement of activities is presented

SELF-STUDY QUIZ

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

10. Green Earth Organization is preparing its statement of activities. Which of the following is a correct presentation in the components of the change in net assets?

    a. Green Earth received a $200,000 donation for which the donor imposed a restriction. This donation will be presented as an increase in unrestricted net assets.

    b. Green Earth incurred $10,000 of expenses related to the maintenance of land that was donated under permanent restriction. These expenses will be presented as a decrease in permanently restricted net assets.

    c. Green Earth incurred a $20,000 loss on the sale of investments which were donated and to be used as the organization wished. The loss is presented as a decrease in unrestricted net assets.

    d. Green Earth is presenting an increase in unrestricted net assets of $40,000 for satisfying donor-imposed restrictions, and a decrease in temporarily restricted net assets of $20,000.

11. The Toys for Kids Organization had to evacuate from its headquarters because mold was discovered in the building and had to be removed. The organization rented a temporary facility to reduce the loss from this interruption. The business interruption insurance policy taken out by the organization covered these expenses. Which of the following must Toys for Kids disclose about the business interruption insurance recovery?

    a. The accounting policy for the insurance recovery.

    b. The cost of the rent and mold remediation.

    c. The total amount recovered during the period.

    d. The principal items entering into the determination of the gain or loss.

SELF-STUDY ANSWERS

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

10. Green Earth Organization is preparing its statement of activities. Which of the following is a correct presentation in the components of the change in net assets? **(Page 25)**

    a. Green Earth received a $200,000 donation for which the donor imposed a restriction. This donation will be presented as an increase in unrestricted net assets. [This answer is incorrect. Revenues are increases in unrestricted net assets unless there are donor-imposed restrictions limiting the use of the assets received (FASB ASC 958-225-45-5) (formerly SFAS 117, par. 20).]

    b. Green Earth incurred $10,000 of expenses related to the maintenance of land that was donated under permanent restriction. These expenses will be presented as a decrease in permanently restricted net assets. [This answer is incorrect. Expenses are decreases in unrestricted net assets. (FASB ASC 958-225-45-7) (formerly SFAS 117, par. 20).]

    c. Green Earth incurred a $20,000 loss on the sale of investments which were donated and to be used as the organization wished. The loss is presented as a decrease in unrestricted net assets. [This answer is correct. Gains and losses are increases or decreases in unrestricted net assets unless donor or law temporarily or permanently restricts their use. (FASB ASC 958-225-45-8) (formerly SFAS 117, par. 22).]

    d. Green Earth is presenting an increase in unrestricted net assets of $40,000 for satisfying donor-imposed restrictions, and a decrease in temporarily restricted net assets of $20,000. [This answer is incorrect. Reclassifications are simultaneous increases in one class of net assets and decreases in another per FASB ASC 958-225-45-3 and 45-13 (formerly SFAS 117, par. 19). If there is an increase of $40,000 to unrestricted net assets because donor-imposed restrictions have been satisfied, there must be a corresponding decrease of $40,000 in temporarily restricted net assets.]

11. The Toys for Kids Organization had to evacuate from its headquarters because mold was discovered in the building and had to be removed. The organization rented a temporary facility to reduce the loss from this interruption. The business interruption insurance policy taken out by the organization covered these expenses. Which of the following must Toys for Kids disclose about the business interruption insurance recovery? **(Page 26)**

    a. The accounting policy for the insurance recovery. [This answer is incorrect. An accounting policy does not need to be disclosed because there are no specific choices organizations need to make regarding how to treat the proceeds. Accounting policies for collaborative arrangements are disclosed because not all organizations will report these transactions the same way.]

    b. The cost of the rent and mold remediation. [This answer is incorrect. The nature of the event resulting in business interruption losses must be disclosed. An organization may choose to disclose these costs because they are not typical, but it is not required.]

    c. The total amount recovered during the period. [This answer is correct. The aggregate amount of business interruption insurance recoveries recognized during the period and the line items in the statement of activities in which those recoveries are reported must be disclosed, as well as the nature of the event resulting in business interruption losses per FASB ASC 225-30-50-1 (formerly EITF 01-13, par. 7).]

    d. The principal items entering into the determination of the gain or loss. [This answer is incorrect. If the business insurance recovery is classified as an extraordinary item, then the principal items entering into the determination of the extraordinary gain or loss is disclosed.]

CASH FLOWS STATEMENT

SOURCE: FASB ASC 230-10 and 958-230

OVERVIEW

A statement of cash flows is required to be presented as part of a full set of financial statements prepared in accordance with generally accepted accounting principles. The statement shows an organization's cash receipts and payments during a period, classified by principal sources and uses. The cash receipts and payments are categorized as operating, investing, and financing activities. In addition, noncash transactions that affect financial position must be disclosed.

A statement of cash flows must be included for each period that a statement of activities is presented along with a statement of financial position. If either statement is presented separately, a statement of cash flows is not required.

ACCOUNTING REQUIREMENTS

WHEN SHOULD THE STATEMENT BE PRESENTED?

A statement of cash flows shows the changes in a nonprofit organization's cash and cash equivalents during a period. (FASB ASC 230-10-45-4) (formerly SFAS 95, par. 7) It should be presented as a basic financial statement when both of the following conditions are met:

a. The financial statements are prepared in accordance with generally accepted accounting principles. (FASB ASC 230-10-15-2; 958-205-45-4) (formerly SFAS 95, par. 3 and SFAS 117, par. 30) A statement of cash flows is not required if the financial statements are prepared on a basis of accounting other than GAAP.

b. Both a statement of financial position and results of operations are presented. (A statement of cash flows should be provided for each period for which results of operations are presented.) (FASB ASC 230-10-15-3) (formerly SFAS 95, par. 3)

Common trust funds, variable annuity accounts, or similar funds maintained by a trustee, administrator, or guardian, however, are not required to present a statement of cash flows if the following conditions are met: (FASB ASC 230-10-15-4) (formerly SFAS 102, paras. 6–7)

a. Substantially all investments during the period were highly liquid.

b. Substantially all investments are carried at market value.

c. The entity had little or no debt, based on average debt outstanding during the period, in relation to average total assets.

d. The entity presents a statement of changes in net assets.

All other entities meeting the requirements in the previous paragraph are required to present a statement of cash flows regardless of their legal form or whether they normally classify their assets and liabilities as current and noncurrent. In addition, the requirement to present a statement of cash flows applies to both interim and annual financial statements.

DEFINITION OF CASH AND CASH EQUIVALENTS

As discussed, the statement of cash flows presents information about changes in cash and cash equivalents. That is, the net effect of cash flows on cash and cash equivalents during the period should be shown in a manner that reconciles beginning and ending cash and cash equivalents. Cash includes currency on hand and demand deposits with banks or other financial institutions. It also includes other accounts that have the general characteristics of demand deposits in that the organization may deposit or withdraw funds at any time without prior notice or penalty. (FASB ASC 230-10-20; 230-10-45-4) (formerly SFAS 95, par. 7) Examples of cash include certificates of deposit (unless penalties or terms associated with them effectively restrict withdrawal of funds), money market accounts, and repurchase agreements that have the preceding characteristics.

Cash equivalents are short-term, highly liquid investments that (a) are readily convertible to known amounts of cash and (b) are so near to their maturity that they present an insignificant risk of changes in value because of changes in interest rates. Examples include Treasury bills, commercial paper, money market accounts that are not classified as cash, and other short-term investments whose *original* maturity is three months or less. (FASB ASC 230-10-20; 958-230-20) (formerly SFAS 95, paras. 8–9) (Equity securities never meet the definition of cash equivalents.)

Even if a short-term, highly liquid investment meets the definition of cash equivalent in the previous paragraph, it may not always be treated as such. Cash equivalents representing contributions with donor-imposed restrictions limiting their use to long-term purposes should not be considered available for current use and should not be classified as cash equivalents on the statement of financial position. Similarly, a short-term investment that otherwise meets the definition of a cash equivalent should *not* be treated as such on the statement of cash flows if it is donor-restricted for long-term purposes. (FASB ASC 958-230-55-2) (formerly 2008 Audit Guide, par. 3.19) For example, an endowment fund investment or an investment restricted for the purchase of equipment would not be treated as a cash equivalent. The investment section of this course provides further guidance on distinguishing between investments and cash equivalents.

The statement of cash flows should use descriptive terms such as *cash* or *cash and cash equivalents* rather than ambiguous terms such as *funds*. The total amount of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows should be the same as similarly titled line items or subtotals in the statement of financial position. Throughout this section, the term cash is used and includes cash equivalents.

BASIC ELEMENTS OF THE STATEMENT OF CASH FLOWS

A statement of cash flows has five basic elements:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities
- Net change in cash during the period
- Supplemental disclosure of noncash investing and financing activities

Accordingly, all cash receipts and payments should be classified as operating, investing, or financing activities, and noncash transactions involving investing and financing activities, such as acquiring assets by assuming liabilities, should be disclosed separately rather than within the body of the statement. (FASB ASC 230-10-45-1; 230-10-45-10) (formerly SFAS 95, paras. 6, 14, and 32) When a cash receipt or cash payment qualifies for more than one classification, it should be included in the category that represents the predominant source of cash flows for the item. (FASB ASC 230-10-45-22) (formerly SFAS 95, par. 24) The measurement of eligible items at fair value under the fair value option does not change the way their related cash flows should be categorized in the cash flow statement. (FASB ASC 825-10-45-3) (formerly SFAS 159, par. 16)

Generally, cash receipts and disbursements should be classified in the statement of cash flows without regard to whether they stem from an item intended as a hedge. For example, the proceeds from a borrowing should be classified as a financing activity even though the debt is considered a hedge of an investment, and the purchase or sale of a futures contract should be classified as an investing activity even though the contract is considered a hedge of a firm commitment to purchase inventory. However, cash flows from derivative instruments accounted for as fair value hedges may be classified in the same category as the cash flows from the hedged item (provided that the derivative instrument does not include an other-than-insignificant financing element at inception as discussed in this section) so long as the accounting policy is disclosed. If hedge accounting is discontinued for an instrument that hedges an identifiable transaction or event, any cash flows subsequent to the date of discontinuance should be classified consistent with the nature of the derivative instrument. (FASB ASC 230-10-45-27) (formerly SFAS 95, par. 14) Exhibit 1-6 shows how a typical nonprofit organization's transactions would be classified into operating, investing, and financing activities.

Exhibit 1-6

Types of Cash Flows

STATEMENT OF CASH FLOWS			
OPERATING	**INVESTING**	**FINANCING**	**NONCASH INVESTING AND FINANCING TRANSACTIONS**
CASH RECEIPTS FROM: • Contributions (other than those restricted for long-term purposes) • Service recipients • Grants • Unrestricted or temporarily restricted interest and dividends available for current use • Other cash receipts not arising from investing or financing activities	**CASH RECEIPTS FROM:** • Sale of property and equipment • Sale or maturity of investments • Collections on loans • Sale or insurance recoveries of collection items • Installment sales • Sale of subsidiary	**CASH RECEIPTS FROM:** • Contributions restricted for long-term purposes • Short-term borrowings • Long-term borrowings • Interest and dividends restricted for long-term purposes • Issuance of membership shares • Derivatives that include a financing element	• Acquiring nonoperating assets, e.g., property and equipment, by assuming liabilities • Acquiring assets by capital lease • Obtaining a building, securities, or collection items by receiving a gift • Capitalization of donated services • Settling liabilities by transferring noncash assets or issuing membership shares.
CASH PAYMENTS FOR: • Wages • Supplies • General and administrative expenses • Interest (excluding amounts capitalized as long-lived assets) • Grants • Settlement of an asset retirement obligation • Other cash payments not related to investing or financing activities	**CASH PAYMENTS FOR:** • Property and equipment (including capitalized interest) • Investments • Loans • Collections • Purchase of subsidiary	**CASH PAYMENTS FOR:** • Repayment of amounts borrowed, e.g., short-term debt, long-term debt, and capital lease obligations • Annuity obligations • Repurchase or redemption of membership shares • Distributions to counterparties of derivatives that include a financing element • Debt issue costs	

Presenting Gross and Net Cash Flows

As a general rule, cash flows from investing and financing activities should be reported in gross rather than net amounts. The presumption is that gross cash receipts and disbursements are more relevant than net amounts. (FASB ASC 230-10-45-7) (formerly SFAS 95, par. 11) Thus, for example, both proceeds from sales of assets and cash payments for capital expenditures should be shown in the cash flows statement rather than the net change in property and equipment. In addition, both proceeds from short-term debt and payments to settle short-term debt should be shown rather than the net change in short-term debt.

While the general rule calls for reporting gross cash flows, net cash flows may be reported from the following activities:

a. Cash receipts and payments from purchasing and selling cash equivalents (FASB ASC 230-10-45-7) (formerly SFAS 95, par. 11)

b. Cash receipts and payments related to investments that are not cash equivalents, loans receivable, and debt when the original maturity of the asset or liability is three months or less (Amounts due on demand are generally considered to have maturities of three months or less.) (FASB ASC 230-10-45-9) (formerly SFAS 95, par. 13)

c. Cash receipts and payments from transactions for which the organization is holding or disbursing cash on behalf of its customers (such as the collection and payment of sales taxes) (FASB ASC 230-10-45-8) (formerly SFAS 95, par. 12)

Although GAAP permits reporting net cash flows from the preceding activities, netting is not required. Presenting gross cash flows for those activities may be preferable in some instances. For example, it may create an unnecessary recordkeeping burden to segregate cash flows from investments with a maturity of three months or less from those of investments with longer maturities.

SELF-STUDY QUIZ

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

12. Green Earth, Inc. is presenting a statement of activities for the years ended 2009 and 2008. However, no statement of financial position is presented. Green Earth is not required to present a statement of cash flows.

    a. True.

    b. False.

13. The Charity Trust, a common trust fund, is presenting a statement of activities and statement of financial position. Which of the following is one of the four conditions Charity Trust must meet in order to not be required to present a statement of cash flows?

    a. Substantially all investments during the period were highly liquid.

    b. Substantially all investments are carried at cost.

    c. The entity was heavily in debt.

    d. The entity does not present a statement of changes in net assets.

14. America's Charity, Inc. has a 30-day Treasury bill, 120-day commercial paper with remaining maturity of one month, a 6-month CD that contains a penalty for early withdrawal, and a tax refund receivable. Which of these assets will be classified as cash or cash equivalents?

    a. 30-day Treasury bill.

    b. 120-day commercial paper.

    c. 6-month CD.

    d. Tax refund receivable.

15. A not-for-profit organization has a checking account balance of $40,000, a $15,000 US Treasury note that matures in six months, a $10,000 five-year US Treasury note purchased one month from maturity, and a $20,000 three-month US Treasury bill which was donated with the restriction it be used for equipment. What amount will the organization include in its balance of cash and cash equivalents?

    a. $40,000.

    b. $50,000.

    c. $55,000.

    d. $60,000.

16. A not-for-profit pet shelter has the following transactions relating to a new pet holding area. Which of the transactions will be classified as an investing activity on its statement of cash flows?

    a. The shelter received a $15,000 grant for its new pet holding area.

    b. The shelter purchased $25,000 of equipment from its operating funds to be used in its new pet holding area.

    c. The shelter received $50,000 in donations for its new pet holding area.

    d. The shelter capitalized the donated services of an architecture firm that designed a new pet holding area.

17. Which of the following transactions may be shown as net cash flows, rather than gross cash flows, on the cash flow statement?

    a. Organization A purchased and sold five-year Treasury notes during the year.

    b. Organization B purchased and sold equipment used in its operations.

    c. Organization C collected and paid sales tax on behalf of its customers.

SELF-STUDY ANSWERS

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

12. Green Earth, Inc. is presenting a statement of activities for the years ended 2009 and 2008. However, no statement of financial position is presented. Green Earth is not required to present a statement of cash flows. **(Page 31)**

    a. **True. [This answer is correct. If either a statement of activities or statement of financial position is presented separately, a statement of cash flows is not required per guidance in FASB ASC 230-10-15-3 (formerly SFAS 95, par. 3). However, if Green Earth did present a statement of financial position, a statement of cash flows would be required for the years ended 2009 and 2008.]**

    b. False. [This answer is incorrect. A statement of cash flows must be included for each period that a statement of activities is presented *along with* a statement of financial position per guidance in FASB ASC 230-10-15-3 (formerly SFAS 95, par. 3).]

13. The Charity Trust, a common trust fund, is presenting a statement of activities and statement of financial position. Which of the following is one of the four conditions Charity Trust must meet in order to not be required to present a statement of cash flows? **(Page 31)**

    a. **Substantially all investments during the period were highly liquid. [This answer is correct. Common trust, variable annuity accounts, or similar funds maintained by a trustee, administrator, or guardian, are not required to present a statement of cash flows if substantially all investments during the period were highly liquid, substantially all investments are carried at market value, the entity had little or no debt, and the entity presents a statement of changes in net assets per FASB ASC 230-10-15-4 (formerly SFAS 102, paras. 6–7).]**

    b. Substantially all investments are carried at cost. [This answer is incorrect. One of the conditions that must be met is substantially all investments are carried at market value per FASB ASC 230-10-15-4 (formerly SFAS 102, paras. 6–7).]

    c. The entity was heavily in debt. [This answer is incorrect. One of the conditions per FASB ASC 230-10-15-4 (formerly SFAS 102, paras. 6–7) is if the entity had little or no debt, based on average debt outstanding during the period, in relation to average total assets.]

    d. The entity does not present a statement of changes in net assets. [This answer is incorrect. One of the conditions per FASB ASC 230-10-15-4 (formerly SFAS 102, paras. 6–7) is if the entity presents a statement of changes in net assets. If the entity is required to represent a statement of cash flows, the requirements apply to both interim and annual financial statements.]

14. America's Charity, Inc. has a 30-day Treasury bill, 120-day commercial paper with remaining maturity of one month, a 6-month CD that contains a penalty for early withdrawal, and a tax refund receivable. Which of these assets will be classified as cash or cash equivalents? **(Pages 31–32)**

    a. **30-day Treasury bill. [This answer is correct. Cash equivalents are short-term, highly liquid investments that (a) are readily convertible to known amounts of cash and (b) are so near to their maturity that they present an insignificant risk of changes in value because of changes in interest rates per FASB ASC 230-10-20; 958-230-20 (formerly SFAS 95, paras. 8–9).]**

    b. 120-day commercial paper. [This answer is incorrect. Although the commercial paper has only one month until maturity, the original maturity is greater than three months from the date of purchase.]

    c. 6-month CD. [This answer is incorrect. A CD may be included with cash and cash equivalents, unless penalties or terms associated with them effectively restrict withdrawal of funds.]

    d. Tax refund receivable. [This answer is incorrect. Even though cash is expected to be received from a government agency, until the cash is in hand the potential refund will be classified as a receivable.]

15. A not-for-profit organization has a checking account balance of $40,000, a $15,000 US Treasury note that matures in six months, a $10,000 five-year US Treasury note purchased one month from maturity, and a $20,000 three-month US Treasury bill which was donated with the restriction it be used for equipment. What amount will the organization include in its balance of cash and cash equivalents? **(Pages 31–32)**

    a. $40,000. [This answer is incorrect. In addition to the $40,000 in the checking account, certain short-term, highly liquid investments meet the definition of cash equivalents.]

    b. $50,000. [This answer is correct. Besides the cash in the organization's checking account, the US Treasury note that was purchased one month before maturity will be included. If the Treasury note's original maturity to the organization was five-years, it does not become a cash equivalent when its remaining maturity is three months or less.]

    c. $55,000. [This answer is incorrect. Unlike the definition of "current", short-term for purposes of cash equivalents is three months or less. The US Treasury note that matures in six months is not a cash equivalent.]

    d. $60,000. [This answer is incorrect. Even though the three-month Treasury bill meets the requirements for a cash equivalent, because the donor imposed a restriction for long-term purposes, it cannot be treated as a cash equivalent.]

16. A not-for-profit pet shelter has the following transactions relating to a new pet holding area. Which of the transactions will be classified as an investing activity on its statement of cash flows? **(Page 33)**

    a. The shelter received a $15,000 grant for its new pet holding area. [This answer is incorrect. Grants are classified as operating activities.]

    b. The shelter purchased $25,000 of equipment from its operating funds to be used in its new pet holding area. [This answer is correct. Cash payments for property and equipment are classified as investing activities per FASB ASC 230-10-20 (previously SFAS 95, paras. 29–30). The fact that the cash came from operating funds does not classify the transaction as an operating activity.]

    c. The shelter received $50,000 in donations for its new pet holding area. [This answer is incorrect. Contributions restricted for long-term purposes are classified as financing activities.]

    d. The shelter capitalized the donated services of an architecture firm that designed a new pet holding area. [This answer is incorrect. Capitalized donated services are classified as noncash investing activities.]

17. Which of the following transactions may be shown as net cash flows, rather than gross cash flows, on the cash flow statement? **(Page 34)**

    a. Organization A purchased and sold five-year Treasury notes during the year. [This answer is incorrect. Cash receipts and payments from purchasing and selling cash equivalents can be reported as net cash flows. Five-year Treasury notes are not cash equivalents, and the purchases and sales of this investment should be reported as gross cash flows.]

    b. Organization B purchased and sold equipment used in its operations. [This answer is incorrect. Cash receipts and payments related to investments that are not cash equivalents, loans receivable, and debt when the original maturity of the asset or liability is three months or less, may be reported as net cash flows. Purchases and sales of equipment should be reported as gross cash flows.]

    c. Organization C collected and paid sales tax on behalf of its customers. [This answer is correct. Cash receipts and payments from transactions for which the organization is holding or disbursing cash on behalf of its customers can be reported as net cash flows per FASB ASC 230-10-45-8 (formerly SFAS 95, par. 12). However, there is no requirement to report permitted transactions as net cash flows if the organization prefers reporting them as gross cash flows.]

CASH FLOWS FROM OPERATING ACTIVITIES

What Is Included?

Cash flows from operating activities are defined by exception; operating activities include all transactions and events that are not investing or financing activities. (FASB ASC 230-10-20) (formerly SFAS 95, par. 21) Generally, however, operating activities meet the following three criteria:

a. The amounts represent the cash effects of transactions or events.

b. The amounts result from an organization's normal operations of providing services, making or receiving contributions, and delivering or producing goods for sale.

c. The amounts are derived from activities that enter into the determination of the change in net assets.

Thus, cash flows from operating activities include cash received from service recipients, contributors, and sales of goods or services and cash used to provide services, solicit funds, and generate goods for sale, such as for salaries, occupancy, inventory, administrative, and other operating costs. Cash receipts from both short and long-term notes receivable from service recipients or customers are also classified as operating activities. Similarly, principal payments on service recipient or customer accounts and both short and long-term notes payable to suppliers for materials or goods also should be classified as operating activities. In addition, interest and dividend income (other than amounts donor-restricted for long-term purposes), the cash effects of agency transactions, and interest expense are considered to be operating activities even though they are not precisely consistent with the preceding criteria. (FASB ASC 230-10-20; 230-10-45-16 and 45-17; 958-230-55-4) (formerly SFAS 95, paras. 21–23)

Cash flows from operating activities exclude (a) amounts not derived from cash receipts and cash payments (for example, accruals, deferrals, and allocations such as depreciation), and (b) amounts considered to be derived from investing or financing activities rather than from operating activities (for example, cash receipts and payments related to property and equipment and contributions received that are donor-restricted for long-term purposes such as for the purchase of equipment).

Formats for Presenting Cash Flows from Operating Activities

Cash flows from operating activities may be presented in either of two basic formats: the direct method or the indirect method. The following paragraphs describe both methods.

Direct Method. The direct method begins with gross cash receipts and deducts gross cash payments for operating costs and expenses, individually listing the cash effects of each major type of operating activity. At a minimum, the following categories of cash receipts and cash payments are required to be presented:

- Cash collected from customers, service recipients, grants, and contributions not donor-restricted for long-term purposes
- Interest and dividends received that are not donor-restricted for long-term purposes
- Other operating cash receipts, if any
- Cash paid to employees and other suppliers of goods or services, including suppliers of insurance and advertising
- Interest paid (net of amounts capitalized) (FASB ASC 230-10-50-2) (formerly SFAS 95, par. 29)
- Unrelated business income taxes or excise taxes paid, if any
- Other operating cash payments, if any (FASB ASC 230-10-45-25) (formerly SFAS 95, par. 27)

Because the direct method shows only cash receipts and payments, no adjustments are necessary for noncash expenses such as depreciation or deferred income taxes. The following illustrates how cash flows from operating activities would be presented using the direct method:

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from service recipients	$ 235,000
Cash received from contributors and grants	425,000
Interest received	2,450
	662,450
Cash paid to employees and suppliers	374,000
Grants paid	115,000
Interest paid	3,475
	492,475
NET CASH PROVIDED BY OPERATING ACTIVITIES	169,975

If the direct method is used, a reconciliation of the change in net assets to net cash flows from operating activities is required to be presented in a separate schedule showing all major classes of operating items, including, at a minimum, changes in receivables and payables related to operating activities and changes in inventory. (FASB ASC 230-10-45-29 and 45-30) (formerly SFAS 95, paras. 29 and 30)

Indirect Method. The indirect method starts with the change in net assets and adjusts for (a) noncash items or items related to investing or financing activities such as depreciation and net realized and unrealized gains on investments, and (b) changes during the period in operating assets and liabilities. The reconciliation should show all major classes of operating items, including, at a minimum, changes in receivables and payables related to operating activities and changes in inventory. Changes in assets and liabilities arising from investing or financing activities (for example, short-term loans or notes receivable or payable not related to operating activities) should be shown as investing or financing activities, as appropriate, however. In addition, accounts payable may have aspects of financing or investing activities, for example, equipment purchased on account. In such cases, it would not be appropriate to include the net change in payables as an adjustment in arriving at cash flows from operating activities. (FASB ASC 230-10-45-28 and 45-29) (formerly SFAS 95, paras. 28 and 29; ASU 2010-08)

Items reconciling the change in net assets to net cash flows from operating activities may be presented in the statement of cash flows or in a separate schedule. (FASB ASC 230-10-45-31) (formerly SFAS 95, par. 30) The following illustrates presenting the reconciliation in the statement of cash flows:

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	$ 223,000
Adjustments to reconcile change in net assets to net cash provided by operating activities	
Depreciation	29,400
Gain on sale of equipment	(6,700)
(Increase) decrease in:	
Receivables	(10,200)
Inventories	26,450
Prepaid expenses	4,100
Increase (decrease) in:	
Accounts payable	37,250
Accrued liabilities	(9,500)
Contributions restricted for long-term purposes	(32,600)
Interest and dividends restricted for long-term purposes	(2,350)
Net unrealized and realized gains on investments	(13,500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	245,350

If the reconciling items were presented in a separate schedule, the cash flow statement would show a single line item for cash flows from operating activities such as the following:

Net cash flows from operating activities	$ 245,350

Agency Transactions. Changes in certain assets and liabilities do not affect the statement of activities and, therefore, theoretically do not affect cash provided from operating activities. Operating activities include all transactions and events not defined as investing or financing activities, however, and are not limited to the cash effects of transactions reported on the statement of activities. Therefore, the cash effects of agency transactions are operating activities. (FASB ASC 958-230-55-4) (formerly 2008 Audit Guide, par. 3.16) Examples of common agency or custodial transactions include federated fund-raising organizations that receive cash designated for particular organizations or other organizations that collect and disburse funds on behalf of a third party.

Agency transactions may be reported net on the statement of cash flows. It is acceptable to report only the net changes to assets and liabilities resulting from agency transactions, as reporting the gross cash receipts and payments may not be necessary to understand the organization's operating, investing, and financing activities. (FASB ASC 230-10-45-8; 958-230-55-4) (formerly SFAS 95, par. 12) However, an organization that receives significant resources from agency transactions (such as federated fund-raising organizations) may choose to report the gross cash receipts and payments on the statement of cash flows to more completely reflect the results of its fund-raising efforts.

Extraordinary Items, Cumulative Accounting Adjustments, and Discontinued Operations

Extraordinary items, cumulative accounting adjustments, or discontinued operations need not be separately disclosed in cash flow statements. Thus, the criteria for classifying transactions and events as operating, investing, or financing also would apply to extraordinary items, cumulative accounting adjustments, and discontinued operations. (FASB ASC 230-10-45-24) (formerly SFAS 95, par. 26)

Other Adjustments to Arrive at Net Cash Flows from Operating Activities

Other adjustments to arrive at net cash flows from operating activities are necessary when the indirect method is used to present cash flows from operating activities. The objective of the adjustments is to present net cash flows generated by operating activities by adding noncash expenses (or expenses related to investing or financing activities) to, and subtracting noncash revenues (or revenues related to investing or financing activities) from, the change in net assets. (FASB ASC 230-10-45-28) (formerly SFAS 95, par. 28) Examples of those adjustments include—

a. Noncash entries to operating assets and liabilities, such as recording a provision for uncollectible promises to give not restricted for long-term purposes or providing a reserve for inventory obsolescence

b. Amortization of discount on unconditional promises to give

c. Amortization of finite-life intangible assets or deferred charges such as copyrights, mailing lists, and trademarks

d. Increases in the cash value of life insurance, net of any premiums paid, if any

e. Contributions donor-restricted for long-term purposes

f. Deferred income taxes resulting from unrelated business taxable income or net investment income subject to excise taxes, if any

g. Deferred revenue

h. Depreciation

i. Realized and unrealized gains and losses on investments

j. Gains or losses associated with the disposal of noncurrent assets

k. Earnings on long-term investments in common stock of a for-profit entity accounted for under the equity method

l. Noncontrolling interests in consolidated for-profit subsidiaries

m. Long-term installment sale receivables

The adjustments should be reflected either in the statement itself or in a separate schedule. When the direct method is used, the items should be excluded from the statement of cash flows because the direct approach only reflects cash receipts and payments. However, the items would be shown in the reconciliation of the change in net assets to net cash provided by operating activities. (FASB ASC 230-10-45-29; 230-10-45-31 and 45-32) (formerly SFAS 95, paras. 29–30)

CASH FLOWS FROM INVESTING ACTIVITIES

Investing activities include the following: (FASB ASC 230-10-20; 230-10-45-11 and 45-12) (formerly SFAS 95, paras. 15–17 and SFAS 102, paras. 8–9)

- Lending money and collecting on loans
- Acquiring and selling or disposing of securities that are not cash equivalents
- Acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time
- Receiving cash from contributions donor-restricted for long-term purposes for which the restrictions have not yet been satisfied and cash is still held

Exhibit 1-6 lists examples of cash flows provided by and used in investing activities. The following paragraphs discuss how to handle cash flows from investing activities in the statement of cash flows.

Noncash Investing Activities

Certain investing activities, such as acquiring assets by assuming liabilities or exchanging assets, are noncash transactions that do not involve cash receipts or payments. Nevertheless, GAAP requires investing activities that do not involve cash to be reported separately so that information is provided on all investing activities. (FASB ASC 230-10-50-3 through 50-6; 958-230-55-5) (formerly SFAS 95, paras. 32 and 74) Noncash investing activities are discussed later in this lesson.

Capital Expenditures

Purchases. Cash outlays for acquiring long-lived assets (including capitalized interest, if any) should be reported as a cash outflow from investing activities. The amount to be reported in a statement of cash flows generally should consist of (a) assets purchased for cash and (b) down payments for assets purchased by assuming liabilities. (FASB ASC 230-10-45-13) (formerly SFAS 95, par. 17) Payments of liabilities, including capital lease obligations, and trade-in allowance and other noncash aspects of the transaction should be excluded from the amounts reported as investing activities.

Investing cash flows only should include advance payments, the down payment, or other amounts paid at the time (or shortly before or after) productive assets are purchased. Subsequent principal payments on an installment loan should be classified as financing activities. (FASB ASC 230-10-45-13) (formerly SFAS 95, par. 17) The noncash aspects of the transaction (equipment acquired by assuming liabilities, net of the trade-in allowance) should be disclosed separately as discussed later in this lesson.

Sales. Proceeds from sales of long-lived assets should be shown as cash inflows from investing activities. (FASB ASC 230-10-45-12) (formerly SFAS 95, par. 16) If an organization enters into an installment sale, the total sales price is not received at the time of sale. Cash receipts in the form of downpayments and collections of principal should be classified as cash provided by investing activities. Interest collected, however, should be classified as cash flows from operating activities.

Collections Items

Purchases, sales, and insurance recoveries of collection items (both capitalized and not capitalized) are considered cash flows from investing activities. (FASB ASC 230-10-20; 230-10-45-12 and 45-13; 958-230-55-5 and 55-5A) (formerly SFAS 95, paras. 15 and 16 and 2008 Audit Guide, paras. 3.15 and 7.08)

Contributions Donor-restricted for Long-term Purposes for Which Restrictions Are Not Yet Satisfied

As discussed later, receipts of contributions donor-restricted for long-term purposes are considered financing activities, not operating activities. In addition, restricted cash is excluded from cash and equivalents for purposes of the statement of cash flows. As a result, even if a contribution restricted for long-term purposes (such as for the purchase of equipment) has not been spent during the period to satisfy the donor restriction, both a cash inflow and a cash outflow must be presented on the statement of cash flows. The restricted contribution received is reported as a cash inflow from financing activities, and a corresponding cash outflow from investing activities is reported to arrive at the proper change in cash and equivalents for the period. For example, an organization receives a cash donation for the purchase of equipment but does not purchase the equipment before the end of its fiscal year. Thus, it still holds cash restricted for the purchase of the equipment at the financial statement date, and the restricted cash is excluded from cash and equivalents on the statement of financial position. The organization's statement of cash flows should reflect both a cash inflow from financing activities for the receipt of the contribution and a corresponding cash outflow from investing activities. The corresponding cash outflow must be reported to arrive at the proper change in cash and equivalents for the year. If the organization had purchased the equipment during the period, however, no corresponding cash outflow would be necessary, as the equipment purchase would already be reflected as a cash outflow from investing activities on the cash flow statement. (FASB ASC 958-230-55-3) (formerly 2008 Audit Guide, par. 3.18)

Investments

Short-term Investments vs. Cash Equivalents. If an organization has amounts that do not meet the definition of cash, it must decide whether to account for them as cash equivalents or as other short-term investments. [Cash equivalents are defined as short-term, highly liquid investments that (a) are readily convertible to known amounts of cash and (b) are so near to their maturity that they present an insignificant risk of changes in value because of changes in interest rates. Cash equivalents exclude short-term investments purchased with contributions that have donor-imposed restrictions limiting their use to long-term purposes.] GAAP allows an organization to establish a policy concerning which short-term, highly liquid investments with original maturities of three months or less are considered cash equivalents and which are to be reported as short-term investments. For example, an organization may choose to hold a portion of its endowment portfolio in cash and other instruments with maturities of less than three months. In that case, the organization may by policy exclude them from cash equivalents. (An organization should disclose its policy in its financial statements.) Once established, the policy should be consistently followed. A change in the type of investments classified as cash equivalents is a change in accounting principle that requires prior period financial statements presented for comparative purposes to be restated. (FASB ASC 230-10-45-6; 230-10-50-1) (formerly SFAS 95, par. 10)

Purchases and sales of investments that are classified as cash equivalents are part of an organization's cash management rather than part of its operating, investing, and financing activities. Thus, the net change in cash equivalents should be included in the net change in cash and cash equivalents shown in the statement of cash flows. In other words, purchases and sales of cash equivalents need not be reported separately. (FASB ASC 230-10-45-5) (formerly SFAS 95, par. 9)

Investments That Are Not Cash Equivalents. Purchases and sales of investments that are not cash equivalents should be classified as investing activities in the statement of cash flows.

Interest and Dividend Income. As previously discussed, receipts from interest and dividends not donor-restricted for long-term purposes should be classified as cash flows from operating activities rather than cash flows from investing activities. (FASB ASC 230-10-45-16; 958-230-55-2) (formerly SFAS 95, par. 22 and 2008 Audit Guide, par. 3.19)

Making Loans

Making loans (notes and loans receivable) is an investment activity. Accordingly, the principal amount of the loan should be shown as cash used for investing activities, and principal collected on the loans should be shown as cash provided by investing activities. (FASB ASC 230-10-45-12 and 45-13) (formerly SFAS 95, paras. 16–17) Interest collected on the loans should be shown as an operating activity. Cash flows relating to investments or loans receivable with original maturities of three months or less may be reported net. (FASB ASC 230-10-45-9) (formerly SFAS 95, par. 13) (Where loans are specifically originated or purchased for resale, held for short periods of time, and are carried at market value or the lower of cost or market, the associated cash receipts and payments should be classified as operating activities.) (FASB ASC 230-10-45-21) (formerly SFAS 102, par. 9)

Purchase (Sale) of a Subsidiary

When a subsidiary is purchased or sold, cash flow statements should report the cash paid to acquire the subsidiary (or cash proceeds from sale) as an investing activity. (FASB ASC 230-10-45-13) (formerly SFAS 95, par. 17) For example, if an organization pays $90,000 to acquire an entity with working capital (other than cash) of $30,000 and net noncurrent assets of $60,000, cash flows from investing activities would be presented as follows:

CASH FLOWS FROM INVESTING ACTIVITIES	
Acquisition of ABC Company	90,000

The fair values of assets obtained and liabilities assumed should be disclosed as noncash investing and financing activities.

CASH FLOWS FROM FINANCING ACTIVITIES

Financing activities include the following: (FASB ASC 230-10-20; 230-10-45-14 and 45-15) (formerly SFAS 95, paras. 18 and 19)

- Obtaining resources from owners and providing them with a return on, and a return of, their investment
- Receiving restricted resources that by donor stipulation must be used for long-term purposes (FASB ASC 958-230-55-3) (formerly 2008 Audit Guide, par. 3.18)
- Borrowing money and repaying amounts borrowed, or otherwise settling the obligation
- Obtaining and paying for other resources from creditors on long-term credit

Exhibit 1-6 lists examples of cash flows provided by financing activities. The following paragraphs discuss how to handle cash flows from financing activities in the statement of cash flows.

Noncash Financing Activities

Certain financing activities do not involve cash receipts or payments (for example, obtaining a building by receiving a gift). Financing activities that do not involve cash should be reported separately so that information is provided on all financing activities. (FASB ASC 230-10-50-3 through 50-6; 958-230-55-5) (formerly SFAS 95, paras. 32 and 74) Noncash financing activities are discussed later in this section.

Restricted Contributions

Receipts of contributions that are restricted for long-term purposes by the donor are financing activities. Long-term purposes include purchasing, improving, or constructing property, equipment, or any other long-lived asset and establishing or adding to a permanent or term endowment. (FASB ASC 230-10-45-14; 958-230-55-3) (formerly SFAS 95, par. 19 and 2008 Audit Guide, par. 3.18)

Restricted Investment Income

Similar to restricted contributions, investment income that is donor-restricted for long-term purposes is considered a financing activity, not an operating receipt. (FASB ASC 230-10-45-14; 958-230-55-3) (formerly SFAS 95, par. 19

and 2008 Audit Guide, par. 3.18) An example of investment income that is donor-restricted for long-term purposes results when a donor establishes a permanent endowment and requires that investment income be reinvested until the endowment reaches a specified amount. Another common example results from a donor establishing an endowment and requiring income earned to be used to purchase equipment for a particular program.

Short-term and Long-term Debt

Cash receipts from both short-term and long-term borrowings should be shown as cash inflows from financing activities. The reduction of short-term and long-term obligations should be reported as a separate cash outflow from financing activities, except for cash flows related to loans with original maturities of three months or less, which may be reported net. (FASB ASC 230-10-45-9; 230-10-45-14 and 45-15) (formerly SFAS 95, par. 13 and paras. 19–20)

Derivatives that Include a Financing Element

For derivatives that include an other-than-insignificant financing element at inception (other than a financing element inherently included in an at-the-market derivative instrument with no prepayments), all cash inflows and outflows at inception and over the term of the derivative are reported by the borrower as cash flows from financing activities. (FASB ASC 230-10-45-14 and 45-15) (formerly SFAS 95, paras. 19 and 20)

SELF-STUDY QUIZ

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

18. Which of the following transactions will be classified as cash flows from operating activities?

    a. Organization A received $2,000 of interest earned on a donated investment. The donor restricted the principal and interest for equipment purchases.

    b. Organization B recorded $20,000 of depreciation on its fixed assets.

    c. Organization C paid $5,000 for new computers and printers.

    d. Organization D received $25,000 from a long-term note receivable due from a customer.

19. A not-for-profit thrift store uses the indirect method to prepare its statement of cash flows. The store had the following balances at the end of 2010:

Change in net assets	$ 220,000
Depreciation	20,000
Cash received from contributions and grants	400,000
Increase in receivables	30,000
Decrease in accounts payable	5,000

    What is the store's net cash provided by operating activities?

    a. $165,000.

    b. $205,000.

    c. $275,000.

    d. $345,000.

20. Red, Inc. is a not-for-profit organization that, along with its regular operations, collects and disburses funds on behalf of Blue, Inc., also a not-for-profit organization. During 2010, Red collected $12,000 on behalf of Blue, and disbursed $18,000 because there were collections due from 2009. How should Red show these transactions on its 2010 statement of cash flows?

    a. Agency transactions are reported in the noncash investing and financing section.

    b. A decrease of $6,000 is included in the change in net assets.

    c. A decrease of $6,000 from operating activities.

    d. $12,000 inflow, and $18,000 outflow from investing activities.

21. The Right Foundation had the following transactions during 2010:

Down payment on new equipment	$ 20,000
Loan payments made on new equipment loan	5,000
Gain on sale of old equipment	10,000
Proceeds from sale of old equipment	7,000

What is Right's net cash outflow from investing activities on its 2010 statement of cash flows?

a. $3,000.

b. $8,000.

c. $13,000.

d. $20,000.

22. During 2010, AOK Organization purchased $10,000 of investments classified as cash equivalents and sold the same type of investments for $15,000. Where is this purchase and sale included on AOK's statement of cash flows?

    a. In the net change in cash and cash equivalents.

    b. In investing activities as a $5,000 inflow.

    c. In the adjustments to change in net assets, if the indirect method is used.

    d. In operating activities as a $5,000 inflow.

23. On January 15, 2010, First Charity made a five-year $100,000 loan to Second Charity. During 2010, Second repaid $15,000 of the loan principal, and paid $2,000 in interest. How does First classify these transactions on its statement of cash flows for 2010?

    a. $85,000 outflow from investing activities, $2,000 inflow from operating activities.

    b. $100,000 outflow from investing activities, $17,000 inflow from investing activities.

    c. $100,000 inflow from financing activities, $15,000 outflow from operating activities, $2,000 outflow from operating activities.

    d. $100,000 outflow from investing activities, $15,000 inflow from investing activities, $2,000 inflow from operating activities.

24. During the current year, a not-for-profit organization had the following transactions:

    $10,000 repayment of a bank loan
    $30,000 contribution to a permanent endowment
    $40,000 value of land donated to the organization
    $60,000 loan made to another NFP organization
    $5,000 of investment income used for scholarships

    What is the organization's net cash flow from financing activities?

    a. $70,000 outflow.

    b. $15,000 outflow.

    c. $20,000 inflow.

    d. $30,000 inflow.

SELF-STUDY ANSWERS

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

18. Which of the following transactions will be classified as cash flows from operating activities? **(Page 39)**

    a. Organization A received $2,000 of interest earned on a donated investment. The donor restricted the principal and interest for equipment purchases. [This answer is incorrect. Interest and dividend income, other than amounts donor-restricted for long-term purposes, are classified as operating activities. Interest and dividend income that is restricted for long-term purposes is classified as financing activities on the statement of cash flows.]

    b. Organization B recorded $20,000 of depreciation on its fixed assets. [This answer is incorrect. Amounts not derived from cash receipts and cash payments, such as accruals, deferrals, and allocations such as depreciation are excluded from the cash flow statement.]

    c. Organization C paid $5,000 for new computers and printers. [This answer is incorrect. Cash receipts and payments related to property and equipment are investing activities.]

    d. Organization D received $25,000 from a long-term note receivable due from a customer. [This answer is correct. Cash receipts from both short and long-term notes receivable from service recipients or customers are classified as operating activities per FASB ASC 230-10-45-16 (previously SFAS 95, par. 22).]

19. A not-for-profit thrift store uses the indirect method to prepare its statement of cash flows. The store had the following balances at the end of 2010:

Change in net assets	$ 220,000
Depreciation	20,000
Cash received from contributions and grants	400,000
Increase in receivables	30,000
Decrease in accounts payable	5,000

    What is the store's net cash provided by operating activities? **(Page 40)**

    a. $165,000. [This answer is incorrect. Because depreciation is a noncash expense, it is added back to the change in net assets to calculate the cash provided by operating activities.]

    b. $205,000. [This answer is correct. When the indirect method is used, start with the change in net assets and adjust for (a) noncash items or items related to investing and financing activities such as depreciation and net realized and unrealized gains on investments, and (b) changes during the period in operating assets and liabilities. $220,000 + $20,000 − $30,000 − $5,000.]

    c. $275,000. [This answer is incorrect. Both increases in receivables and decreases in accounts payable are decreases for net cash provided by operating activities because an increase in receivables means less cash was collected, and an increase in payables means more cash was paid out.]

    d. $345,000. [This answer is incorrect. The indirect method does not start with cash received from contributions and grants. That is a component of the cash flow statement when the direct method is used.]

20. Red, Inc. is a not-for-profit organization that, along with its regular operations, collects and disburses funds on behalf of Blue, Inc., also a not-for-profit organization. During 2010, Red collected $12,000 on behalf of Blue, and disbursed $18,000 because there were collections due from 2009. How should Red show these transactions on its 2010 statement of cash flows? **(Page 41)**

    a. Agency transactions are reported in the noncash investing and financing section. [This answer is incorrect. Agency transactions by their nature involve cash, and therefore, need to be included in one of the sections with cash transactions.]

    b. A decrease of $6,000 is included in the change in net assets. [This answer is incorrect. Agency transactions are not part of the statement of activities and, therefore, do not affect the change in net assets.]

    c. A decrease of $6,000 from operating activities. [This answer is correct. Operating activities include all transactions and events not defined as investing or financing activities, however, and are not limited to the cash effects of transactions reported in the statement of activities. Therefore, the cash effects of agency transactions are operating activities per FASB ASC 958-230-55-4 (formerly 2008 Audit Guide, par. 3.16).]

    d. $12,000 inflow, and $18,000 outflow from investing activities. [This answer is incorrect. Investing activities typically include transactions involving the purchase and sale of assets used in the organization's business, and proceeds and payments of loans. However, agency transactions are not considered loans.]

21. The Right Foundation had the following transactions during 2010:

Down payment on new equipment	$ 20,000
Loan payments made on new equipment loan	5,000
Gain on sale of old equipment	10,000
Proceeds from sale of old equipment	7,000

    What is Right's net cash outflow from investing activities on its 2010 statement of cash flows? **(Page 42)**

    a. $3,000. [This answer is incorrect. The gain on the sale of equipment is included in operating activities as a reduction in the change in net assets, if the indirect method is used.]

    b. $8,000. [This answer is incorrect. The loan payments on the equipment are included in financing activities.]

    c. $13,000. [This answer is correct. Investing activities includes cash outlays for acquiring long-lived assets, such as assets purchased for cash, and down payments for assets purchased by assuming liabilities per FASB ASC 230-10-45-13 (formerly SFAS 95, par. 17). Payments of liabilities should be excluded from the amounts reported as investing activities. Proceeds from sales of long-lived assets should be shown as cash inflows from investing activities per FASB ASC 230-10-45-12 (formerly SFAS 95, par. 16).]

    d. $20,000. [This answer is incorrect. The sale of the old equipment will affect the investing activities section per FASB ASC 230-10-45-12 (formerly SFAS 95, par. 16).]

22. During 2010, AOK Organization purchased $10,000 of investments classified as cash equivalents and sold the same type of investments for $15,000. Where is this purchase and sale included on AOK's statement of cash flows? **(Page 43)**

    a. In the net change in cash and cash equivalents. [This answer is correct. Purchases and sales of investments that are classified as cash equivalents are part of an organization's cash management rather than part of its operating, investing, and financing activities. Thus the net change in cash equivalents should be included in the net change in cash and cash equivalents shown in the statement of cash flows. In other words, purchases and sales of cash equivalents need not be reported separately (FASB ASC 230-10-45-5) (previously SFAS 95, par. 9).]

b. In investing activities as a $5,000 inflow. [This answer is incorrect. Purchases and sales of investments that are *not* cash equivalents should be classified as investing activities in the statement of cash flows.]

c. In the adjustments to change in net assets, if the indirect method is used. [This answer is incorrect. This is a cash transaction, not a noncash adjustment to the change in net assets.]

d. In operating activities as a $5,000 inflow. [This answer is incorrect. These types of transactions are part of the organization's cash management, and is not included in the operations of the organization.]

23. On January 15, 2010, First Charity made a five-year $100,000 loan to Second Charity. During 2010, Second repaid $15,000 of the loan principal, and paid $2,000 in interest. How does First classify these transactions on its statement of cash flows for 2010? **(Page 44)**

a. $85,000 outflow from investing activities, $2,000 inflow from operating activities. [This answer is incorrect. Cash flows relating to investments or loans receivable with original maturities of three months or less may be reported net.]

b. $100,000 outflow from investing activities, $17,000 inflow from investing activities. [This answer is incorrect. Interest collected on loans should be shown as an operating activity.]

c. $100,000 inflow from financing activities, $15,000 outflow from operating activities, $2,000 outflow from operating activities. [This answer is incorrect. This is how Second would classify the transactions on its statement of cash flows.]

d. $100,000 outflow from investing activities, $15,000 inflow from investing activities, $2,000 inflow from operating activities. [This answer is correct. Making loans is an investment activity. Accordingly, the principal amount of the loan should be shown as cash used for investing activities, and principal collected on the loans should be shown as cash provided by investing activities per FASB ASC 230-10-45-12 and 45-13 (formerly SFAS 95, paras. 16–17). Interest collected on the loans should be shown as an operating activity.]

24. During the current year, a not-for-profit organization had the following transactions:

$10,000 repayment of a bank loan
$30,000 contribution to a permanent endowment
$40,000 value of land donated to the organization
$60,000 loan made to another NFP organization
$5,000 of investment income used for scholarships

What is the organization's net cash flow from financing activities? **(Page 44)**

a. $70,000 outflow. [This answer is incorrect. The loan made to another organization is an investing activity.]

b. $15,000 outflow. [This answer is incorrect. The investment income used for scholarships is an operating activity.]

c. $20,000 inflow. [This answer is correct. Borrowing money and repaying amounts borrowed is a financing activity. Receipts of contributions that are restricted for long-term purposes by the donor are financing activities. Obtaining land by a gift is a noncash activity, a loan made is an investing activity, and investment income used, for anything other than something that can be classified as investing or financing activities, will be classified as operating activities.]

d. $30,000 inflow. [This answer is incorrect. Financing activities that do not involve cash should be reported separately so that information is provided on all financing activities.]

NONCASH INVESTING AND FINANCING ACTIVITIES

Investing and financing activities that do not involve cash receipts and payments during the period should be excluded from the cash flow statement and reported separately. That can either be done in a supplemental schedule on the face of the cash flows statement (usually at the bottom of the statement) or in the notes to the financial statements. (FASB ASC 230-10-50-3 through 50-6; 958-230-55-5) (formerly SFAS 95, paras. 32 and 74)

Noncash investing and financing activities include the following: (FASB ASC 230-10-50-4) (formerly SFAS 95, par. 32)

- Acquiring assets by assuming liabilities
- Obtaining assets by entering into a capital lease
- Exchanging noncash assets or liabilities for other noncash assets or liabilities

Exhibit 1-6 lists examples of noncash investing and financing transactions. The following paragraphs discuss how to treat noncash investing and financing transactions as they relate to the statement of cash flows.

Assets Acquired by Assuming Liabilities

Assets acquired by assuming liabilities, including capital lease obligations, are noncash transactions that should be disclosed separately. Seller financing, as well as third-party financing, is considered a noncash transaction that must be disclosed. (FASB ASC 230-10-50-4) (formerly SFAS 95, par. 32)

Gifts of Long-lived Assets

Nonprofit organizations often receive contributions of land, buildings, equipment, collection items, or other long-lived assets due to the tax advantages afforded donors on the contribution of appreciated property. Such asset contributions do not involve the receipt of cash and are, therefore, considered noncash investing and financing transactions. (FASB ASC 230-10-50-3 through 50-5; 958-230-55-5) (formerly SFAS 95, par. 32 and 2008 Audit Guide par. 3.15)

Issuance of Social or Country Club Membership Shares

Social and country clubs typically have members' equity in the form of membership shares, which often may be sold, transferred, or redeemed by the club if a member decides to terminate membership. Cash receipts from issuance of membership shares should be reported as cash inflows from financing activities. (FASB ASC 230-10-45-14) (formerly SFAS 95, par. 19)

The following transactions related to issuance of membership club capital shares do not affect cash flows and should be disclosed as noncash investing and financing activities:

- Capital shares issued for receivables or other noncash consideration such as property and equipment
- Capital shares issued to settle debt

Purchase (Sale) of a Subsidiary

As previously discussed, when a subsidiary is purchased or sold, the cash paid to acquire the entity (or cash proceeds from sale of the entity) should be shown as cash used (or provided) by investing activities. The fair value of assets acquired and the fair value of liabilities assumed should be disclosed as a noncash transaction. For example, the fair value of assets acquired and liabilities assumed may be reported in a schedule of noncash investing activities as follows:

Acquisition of ABC Company	
Working capital other than cash	$ 17,000
Equipment and leasehold improvements	120,000
Intangibles and other assets	30,000
Long-term debt assumed	(90,000)
Cash paid to acquire ABC Company	$ 77,000

EXAMPLE OF A STATEMENT OF CASH FLOWS

Exhibit 1-7 presents examples of statements of financial position and a statement of activities and illustrates how a related statement of cash flows may be presented using the direct and indirect methods.

Exhibit 1-7

Illustrative Cash Flow Statement

SAVE OUR CHILDREN, INC.
STATEMENTS OF FINANCIAL POSITION
June 30

	20X7	20X6
ASSETS		
Cash and cash equivalents	$ 29,800	$ 15,700
Short-term investments	11,400	11,200
Contributions receivable		
Unrestricted	—	5,800
United Way funding for the next fiscal year	155,000	135,000
Restricted to payment of long-term debt	41,400	58,200
Restricted to Capital Campaign	7,000	—
	203,400	199,000
Accounts receivable	—	1,400
Prepaid expenses	8,400	8,800
Long-term investments	51,000	14,000
Deposits	1,000	1,500
Property and equipment, net	649,500	664,500
TOTAL ASSETS	$ 954,500	$ 916,100
LIABILITIES		
Accounts payable	$ —	$ 3,500
Compensation	6,400	8,400
Long-term debt	80,000	86,000
TOTAL LIABILITIES	86,400	97,900
NET ASSETS		
Unrestricted	600,600	599,700
Temporarily restricted	260,500	214,500
Permanently restricted	7,000	4,000
TOTAL NET ASSETS	868,100	818,200
TOTAL LIABILITIES AND NET ASSETS	$ 954,500	$ 916,100

SAVE OUR CHILDREN, INC.
STATEMENTS OF ACTIVITIES
Year Ended June 30, 20X7

UNRESTRICTED NET ASSETS	
Contributions	$ 89,700
Federal financial assistance	40,600
Other	5,300
TOTAL UNRESTRICTED REVENUE AND GAINS	135,600
Net assets released from restrictions	
United Way funding for the current year	135,000
Restrictions satisfied by payments	11,800
TOTAL UNRESTRICTED REVENUE, GAINS, AND OTHER SUPPORT	282,400

Expenses		
Program services		
Counseling and case management		144,700
Education		93,500
Supporting services		
Management and general		38,500
Fund-raising		4,800
	TOTAL EXPENSES	281,500
	INCREASE IN UNRESTRICTED NET ASSETS	900
TEMPORARILY RESTRICTED NET ASSETS		
United Way funding for the next year		155,000
Capital Campaign Contributions		36,500
Interest income on Capital Campaign assets		500
Unrealized gain on Capital Campaign investment assets		800
Net assets released from restrictions		
Expiration of time restrictions on United Way funding		(135,000)
Restrictions satisfied by payments		(11,800)
	INCREASE IN TEMPORARILY RESTRICTED NET ASSETS	46,000
PERMANENTLY RESTRICTED NET ASSETS		
Endowment fund contributions		3,000
	INCREASE IN PERMANENTLY RESTRICTED NET ASSETS	3,000
	INCREASE IN NET ASSETS	49,900
NET ASSETS AT BEGINNING OF YEAR		818,200
	NET ASSETS AT END OF YEAR	$ 868,100

ADDITIONAL INFORMATION FOR SAVE OUR CHILDREN, INC.

- The organization financed the purchase of a new copier through a long-term note payable for $5,200. Additional equipment totaling $3,600 was purchased in 20X7; none was sold.
- Short-term investments have original maturities of three months or less.
- Collections of contributions receivable donor-restricted to long-term purposes were $16,800 for payment of long-term debt, $29,500 for the Capital Campaign, and $3,000 for the endowment fund.
- Interest of $500 was earned during 20X7 that was restricted to long-term capital investment.
- The organization purchased long-term investments totaling $48,700; maturities of long-term investments totaled $12,500. No gain or loss on sales of investments was realized during 20X7.
- No interest, unrelated business income taxes, or excise taxes were paid during 20X7.

STATEMENT OF CASH FLOWS—INDIRECT METHOD

CASH FLOWS FROM OPERATING ACTIVITIES		
Increase in net assets	$	49,900 [a]
Adjustments to reconcile increase in net assets to cash provided by operating activities:		
Depreciation		23,800 [b]
Unrealized gains on investments		(800) [c]
(Increase) decrease in operating assets:		
Unrestricted contributions receivable		5,800 [d, e]

United Way funding		(20,000) [d, e]
Accounts receivable		1,400 [d, e]
Prepaid expenses and other		900 [e]
Increase (decrease) in operating liabilities:		
Accounts payable		(3,500) [e]
Compensation		(2,000) [e]
Contributions restricted for long-term purposes:		
Contributions		(39,500) [f]
Interest		(500) [g]
	NET CASH PROVIDED BY OPERATING ACTIVITIES	15,500
CASH FLOWS FROM INVESTING ACTIVITIES		
Short-term investments, net		(200) [h]
Purchases of long-term investments		(48,700) [i]
Proceeds from maturity of long-term investments		12,500 [j]
Payments for property and equipment		(3,600) [k]
	NET CASH USED BY INVESTING ACTIVITIES	(40,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Collections of contributions restricted for long-term purposes:		
Long-term debt		16,800 [l]
Capital Campaign		29,500 [l]
Endowment fund		3,000 [l]
Interest on contributions restricted for long-term purposes		500 [m]
Payments on equipment note payable		(800) [n]
Payments on SHDA note		(10,400) [n]
	NET CASH PROVIDED BY FINANCING ACTIVITIES	38,600
	NET INCREASE IN CASH AND CASH EQUIVALENTS	14,100
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR		15,700
	CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 29,800
SUPPLEMENTAL DISCLOSURES[o, p, q, r]		
Noncash investing and financing transaction:		
Acquisition of equipment		
Cost of equipment		$ 5,200
Equipment loan		(5,200)

Notes:

[a] When the indirect method is used to prepare the statement of cash flows, cash flows from operating activities begins with an increase in net assets of $49,900, as reported in the statement of activities.

[b] Depreciation is a noncash expense. Thus, it is added back to the increase in net assets in arriving at cash flows from operating activities. The amount should be the same as that reported in the statement of functional expenses if that statement is presented. Amortization of intangible assets is also a noncash expense and would be added back as well.

c Unrealized gains and losses on investments are noncash amounts that should be subtracted from (for gains) or added back to (in the case of losses) the increase in net assets in arriving at cash flows from operating activities. The amount reflected should be the same as the total of all net unrealized gains and losses reported in the statement of activities, regardless of their classifications as unrestricted, temporarily restricted, or permanently restricted.

d The net change in unrestricted contributions receivable and other receivables should be adjusted for any provision for uncollectible accounts presented separately as an adjustment to increase in net assets. In this particular example, no provision for uncollectible accounts was recorded; therefore, any change can be attributable to cash amounts and, accordingly, only the net change is reflected as an adjustment. (See note e.)

e When cash flows from operating activities are presented using the indirect method, the increase in net assets (or change in net assets) should be adjusted for changes during the period in operating assets and liabilities to approximate actual cash receipts and payments attributed to operating activities. If there are no material noncash entries posted to operating assets and liabilities, the net change would be as follows:

	20X7	20X6	Net Change
Unrestricted contributions receivable	$ —	$ 5,800	$ (5,800)
United Way funding	155,000	135,000	20,000
Accounts receivable	—	1,400	(1,400)
Prepaid expenses and other	9,400	10,300	(900)
Accounts payable	—	(3,500)	3,500
Compensation	(6,400)	(8,400)	2,000
Total	$ 158,000	$ 140,600	$ 17,400

f Contributions restricted for long-term investment are required to be shown as financing activities. As a result, any such contributions that are recognized in the statement of activities for the period, whether they are cash or restricted contributions receivable, must be deducted from the increase in net assets and shown as a financing activity to the extent such revenue has been collected. Contributions restricted for long-term purposes for the year ended 20X7 were as follows:

Capital Campaign contributions	$ 36,500
Endowment fund contributions	3,000
Total contributions restricted for long-term purposes	$ 39,500

g Similar to contributions restricted for long-term purposes, interest and dividends restricted for long-term purposes are also required to be shown as financing activities. Accordingly, any such interest and dividends recognized in the statement of activities for the period must be deducted from increase in net assets and shown as a financing activity to the extent such revenue has been collected.

h The change in short-term investments with original maturities of three months or less may be shown net as an investing activity. For purposes of this example, such short-term investments are not considered cash equivalents.

i Purchases of long-term investments are shown as cash used by investing activities.

j Proceeds from the maturity or sale of long-term investments are shown as cash flows from investing activities. In this example, no gain or loss was recognized because long-term investments were allowed to mature and were not sold. However, had a gain or loss been recognized on the sale, it would have been reflected as an adjustment to reconcile the increase in net assets to cash provided by operating activities.

k Cash payments made for property and equipment are shown as cash used by investing activities. Conversely, any proceeds realized from the sale of property and equipment would be shown as cash provided by investing activities and any related gain or loss would be shown as an adjustment to reconcile the increase in net assets to cash provided by operating activities.

[l] Collections of contributions restricted for long-term purposes are shown as financing activities. Collection amounts for contributions restricted for long-term investment are computed by offsetting the change in the corresponding receivable account against the contribution recognized during the period. (See note f.)

[m] Receipts of interest and dividends restricted for long-term investment are shown as financing activities. (See note f.)

[n] Payments of long-term debt are shown as cash used by financing activities. Such payments may be aggregated and shown as one line item if the nonprofit organization prefers.

[o] Alternately, the supplemental disclosures could be made in the notes to the financial statements rather than on the face of the statement of cash flows.

STATEMENT OF CASH FLOWS—DIRECT METHOD

CASH FLOWS FROM OPERATING ACTIVITIES	
Revenue collected	
United Way	$ 135,000 [p]
Other	142,800 [p]
Payments for expenses	
Compensation and payments to suppliers	(262,300) [p]
NET CASH PROVIDED BY OPERATING ACTIVITIES	15,500 [q]
CASH FLOWS FROM INVESTING ACTIVITIES[r]	
Short-term investments, net	(200)
Purchases of long-term investments	(48,700)
Proceeds from maturity of long-term investments	12,500
Payments for property and equipment	(3,600)
NET CASH USED BY INVESTING ACTIVITIES	(40,000)
CASH FLOWS FROM FINANCING ACTIVITIES[r]	
Collections of contributions restricted for long-term purposes:	
Long-term debt	16,800
Capital Campaign	29,500
Endowment fund	3,000
Interest on contributions restricted for long-term purposes	500
Payments on equipment note payable	(800)
Payments on SHDA note	(10,400)
NET CASH PROVIDED BY FINANCING ACTIVITIES	38,600
NET INCREASE IN CASH AND CASH EQUIVALENTS	14,100
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	15,700
CASH AND CASH EQUIVALENTS AT END OF YEAR	$ 29,800
SUPPLEMENTAL DISCLOSURES[r]	
Noncash investing and financing transaction:	
Acquisition of equipment	
Cost of equipment	$ 5,200
Equipment loan	(5,200)

p Under the direct method, support and revenues and expenses presented in the statement of activities are adjusted for accrued amounts at the beginning and ending of the period and are grouped into categories. Noncash revenues and expenses are excluded. Amounts for Save Our Children, Inc., are calculated as follows:

- Revenue collected—United Way:

Temporarily restricted support per statement of activities	$ 155,000
Increase in contributions receivable—United Way	(20,000)
	$ 135,000

- Revenue collected—Other:

Total unrestricted support per statement of activities	$ 135,600
Decrease in unrestricted contributions receivable	5,800
Decrease in accounts receivable	1,400
	$ 142,800

- Compensation and payments to suppliers:

Total expenses per statement of activities	$ 281,500
Less depreciation (noncash)	(23,800)
Decrease in prepaid expenses and other	(900)
Decrease in accounts payable	3,500
Decrease in compensation payable	2,000
	$ 262,300

Save Our Children, Inc., did not collect operating interest revenue or pay any interest, nor did it pay any unrelated business income taxes or excise taxes. For nonprofit organizations that do collect and/or pay such items, the cash collected or paid for interest and unrelated business income taxes or excise taxes should be included in the statement of cash flows using the direct method as separate line items.

q If Save Our Children, Inc., prepared its cash flow statement using the direct method, it would also be required to present a separate schedule that reconciles the change in net assets to net cash provided by operating activities, such as the following:

RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY OPERATING ACTIVITIES

Increase in net assets	$ 49,900
Adjustments to reconcile increase in net assets to cash provided by operating activities:	
Depreciation	23,800
Unrealized gain on investments	(800)
(Increase) decrease in operating assets:	
Unrestricted contributions receivable	5,800
United Way funding	(20,000)
Accounts receivable	1,400
Prepaid expenses and other	900
Increase (decrease) in operating liabilities:	
Accounts payable	(3,500)
Compensation	(2,000)
Contributions restricted for long-term purposes:	
Contributions	(39,500)
Interest	(500)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 15,500

r Cash flows from investing activities, cash flows from financing activities, and the schedule of noncash investing and financing activities are presented in the same manner as under the indirect method.

* * *

DISCLOSURE REQUIREMENTS

The following are required disclosures related to statements of cash flows: (Many of the requirements listed are presentation matters rather than disclosures and are discussed in the Accounting Requirements section. Those requirements have been summarized and repeated here, however, so that the primary considerations for statements of cash flows may be quickly identified.)

a. Descriptive terms such as *cash* or *cash and cash equivalents* should be used rather than terms such as *funds*.

b. Cash receipts and cash payments should be classified by operating, investing, and financing activities.

c. Generally, cash inflows and outflows from investing and financing activities should be reported at gross amounts (for example, outlays for acquisitions should be reported separately from sales or other dispositions of property and equipment). Cash receipts and payments pertaining to investments (other than cash equivalents), loans receivable, and debt with original maturity of three months or less may be reported net, however.

d. The net effect of cash flows on cash and cash equivalents during the period should be shown in a manner that reconciles beginning and ending cash and cash equivalents.

e. A reconciliation of the change in net assets and net cash flows from operating activities that reports all major classes of reconciling items separately, including, at a minimum, changes during the period in receivables and payables pertaining to operating activities and in inventory, should be presented. (If the indirect method is used, the reconciliation may be presented in a separate schedule or in the statement itself.)

f. The following classes of operating cash receipts and payments should be shown separately, at a minimum, when the direct method is used: (FASB ASC 230-10-45-25) (formerly SFAS 95, par. 27)

    (1) Cash collected from contributions not donor-restricted for long-term purposes, customers, service recipients, and grants

    (2) Interest and dividends received that are not donor-restricted for long-term purposes

    (3) Other operating cash receipts

    (4) Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like

    (5) Interest paid (net of amounts capitalized)

    (6) Unrelated business income taxes or excise taxes paid, if any

    (7) Other operating cash payments

g. The total amount of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows should be the same as similarly titled line items or subtotals in the statement of financial position.

h. The accounting policy for determining which items are treated as cash and cash equivalents should be disclosed and should exclude cash equivalents purchased with contributions restricted to long-term investment. (FASB ASC 230-10-45-6; 230-10-50-1; 958-230-55-2 (formerly SFAS 95, par. 10 and 2008 Audit Guide, par. 3.19)

i. Noncash investing and financing transactions should either be disclosed in narrative form or summarized in a schedule and should relate any cash aspects of the transactions. If there are only a few noncash transactions, it may be convenient to include them on the face of the cash flows statement. If the transactions are reported elsewhere in the financial statements, they should be clearly referenced to the statement of cash flows. (FASB ASC 230-10-50-3; 230-10-50-6) (formerly SFAS 95, paras. 32 and 74)

j. If the indirect method of reporting cash flows from operating activities is used, the amounts of interest paid (net of amounts capitalized) and unrelated business income taxes or excise taxes paid during the period should be disclosed. (FASB ASC 230-10-50-2) (formerly SFAS 95, par. 29) (The disclosures may be made on the face of the cash flows statement or in the notes. When included in the notes, they may be added to the existing long-term debt and income tax notes or disclosed in a separate note of supplemental cash flow disclosures.)

k. If cash flows from derivative instruments that are accounted for as fair value hedges are classified in the same category as cash flows from the item being hedged, the fact that it is the organization's policy to present such cash flows in that manner should be disclosed. (FASB ASC 230-10-45-27) (formerly SFAS 95, par. 14)

SELF-STUDY QUIZ

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

25. XYZ Organization, a soup kitchen, had the following transactions. Which of these transactions is classified as noncash investing and financing activities?

    a. Two individuals donated $5,000 worth of time working in the soup kitchen.

    b. XYZ traded-in its old van for a new van, and received $5,000 of value.

    c. XYZ paid $4,000 for a down payment on its new van.

    d. XYZ's CPA charged $7,000 for its audit, but would normally charge $10,000 for the service.

26. If a not-for-profit organization uses the indirect method for preparing its statement of cash flows, which of the following must the organization present or disclose?

    a. Cash collected from contributions.

    b. The amount of interest paid.

    c. The amount of contributions restricted for long-term use included in cash and cash equivalents.

    d. Quantifiable evidence that the organization is meeting its objectives.

SELF-STUDY ANSWERS

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

25. XYZ Organization, a soup kitchen, had the following transactions. Which of these transactions is classified as noncash investing and financing activities? **(Page 52)**

    a. Two individuals donated $5,000 worth of time working in the soup kitchen. [This answer is incorrect. This type of donation, although valuable to the organization, is not reported as noncash investing and financing activities because it is not a donated service that will be capitalized. The donated services can be disclosed in the notes, if the organization wishes, for informational purposes.]

    b. XYZ traded-in its old van for a new van, and received $5,000 of value. [This answer is correct. Noncash investing and financing activities include acquiring assets by assuming liabilities, obtaining assets by entering into a capital lease, and exchanging noncash assets or liabilities for other noncash assets or liabilities per FASB ASC 230-10-50-4 (formerly SFAS 95, par. 32).]

    c. XYZ paid $4,000 for a down payment on its new van. [This answer is incorrect. A down payment for an asset is classified as investing activities.]

    d. XYZ's CPA charged $7,000 for its audit, but would normally charge $10,000 for the service. [This answer is incorrect. Even though $3,000 is an in-kind contribution that must be recorded on XYZ's statement of activities because it is a professional service, it is not reported as a noncash investing or financing activity.]

26. If a not-for-profit organization uses the indirect method for preparing its statement of cash flows, which of the following must the organization present or disclose? **(Page 59)**

    a. Cash collected from contributions. [This answer is incorrect. If an organization uses the direct method, one of the cash receipts categories that must be shown separately is cash collected from contributions that are not donor-restricted for long-term purposes, customers, services recipients, and grants.]

    b. The amount of interest paid. [This answer is correct. If the indirect method of reporting cash flows from operating activities is used, the amounts of interest paid, net of amounts capitalized, and unrelated business income taxes or excise taxes paid during the period should be disclosed per FASB ASC 230-10-50-2 (previously SFAS 95, par. 29).]

    c. The amount of contributions restricted for long-term use included in cash and cash equivalents. [This answer is incorrect. The accounting policy for determining which items are treated as cash and cash equivalents should be disclosed and should exclude cash and cash equivalents purchased with contributions restricted to long-term investment.]

    d. Quantifiable evidence that the organization is meeting its objectives. [This answer is incorrect. Only information regarding an organization's cash receipts and cash payments, as well as certain noncash information and items needed to reconcile the change in net assets to net cash provided by operating activities, should be presented or disclosed regarding the cash flow statement. An organization may wish to disclose any information it has about evidence of meeting its goal in the notes to show contributors that their contributions are working.]

FUND ACCOUNTING

SOURCE: FASB ASC 958-205, 958-210 and the Audit Guide

OVERVIEW

Although GAAP for nonprofit organizations focuses on the entity as a whole, it does not preclude the use of fund accounting for external reporting. However, if organizations choose to use fund accounting, they must classify fund balances on the statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the absence or existence and type of donor-imposed restrictions. Interfund receivables and payables should also be eliminated when displaying total assets and liabilities on the statement of financial position.

ACCOUNTING REQUIREMENTS

Fund accounting is a system of recording resources whose use may be limited by donors, granting agencies, boards, other individuals or entities, or by law. Each fund consists of a self-balancing set of asset, liability, and fund balance accounts associated with specific activities, donor-imposed restrictions, or objectives. (2008 Audit Guide, par. 16.02)

Disaggregated reporting by fund groups is not a necessary part of external reporting. GAAP establishes a financial reporting model for nonprofit organizations that focuses on the entity as a whole, with net assets classified solely on the presence or absence of donor-imposed restrictions. (FASB ASC 958-205-45-3) (formerly SFAS 117, par. 18, fn. 5 and 2008 Audit Guide, par. 16.01) Fund accounting is not prohibited for external reporting, however, as long as organizations conform with the net assets reporting model. (FASB ASC 958-205-45-3) (formerly SFAS 117, par. 18, fn. 5) Therefore, if fund accounting is presented, fund balances should be classified on the statement of financial position as unrestricted, temporarily restricted, or permanently restricted net assets based on the absence or existence and type of donor-imposed restrictions. In addition, because GAAP reporting focuses on the organization as a whole, interfund receivables and payables should eliminate when total assets and liabilities are displayed on the statement of financial position. (FASB ASC 958-210-45-2) (formerly SFAS 117, par. 85, fn. 8)

Some of the common funds used by nonprofit organizations include the following: (Audit Guide, paras. 16.06–.21)

- *Unrestricted current (operating or general) funds*, which are used to record activities supported by resources over which the organization board has discretionary control
- *Restricted current funds*, which are used to record activities supported by resources limited by external parties to specific operating purposes
- *Plant fund*, which is used to record property and equipment and resources held to acquire them
- *Loan funds*, which are used to account for loans made to students, employees, or other constituents, and resources available to make loans
- *Endowment funds*, which are used to account for assets held to provide income for the maintenance of the organization and may include endowments, term endowments, and quasi-endowments
- *Annuity and life-income (split-interest) funds*, which are used to account for resources provided by donors when the organization has a beneficial interest but is not the sole beneficiary
- *Agency funds*, which are used to account for resources held by the organization on behalf of others

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

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

a. Current restricted funds may include a combination of donor-restricted contributions and grants that represent exchange transactions with limitations on the use of the funds. If so, only the fund balance amount related to donor-restricted contributions should be classified as temporarily restricted. The grant-related amount would be unrestricted, because the restrictions were imposed by the other party to the exchange, not by a donor.

b. A plant fund might be comprised of several individual components, such as (1) unexpended plant funds, (2) funds for renewal and replacement, and (3) property investment, and the funds may or may not have donor-imposed restrictions associated with them. They should be recorded as temporarily or permanently restricted net assets only to the extent there are donor-imposed limitations. Any funds representing board designations for property replacement should be classified as unrestricted net assets. (Audit Guide, paras. 16.10–.11)

c. Endowment fund balances might include multiple net asset classes. Term endowments, based on their nature, would generally represent temporarily restricted net assets, while permanent endowments would normally represent permanently restricted net assets. Quasi-endowments, or board designations not resulting from donor-imposed restrictions, would represent unrestricted net assets.

Exhibit 1-8 presents an example statement of financial position for an organization using fund accounting for external reporting. If an organization uses a similar columnar fund format for the statement of activities, the statement must present the change in net assets for each of the three net asset classifications (unrestricted, temporarily restricted, and permanently restricted).

Exhibit 1-8

Example Net Asset Presentation When an Organization Uses Fund Accounting for External Reporting

Assumptions:

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

Statement of Financial Position at December 31, 20X1:

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

* * *

DISCLOSURE REQUIREMENTS

Nonprofit organizations using fund accounting for external reporting purposes should clearly identify and arrange interfund receivables and payables in the statement of financial position so that their amounts eliminate when total assets and liabilities are displayed. (FASB ASC 958-210-45-2) (formerly SFAS 117, par. 85, fn. 8)

SELF-STUDY QUIZ

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

27. You have just been hired to compile the financial statements of a not-for-profit organization. This organizations has been using fund accounting for internal purposes for the last 25 years, but this will be the first set of externally reported financial statements. Which of the following is true regarding your client's use of fund accounting?

    a. GAAP prohibits the organization from reporting fund amounts.

    b. GAAP requires the use of fund accounting for not-for-profit organizations, along with the net asset reporting model.

    c. GAAP requires an organization to present fund balances as unrestricted, temporarily restricted, and permanently restricted.

28. Learning Children Organization uses fund accounting. During the year the organization received a $2,000 donation to be used for notebooks, pencils, art supplies, and other learning aids. Which of the following funds will Learning Children record this donation?

    a. Restricted current funds.

    b. Unrestricted current.

    c. Plant fund.

    d. Agency funds.

SELF-STUDY ANSWERS

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

27. You have just been hired to compile the financial statements of a not-for-profit organization. This organizations has been using fund accounting for internal purposes for the last 25 years, but this will be the first set of externally reported financial statements. Which of the following is true regarding your client's use of fund accounting? **(Page 63)**

    a. GAAP prohibits the organization from reporting fund amounts. [This answer is incorrect. Fund accounting is not prohibited for external reporting, as long as organizations conform to the net assets reporting model.]

    b. GAAP requires the use of fund accounting for not-for-profit organizations, along with the net asset reporting model. [This answer is incorrect. SFAS 117 actually eliminated the previous requirement to use fund accounting.]

    c. GAAP requires an organization to present fund balances as unrestricted, temporarily restricted, and permanently restricted. [This answer is correct. Fund accounting is not prohibited for external reporting, as long as organizations conform with the net assets reporting model. Therefore, if fund accounting is presented, fund balances should be classified as unrestricted, temporarily restricted, or permanently restricted net assets based on the absence or existence and type of donor-imposed restrictions.]

28. Learning Children Organization uses fund accounting. During the year the organization received a $2,000 donation to be used for notebooks, pencils, art supplies, and other learning aids. Which of the following funds will Learning Children record this donation? **(Page 63)**

    a. Restricted current funds. [This answer is correct. This fund is used to record activities supported by resources limited by external parties to specific operating purposes.]

    b. Unrestricted current. [This answer is incorrect. This fund is used to record activities supported by resources over which the organization board has discretionary control.]

    c. Plant fund. [This answer is incorrect. This fund is used to record property and equipment and resources held to acquire them.]

    d. Agency funds. [This answer is incorrect. This fund is used to account for resources held by the organization on behalf of others.]

PRESENTATION OF FINANCIAL STATEMENTS

SOURCE: FASB ASC 205 and 958-205

OVERVIEW

Comparative presentations enhance the usefulness of financial statements. Therefore, although not required, it ordinarily is desirable for financial statement presentations to include the financial statements of two or more years.

Discontinued operations should be separately presented in the statement of activities, net of related tax effect (if any). They should be presented after the change in net assets from continuing operations but before extraordinary items and the cumulative effect of accounting changes if applicable.

When preparing financial statements, management should assess the nonprofit organization's ability to continue as a going concern. Disclosure is required whenever there is substantial doubt about the organization's ability to continue as a going concern.

ACCOUNTING REQUIREMENTS

COMPARATIVE FINANCIAL STATEMENTS

Current year financial statements are presumed to be more useful if financial statements for one or more prior years are presented with them for comparative purposes. Although GAAP does not require such presentations, comparative financial statements often help readers more clearly understand the nature and trends of current changes affecting an entity. Furthermore, they help emphasize that the organization is an ongoing entity and the current period is just one of a number of periods in its history. (FASB ASC 205-10-45-1; 958-205-45-7) (formerly ARB 43, Ch. 2A, par. 1 and SFAS 117, par. 70)

Normally, it is preferable to present a statement of financial position, statement of activities, and statement of functional expenses (if required) for one or more prior years when current year financial statements are presented. (FASB ASC 205-10-45-2) (formerly ARB 43, Ch. 2A, par. 2) [If both a statement of financial position and statement of activities are presented, the presentation also should include a statement of cash flows for each year for which a statement of activities is presented. (FASB ASC 230-10-15-3) (formerly SFAS 95, par. 3)] To the extent they continue to be significant, notes to prior year financial statements should be repeated, or at least referred to, in the comparative presentation. (FASB ASC 205-10-45-4) (formerly ARB 43, Ch. 2A, par. 2)

Prior year figures included in comparative financial statements should be comparable to those shown in the current year. Any exceptions to comparability should be clearly described. (FASB ASC 205-10-45-3) (formerly ARB 43, Ch. 2A, par. 3)

Nonprofit organizations sometimes choose to present only summarized comparative information that does not include the minimum information required by GAAP. For example, organizations may present prior year information in total instead of by net asset class, or present information about the prior year change in net assets without details about revenues, expenses, gains, and losses by asset class. If comparative information is not sufficient to constitute a presentation in accordance with GAAP, organizations should use financial statement titles appropriately describing the summarized prior year information. An example of an appropriate financial statement title would be:

Statement of Activities
For the Year Ended 20X2, with Summarized Financial Information for the Year Ended 20X1

Organizations must also disclose the summarized nature of the prior year presentation in a note to the financial statements. Presenting descriptive titles on the face of the financial statements without a corresponding footnote disclosure does not constitute proper use of the titles. (FASB ASC 958-205-45-8; 958-205-50-4) (formerly 2008 Audit Guide, par. 3.20)

DISCONTINUED OPERATIONS

Disposal of a Component of an Entity

The results of continuing operations must be reported separately from discontinued operations. Discontinued operations should be separately presented in the statement of activities, net of related tax effect (if any). They should be presented after the change in net assets from continuing operations but before extraordinary items. (FASB ASC 205-20-45-3) (formerly SFAS 144, par. 43) Exhibit 1-9 illustrates presenting discontinued operations in the statement of activities.

Exhibit 1-9

Illustrative Example Statement of Activities Presentation of Discontinued Operations

INCREASE IN UNRESTRICTED NET ASSETS FROM CONTINUING OPERATIONS	98,800
Discontinued operations—loss on disposal of performing arts activities	(24,000)
Extraordinary item—loss on expropriation of assets by foreign government	(71,400)
INCREASE IN UNRESTRICTED NET ASSETS	$ 3,400

* * *

The operating results of a component of an entity that is classified as held for sale or that has been disposed of should be presented in discontinued operations if the operations and cash flows of the component will be (or have been) eliminated from the ongoing operations of the entity and the entity will not have any significant continuing involvement in the component's operations. (FASB ASC 205-20-45-1) (formerly SFAS 144, par. 42) A *component of an entity* consists of operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the other operations and cash flows of the entity. (FASB ASC 205-10-20) (formerly SFAS 144, par. 41)

The operating results of a component classified as held for sale should be reported in discontinued operations in the period in which they occur. The amount reported in discontinued operations should include any gain or loss recognized, in discontinued operations. (FASB ASC 205-20-45-3) (formerly SFAS 144, par. 43)

In determining whether the operations and cash flows of the disposed component will be (or have been) eliminated from the ongoing operations of the entity, an evaluation should be made of whether continuing direct or indirect cash flows are expected to be (or have been) generated. If continuing direct cash flows are significant, the operations should not be presented as a discontinued operation. (FASB ASC 205-20-55-4 and 55-5) (formerly EITF 03-13, par. 4) Direct cash flows are those expected to be recognized by the ongoing entity as a result of (a) a migration of revenues (or costs) from the disposed component after the disposal, or (b) the continuation of activities between the ongoing entity and the disposed component. (FASB ASC 205-20-55-7 and 55-8) (formerly EITF 03-13, par. 6) The significance of the cash flows is a matter of judgment to be determined by comparing the expected continuing cash flows of the ongoing entity after the disposal to the expected cash flows that would have been generated by the disposed component if the transaction had not occurred. (FASB ASC 205-20-55-14) (formerly EITF 03-13, par. 8)

If the continuing cash flows are indirect, or if continuing direct cash flows are not significant, an evaluation should be made as to whether the ongoing entity will have a significant continuing involvement in the operations of the disposed component. Continuing involvement in operations typically exists if the ongoing entity has the ability to influence the operating or financial policies of the disposed component. Key considerations include the retention of risk or the ability to obtain benefits associated with the ongoing operations of the disposed component. If continuing involvement exists, a determination of its significance should be made based on quantitative and qualitative assessments from the perspective of the disposed component. (FASB ASC 205-20-55-15 and 55-16) (formerly EITF 03-13, paras. 9–10)

If a significant event or circumstance occurs in a one-year period after disposal that may impact the assessment of whether the operations and cash flows of the component will be (or have been) eliminated from the ongoing operations of the entity and the entity will not have any significant continuing involvement in the component's operations, the ongoing entity should reassess whether the criteria will be met by the end of the one-year period. If the criteria will not be met, the component's operations should not be presented as discontinued operations. In certain cases, the assessment period may extend beyond one year after the disposal. (FASB ASC 205-20-55-22 and 55-23) (formerly EITF 03-13, paras. 13–14)

Adjustments to amounts previously reported in discontinued operations that relate directly to the disposal of a component of an entity in a prior period should be separately classified in discontinued operations in the current period. Circumstances in which those types of adjustments may arise include resolution of contingencies and settlement of employee benefit plan obligations related directly to the disposal transaction. (FASB ASC 205-20-45-4 and 45-5) (formerly SFAS 144, paras. 43 and 44)

Allocation of Interest to Discontinued Operations

Interest on debt that will be assumed by the buyer or requires repayment as a result of a disposal transaction should be allocated to discontinued operations. (FASB ASC 205-20-45-6) (formerly EITF 87-24)

Other consolidated interest that is not directly attributable to other operations of the organization may also be allocated to discontinued operations. The allocation should be based on the ratio of—

- net assets to be sold or discontinued less debt required to be paid as a result of the disposal to
- the sum of (1) total net assets of the consolidated organization plus (2) consolidated debt other than debt of the discontinued operation that will be assumed by the buyer, debt required to be paid as a result of the disposal, and debt directly attributed to other operations of the organization. (FASB ASC 205-20-45-7) (formerly EITF 87-24)

This allocation assumes a uniform ratio of consolidated debt to net assets for all operations. However, if the assets to be sold are not typical, a normal debt to net assets ratio for that type of activity or business may be used. If allocation based on net assets would not provide meaningful results, interest should be allocated based on debt specifically attributed to discontinued operations. This guidance applies to presentation of both continuing and discontinued operations in the statement of activities (including the presentation of the gain or loss on disposal of a component of an organization). Interest allocation should be applied consistently to all discontinued operations. (FASB ASC 205-20-45-8) (formerly EITF 87-24)

Allocation of Overhead to Discontinued Operations

General overhead of the organization (such as management and general expenses) should not be allocated to discontinued operations. (FASB ASC 205-20-45-9) (formerly EITF 87-24)

Long-lived Asset or Disposal Group Classified as Held for Sale

A long-lived asset that is classified as held for sale should be presented separately in the statement of financial position. The assets and liabilities of a disposal group classified as held for sale should be presented separately in the asset and liability sections of the statement of financial position and should *not* be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale should be disclosed separately, either on the face of the statement of financial position or in the notes to financial statements. (FASB ASC 205-20-45-10; 205-20-50-2) (formerly SFAS 144, par. 46)

GOING CONCERN

Uncertainty about an organization's ability to continue as a going concern relates to its ability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of its activities, restructuring of debt, externally forced revisions of its activities, or similar actions. Thus, it is more than an evaluation of whether recorded assets and liabilities are recoverable and properly classified. When preparing financial statements, management should assess the organization's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the statement of financial position date.

SELF-STUDY QUIZ

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

29. Healthy Kids, Inc. prepared a statement titled "Statement of activities for the year ended 2010, with summarized financial information for the year ended 2009". Which of the following is true regarding Healthy Kids' use of this statement?

    a. Healthy Kids should disclose the nature of the prior year presentation in a note.

    b. Healthy Kids cannot include this report with its externally reported financial statements.

    c. Summarized comparative information is required by GAAP.

30. Team Sports, Inc. is a not-for-profit organization that allows children in need to be involved in local sports. The entity decides to exit its uniform sales business and commits to a plan to sell the division with its operations. The uniform division is classified as held for sale at that date. The operations and cash flows of the division will be eliminated from the ongoing operations of the entity as a result of the sale transaction, and the entity will not have any continuing involvement in the operations of the division after it is sold. Team Sports may report the uniform division in discontinued operations.

    a. True.

    b. False.

31. Team Sports, Inc. is holding for sale gym equipment with a book value of $50,000. Which of the following is true regarding how Team Sports should classify this equipment?

    a. They should be presented on the statement of financial position, net of any taxes.

    b. They should be offset with any corresponding liabilities.

    c. Each asset held for sale should be listed on the face of the statement or in the notes.

    d. They should be presented separately in the statement of financial position.

SELF-STUDY ANSWERS

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

29. Healthy Kids, Inc. prepared a statement titled "Statement of activities for the year ended 2010, with summarized financial information for the year ended 2009". Which of the following is true regarding Healthy Kids' use of this statement? **(Page 69)**

    a. Healthy Kids should disclose the nature of the prior year presentation in a note. [This answer is correct. Organizations must disclose the summarized nature of the prior year presentation in a note to the financial statements. Presenting descriptive titles on the face of the financial statements without a corresponding footnote disclosure does not constitute proper use of the titles per FASB ASC 958-205-45-8; 958-205-50-4.]

    b. Healthy Kids cannot include this report with its externally reported financial statements. [This answer is incorrect. If the comparative information in the statement is not sufficient to constitute a presentation in accordance with GAAP, organizations should use financial statement titles appropriately describing the summarized prior year information.]

    c. Summarized comparative information is required by GAAP. [This answer is incorrect. Summarized comparative information often does not include the minimum information required by GAAP. For example, organizations may present prior year information in total instead of by net asset class, or present information about the prior year change in net assets without details about revenues, expenses, gains, and losses by asset class.]

30. Team Sports, Inc. is a not-for-profit organization that allows children in need to be involved in local sports. The *entity* decides to exit its uniform sales business and commits to a plan to sell the division with its operations. The uniform division is classified as held for sale at that date. The operations and cash flows of the division will be eliminated from the ongoing operations of the *entity* as a result of the sale transaction, and the *entity* will not have any continuing involvement in the operations of the division after it is sold. Team Sports may report the uniform division in discontinued operations. **(Page 70)**

    a. True. [This answer is correct. A component of an *entity* consists of operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from other operations and cash flows of the entity (FASB ASC 205-10-20).]

    b. False. [This answer is incorrect. The operating results of a component of an *entity* that is classified as held for sale that has been disposed of should be presented in discontinued operations if the operations and cash flows of the component will be (or have been) eliminated from the ongoing operations of the entity and the *entity* will not have any significant involvement in the component's operations (FASB ASC 205-20-45-1).]

31. Team Sports, Inc. is holding for sale gym equipment with a book value of $50,000. Which of the following is true regarding how Team Sports should classify this equipment? **(Page 71)**

    a. They should be presented on the statement of financial position, net of any taxes. [This answer is incorrect. Only items that appear on the statement of activities might be shown net of any taxes.]

    b. They should be offset with any corresponding liabilities. [This answer is incorrect. The assets and liabilities of a disposal group should not be offset and presented as a single amount, but should remain in its respective section of the statement of financial position.]

    c. Each asset held for sale should be listed on the face of the statement or in the notes. [This answer is incorrect. The major classes of assets and liabilities classified as held for sale should be disclosed separately, either on the face of the statement of financial position or in the notes to the financial statements.]

    d. They should be presented separately in the statement of financial position. [This answer is correct. The assets and liabilities of a disposal group classified as held for sale should be presented separately in the asset and liability sections of the statement of financial position and should not be offset and presented as a single amount per FASB ASC 205-20-45-10; 205-20-50-2.]

DISCLOSURE REQUIREMENTS

COMPARATIVE FINANCIAL STATEMENTS

Reclassifications or other changes may cause items for two or more periods to no longer be comparable. Changes affecting comparability should be disclosed. (FASB ASC 205-10-50-1) (formerly ARB 43, Ch. 2A, par. 3)

As discussed, organizations presenting summarized prior year information must describe the summarized nature of the presentation in a note to the financial statements. (FASB ASC 958-205-45-8; 958-205-50-4) (formerly 2008 Audit Guide, par. 3.20)

DISCONTINUED OPERATIONS

Disposal of a Component of an Entity

The following disclosures should be made when a component of an entity has been disposed of or classified as held for sale:

a. For current and prior periods, operating results for the component in discontinued operations, including any gain or loss on disposal, less applicable income taxes, if any, reported as a separate component of the change in net assets before extraordinary items and the cumulative effect of accounting changes, if applicable. A gain or loss recognized on the disposal can be disclosed either on the face of the statement of activities or in the notes to the financial statements. (FASB ASC 205-20-45-3) (formerly SFAS 144, par. 43)

b. The nature and amount of any adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of the entity in a prior period (Such adjustments should be classified separately in the current period in discontinued operations.) (FASB ASC 205-20-45-4; 205-20-50-5) (formerly SFAS 144, par. 44)

For each discontinued operation that generates continuing cash flows, the following information should be disclosed in the notes to the financial statements: (FASB ASC 205-20-50-4) (formerly EITF 03-13, par. 17)

a. The nature of the activities

b. The period of time continuing cash flows are expected to be generated

c. The principal factors that were used to conclude that the expected continuing cash flows are not direct cash flows of the disposed component.

For ongoing entities that will engage in a continuation of activities with a disposed component after its disposal, the following information should be disclosed: (FASB ASC 205-20-50-6) (EITF 03-13, par. 17)

a. For all periods presented, any intra-entity amounts that were eliminated in consolidation prior to the disposal that relate to the continuing revenues and expenses

b. In the period in which the operations are initially classified as discontinued, the types of continuing involvement that the entity will have after the disposal

Assets Sold or Held For Sale

The following information should be disclosed in the notes to the financial statements that cover the period in which a long-lived asset either has been sold or is classified as held for sale: (FASB ASC 205-20-50-1) (formerly SFAS 144, par. 47)

a. A description of the facts and circumstances leading to the expected disposal, the expected manner and timing of that disposal, and, if not separately presented on the face of the statement of financial position, the carrying amounts of the major classes of assets and liabilities included in the disposal group

b. The loss recognized for any initial or subsequent write-down to fair value less cost to sell (or gain recognized for subsequent increases in fair value to the extent of such losses) and, if not presented separately on the face of the statement of activities, the caption in that statement that includes the gain or loss

c. If applicable, amounts of revenue and income or loss reported in discontinued operations

d. The segment in which the long-lived asset is reported, if applicable

Assets and liabilities held for sale should be presented separately in the asset and liability sections of the statement of financial position, with the major classes of such assets and liabilities separately disclosed either on the face of the statement of financial position or in the notes (FASB ASC 205-20-50-2) (formerly SFAS No. 144, par. 46)

If a decision was made during the period not to sell a long-lived asset previously classified as held for sale, a description of the facts and circumstances leading to the decision and the effect of the decision on the change in net assets for all periods presented should be disclosed in the notes to financial statements that include the period of that decision. (FASB ASC 205-20-50-3) (formerly SFAS No. 144, par. 48)

GOING CONCERN

If there is substantial doubt about an organization's ability to continue as a going concern for a period of time not to exceed one year beyond the statement of financial position date, the following information should be disclosed:

a. Pertinent conditions and events giving rise to the assessment of substantial doubt about the organization's ability to continue as a going concern for a period of time not to exceed one year from the statement of financial position date

b. Possible effects of the conditions and events

c. Management's evaluation of the significance of those conditions and events and any mitigating factors

d. Possible discontinuance of activities

e. Management's plans, including relevant prospective financial information

f. Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities (AU 341.10)

If the substantial doubt about the organization's ability to continue as a going concern is alleviated, the following information should be disclosed:

a. Conditions and events that initially caused the substantial doubt

b. Possible effects of the conditions and events

c. Mitigating factors, including management's plans (AU 341.11)

Material noncompliance with donor-imposed or grantor-imposed restrictions should be considered when assessing the organization's ability to continue as a going concern and disclosed if there is at least a reasonable possibility that the noncompliance could lead to a material loss of revenue or could cause the organization to be unable to continue as a going concern. (FASB ASC 958-450-50-2) (formerly 2008 Audit Guide, par 3.50)

SELF-STUDY QUIZ

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

32. Team Sports, Inc. is a not-for-profit organization that allows children in need to be involved in local sports. The entity decides to exit its uniform sales business and commits to a plan to sell the division with its operations. The uniform division is classified as held for sale at that date. The operations and cash flows of the division have been eliminated from the ongoing operations of the entity as a result of the pending sale transaction, and the entity will not have any continuing involvement in the operations of the division after it is sold. Which of the following is an example of a required disclosure Team Sports must make about this disposed component?

    a. The organization eliminated $7,000 of its uniform division's revenue which were purchases of Team Sports.

    b. The organization expects cash flows to be generated from the uniform division for the next twelve months.

    c. The gain on the disposal of the uniform division was $20,000.

    d. The organization will continue to sell existing uniforms until the operation is sold.

33. Team Sports, Inc. is holding for sale gym equipment with a book value of $50,000, and a fair market value of $20,000. Management believes it will cost $2,000 to sell the equipment. Team Sports must disclose the $28,000 loss recognized for the write-down to fair value.

    a. True.

    b. False.

SELF-STUDY ANSWERS

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

32. Team Sports, Inc. is a not-for-profit organization that allows children in need to be involved in local sports. The entity decides to exit its uniform sales business and commits to a plan to sell the division with its operations. The uniform division is classified as held for sale at that date. The operations and cash flows of the division have been eliminated from the ongoing operations of the entity as a result of the pending sale transaction, and the entity will not have any continuing involvement in the operations of the division after it is sold. Which of the following is an example of a required disclosure Team Sports must make about this disposed component? **(Page 75)**

    a. The organization eliminated $7,000 of its uniform division's revenue which were purchases of Team Sports. [This answer is incorrect. Any intra-entity amounts that were eliminated in consolidation prior to the disposal that relate to the continuing revenues and expenses is a disclosure required for ongoing entities that will engage in a continuation of activities with a disposed component after its disposal.]

    b. The organization expects cash flows to be generated from the uniform division for the next twelve months. [This answer is incorrect. The period of time continuing cash flows are expected to be generated is a disclosure that is made for discontinued operations that generates continuing cash flows.]

    c. The gain on the disposal of the uniform division was $20,000. [This answer is correct. Operating results for the component in discontinued operations, including any gain or loss on disposal, less applicable taxes, if any, are reported as a separate component of the change in net assets per FASB ASC 205-20-45-3.]

    d. The organization will continue to sell existing uniforms until the operation is sold. [This answer is incorrect. In the period in which the operations are initially classified as discontinued, the types of continuing involvement that the entity will have after the disposal is disclosed for ongoing entities that will engage in a continuation of activities with a disposed component after its disposal.]

33. Team Sports, Inc. is holding for sale gym equipment with a book value of $50,000, and a fair market value of $20,000. Management believes it will cost $2,000 to sell the equipment. Team Sports must disclose the $28,000 loss recognized for the write-down to fair value. **(Page 75)**

    a. True. [This answer is correct. And, if not presented separately on the face of the statement of activities, the caption in that statement includes the gain or loss per FASB ASC 205-20-50-1.]

    b. False. [This answer is incorrect. The loss recognized for any initial or subsequent write-down to fair value less cost to sell, or gain recognized for subsequent increases in fair value to the extent of such losses, must be disclosed.]

STATEMENT OF FINANCIAL POSITION

SOURCE: FASB ASC 958-210, 210-10 and 210-20

OVERVIEW

The statement of financial position is one of the basic financial statements necessary to present a nonprofit organization's financial position and changes in net assets in accordance with generally accepted accounting principles. It should focus on the organization as a whole and report total assets, total liabilities, and total net assets. It should also report totals for unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets, as well as information about the nature and amounts of temporarily restricted and permanently restricted net assets (unless disclosed in the notes to financial statements). If not otherwise disclosed in the notes, the statement of financial position should present information about an organization's liquidity by either sequencing assets and liabilities or classifying assets and liabilities as current and noncurrent.

Nonprofit organizations may present liquidity information in the statement of financial position by classifying assets and liabilities as current and noncurrent. If so, classified statements of financial position should present current assets and current liabilities separately from other assets and liabilities. Current assets are those that will be realized in cash, sold, or used within one year (or operating cycle, if longer). Current liabilities are obligations that will be liquidated by using current assets or creating other current liabilities.

Related assets and liabilities may be offset and presented in the statement of financial position as a net amount if a right of setoff exists. Generally, a right of setoff exists if four conditions are met. Certain exceptions to that general rule exist, however, for fair value amounts of derivative instruments executed with the same counterparty under a master netting arrangement.

ACCOUNTING REQUIREMENTS

THE STATEMENT OF FINANCIAL POSITION

The statement of financial position should provide financial statement users with relevant information about an organization's assets, liabilities, and net assets at a specific moment in time, focusing on the organization as a whole. (FASB ASC 958-210-5-2) (formerly SFAS 117, par. 9) It should report total assets, liabilities, and net assets, and totals for unrestricted, temporarily restricted, and permanently restricted net assets. The statement should also present information about the nature and amounts of temporarily restricted and permanently restricted net assets unless that information is fully disclosed in the notes to financial statements. Contractual limitations on the use of particular assets should be presented on the face of the statement or disclosed in the notes. In addition, board-designated endowments or other limitations on the use of unrestricted net assets may be presented on the face of the statement of financial position within the unrestricted net asset classification. (FASB ASC 958-210-45-1; 958-210-45-7 and 45-9; 958-210-45-11) (formerly SFAS 117, paras. 10, 13, and 16, and 2008 Audit Guide, par. 3.07)

Assets and liabilities should be presented on the statement of financial position in reasonably homogeneous groups. However, if cash or other assets have donor-imposed restrictions limiting their use to long-term purposes, they should not be grouped with similar assets available for current use. (FASB ASC 958-210-45-4 and 45-6) (formerly SFAS 117, par. 11 and 2008 Audit Guide, par. 3.03)

The statement should present information about liquidity in one of the following formats: (FASB ASC 958-210-45-8) (formerly SFAS 117, par. 12)

a. Sequencing assets according to their nearness of conversion to cash, and liabilities according to the nearness of their maturity and resulting use of cash on the statement of financial position

b. Classifying assets and liabilities on the statement of financial position as current and noncurrent

Alternatively, the organization could disclose information about liquidity, including information about restrictions on the use of particular assets, in the notes to financial statements.

Exhibit 1-10

Sequenced Statement of Financial Position

SAFE HAVEN, INC.
STATEMENTS OF FINANCIAL POSITION
June 30, 20X7 and 20X6

	20X7	20X6
ASSETS		
Cash and cash equivalents	$ 29,907	$ 15,655
Short-term investments	1,337	11,209
Accounts receivable	—	1,355
Prepaid expenses	6,402	8,845
Contributions receivable	198,188	190,304
Long-term investments	64,875	13,282
Deposits on leased and other property	1,000	1,500
Property and equipment	648,410	664,342
TOTAL ASSETS	$ 950,119	$ 906,492
LIABILITIES		
Accounts payable	$ —	$ 3,445
Compensation	6,416	8,145
Long-term debt	79,991	85,930
TOTAL LIABILITIES	86,407	97,520
NET ASSETS		
Unrestricted	601,518	598,875
Temporarily restricted	255,325	205,932
Permanently restricted	6,869	4,165
TOTAL NET ASSETS	863,712	808,972
TOTAL LIABILITIES AND NET ASSETS	$ 950,119	$ 906,492

* * *

Exhibit 1-11

Classified Statement of Financial Position

SAFE HAVEN, INC.
STATEMENTS OF FINANCIAL POSITION
June 30, 20X7 and 20X6

	20X7	20X6
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 29,907	$ 15,655
Short-term investments	1,337	11,209

	20X7	20X6
Contributions receivable		
Unrestricted	—	5,748
United Way Services funding for the next fiscal year	154,938	135,256
Restricted to payment of long-term debt	16,600	16,171
Restricted to purchase of the new men's shelter	6,950	—
	178,488	157,175
Accounts receivable	—	1,355
Prepaid expenses	6,402	8,845
TOTAL CURRENT ASSETS	216,134	194,239
LONG-TERM CONTRIBUTIONS RECEIVABLE		
Restricted to payment of long-term debt	19,700	33,129
LONG-TERM INVESTMENTS	64,875	13,282
PROPERTY AND EQUIPMENT	648,410	664,342
OTHER ASSETS		
Deposits on leased and other property	1,000	1,500
TOTAL ASSETS	$ 950,119	$ 906,492
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	$ —	$ 3,445
Compensation	6,416	8,145
Current portion of long-term debt	15,060	10,314
TOTAL CURRENT LIABILITIES	21,476	21,904
LONG-TERM DEBT, less current portion	64,931	75,616
TOTAL LIABILITIES	86,407	97,520
NET ASSETS		
Unrestricted	601,518	598,875
Temporarily restricted	255,325	205,932
Permanently restricted	6,869	4,165
TOTAL NET ASSETS	863,712	808,972
TOTAL LIABILITIES AND NET ASSETS	$ 950,119	$ 906,492

* * *

SELF-STUDY QUIZ

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

34. Which financial statement provides users with information about an organization's assets, liabilities, and net assets?

    a. Statement of Activities.

    b. Statement of Financial Position.

    c. Statement of Cash Flows.

35. A not-for-profit organization has prepared its statement of financial position. Which of the following represents a correctly applied accounting requirement regarding this statement?

    a. The organization included all cash as current, including cash with a donor imposed restriction that the organization must use the donation for new equipment.

    b. The organization reported the nature and amounts of its unrestricted net assets on the face of the statement.

    c. The organization reported the increases in each net asset classification on the statement.

    d. The organization disclosed its liquidity information by presenting a sequenced statement of financial position.

36. Unique, Inc., a not-for-profit organization, had the following assets at the end of its year:

Cash available for current operations	$	10,000
Unconditional promises to give expected in 6 months		5,000
Prepaid insurance		2,000
Building and equipment		50,000
10-year bonds classified as held-to-maturity		30,000

    Which of the following assets would first be listed under "Cash" on Unique's statement of financial position?

    a. Unconditional promises to give.

    b. Prepaid insurance.

    c. Building and equipment.

    d. 10-year bonds.

SELF-STUDY ANSWERS

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

34. Which financial statement provides users with information about an organization's assets, liabilities, and net assets? **(Page 79)**

    a. Statement of Activities. [This answer is incorrect. The statement of activities should report information about the organization's revenues, gains, losses, expenses, and reclassifications.]

    b. Statement of Financial Position. [This answer is correct. The statement of financial position should provide financial statement users with relevant information about an organization's assets, liabilities, and net assets at a specific moment in time, focusing on the organization as a whole per FASB ASC 958-210-5-2.]

    c. Statement of Cash Flows. [This answer is incorrect. The statement of cash flows shows an organization's cash receipts and payments during a period, classified by principal sources and uses.]

35. A not-for-profit organization has prepared its statement of financial position. Which of the following represents a correctly applied accounting requirement regarding this statement? **(Page 79)**

    a. The organization included all cash as current, including cash with a donor imposed restriction that the organization must use the donation for new equipment. [This answer is incorrect. If cash or other assets have donor-imposed restrictions limiting their use to long-term purposes, they should not be grouped with similar assets available for current use.]

    b. The organization reported the nature and amounts of its unrestricted net assets on the face of the statement. [This answer is incorrect. The statement should present information about the nature and amounts of temporarily restricted and permanently restricted net assets unless that information is fully disclosed in the notes to the financial statements.]

    c. The organization reported the increases in each net asset classification on the statement. [This answer is incorrect. The organization should report total assets, liabilities, and net assets, and the totals for each net asset classification. Increases or decreases to the net asset classifications are reported on the statement of activities.]

    d. The organization disclosed its liquidity information by presenting a sequenced statement of financial position. [This answer is correct. The statement of financial position should present information about liquidity by either a sequenced or classified statement per FASB ASC 958-210-45-8; 958-210-50-1.]

36. Unique, Inc., a not-for-profit organization, had the following assets at the end of its year:

Cash available for current operations	$	10,000
Unconditional promises to give expected in 6 months		5,000
Prepaid insurance		2,000
Building and equipment		50,000
10-year bonds classified as held-to-maturity		30,000

    Which of the following assets would first be listed under "Cash" on Unique's statement of financial position? **(Page 79)**

    a. Unconditional promises to give. [This answer is correct. Assets should be sequenced according to their nearness of conversion to cash per FASB ASC 958-210-45-8.]

    b. Prepaid insurance. [This answer is incorrect. This would appear after unconditional promises to give on a sequenced statement of financial position.]

    c. Building and equipment. [This answer is incorrect. This would appear last on a sequenced statement of financial position.]

    d. 10-year bonds. [This answer is incorrect. This would appear after prepaid insurance on a sequenced statement of financial position.]

CURRENT ASSETS AND CURRENT LIABILITIES

Classified statements of financial position distinguish current assets and current liabilities from other assets and liabilities. They may be more useful than sequenced statements of financial position because they present information that funders, lenders, and other financial statement readers frequently use to measure an organization's liquidity. For example, to assess an organization's ability to meet obligations when they are due, financial statement users often compute an organization's working capital (current assets less current liabilities), current ratio (current assets divided by current liabilities), and quick ratio (cash and assets quickly convertible into cash divided by current liabilities).

Current Assets

Current assets are cash and those assets that are reasonably expected to be realized in cash or sold or consumed within one year or within an organization's normal operating cycle if it is longer. (FASB ASC 210-10-20) (An organization whose operating cycle is not clearly defined should classify assets as current based on a one year time period.) An organization's normal operating cycle is the time needed to convert cash first into materials and services, then into products or services, then by providing services or sale of goods into receivables, and finally by collection back into cash. For most organizations, that period is less than one year or not recognizable. For some entities with extended production processes, however, the operating cycle may be longer than one year. (FASB ASC 210-10-45-3)

Generally, current assets include the following:

- Cash and cash equivalents available for current operations
- Investments in certain equity securities and debt securities representing the investment of cash available for current operations
- Inventories
- Trade accounts receivable
- Unconditional promises to give that are expected to be collected within one year (or operating cycle, if longer)
- Notes and other receivables that are expected to be collected within one year (or operating cycle, if longer)
- Prepaid expenses such as insurance, interest, rents, etc. (Although prepaid expenses will not be converted into cash, they are considered current assets because they would have required the use of current assets had they not been paid in advance.) (FASB ASC 210-10-45-1 and 45-2) (formerly ARB 43, Ch. 3A, par. 4)

The following are *not* current assets, however, since they generally are not expected to be converted into cash within one year (or operating cycle, if longer):

- Cash or other assets received with donor-imposed restrictions that limit their use to long-term purposes (FASB ASC 958-210-45-6) (formerly SFAS 117, par. 11)
- Cash restricted or designated for other special purposes, such as cash restricted from withdrawal or use for current operations, or for the liquidation of long-term debt (Restricted cash may be classified as a current asset if it is considered to offset maturing debt that has been properly classified as a current liability, however.)
- Long-term investments
- Unconditional promises to give not expected to be collected within one year (or operating cycle, if longer)
- Other receivables from unusual transactions not expected to be collected within one year (or operating cycle, if longer)

- Cash surrender value of life insurance policies
- Land and other natural resources
- Depreciable assets
- Capitalized collections
- Prepayments or deferred charges that will not be charged to expense within one year (or operating cycle, if longer) (FASB ASC 210-10-45-4) (formerly ARB 43, Ch. 3A, par. 6)

Current Liabilities

Current liabilities are obligations whose liquidation is reasonably expected to require (a) the use of current assets or (b) the creation of other current liabilities. (FASB ASC 210-10-20) Current liabilities include the following:

- Payables for materials and supplies
- Amounts collected before goods or services are delivered
- Accruals for wages, salaries, commissions, rents, royalties, and unrelated business income taxes
- Other obligations, including portions of long-term obligations, that are expected to be liquidated within one year (or operating cycle, if longer) (FASB ASC 210-10-20; 210-10-45-8 and 45-9) (formerly ARB 43, Ch. 3A, par. 7)

Current liabilities do *not* include long-term notes, bonds, annuity obligations, and other obligations that will be liquidated through accounts not classified as current assets. (FASB ASC 210-10-45-12) (formerly ARB 43, Ch 3A, par. 8)

OFFSETTING ASSETS AND LIABILITIES

Assets and liabilities should not be offset in a statement of financial position (i.e., reported at a net amount) unless a right of setoff exists. (FASB ASC 210-20-05-1) (formerly APB 10, par. 7) A right of setoff is a debtor's legal right to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met: (FASB ASC 210-20-45-1) (formerly FIN 39, par. 5)

a. Each of *two* parties owes the other a determinable amount.

b. The reporting party has the right to set off the amount it owes against the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is legally enforceable.

When determining whether assets and liabilities may be offset, accountants should note the following:

- The reporting party must actually intend to set off amounts owed. Thus, even though the ability to offset may exist, assets and liabilities should not be offset if the reporting party does not intend to set off. (FASB ASC 210-20-45-4) (formerly FIN 39, par. 45)
- Because the right of setoff must be enforceable at law, situations involving state laws and the U.S. Bankruptcy Code may modify or restrict the reporting party's right of setoff. (FASB ASC 210-20-45-8) (formerly FIN 39, par. 6)
- Assets and liabilities need not be denominated in the same currency or bear interest at the same rates to be offset. If an asset and liability have different maturities, however, only the party with the earlier maturity may offset since the party with the longer maturity must settle in the manner the other party selects at the earlier maturity date. (FASB ASC 210-20-45-3) (formerly FIN 39, par. 4)

Offsetting Securities against Taxes Payable

Generally, a government's securities should not be offset against taxes and other liabilities owed to it. The only exception to that rule is when it is clear that the security purchase is, in effect, an advance payment of taxes that will be owed in the near future (for example, if a government issues securities that it designates as acceptable for the payment of taxes). (FASB ASC 210-20-45-6 and 45-7) (formerly APB 10, par. 7)

Offsetting Derivative Instruments

Questions have been raised about offsetting derivative instruments that are measured at fair value rather than notional amounts or amounts to be exchanged. GAAP clearly states that the carrying amount for such instruments is fair value. Thus, so long as the conditions in paragraph [OLDREF] are met, the fair value of contracts in a loss position may be offset against the fair value of contracts in a gain position. (FASB ASC 815-10-45-4) (formerly FIN 39, par. 8)

Master Netting Arrangements. Under a master netting arrangement, individual contracts are effectively consolidated into a single agreement between the parties. Failure to make one payment under the master netting arrangement entitles the other party to terminate the entire arrangement and demand the net settlement of all contracts. Such arrangements typically do not meet the conditions for offsetting because the right to set off is conditional (i.e., a party must default). However, because the FASB believes that presenting aggregate fair values of the individual contracts does not provide information that is more useful than presenting net amounts, GAAP provides an exception to the general rule. It allows an entity to offset the fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. The fair value recognized for some of these contracts may include an accrual component for the periodic unconditional receivables and payables that result from the contract. This accrual component may also be offset. (FASB ASC 815-10-45-5) (formerly FIN 39, par. 10)

The exception applies only to *fair value amounts* recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value with the same counterparty under a master netting arrangement. It does not apply to other contracts not recorded at fair value (for example, repurchase agreements and reverse repurchase agreements) that are executed under master netting arrangements. (FASB ASC 815-10-45-5) (formerly FIN 39, par. 10) Gross amounts recorded for such assets and liabilities provide useful information about the timing and amount of future cash flows that would be lost if the amounts were offset. Thus, such contracts may not be offset solely because they are executed under a master netting arrangement; they may be offset only if they meet the four right of setoff conditions previously listed.

Organizations are required to make an accounting policy decision to offset the fair value amounts. The choice to offset or not must be consistently applied. A reporting entity cannot offset fair value amounts for derivative instruments recognized at fair value under master netting arrangements without also offsetting the fair value amounts recognized for the right to reclaim or obligation to return cash collateral. (FASB ASC 815-10-45-6) (formerly FIN 39, par. 10A)

Offsetting Receivables and Payables from Repurchase and Reverse Repurchase Agreements

Amounts recognized as payables under repurchase agreements may (but are not required to) be offset against amounts recognized as receivables under reverse repurchase agreements if all of the following conditions are met: (FASB ASC 210-20-45-11; 210-20-45-14 through 45-17) (formerly FIN 41, paras. 3 and 4)

a. The repurchase and reverse repurchase agreements are executed with the same counterparty.

b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.

c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.

d. The securities underlying the agreements exist in "book entry" form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.

e. The agreements will be settled on a securities transfer system that requires the security's owner of record to initiate the transfer by notifying its custodian to transfer the security. In addition, an associated banking arrangement is in place that requires each party to maintain available cash on deposit only for the amount of any net payable unless it fails to instruct its securities custodian to transfer securities to its counterparty. It must be probable that the associated banking arrangement will provide sufficient daylight overdraft or other intraday credit at the settlement date for each of the parties.

f. The reporting entity intends to use the same account at the clearing bank or other financial institution at the settlement date to transact both (1) the cash inflows from settlement of the reverse repurchase agreement and (2) the cash outflows from settlement of the offsetting repurchase agreement.

The reporting party may offset related receivables and payables regardless of whether it actually intends to set off the amounts. Thus, the requirements provide an exception to the general rule (the four conditions allowing setoff).

Circumstances Not Covered by FASB ASC 210-20 (formerly FASB Interpretation No. 39)

Accounting Standards for offsetting in FASB ASC 210-20 (formerly FIN 39) do not apply to offsetting cash balances on deposit in banks and other financial institutions because amounts on deposit should not be considered amounts owed to the depositor. Accordingly, the condition in item a. for right of setoff is not met because each of two parties does not owe the other a determinable amount. (FASB ASC 210-20-15-3) (formerly FIN 39, par. 43)

In addition, derecognition or nonrecognition of assets or liabilities is not addressed. Derecognition is the removal of a *recognized* asset or liability, for example, by sale of the asset or extinguishment of the liability, and generally results in a gain or loss. Nonrecognition, on the other hand, involves not recognizing assets or liabilities (commonly known as off-balance-sheet financing) and, therefore, results in no gain or loss. Offsetting relates solely to the display of a recognized asset or liability, in contrast to derecognition or nonrecognition, which relates to the *measurement* of assets or liabilities. (FASB ASC 210-20-15-2) (formerly FIN 39, par. 5)

Accounting Standards for offsetting in FASB ASC 210-20 (formerly FIN 39) also do not modify other standards that require a particular accounting treatment that results in offsetting or is similar to offsetting in specific circumstances. (FASB ASC 210-20-15-3) (formerly FIN 39, par. 7)

SELF-STUDY QUIZ

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

37. Unique, Inc., a not-for-profit organization, had the following assets at the end of its year:

Cash available for current operations	$	10,000
Unconditional promises to give expected in 6 months		5,000
Prepaid insurance		2,000
Building and equipment		50,000
10-year bonds classified as held-to-maturity		30,000

How much does Unique report as current assets on its statement of financial position?

a. $15,000.

b. $17,000.

c. $47,000.

d. $67,000.

38. Unique, Inc., a not-for-profit organization, had the following liabilities at the end of its year:

Accounts payable for office supplies	$	10,000
Accrued salaries, paid 3 months after year-end		5,000
Note payable (payment obligation is $1,000 per month)		36,000
Revenue received for services to be performed next year		7,000

How much does Unique report as current liabilities on its statement of financial position?

a. $27,000.

b. $29,000.

c. $34,000.

d. $51,000.

39. At the end of 2010, US Organization owed its affiliate UK Organization $100,000 due by December 31, 2011. UK Organization also owed $150,000 to US Organization due by December 31, 2012. The $150,000 due to US Organization is the foreign exchange translation amount at US's statement of financial position date. US Organization is preparing its statement of financial position for 2010. Which of the following is true regarding US's ability to offset its payable to/ receivable from UK on the statement?

a. US cannot offset the payable/receivable because the currencies used are different.

b. US can offset the payable/receivable because each of two parties owes the other a determinable amount.

c. US can offset the payable/receivable because it is owed more than UK.

d. US cannot offset the payable/receivable because its maturity date is later than UK's maturity date.

SELF-STUDY ANSWERS

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

37. Unique, Inc., a not-for-profit organization, had the following assets at the end of its year:

Cash available for current operations	$	10,000
Unconditional promises to give expected in 6 months		5,000
Prepaid insurance		2,000
Building and equipment		50,000
10-year bonds classified as held-to-maturity		30,000

How much does Unique report as current assets on its statement of financial position? **(Page 85)**

a. $15,000. [This answer is incorrect. Prepaid expenses are considered current assets even though they are not converted into cash because they would have required the use of current assets had they not been paid in advance.]

b. $17,000. [This answer is correct. Current assets are cash and those assets that are reasonably expected to be realized in cash or sold or consumed within one year or within an organization's normal operating cycle if it is longer ($10,000 + $5,000+ $2,000).]

c. $47,000. [This answer is incorrect. Long-term investments are not included in current assets.]

d. $67,000. [This answer is incorrect. Depreciable property is not a current asset.]

38. Unique, Inc., a not-for-profit organization, had the following liabilities at the end of its year:

Accounts payable for office supplies	$	10,000
Accrued salaries, paid 3 months after year-end		5,000
Note payable (payment obligation is $1,000 per month)		36,000
Revenue received for services to be performed next year		7,000

How much does Unique report as current liabilities on its statement of financial position? **(Page 86)**

a. $27,000. [This answer is incorrect. Amounts collected before goods or services are delivered are current liabilities.]

b. $29,000. [This answer is incorrect. Accrued wages, salaries, commissions, rents, royalties, and unrelated business income taxes are current liabilities.]

c. $34,000. [This answer is correct. Current liabilities are obligations whose liquidation is reasonably expected to require the use of current assets, or the creation of other current liabilities. Only the portion of the note payable that extends beyond one year's worth of payments is considered long-term ($10,000 + $5,000+ $12,000 + $7,000).]

d. $51,000. [This answer is incorrect. The note will paid over 3 years, only a year's worth of payments are considered current.]

39. At the end of 2010, US Organization owed its affiliate UK Organization $100,000 due by December 31, 2011. UK Organization also owed $150,000 to US Organization due by December 31, 2012. The $150,000 due to US Organization is the foreign exchange translation amount at US's statement of financial position date. US Organization is preparing its statement of financial position for 2010. Which of the following is true regarding US's ability to offset its payable to/ receivable from UK on the statement? **(Page 86)**

    a. US cannot offset the payable/receivable because the currencies used are different. [This answer is incorrect. Assets and liabilities need not be denominated in the same currency or bear interest at the same rates to be offset.]

    b. US can offset the payable/receivable because each of two parties owes the other a determinable amount. [This answer is incorrect. A right of offset exists when each of two parties owes the other a determinable amount, the reporting party has the right to set off the amount it owes against the amount owed by the other party, the reporting party intends to set off, and the right of setoff is legally enforceable.]

    c. US can offset the payable/receivable because it is owed more than UK. [This answer is incorrect. It does not matter whether an entity nets an asset or liability when it offsets. However, there are other conditions that must be met in order to be able to offset for purposes of GAAP, such as that the reporting party has the right to set off the amount it owes.]

    d. US cannot offset the payable/receivable because its maturity date is later than UK's maturity date. [This answer is correct. If an asset and liability have different maturities, only the party with the earlier maturity may offset since the party with the longer maturity must settle in the manner the other party selects at the earlier maturity date.]

DISCLOSURE REQUIREMENTS

FINANCIAL STATEMENT PRESENTATION

The following are required disclosures and those generally accepted for nonprofit organizations related to the statement of financial position. (Many of the listed requirements deal with presentation rather than disclosure and are discussed in the Accounting Requirements section. Presentation requirements are summarized in this section, however, so that the primary considerations for statements of financial position can be readily identified.)

The statement of financial position should report the following:

a. Total assets, total liabilities, total net assets, and separate totals for unrestricted, temporarily restricted, and permanently restricted net assets (FASB ASC 958-210-45-1) (formerly SFAS 117, paras. 10 and 13)

b. Assets and liabilities aggregated into reasonably homogeneous groups that reflect donor-imposed restrictions and other contractual restrictions (FASB ASC 958-210-45-4) (formerly SFAS 117, paras. 11 and 94)

c. Information about the nature and amounts of different types of permanent and temporary net asset restrictions (unless disclosed in the notes to financial statements) (FASB ASC 958-210-45-9) (formerly SFAS 117, par. 14)

d. If not disclosed in the notes to the financial statements: (FASB ASC 958-210-45-7) (formerly 2008 Audit Guide, paras. 3.07 and 4.05):

   (1) Information about the nature and amount of limitations on the use of cash and cash equivalents

   (2) Contractual limitations on the use of particular assets

e. Liquidity and maturity of assets and liabilities either by sequencing assets and liabilities, or by classifying assets and liabilities as current and noncurrent (if not disclosed in a separate note to the financial statements) (FASB ASC 958-210-45-8) (formerly SFAS 117, par. 12)

f. If a classified statement of financial position is presented:

   (1) A total of current assets (Generally accepted)

   (2) A total of current liabilities (FASB ASC 210-10-45-5) (formerly SFAS 6, par. 15)

g. A separate line item on the face of the statement called "Cash" or "Cash and cash equivalents" (Generally accepted)

h. Cash or other assets received with donor-imposed restrictions limiting their use to long-term purposes presented separately from similar assets available for current use and described as to their nature (if not separately disclosed in the notes to the financial statements) (FASB ASC 958-210-45-6) (formerly SFAS 117, par. 11 and 2008 Audit Guide, par. 3.03)

The notes to financial statements should disclose the following information related to the statement of financial position:

a. If not clearly presented on the face of the statement of financial position:

   (1) The liquidity and maturity of assets and liabilities including restrictions on the use of particular assets (FASB ASC 958-210-50-1) (formerly SFAS 117, par. 12)

   (2) Description of the cash or other assets received with donor-imposed restrictions limiting their use to long-term purposes (FASB ASC 958-210-50-3) (formerly 2008 Audit Guide, par. 3.03)

(3) Information about the nature and amount of limitations on the use of cash and cash equivalents (FASB ASC 958-210-50-3) (formerly 2008 Audit Guide, par. 4.05)

(4) Contractual limitations on the use of particular assets (FASB ASC 958-210-50-3) (formerly 2008 Audit Guide, par. 3.07)

(5) Information about the nature and amounts of different types of permanent or temporary net asset restrictions (FASB ASC 958-210-50-3) (formerly SFAS 117, paras. 14 and 15)

b. Unusual organization circumstances that are present, such as: (FASB ASC 958-210-50-2) (formerly 2008 Audit Guide, par. 4.05)

- Special borrowing arrangements
- Requirements imposed by resource providers that cash be held in separate accounts
- Known significant liquidity problems

c. The fact that the organization has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions

d. Information about significant limits that result from contractual agreements, including the existence of loan covenants (FASB ASC 958-210-50-2) (formerly SFAS 117, par. 16)

OFFSETTING ASSETS AND LIABILITIES

A reporting entity should disclose the policy to offset or not to offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim or obligation to return cash collateral arising from derivative instruments recognized at fair value under master netting arrangements. (FASB ASC 815-10-50-7) (formerly FIN 39, par. 10B)

A reporting entity should disclose the following regarding fair value amounts recognized for derivative instruments under master netting arrangements at the end of each reporting period: (FASB ASC 815-10-45-5; 815-10-50-8) (formerly FIN 39, paras. 10 and 10B)

a. If an accounting policy decision to offset fair value amounts has been made, separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have (i) been offset against net derivative positions under master netting arrangements that are eligible for offsetting and (ii) not been offset against net derivative positions under master netting arrangements.

b. If an accounting policy decision to not offset fair value amounts has been made, separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements.

SELF-STUDY QUIZ

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

40. Generous, Inc., a not-for-profit organization, is presenting a classified statement of financial position. Which of the following is unique to this statement as compared to a sequenced statement of financial position?

    a. Generous included a line item called “Cash”.

    b. Generous included a total of current assets.

    c. Generous identified significant categories of payables.

    d. Generous reported total net assets.

SELF-STUDY ANSWERS

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

40. Generous, Inc., a not-for-profit organization, is presenting a classified statement of financial position. Which of the following is unique to this statement as compared to a sequenced statement of financial position? **(Page 92)**

    a. Generous included a line item called "Cash". [This answer is incorrect. Whether a classified or sequenced statement of financial position is prepared, a separate line item on the face of the statement called "Cash" or "Cash and cash equivalents" must be presented.]

    b. Generous included a total of current assets. [This answer is correct. If a classified statement of financial position is presented total current assets and total current liabilities are presented.]

    c. Generous identified significant categories of payables. [This answer is incorrect. Neither style of statement requires that significant categories of payables be presented. However, GAAP requires that significant categories of receivables be presented.]

    d. Generous reported total net assets. [This answer is incorrect. The statement of financial position must report total net assets and separate totals for unrestricted, temporarily restricted, and permanently restricted net assets, no matter what style of statement is used.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (NPGTG101)

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

1. The Humanity Fund, a not-for-profit organization, reported a $10,000 increase in net assets on its statement of activities. The net assets reported on this statement will correspond with net assets reported on which other statement?
   a. Statement of Financial Position.
   b. Statement of Changes in Net Assets.
   c. Statement of Cash Flows.
   d. Statement of Functional Expenses.
2. Morgan Organization paid $20,000 in costs for a fundraising effort. The organization raised $100,000 from this effort. How will Morgan Organization report the fundraising costs on its statement of activities?
   a. As an increase in unrestricted net assets.
   b. As a reclassification.
   c. As an expense.
   d. As a net gain.
3. Justice for All is a calendar year, not-for-profit organization. On December 31, 2010, Jake contributed $20 towards the general activities of the organization. The organization used the money in early 2011 for office supplies. How does Justice for All report this contribution on its 2010 statement of activities?
   a. As temporarily restricted support.
   b. As unrestricted support.
   c. As deferred revenue.
   d. As a reciprocal transaction.
4. In which of the following categories must a not-for-profit organization report its expenses?
   a. Decreases in permanently restricted net assets.
   b. Decreases in temporarily restricted net assets.
   c. Decreases in unrestricted net assets.
   d. Expenses are reclassified among the three net asset classes, as appropriate.
5. Habitat House, a not-for-profit organization, is preparing its first set of financial statements. According to GAAP, what format is Habitat House required to use when preparing its first statement of activities?
   a. Single column.
   b. Multicolumn.
   c. Two separate statements.
   d. No particular format is required, as long as proper net asset presentation is made.

6. If a not-for-profit organization has all of the following, which of the following is presented last in the statement of activities?

   a. Extraordinary items.

   b. Discontinued operations of a component of an entity.

   c. Unusual or infrequent items.

   d. Change in net assets from continuing operations.

7. Which of the following organizations may have an extraordinary item to report?

   a. Organization A had to write off contributions receivable for the first time since its existence.

   b. Organization B adjusted accruals on long-term contracts.

   c. Organization C recorded the effects of a strike.

   d. Organization D had a loss on expropriation of assets by a foreign government.

8. Theatre Workshop, a not-for-profit organization that produces community theater, sold costumes worn by a famous actor that volunteered at the Workshop last summer. The proceeds were $1,000,000, which is ten times more than the organization's normal contributions. How should Theatre Workshop present the proceeds from the sale of the costumes?

   a. Net of any tax.

   b. As an unusual or infrequent item.

   c. As a separate line item following the change in net assets.

   d. As an extraordinary item.

9. ABC Organization and DEF Organization, two unrelated not-for-profit organizations, joined together to produce a short documentary that highlights the harmful effects of smoking. Both organizations are active participants and are exposed to significant risks and rewards dependent on the commercial success of the activity. ABC Organization is the principal participant for the production of the film. How should ABC record the transactions regarding this film?

   a. On the equity method.

   b. On a gross basis.

   c. On a net basis.

   d. On the cash method.

10. Habitat House, Inc., a not-for-profit organization, is preparing its statements of activities and classifies items within the net asset classes as operating and nonoperating. Which of the following is true regarding the use of the term *operations*?

    a. Operations is a standard term used by not-for-profit organizations.

    b. The organization's programs should be listed under operations on the statement.

    c. The nature of items included in operations should be described on the statement or in the notes.

    d. Only organizations that are not health and welfare organizations can use the term *operations*.

11. Feed Families, Inc. made payments (that cannot be allocated to its functional expense classifications) to its local not-for-profit organization, Shelter Families, Inc. How should Feed Families report these payments on its statement of activities?

    a. As a separate supporting service line item.

    b. As a component of change in net assets.

    c. It should be included with miscellaneous expenses.

    d. As a nonoperating unrestricted expense.

12. Feed Families, Inc., a not-for-profit organization, is presenting statements of activities for the years ended 2010, 2009, and 2008, along with statements of financial position for 2010 and 2009. Which period(s) must Feed Families report on its statement(s) of cash flows?

    a. 2010 only.

    b. 2010 and 2009 only.

    c. 2010, 2009, and 2008.

    d. A statement of cash flows is not required.

13. Shelter Families, Inc., a not-for-profit organization, is presenting cash basis statements of activities for the years ended 2010 and 2009 along with cash basis statements of financial position for 2010 and 2009. Shelter Families is required to present cash flow statements for 2010 and 2009.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

14. A not-for-profit organization has a checking account balance of $30,000, a $15,000 US Treasury note that matures in one year, a $10,000 five-year US Treasury note purchased two months from maturity, a $5,000 six-month CD with an early withdrawal penalty, and a $10,000 line of credit balance due to the bank. What amount will the organization include in its balance of cash and cash equivalents?

    a. $30,000.

    b. $35,000.

    c. $40,000.

    d. $45,000.

15. A not-for-profit hospital has a checking account balance of $30,000, a $10,000 five-year US Treasury note purchased six months from maturity, $15,000 of stock the organization plans to sell in the next month, and a $20,000 three-month US Treasury bill donated with the restriction it be used for a new children's wing. What amount will the hospital include in its balance of cash and cash equivalents?

    a. $30,000.

    b. $40,000.

    c. $45,000.

    d. $50,000.

16. Children's Hospital acquired equipment for its new wing by using donations made specifically for the wing, and by obtaining a loan. Which element of the statement of cash flows is the portion acquired by assuming the liability classified?

    a. Operating activities.

    b. Investing activities.

    c. Financing activities.

    d. Noncash investing and financing activities.

17. Children's Hospital is installing a new pool for its patients that require water therapy. Which of the following transactions will Children's classify as a financing activity on its statement of cash flows relating to the new pool?

    a. Children's paid $10,000 in wages to employees involved in planning of the pool.

    b. Children's paid $50,000 for equipment in the pool room.

    c. Children's received $100,000 from donors to be used for the pool.

    d. Children's capitalized services donated by its accounting firm for keeping track of the pool budget.

18. A not-for-profit organization is preparing its first set of financial statements, and is deciding whether it will present a direct method or indirect method cash flow statements. As the organization's accountant, what could you tell your client about its choices?

    a. If the indirect method is used, they must also present a reconciliation of the change in net assets to cash flows from operating activities in a separate schedule.

    b. The direct method starts with the change in net assets.

    c. The indirect method shows interest and dividends received.

    d. The direct method shows only cash receipts and payments.

19. A community after-school program uses the indirect method to prepare its statement of cash flows. The organization had the following balances at the end of 2010:

Change in net assets	$ 100,000
Depreciation	5,000
Gain on sale of equipment	3,000
Cash received from contributions and grants	200,000
Decrease in receivables	20,000
Increase in accounts payable	7,000

    What is the store's net cash provided by operating activities?

    a. $85,000.

    b. $129,000.

    c. $227,000.

    d. $229,000.

20. The JGL Foundation recorded a $10,000 provision for uncollectible promises to give not restricted for long-term purposes. How should JGL classify this entry in its statement of cash flows if it uses the indirect method?

    a. Adjust change in net assets by adding $10,000.

    b. Include $10,000 as a noncash investing and financing activity.

    c. Reduce cash from operating activities by $10,000.

    d. Increase cash flows from financing activities by $10,000.

21. The Joyful Child Organization had the following transactions related to creating a new playground during 2010:

Down payment on new playground equipment	$	10,000
Proceeds from sale of old play ground equipment		6,000
Trade-in value of old play ground equipment		2,000
Loan payments made on new playground equipment		1,000

    What is Joyful Child's net cash inflow or outflow from investing activities on its 2010 statement of cash flows?

    a. $2,000 outflow.

    b. $3,000 outflow.

    c. $4,000 outflow.

    d. $7,000 inflow.

22. During 2010, a not-for-profit organization received a cash donation of $5,000 to be used for new equipment. The organization held the donation throughout 2010, and purchased $12,000 of equipment in 2011. How is this donation reflected on the organization's 2010 statement of cash flows?

    a. As a $5,000 cash inflow from financing activities, and $12,000 cash outflow from investing activities.

    b. As a $5,000 cash inflow from financing activities, and $5,000 cash outflow from investing activities.

    c. As a $5,000 cash inflow from investing activities, and $5,000 cash outflow from investing activities.

    d. As a $5,000 cash inflow from investing activities, and $5,000 reported as noncash investing and financing activities.

23. P Organization acquired the working capital (other than cash) and net noncurrent assets of S Organization for $100,000. The fair value of assets obtained is $125,000. Which of the following is a correct classification of this transaction on P's statement of cash flows?

    a. $25,000 cash flow from investing activities.

    b. $25,000 cash flow from financing activities.

    c. $100,000 cash flow from investing activities.

    d. $100,000 noncash investing and financing activity.

24. During the current year, Golden Organization, a not-for-profit organization that trains adults to get back into the workforce, had the following transactions:

    $40,000 repayment of a bank loan

    $30,000 contribution to a permanent endowment for which the investment income can be used for the organization's general programs

    $10,000 value of equipment donated to the organization

    $15,000 of investment income earned that must be used to purchase equipment for its "Back to Work" program

    What is Golden's net cash flow from financing activities?

    a. $25,000 outflow.

    b. $ 5,000 inflow.

    c. $10,000 inflow.

    d. $15,000 inflow.

25. On December 15, 2010, Golden Organization took out a lease for a car to be used by program participants needing transportation to job interviews. The lease is classified as a capital lease and the present value of minimum lease payments is $15,000. No payments were made on the lease until 2011. Which classification will Golden report this lease on its 2010 statement of cash flows?

    a. Cash flow from operating activities.

    b. Cash flow from investing activities.

    c. Cash flow from financing activities.

    d. Noncash investing and financing activities.

26. ABC, a not-for-profit organization, is your client and has prepared its first set of financial statements. You are reviewing ABC's internally prepared statement of cash flows. Which of the following is an acceptable presentation on the statement?

    a. ABC reconciled beginning and ending cash and cash equivalents at the bottom of the statement.

    b. ABC combined its investing and financing activities into one category, because it only had one of each classification.

    c. ABC classified all cash receipts and cash payments under the categories Cash Inflows and Cash Outflows.

    d. ABC uses the term *funds*, instead of *cash and cash equivalents*.

27. Which of the following is true regarding fund accounting?

    a. It focuses on the entity as a whole.

    b. It is a form of the single-entry accounting system.

    c. It can only be used by state and local governments.

    d. It is not a necessary part of external reporting.

28. Which of the following should a not-for-profit organization disclose if it uses fund accounting for external reporting purposes?

    a. Interfund transfers shown as a change in fund balance.

    b. Interfund receivables and payables identified in the statement of financial position so the amounts eliminate.

    c. Material interfund borrowings when restricted funds have been loaned or when liquidity of either fund is in question.

    d. Do not select this answer choice.

29. Good Organization completed its third year on June 30, 2010, and is preparing its annual financial statements. Which of the following is required of Good regarding comparative financial statements?

    a. Good must report its financial information for June 30, 2010 and 2009 on all presented statements.

    b. Good must report its financial information for June 30, 2010, 2009, and 2008 on all presented statements.

    c. Good must report its financial information for June 30, 2010 and 2009 on its statement of financial position, and June 30, 2010, 2009, and 2008 on its statement of activities and cash flows statement.

    d. Good is not required to report comparative financial statements on any financial statements.

30. Pink Ribbon, Inc. has classified one of its components, Red, as held for sale. How are the operating results of Red presented on the statement of activities if Red has been eliminated from the ongoing operations of Pink, and Pink will not have significant continuing involvement in Red's operations?

    a. Along with operating results until Pink officially sells Red.

    b. Along side the results from continuing operations, in columnar form.

    c. After the change in net assets from continuing operations.

    d. After any extraordinary items Pink is presenting.

31. The management of ABC Organization is preparing the organization's financial statements and determining the organization's ability to continue as a going concern. As the organization's accountant, what can you tell your client about this going concern assessment?

    a. It is more than an evaluation of whether recorded assets and liabilities are recoverable and properly classified.

    b. Management should assess the organization's ability to continue as a going concern for two years beyond the financial statement date.

    c. If the working capital is negative, the organization will not be able to continue as a going concern past one more year.

    d. A going concern disclosure should be included if the organization has had five or more consecutive years of negative changes in net assets.

32. ABC Organization is preparing comparative financial statements. Which of the following is an example of a disclosure ABC is required to make regarding comparative statements?

    a. ABC has prepared comparative statements as they are more useful to the user of the financial statements.

    b. ABC has prepared comparative statements to satisfy requirements of a bank loan.

    c. ABC has reclassified items classified as revenue in the prior year to deferred revenue.

    d. ABC believes the comparative statements have been prepared in accordance with GAAP.

33. Due to the current economic conditions in the U.S., ABC Organization has had insufficient contributions to support its programs. Which of the following is an example of a disclosure ABC is required to make in 20X5 if management determines there is substantial doubt about the organization's ability to continue as a going concern?

    a. The management of ABC believes the country's current struggles will dissipate by the end of 20X9, and ABC will continue as a going concern.

    b. The management of ABC expects to have negative net assets unless contributions increase by $500,000 over the prior year.

    c. The management of ABC will not discontinue any of its current activities, but will not start any new activities until the cash flow is positive.

    d. Do not select this answer choice.

34. Serenity Now, Inc, a not-for-profit organization that helps individuals to become well-balanced in mind, body, and spirit, is preparing its first statement of financial position. Which of the following items will be reported on this statement?

    a. Extraordinary items.

    b. Change in net assets.

    c. Cash provided by operating activities.

    d. Unrestricted net assets.

35. Serenity Now, Inc received a $100,000 unrestricted donation. The board of Serenity Now has restricted this contribution to be used for a new relaxation area for patients of its program. Within which net asset classification should the asset appear on the statement of financial position?

    a. Unrestricted net assets.

    b. Temporarily restricted net assets.

    c. Permanently restricted net assets.

    d. Board designated net assets.

36. Serenity Now, Inc had the following assets at the end of its year:

Cash available for current operations	$	20,000
Unconditional promises to give expected within 12 months		7,000
Unconditional promises to give expected within 18 months		2,000
Prepaid rent		3,000
Art collection		10,000
Inventory		4,000

Which of these assets should be listed first on Serenity Now's statement of financial position?

a. Cash.

b. Contributions receivable.

c. Prepaid rent.

d. Inventory.

37. Serenity Now, Inc had the following assets at the end of its year:

Cash available for current operations	$	20,000
Unconditional promises to give expected within 12 months		7,000
Unconditional promises to give expected within 18 months		2,000
Prepaid rent		3,000
Art collection		10,000
Inventory		4,000

How much does Serenity Now report as current assets on its statement of financial position?

a. $30,000.

b. $34,000.

c. $36,000.

d. $44,000.

38. Serenity Now, Inc had the following liabilities at the end of its year:

Accounts payable for supplies	$	12,000
Accrued tax		2,000
Note payable (payment obligation is $2,000 per month)		60,000

How much does Serenity Now report as current liabilities on its statement of financial position?

a. $12,000.

b. $14,000.

c. $38,000.

d. $74,000.

39. Good Organization owns $20,000 in US Treasury bonds that mature in 2011. At the end of 2010, Good owes the federal government $2,000 for unrelated business income taxes. Good should offset the $2,000 liability with $2,000 of its US Treasury bonds on its 2010 statement of financial position.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice

40. Which of the following must be reported on the face of the statement of financial position, rather than as a disclosure in the notes to the financial statements?

    a. Information about the nature and amounts of net asset restrictions.

    b. Contractual limitations on the use of particular assets.

    c. The liquidity and maturity of assets and liabilities including restrictions.

    d. Total assets, total liabilities, total net assets.

Lesson 2: Split-interest Agreements

SOURCE: FASB ASC 958-30

INTRODUCTION

Split-interest agreements are contributions that are to be shared by the nonprofit organization and other beneficiaries. A split-interest agreement is created when a donor contributes assets directly to a nonprofit organization or places them in a trust for the benefit of the nonprofit organization, but for which the organization is not the sole beneficiary.

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

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the characteristics and the accounting requirements of split-interest agreements.
- Outline the general rules for recording split-interest agreements to charitable lead trusts, charitable remainder trusts, charitable gift annuities, and pooled income funds.

ACCOUNTING REQUIREMENTS

Nonprofit organizations receive contributions from donors in many different forms. Some gifts may be for the sole use of the recipient nonprofit organization, while others are passed on, in whole or in part, to others. Split-interest agreements are contributions that are to be shared by the nonprofit organization and other beneficiaries. The other beneficiaries generally are not other nonprofit organizations. A typical split-interest agreement has a lead interest and a remainder interest. (FASB ASC 958-30-05-4)

A split-interest agreement is created when a donor contributes assets directly to a nonprofit organization or places them in a trust for the benefit of the nonprofit organization, but for which the organization is not the sole beneficiary. The contributed assets may be held, invested, and administered by the nonprofit organization, a trustee, or a fiscal agent, who is responsible for making the required distributions to the beneficiaries. The term of the agreement may be expressed in a finite number of years, in perpetuity, or may be based on the occurrence of a certain event, such as the death of the donor, a beneficiary, or another individual. The lead interest provides the right to receive the benefits of assets during the split-interest agreement's term. The remainder interest provides the right to receive all or a portion of the split-interest agreement's assets that are remaining at the end of the agreement's term. Upon expiration of the agreement, the remaining assets may be distributed to (or retained by) the organization or distributed to other beneficiaries. (FASB ASC 958-30-05-5) (formerly 2008 Audit Guide, par. 6.02)

There are two basic types of split-interest agreements—revocable and irrevocable. (FASB ASC 958-30-05-7) (formerly 2008 Audit Guide, par. 6.02) A nonprofit organization should determine whether the agreement is revocable or irrevocable when it is notified of or receives assets under a split-interest agreement.

REVOCABLE SPLIT-INTEREST AGREEMENTS

A revocable split-interest agreement (that is, one that can be cancelled by the donor) should be treated as an intention to give. (FASB ASC 958-30-25-2) (formerly 2008 Audit Guide, par. 6.06) Thus, it should *not* be recognized as a contribution unless it is legally enforceable.

Any assets transferred to a nonprofit organization under a revocable split-interest agreement should be measured at fair value and recognized by debiting assets and crediting a refundable advance. If the transferred assets are investments in equity securities with readily determinable fair values or investments in debt securities, they should be reported on the statement of financial position following the guidance in course two. Changes in the carrying value of assets received under revocable split-interest agreements and income from those assets that is not available for the organization's unconditional use should be recognized as adjustments to the recorded assets and related refundable advance. If income generated by assets is available for the organization's unconditional use, it should be recognized as either unrestricted, temporarily restricted, or permanently restricted contribution revenue, depending on the existence or absence of donor restrictions. Assets received under a revocable split-interest agreement should be recognized as contribution revenue only when the agreement becomes irrevocable or the assets become available to the organization for its unconditional use, whichever occurs first. (FASB ASC 958-30-25-2; 958-30-30-3; 958-30-35-11 and 35-12) (formerly 2008 Audit Guide, par. 6.06)

IRREVOCABLE SPLIT-INTEREST AGREEMENTS

An irrevocable split-interest agreement cannot be cancelled by the donor. Generally, a contribution received by a nonprofit organization under an irrevocable split-interest agreement should be measured at fair value. (FASB ASC 958-30-30-4) (formerly 2008 Audit Guide, par. 6.07) [An exception to that rule exists if the donor has placed conditions on the gift. In such cases, the contribution should not be recognized until the conditions have been met. (FASB ASC 958-605-25-11) (formerly SFAS 116, par. 22)] The time at which an organization is considered to receive an irrevocable split-interest agreement depends on whether the organization or a third party is trustee for the agreement. If the organization is trustee or fiscal agent of the assets, the gift is considered received when the donor executes the agreement. If an unrelated third party (such as a bank, trust company, or private individual) is the trustee or fiscal agent of the assets, the nonprofit organization should record the split-interest agreement when it is notified of the gift's existence. However, if an unrelated third-party trustee has variance power and can redirect the benefits to another organization, the agreement should be considered an intention to give and should not be recognized by the organization until it has an unconditional right to receive benefits under the agreement. (FASB ASC 958-30-25-4; 958-30-25-17 and 25-18) (formerly 2008 Audit Guide, par. 6.05)

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

Initially Recording the Agreement

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

a. *Third-party Trustee*. If assets contributed under an irrevocable split-interest agreement are held or controlled by a third party, the organization should recognize its beneficial interest in the assets and contribution revenue at fair value. (FASB ASC 958-30-30-11) (formerly SFAS 136, par. 15)

b. *Organization Is Trustee*. If the organization holds or controls the assets contributed under an irrevocable split-interest agreement, it should: (formerly 2008 Audit Guide, par 6.09)

   (1) Measure the assets received at their fair value. (FASB ASC 958-30-30-4);

   (2) Measure the liability for any portion of the assets held for the donor or other beneficiaries at fair value. If a present value technique is used, fair value should generally be measured at the present value of the future payments to be made to the other beneficiaries. (FASB ASC 958-30-30-5)

   (3) Measure contribution revenue at fair value. (FASB ASC 958-30-30-4; 958-605-30-2) (formerly SFAS 116, par. 8)

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

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

- If the organization has a remainder interest in the assets (i.e., if it receives assets only when obligations to other beneficiaries are satisfied), the fair value of the liability based on the present value of future payments to be made to other beneficiaries often can be computed directly from the terms of the split-interest agreement. In that case, the fair value of contribution revenue is estimated as the difference between the fair values of the contributed assets and the liability for payments to be made to beneficiaries. (FASB ASC 958-30-30-7 and 30-8) (formerly 2008 Audit Guide, paras. 6.07 and 6.09)

As a general rule, contribution revenue recognized under split-interest agreements should be classified as temporarily restricted unless the donor stipulates otherwise since contributions of assets to be received in the future carry an implied time restriction. In some cases, however, explicit donor stipulations will result in classifying contribution revenue as permanently restricted or unrestricted. (FASB ASC 958-30-45-1 and 45-2) (formerly 2008 Audit Guide, par. 6.08) For example, if the donor places a permanent restriction on the organization's use of its beneficial interest in the agreement assets, the contribution would be classified as an increase in permanently restricted net assets. If the donor stipulates that the organization has an immediate, unrestricted right to its interest in the agreement assets, the contribution would be classified as an increase in unrestricted net assets.

Recording Changes in Value during the Agreement Term

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

a. *Third-party Trustee.* If assets contributed under an irrevocable split-interest agreement are held or controlled by a third party, the organization should recognize changes in the fair value of its beneficial interest using the same valuation technique that it initially used to measure the beneficial interest. (FASB ASC 958-30-35-10; 958-605-35-3) (formerly SFAS 136, par. 15) When measuring fair value using present value techniques, all of the elements of the present value measurement, including the discount rate, should be revised at each measurement date to reflect current market conditions. (FASB ASC 958-30-35-3) (formerly 2008 Audit Guide, par. 6.12)

b. *Organization Is Trustee.* If the assets held by the nonprofit organization are investments in equity securities with readily determinable fair values or investments in debt securities, the organization should recognize changes in fair value in accordance with the guidance in course two. If the nonprofit organization holds other assets as trustee in a split-interest agreement, subsequent changes in fair value should be recognized in accordance with the applicable guidance also in course two or refer to *PPC's Guide to Nonprofit GAAP*. (FASB ASC 958-30-35-4) (formerly 2008 Audit Guide, par. 6.04) The measurement of the liability for future payments to beneficiaries will change as a result of (1) amortization of the discount set up to record the benefits to be received at fair value and (2) revaluations of the future payments to the beneficiaries based on changes in life expectancy and other actuarial assumptions, unless the measurement objective is fair value (see the following practical consideration). Generally, the rate used to determine the discount should not change after initially recognizing the split-interest agreement unless the measurement objective is fair value. (FASB ASC 958-30-35-6) (formerly 2008 Audit Guide, paras. 6.13–.14) Thus, the discount should typically only be adjusted for current period amortization.

The transactions and events that must be recorded during the term of the split-interest agreement should be recorded as increases or decreases to the assets and liabilities recorded under the agreement, with a corresponding amount recorded as "change in value of split-interest agreements'' in the statement of activities. The amount recognized in the statement of activities should be classified as unrestricted, temporarily restricted, or permanently restricted depending on the classification used when the contribution was initially recorded. (FASB ASC 958-30-45-3) (formerly 2008 Audit Guide, par. 6.11)

A nonprofit organization serving as trustee or fiscal agent for the assets covered by the agreement also should recognize income earned on assets, gains and losses on sales of assets, and distributions to other beneficiaries. The transactions should be reflected on the organization's statement of financial position, statement of activities, and statement of cash flows. (FASB ASC 958-30-35-5) (formerly 2008 Audit Guide, par. 6.17)

Accounting for the Termination of the Agreement

At the end of the split-interest agreement term, an amount necessary to reduce all related assets and liabilities to zero should be recognized in the statement of activities as "change in value of split-interest agreements." That amount should be classified as unrestricted, temporarily restricted, or permanently restricted, as appropriate. Any distributions previously received under the terms of the agreement that become available to the nonprofit organization for its unrestricted use when the agreement terminates should be reclassified from temporarily restricted to unrestricted net assets. (FASB ASC 958-30-40-1; 958-30-45-5) (formerly 2008 Audit Guide, par. 6.19)

SELF-STUDY QUIZ

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

41. Ronald took out a life insurance policy and named his favorite charity, Love for Kids, as beneficiary. Ronald has the ability to change the beneficiary to another person or organization if he wishes. How should Love for Kids record this donation?

    a. Debit assets and credit a refundable advance.

    b. Debit assets and credit contribution.

    c. Debit assets credit restricted net assets.

42. Julio, a professional baseball player, created the Number One Foundation, a not-for-profit organization. Julio placed a rental property building he owns in a trust naming Number One Foundation and his children as beneficiaries, and Number One as trustee. The agreement is irrevocable. The building cost Julio $150,000, and the fair value is $200,000. Number One Foundation is allocated 60% of the income earned by the trust, the remaining 40% is allocated to the other beneficiaries. The income remains in the trust until the agreement is terminated. How much should Number One Foundation recognize for its beneficial interest in the assets when the agreement is executed?

    a. $0.

    b. $120,000.

    c. $150,000.

    d. $200,000.

43. Assume the same facts in the above example. Three years have gone by and the building is now sold. Number One Foundation should recognize the change in fair value upon the termination of the agreement.

    a. True.

    b. False.

SELF-STUDY ANSWERS

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

41. Ronald took out a life insurance policy and named his favorite charity, Love for Kids, as beneficiary. Ronald has the ability to change the beneficiary to another person or organization if he wishes. How should Love for Kids record this donation? **(Page 107)**

    a. Debit assets and credit a refundable advance. [This answer is correct. Any assets transferred to a nonprofit organization under a revocable split-interest agreement, if the organization is aware of the transfer, should be measured at fair value and recognized by debiting assets and crediting a refundable advance. A revocable split-interest agreement is treated as an intention to give per FASB ASC 958-30-25-2.]

    b. Debit assets and credit contribution. [This answer is incorrect. A credit to contribution is recorded when the contribution is irrevocable.]

    c. Debit assets credit restricted net assets. [This answer is incorrect. An entry is not directly made to restricted net assets; contributions are classified as unrestricted, temporarily restricted, or permanently restricted.]

42. Julio, a professional baseball player, created the Number One Foundation, a not-for-profit organization. Julio placed a rental property building he owns in a trust naming Number One Foundation and his children as beneficiaries, and Number One as trustee. The agreement is irrevocable. The building cost Julio $150,000, and the fair value is $200,000. Number One Foundation is allocated 60% of the income earned by the trust, the remaining 40% is allocated to the other beneficiaries. The income remains in the trust until the agreement is terminated. How much should Number One Foundation recognize for its beneficial interest in the assets when the agreement is executed? **(Page 108)**

    a. $0. [This answer is incorrect. When the agreement is conditional the organization must wait until conditions are met, or it has the unconditional right to receive benefits. Since the foundation is trustee, it does not need to wait to recognize an asset.]

    b. $120,000. [This answer is incorrect. A liability is recorded for any portion of the assets held for other beneficiaries at fair value, that amount is not netted with the foundation's assets.]

    c. $150,000. [This answer is incorrect. The donor's cost is not considered when an organization is recognizing the asset.]

    d. $200,000. [This answer is correct. If the organization holds or controls the assets contributed under an irrevocable split-interest agreement, it should measure the assets received at their fair value (FASB ASC 958-30-30-4), measure the liability for any portion of the assets held for the donor or other beneficiaries at fair value, and measure the contribution revenue at fair value.]

43. Assume the same facts in the above example. Three years have gone by and the building is now sold. Number One Foundation should recognize the change in fair value upon the termination of the agreement. **(Page 110)**

    a. True. [This answer is incorrect. A change in fair value is recognized during the agreement, not upon the termination of the agreement.]

    b. False. [This answer is correct. At the end of a split-interest agreement term, an amount necessary to reduce all related assets and liabilities *to zero* should be recognized in the statement of activities as "change in value of split-interest agreements." (FASB ASC 958-30-25-2) That amount should be classified as unrestricted, temporarily restricted, or permanently restricted, as appropriate.]

Common Types of Split-interest Agreements

Common types of split-interest agreements are: (FASB ASC 958-30-05-6) (formerly 2008 Audit Guide, par. 6.01))

- Charitable lead trusts
- Charitable remainder trusts
- Charitable gift annuities
- Pooled (life) income funds

The following paragraphs describe how the general rules should be applied to each of those types of split-interest agreements. This section also discusses perpetual trusts held by third parties. Although those agreements may not meet the definition of a split-interest agreement because the nonprofit organization may be the sole beneficiary, the accounting issues are similar.

Charitable Lead Trusts

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

- Charitable lead annuity trusts (CLATs). Under this type of charitable lead trust, the nonprofit organization periodically receives a fixed dollar amount from the trust.
- Charitable lead unitrusts (CLUTs). Under this type of charitable lead trust, the nonprofit organization periodically receives a distribution of a fixed percentage of the trust's fair value during the agreement's term. (FASB ASC 958-30-20) (formerly 2008 Audit Guide, par. 6.22)

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

Third Party Is Trustee. Exhibit 2-1 presents an example charitable lead trust with a third party as trustee. As illustrated in the example, an organization should initially measure its beneficial interest in the trust and contribution revenue at fair value. Then during the term of the agreement, the organization should record distributions as reductions in the beneficial interest, rather than as contribution revenue. The organization should recognize changes in the fair value of the beneficial interest by adjusting that account and recording either a debit or credit to the change in value of the split-interest agreements account on its statement of activities, as appropriate. If the organization used present value techniques to determine fair value, it should also amortize the discount on the present value of future benefits by increasing its beneficial interest balance and recognizing the change in value of split-interest agreements on its statement of activities (an increase in net assets). When measuring fair value using present value techniques, the discount rate assumptions should be revised to reflect current market conditions. In addition, present value techniques also need to consider all other present value assumptions, including revaluations of expected benefits based on revisions in the life expectancy of the donor (if the trust terminates at the donor's death). When the trust terminates, the organization should adjust its remaining beneficial interest account to zero and record a corresponding debit to the change in value of split-interest agreements account. (FASB ASC 820-10-55-5; 958-30-35-3; 958-30-35-10; 958-30-40-1; 958-605-35-3) (formerly SFAS 136, par. 15 and 2008 Audit Guide, paras. 6.12, 6.26, and 6.29)

Exhibit 2-1

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

Assumptions

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

Initial Recording

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

Beneficial interest in lead trust	230,000	
Contribution revenue—temporarily restricted		230,000

Recording Over Term of the Agreement

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

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

Reclassify Net Assets. In addition, the following entry would be required to reflect the Hope Organization's unrestricted use of the distribution:

Net assets released from restrictions— temporarily restricted	25,000	
Net assets released from restrictions—unrestricted		25,000

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

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

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

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

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

Termination of the Agreement

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

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

* * *

Organization Is Trustee. Exhibit 2-2 presents an example of a charitable lead trust for which the nonprofit organization holds the trust assets. An organization should initially measure the trust assets received as assets held in charitable lead trust at their fair value on the date of the agreement. Contribution revenue should be measured at fair value. If a present value technique as described in FASB ASC 820-10 (formerly SFAS No. 157) is used, the fair value of the contribution may be estimated as the present value of the specified dollar amounts to be received over the expected term of the agreement (the life of the donor). The fair value of the liability for amounts held for others can be estimated as the difference between the fair values of the assets received and the contribution revenue. (FASB ASC 958-30-30-4 and 30-5; 958-30-30-7; 958-605-30-2) (formerly 2008 Audit Guide, paras. 6.09 and 6.24)

Exhibit 2-2

Illustrative Example Charitable Lead Trust
When Organization Is the Trustee

Assumptions

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

Initial Recording

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

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

Recording Over Term of the Agreement

The amount of the ultimate payment to Ms. Smith's estate is affected by changes in the value of the trust assets, so the agreement contains an embedded derivative. However, that embedded derivative is exempt from reporting at fair value under FASB ASC 815-10-15-52 [formerly SFAS No. 133, par. 10(c)] because it is a single payment whose amount and timing is solely life-contingent. (FASB ASC 958-30-55-25) [formerly the FASB's Derivatives Implementation Group (DIG) Implementation Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement*] Therefore, the liability for amounts held for others would not be remeasured due to changes in current market conditions. However, the liability will be adjusted in subsequent periods for amortization of the discount and any reevaluations of future cash flows due to revisions in the donor's life expectancy.

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

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

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

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

Reclassify Net Assets. In addition, the following entry would be required to reflect the Hope Organization's unrestricted use of the distribution:

Net assets released from restrictions— temporarily restricted	25,000	
Net assets released from restrictions—unrestricted		25,000

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

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

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

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

Termination of the Agreement

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

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

* * *

In subsequent periods, the organization should remeasure the assets and liabilities initially recorded to reflect the transactions and events that have occurred during the period. When the organization receives its lead interest distributions under the agreement, it should recognize the distributions as a reduction in the assets held under split-interest agreements account (an asset) and an increase in its own assets.

Upon receiving distributions, the nonprofit organization also determines whether it should reclassify net assets from temporarily restricted to unrestricted net assets. If the only restriction on the net assets was an implied time restriction, that time restriction expires upon distribution and a corresponding amount of net assets are reclassified. However, if the net assets were also subject to purpose restrictions that have not been met, the net assets remain restricted.

According to FASB ASC 958-30-55-6 through 55-8 [formerly Derivatives Implementation Group (DIG) Issue No. B35], the measurement of the liability to the noncharitable beneficiary of a lead interest trust during the life of the agreement depends upon whether the payment to the beneficiary is period certain. If the payment is period certain, then the liability to the beneficiary may contain an embedded derivative that is measured in accordance with FASB ASC 815-15 (formerly SFAS No. 133).

If the split-interest agreement does not contain an embedded derivative that must be recognized in accordance with FASB ASC 815-15 (formerly SFAS No. 133), the organization can elect to measure the obligation to the noncharitable beneficiary at fair value in accordance with the Fair Value Option Subsections of FASB ASC 825-10 (formerly SFAS No. 159). Alternatively, the organization holding the lead interest recognizes the amortization of the discount and, if applicable, revaluations of the future cash flows based on revisions in the donor's life expectancy. The nonprofit organization should use the same technique and the same interest rate to measure its rights as it used when it initially recognized them. After remeasuring the lead interest, the nonprofit organization should adjust the liability account so that the difference between the assets held under the agreement and the liability to the noncharitable remainder beneficiary is equal to the remeasured lead interest. The offset to that entry is a change in the value of split-interest agreements, which is recognized in the statement of activities. The change should be classified as unrestricted, temporarily restricted, or permanently restricted depending on the classification initially determined when the contribution was recorded.

Finally, the organization should recognize changes in the fair value of the trust assets and investment income as increases or decreases in assets held under the agreement and the liability to the remainder beneficiary. (FASB ASC 958-30-35-5) (formerly 2008 Audit Guide, par. 6.25) Those changes are not recognized as revenues, gains, and losses of the organization because they accrue to the remainder beneficiary rather than the lead interest. If the trust assets are investments in equity securities with readily determinable fair values or investments in debt securities, the organization should recognize changes in fair value in accordance with the guidance in course two. If the nonprofit organization holds other assets as trustee in a split-interest agreement, subsequent changes in fair value should be recognized in accordance with the applicable guidance also in course two or refer to *PPC's Guide to Nonprofit GAAP*. (FASB ASC 958-30-35-4) (formerly 2008 Audit Guide, par. 6.04)

When the trust terminates, the organization should adjust the assets held in charitable lead trust account and the liability due to others account balances to zero. The difference should be recorded as a debit or credit to the change in value of split-interest agreements account. (FASB ASC 958-30-40-1)

Organization Holds the Assets and There Is an Embedded Derivative. To help nonprofit organizations determine if their split-interest agreements contained embedded derivatives that have to be accounted for in accordance with FASB ASC 815-15 (formerly SFAS No. 133), Example 2 in FASB ASC 958-30-55 [formerly Derivatives Implementation Group (DIG) Issue No. B35], provides eight cases and explains whether there are embedded derivatives. In general, a split-interest agreement should be examined to see if it has an embedded derivative that must be measured at fair value if it requires a payment(s) to a noncharitable beneficiary in an amount(s) that can vary based on the assets in the trust and that payment (those payments) is (are) made for either: (a) a defined period (e.g. ten years), or (b) a defined period plus a life contingency (e.g., life, but no less than ten years). (FASB ASC 958-30-25-7)

There are two allowable ways of accounting for an irrevocable split-interest gift that contains an embedded derivative that is within the scope of FASB ASC 815-15 (formerly SFAS No. 133). (FASB ASC 958-30-25-12)

a. Divide the liability to the beneficiary into two parts: a debt host contract and an embedded derivative. (GAAP refers to this as bifurcating the liability.) The debt host is the liability for the payment to the beneficiary that would be required if the fair value of the trust assets does not change over the specified period. The embedded derivative represents the liability (or contra-liability) for the increase (or decrease) in the payments to the beneficiary due to changes in the fair value of the trust assets over the specified period. The organization then accounts for the two liabilities.

b. Elect to measure the entire split-interest obligation at fair value in conformity with FASB ASC 815-15-25 (formerly SFAS No. 133) or the Fair Value Option Subsections of FASB ASC 825-10 (formerly SFAS No. 159).

If the organization recognizes at fair value only the embedded derivative portion of the obligation to the beneficiary during the agreement's term, the trust assets are used as fair value hedges for the liability to the beneficiary. As a result, trust assets that are financial instruments are measured at fair value, even if they normally would not be recognized at fair value in accordance with GAAP or the organization's policies for other investments. However, if the trust is funded with a nonfinancial asset that is not readily converted to cash (such as real estate) and that trust asset must be returned to the donor or the donor's beneficiary at the agreement's end, then neither the liability to the noncharitable beneficiary nor the nonfinancial asset is recognized during the agreement's term at fair value. The embedded derivative in the liability to the noncharitable beneficiary is not within the scope of FASB ASC 815 (formerly SFAS No. 133). It is exempt as explained in FASB ASC 815-10-15-59 [formerly paragraph 10(e)(2) of SFAS No. 133]; that is, the agreement is a contract not traded on an exchange for which settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash. The real estate would not be subsequently revalued to fair value unless that was the organization's policy for all real estate investments.

Separately Accounting for the Debt Host and the Embedded Derivative. In circumstances in which the liability for the debt host is initially measured using present value techniques, discount rate assumptions should not be changed after initial recognition. If the fair value of the liability (or contra-liability) for the embedded derivative is measured using present value techniques, all of the elements in the fair value measurement, including the discount rate assumptions, are updated in subsequent periods to reflect current market conditions. (FASB ASC 958-30-35-7) (formerly 2008 Audit Guide, par. 6.15)

If an organization cannot reliably identify and measure the embedded derivative, the entire liability to the noncharitable beneficiary is measured at fair value. If the fair value of the liability is measured using present value techniques, all of the elements used in that measurement, including discount rate assumptions, should be revised to reflect current market conditions at subsequent measurement dates. (FASB ASC 958-30-35-8) (formerly paragraph 16 of SFAS No. 133) Alternatively, the organization can irrevocably elect to measure the entire liability at fair value in accordance with FASB ASC 815-15-25 (formerly SFAS No. 155) or the Fair Value Option Subsections of FASB ASC 825-10 (formerly SFAS No. 159), even if it can reliably identify and measure the derivative.

Election to Measure the Obligation to the Noncharitable Beneficiary at Fair Value. An organization that holds the assets of a split-interest agreement as a trustee can irrevocably elect to subsequently measure the entire obligation for a split-interest agreement at fair value. (FASB ASC 958-30-30-8; 958-30-35-2) (formerly 2008 Audit Guide, par. 6.14) The election may be made on an instrument-by-instrument basis and should be supported by concurrent documentation or by a preexisting documented policy for automatic election. (FASB ASC 815-15-25-4 and 25-5; 825-10-25-2) If an organization elects to measure the obligation for a split-interest agreement at fair value using present value techniques, the entire split-interest liability should be remeasured at fair value. All assumptions, including discount rate assumptions, should be revised at each measurement date to reflect current market conditions. (FASB ASC 958-30-35-3) (formerly 2008 Audit Guide, par. 6.12)

Perpetual Trust Held by a Third Party

Some donors establish and fund a trust that is administered by an individual or organization other than the nonprofit beneficiary. In a perpetual trust that is held by a third party, the nonprofit organization has an irrevocable right to receive the income earned from the trust's assets in perpetuity. However, the organization will never receive the trust's assets. In addition, the donor may restrict the use of the distributions paid by the trust. (FASB ASC 958-605-20) (formerly 2008 Audit Guide, par. 6.27)

An example of a perpetual trust held by a third party is illustrated in Exhibit 2-3. As the example illustrates, at the trust's inception, an organization should record an asset for its beneficial interest in a perpetual trust asset and recognize permanently restricted contribution revenue, measured at fair value. (FASB ASC 958-605-30-14) (formerly 2008 Audit Guide, par. 6.29) 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 FASB ASC 820 (formerly SFAS No. 157). If present value techniques are used, the contribution revenue and the beneficial interest in trust would be measured as the present value of the estimated future distributions expected to be received over the expected term of the agreement. A reasonable estimate of the contribution's fair value may be the fair value of the assets in the trust unless facts and circumstances indicate that the fair value of the assets in the trust would be different from the the fair value of the beneficial interest. The contribution revenue is classified as permanently restricted because the terms of the trust closely resemble a donor-restricted permanent endowment, rather than a multi-year promise to give (which would be classified as temporarily restricted). (FASB ASC 958-605-45-8) (formerly 2008 Audit Guide, par. 6.29)

Exhibit 2-3

Illustrative Example
Perpetual Trust Held by a Third Party

Assumptions

Michael Richards establishes and funds a trust with assets valued at $200,000, naming Baron Bank as trustee. Baron Bank is to invest and manage the trust assets in perpetuity. The Contemporary Art Museum is the sole beneficiary of the trust, and each year will receive the income from the trust assets in perpetuity. The Museum can use the distributed income in any way that is consistent with its mission.

Initial Recording

The Museum would make the following entry to recognize the promise when it learns of the perpetual trust:

Beneficial interest in perpetual trust	200,000	
Contribution revenue—permanently restricted		200,000

Recording Over Term of the Agreement

Income Earned on Assets. Assume that in the first year, the trust assets earn $15,000, which is distributed to the Museum. The Museum would make the following entry to record the distribution:

Cash	15,000	
Investment income—unrestricted		15,000

Revaluation Adjustment. At the end of the third year, the fair value of the trust assets is determined to be $250,000. The Museum would make the following entry to reflect the change in the fair value of the assets:

Beneficial interest in perpetual trust	50,000	
Gain—permanently restricted		50,000

* * *

After the trust is created, it remains in perpetuity. The organization should recognize investment income when received as increases to unrestricted net assets and annually review the fair value of its beneficial interest in the trust assets. If necessary, the organization should adjust the asset for its beneficial interest in a perpetual trust account to reflect the current fair value of the assets and recognize a corresponding permanently restricted gain or loss. The asset value review should use the same valuation technique used when the organization initially recorded the asset. (FASB ASC 958-605-35-3; 958-605-45-8) (formerly 2008 Audit Guide, par. 6.29)

Charitable Remainder Trust

Charitable reminder trusts are split-interest agreements in which a nonprofit beneficiary receives its interest in the donated assets after the donor or another beneficiary has received benefits for a specified time period. The donor establishes and funds the trust and specifies beneficiaries to receive distributions over the life of the split-interest agreement. At the termination of the agreement, the remaining assets in the trust pass to the nonprofit organization for its use. (FASB ASC 958-30-20; 958-30-05-10)The donor may place temporary or permanent restrictions on the assets transferred to the nonprofit organization.

Charitable remainder trusts generally take the following two forms: (FASB ASC 958-30-20; 958-30-05-10)

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

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

The recording of the charitable remainder trust agreement depends on whether or not the nonprofit organization is the trustee or otherwise controls the assets.

Third Party Is Trustee. Exhibit 2-4 presents an example charitable remainder unitrust in which a third party is trustee. As the example illustrates, an organization should initially measure its beneficial interest in the trust and contribution revenue at fair value. (FASB ASC 958-30-30-11; 958-605-30-14) (formerly SFAS 136, par. 15) Present value techniques are one valuation technique for measuring the fair value of the contribution and the beneficial interest; other valuation techniques also are available, as described in FASB ASC 820-10 (formerly SFAS No. 157). If present value techniques are used, the contribution revenue and the beneficial interest in trust would be measured as the present value of the estimated future distributions the organization expects to receive over the term or upon termination of the agreement. The organization should recognize changes in the fair value of the beneficial interest (using the same measurement technique initially used to record the assets) by adjusting that account and recording either a debit or credit to the change in value of the split-interest agreements account on its statement of activities, as appropriate. When subsequently measuring fair value using a present value technique, all of the elements used in that measurement, including the discount rate, revaluations of the expected benefits to be received, and changes in other actuarial assumptions should be revised to reflect current market conditions. (FASB ASC 958-30-35-3) When the trust terminates, the organization should record the assets when received and adjust the remaining beneficial interest account to zero. Any difference should be recorded as a debit or credit to the change in value of split-interest agreements account. (FASB ASC 958-30-40-1)

Exhibit 2-4

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

<u>Assumptions</u>

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

<u>Initial Recording</u>

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

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

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

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

Assume for purposes of this example that the Society considered current market conditions at the end of the first year, and the discount rate and other assumptions for measuring the fair value of the beneficial interest did not change. Accordingly, the Society would only need to recognize amortization of the discount. Assuming the amortization of the discount on the benefits expected to be received by the Society during the first year is $60,000, the following entry would be made:

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

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

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

<u>Termination of the Agreement</u>

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

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

* * *

Organization Is Trustee. Exhibit 2-5 presents an example of a charitable remainder unitrust with the nonprofit organization as trustee. An organization should initially measure the trust assets received at their fair value on the date of the agreement. The liability under the unitrust agreement is measured at fair value. If a present value technique is used, the fair value of the liability should be measured at the present value of the future payments to be distributed over the beneficiary's expected life. Contribution revenue is recognized for the difference between the fair values of the assets and the liability. (FASB ASC 958-30-25-4; 958-30-30-4 and 30-5; 958-30-30-8)

Exhibit 2-5

Illustrative Example Charitable Remainder Trust When Organization Is the Trustee

<u>Assumptions</u>

Jeremy Anderson establishes and funds a $1,000,000 charitable remainder unitrust, naming the Multiple Sclerosis Society as trustee. Under the agreement, Mr. Anderson's spouse receives an annual distribution equal to 10% of the fair market value of the assets in the trust until her death. Income earned on the assets in the trust remains in the trust until the death of Mrs. Anderson. When Mrs. Anderson dies, the trust assets are to be distributed to the Multiple Sclerosis Society and are permanently restricted as an endowment. The Multiple Sclerosis Society used present value techniques to measure the liability at initial recognition. The present value of the future payments to be made over Mrs. Anderson's life is calculated as $527,000.

<u>Initial Recording</u>

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

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

Recording Over Term of the Agreement

The amount of the payments to Mrs. Anderson is affected by changes in the value of the trust assets, so the agreement contains an embedded derivative. However, that embedded derivative is exempt from reporting at fair value under FASB ASC 815-10-15-52 (formerly SFAS No. 133) because each payment is solely life-contingent. (FASB ASC 958-30-55-25) [formerly Derivatives Implementation Group (DIG) Issue No. B35] Therefore, the liability under the unitrust agreement to Mrs. Anderson would not be remeasured at fair value during the term of the agreement due to changes in current market conditions. However, since the Multiple Sclerosis Society used a present value technique to record the liability, the liability will be adjusted in subsequent periods for amortization of discount and revaluations of projected future payments to the lead beneficiaries.

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

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

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

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

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

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

Revaluation of Future Distributions. If changes in actuarial assumptions in the fourth year results in a $52,000 revaluation increase to the liability under unitrust agreement, the change would be recorded as follows:

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

Termination of the Agreement

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

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

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

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

* * *

During the term of the agreement, the organization should record the transactions and events that have occurred during the period. The assets held under the split-interest agreement are adjusted for investment income earned on the assets, gains and losses on those assets, and distributions to the lead beneficiaries. The liability is adjusted for distributions to the lead beneficiaries, amortization of the discount, and revaluations of the present value of expected future payments to the lead beneficiaries.

The nonprofit organization recognizes payments made to the donor or other lead beneficiary as decreases in the assets held under the split-interest agreement and decreases in the liability account, rather than as expenses. No reclassification of net assets is necessary as a result of the distribution, because the net assets recognized at the inception of the agreement were related to the remainder interest and no change in the remainder interest results from the distribution.

According to FASB ASC 958-30-55-6 through 55-8 [formerly Derivatives Implementation Group (DIG) Issue No. B35] the measurement of the liability to the noncharitable beneficiary of a remainder trust during the life of the agreement depends upon whether the payments to the noncharitable beneficiary are variable in amount and whether they are period certain. If the payments to the noncharitable beneficiary are both for a fixed period and variable in amount, then the liability to the beneficiary may contain an embedded derivative that is measured in accordance with FASB ASC 815-15 (formerly SFAS No. 133).

If the split-interest agreement does not contain an embedded derivative that must be recognized in accordance with FASB ASC 815-15 (formerly SFAS No. 133), as amended the organization can elect to measure the obligation to the noncharitable beneficiary at fair value in accordance with the Fair Value Option Subsections of FASB ASC 825-10 (formerly SFAS No. 159). Alternatively, the organization holding the remainder interest recognizes the changes in the liability to the lead beneficiaries that result from (a) amortization of the discount, (b) revaluations of the present value of the liability, and (c) changes in actuarial assumptions. The organization should use the same technique and the same discount rate to measure its liability as it used when it initially recognized the obligation. After remeasuring the liability to the lead beneficiary, the nonprofit organization adjusts the liability account so that it is equal to the remeasured amount. The offset to that entry is a change in the value of split-interest agreements, which is recognized in the statement of activities. The change should be classified as unrestricted, temporarily restricted, or permanently restricted depending on the classification initially determined when the contribution was recorded.

Finally, a nonprofit organization that holds the remainder interest recognizes changes in the fair value of the trust assets and investment income as increases or decreases in assets held under the agreement and the liability to the lead beneficiary. (For an exception to this general rule, see the discussion of charitable gift annuities.) GAAP requires that equity securities with readily determinable fair values and all debt securities be reported at fair value. GAAP also provides standards for recognizing the changes in fair value of other investments.

When the trust terminates, the organization should adjust the liability under unitrust agreement account to zero, with the difference recorded as a credit to the change in value of split-interest agreements account. The trust assets should then be reclassified from assets held in charitable remainder trust to assets available for use by the organization.

Organization Holds the Assets and There Is an Embedded Derivative. To help nonprofit organizations determine if their split-interest agreements contained embedded derivatives that had to be accounted for in accordance with FASB ASC 815-15 (formerly SFAS No. 133), Example 2 in FASB ASC 958-30-55 [formerly Derivatives Implementation Group (DIG) Issue No. B35], provides eight cases and explains whether there are embedded derivatives. In general, a split-interest agreement should be examined to see if it has an embedded derivative that must be measured at fair value if it requires a payment(s) to a noncharitable beneficiary in an amount(s) that can vary based on the assets in the trust and that payment (those payments) is (are) made for either: (a) a defined period (e.g. ten years), or (b) a defined period plus a life contingency (e.g., life, but no less than ten years). (FASB ASC 958-30-25-7)

The following are two allowable ways of accounting for an irrevocable split-interest gift that contains an embedded derivative that is within the scope of FASB ASC 815-15 (formerly SFAS No. 133): (FASB ASC 958-30-25-12)

- Bifurcate the split-interest obligation into a debt host contract and an embedded derivative in accordance with FASB ASC 815-15-25-1.

- Elect to measure the entire split-interest obligation at fair value in conformity with FASB ASC 815-15-25 (formerly SFAS No. 133) or the Fair Value Option Subsection of FASB ASC 825-10 (formerly SFAS No. 159).

Charitable Gift Annuity

A charitable gift annuity is very similar to a charitable remainder annuity trust in that a donor contributes assets in exchange for distributions of a fixed amount for a specified period of time to the donor or other beneficiaries. Unlike a charitable remainder annuity trust, however, no trust is established under a charitable gift annuity arrangement. Instead, the assets are transferred directly to the nonprofit organization and are held as general assets of the organization, and the related annuity liability is also recorded as a general obligation of the organization. (FASB ASC 958-30-05-11) (formerly 2008 Audit Guide, par. 6.35) As a result, investment income earned and changes in the fair value of the investments are recognized in the same manner as the income, gains, and losses of the organization's other investments. That is, the income, gains, and losses are recognized in the statement of activities rather than as increases and decreases in the liability to the lead beneficiary.

Exhibit 2-6 illustrates a charitable gift annuity arrangement. As the exhibit demonstrates, an organization should measure the assets received at fair value on the date of the agreement. An annuity payment liability should be measured at fair value. Present value techniques are one valuation technique for measuring the fair value of the annuity payment liability; other valuation techniques also are available, as described in FASB ASC 820 (formerly SFAS No. 157). If a present value technique is used, the fair value of the liability should be measured at the present value of the future payments to be distributed over the beneficiary's expected life. The difference between the fair values of the assets received and the liability to others is recognized as contribution revenue.

Exhibit 2-6

Illustrative Example
Charitable Gift Annuity

Assumptions

Justin Allen transfers assets having a fair value of $400,000 to Treepoint Private School under an arrangement whereby the School agrees to pay annual distributions of $20,000 to Mr. Allen's spouse until her death. The transferred assets are available for the School's unrestricted use. The School used present value techniques to measure the annuity payment liability at initial recognition. The present value of future distributions to be made to Mrs. Allen is calculated to be $134,000.

Initial Recording

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

Assets	400,000	
Annuity payment liability		134,000
Contribution revenue—unrestricted		266,000

Recording Over Term of the Agreement

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

Annuity payment liability	20,000	
Cash		20,000

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

Change in the value of split-interest agreements—unrestricted	1,500	
Annuity payment liability		1,500

Revaluation of Future Distributions. If, in the third year, the estimated life expectancy of Mrs. Allen changes from 10 years to 12 years, resulting in a $17,000 increase in the present value of future distributions to Mrs. Allen, the School would record the following entry:

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

Termination of the Agreement

Assuming Mrs. Allen dies after 11 years, leaving an annuity payment liability of $8,000 on the School's books, the School would make the following entry to record the termination of the agreement and reduce the remaining liability to zero:

Annuity payment liability	8,000	
Change in the value of split-interest agreements—unrestricted		8,000

* * *

During the term of the agreement, distributions to beneficiaries should decrease the organization's cash and the annuity payment liability. Also, the organization should amortize the present value of the expected amount to be paid to others by increasing the annuity payment liability account and recording a debit to the change in value of split-interest agreements account (a decrease in net assets). If the value of future benefits to be paid to others changes because of a change in the beneficiary's life expectancy, the organization should adjust the annuity payment liability account to reflect the change, and record either a debit or credit to the change in value of split-interest agreements account, as appropriate.

When, under the conditions of the arrangement, payments to others must cease (upon death of the beneficiary, or if the specified time has passed or the specified amount of distributions have been made), the organization should reduce its annuity payment liability account to zero, with a corresponding debit to the change in value of split-interest agreements account.

Pooled (Life) Income Fund

Pooled (or life) income funds are those arrangements in which a nonprofit organization pools, invests, and manages life income gifts from many different donors. The funds are unitized and donors are assigned a specific number of units based on the relationship of the fair value of their contribution to the fair value of the pool as a whole at the time the donor enters the pool. During the term of the life income gifts, the donor, or beneficiary specified by the donor, receives the actual income earned on the donor's units in the pool. "Income" is defined under the split-interest agreement covering the arrangement. When the donor dies, the donor's units revert to the nonprofit organization. Net income unitrusts are similar to pooled life income trusts, and, accordingly, are accounted for similarly. (FASB ASC 958-30-5-12) (formerly 2008 Audit Guide, par. 6.39)

Exhibit 2-7 provides an example of a pooled (life) income fund. As the example illustrates, when donor assets are received by an organization, they should be measured at their fair value. Contribution revenue should also be measured at fair value. The present value of the assets to be received by the organization upon the death of the donor is one possible valuation technique to measure the fair value of the contribution. The difference between the fair values of the assets received and the contribution recognized should be recorded as a discount for future interest (deferred revenue). (FASB ASC 958-30-25-15; 958-30-30-10)

Exhibit 2-7

Illustrative Example
Pooled (Life) Income Fund

<u>Assumptions</u>

Doris White makes a $600,000 life income gift to the Arts Council, which is pooled with other donor life income gifts. Ms. White's gift is assigned a specific number of units in the pool. Ms. White will receive the income earned from the units until her death, at which time the Arts Council will receive the units for its unrestricted use. The Arts Council used present value techniques to measure the initial contribution. The present value of the assets expected to be received by the Arts Council is calculated to be $350,000.

<u>Initial Recording</u>

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

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

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

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

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

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

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

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

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

<u>Termination of the Agreement</u>

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

Discount for future interest	28,000	
Change in the value of split-interest agreements—unrestricted		28,000

Reclassify Assets. At Ms. White's death, the Arts Council would reclassify the pooled life income fund assets to general use assets, as follows:

Cash or investment assets	600,000	
Assets of pooled income fund		600,000

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

Net assets released from restrictions— temporarily restricted	600,000	
Net assets released from restrictions—unrestricted		600,000

* * *

During the term of the life income gift, income on the donor's units and payment of that income to the donor should be recorded by the organization as an increase and decrease in a liability to the donor. The organization should also amortize the discount for future interest liability and credit the change in the value of split-interest agreements account (an increase in net assets). (FASB ASC 958-30-35-9) When the donor dies, the organization should reclassify an amount equal to the units held by the donor from assets of pooled income fund account to assets available for its general use. Any remaining balance in the discount for future interest account should be reduced to zero with a corresponding credit to the change in the value of split-interest agreements account.

DISCLOSURE REQUIREMENTS

FINANCIAL STATEMENT PRESENTATION

Assets and liabilities from split-interest agreements should be disclosed separately from other assets and liabilities in the statement of financial position or in the notes to the financial statements. Contribution revenue and changes in the value of split-interest agreements should also be reported as separate line items on the statement of activities or disclosed in the notes to the financial statements. (FASB ASC 958-30-45-6 and 45-7; 958-30-50-1) (formerly 2008 Audit Guide, par. 6.20)

DISCLOSURES

The following split-interest agreement disclosures should be made: (FASB ASC 958-30-50-1 and 50-2) (formerly 2008 Audit Guide, paras. 6.09, 6.20, and 6.37)

a. A summary of the terms of the split-interest agreements

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

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

d. Legally mandated reserves arising from split-interest agreements

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

If the assets and liabilities under split-interest agreements are measured at fair value on a recurring bases after initial recognition, additional disclosures about fair value measurement are required by FASB ASC 820-10-50-1 and 50-2. (FASB ASC 958-30-50-1) (formerly 2008 Audit Guide, par. 6.20)

Additional disclosures are required by the Fair Value Option Subsections of Subtopic 825-10 if an organization elects to measure a liability recognized under a split-interest agreement pursuant to paragraph 958-30-35-2. (FASB ASC 958-30-50-1) (formerly 2008 Audit Guide par. 6.20)

SELF-STUDY QUIZ

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

44. Assume the same facts as in #42. In 20X9, the trust earned $75,000 of net rental income. The foundation also receives $50,000 each year from the trust which must be used for scholarship. Which of the following is part of an entry Number One Foundation will make in 20X9?

    a. Credit to assets held in trust for $50,000.

    b. Debit to liability for amounts held for others for $50,000.

    c. Credit liability for amounts held for others for $75,000.

    d. Debit to cash for $75,000.

45. Herb Lynx transfers assets having a fair value of $600,000 to his alma mater under an arrangement whereby the University agrees to pay annual distributions of $40,000 to Mr. Lynx's spouse until her death. The transferred assets are available for the University's unrestricted use. Which of the following accounts will be credited when the University records the agreement upon the execution of the contract?

    a. Cash.

    b. Change in the value of split-interest agreements.

    c. Annuity payment liability.

    d. Accumulated amortization.

SELF-STUDY ANSWERS

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

44. Assume the same facts as in #42. In 20X9, the trust earned $75,000 of net rental income. The foundation also receives $50,000 each year from the trust which must be used for scholarship. Which of the following is part of an entry Number One Foundation will make in 20X9? **(Pages 113 and 115)**

    a. Credit to assets held in trust for $50,000. [This answer is correct. To record the annual distribution, Number One Foundation will debit cash for $50,000 and credit assets held in trust for $50,000. When the foundation records the income earned on the building, it will debit assets held in trust for $75,000 and credit its portion of the income ($45,000) as a contribution and credit the other beneficiaries' portion ($30,000) as a liability for amounts held for others.]

    b. Debit to liability for amounts held for others for $50,000. [This answer is incorrect. Debits to this account are typically made for changes in value and the termination of the agreement.]

    c. Credit liability for amounts held for others for $75,000. [This answer is incorrect. A portion of the investment income is recorded as a contribution because Number One Foundation is allocated 60% of the income.]

    d. Debit to cash for $75,000. [This answer is incorrect. The foundation does not receive the trust's investment income in cash.]

45. Herb Lynx transfers assets having a fair value of $600,000 to his alma mater under an arrangement whereby the University agrees to pay annual distributions of $40,000 to Mr. Lynx's spouse until her death. The transferred assets are available for the University's unrestricted use. Which of the following accounts will be credited when the University records the agreement upon the execution of the contract? **(Page 124)**

    a. Cash. [This answer is incorrect. Cash will be credited when the University makes an annual distribution to Mrs. Lynx.]

    b. Change in the value of split-interest agreements. [This answer is incorrect. This account is used when amortization of the discount and revaluation of future distribution are recorded, and may be adjusted, if necessary, upon termination of the agreement.]

    c. Annuity payment liability. [This answer is correct. The entry the University should record is a debit to assets for $600,000. The credits are to an annuity payment liability (typically at present value) and the balance will be contribution revenue.]

    d. Accumulated amortization. [This answer is incorrect. Amortization of the discount is recorded, but not upon the initial recognition of the agreement. Also, the entry for amortization of the discount involves the change in value of split-interest agreement account and the annuity payment liability account.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (NPGTG101)

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

41. Which of the following is an example of a split-interest agreement?

    a. Organization A and Organization B are working together to produce materials for a stop smoking campaign.

    b. Organization C incurred printing expenses that can be allocated to both fundraising costs and to its adult literacy program.

    c. Hannah donated stock to Organization D for which D can use the income. When Hannah dies, D gets 50% of the stock and Hannah's daughter gets the other 50%.

    d. Donald donated land to Organization E with the restriction that E uses at least half of the land for a sports complex. The remaining interest can be sold off or used as E wishes.

42. Ann places a life insurance policy in a trust that names the nonprofit organization, Pet Shelter, as a beneficiary. Three of Ann's children are also beneficiaries, but if any child dies before Ann, their portion will be transferred to Pet Shelter. Pet Shelter is also named trustee. The agreement is irrevocable. How will this donation initially be measured by Pet Shelter?

    a. At fair value.

    b. At Ann's cost.

    c. At future value of the future cash flow.

    d. It is not recognized until Ann dies and proceeds are known.

43. Assume the same facts in the above example, except that Ann's donation are stocks that are publicly traded. Which of the following should Pet Shelter do regarding changes in the value of the stock after the initial recording of the donation?

    a. Recognize an amount to reduce related assets and liabilities to zero.

    b. Recognize the change in fair value in its statement of activities.

    c. Recognize the change in fair value in its statement of comprehensive income.

    d. Nothing is recognized until Ann dies.

44. Todd Smith establishes and funds a $1,500,000 charitable remainder unitrust, naming Bank Two as trustee. Under the charitable remainder unitrust agreement, Mr. Smith's spouse receives an annual distribution equal to 20% of the fair market value of the assets in the trust until her death. Income earned on the assets in the trust remains in the trust until the death of Mrs. Smith. When Mrs. Smith dies, the assets in the trust are to be distributed to Mr. Smiths favorite ball player's foundation, Number One Foundation, and permanently restricted as an endowment. The Foundation measures the fair value of its beneficial interest by calculating the present value of its expected future benefits. The present value of future benefits to be received by the Foundation is calculated as $642,000. Which of the following is a portion of the entry Number One Foundation will record when the trust is established?

    a. Credit to contribution revenue for $300,000.

    b. Credit to beneficial interest in remainder trust for $642,000.

    c. Credit to contribution revenue for $642,000.

    d. No entry is made until Mrs. Smith dies.

45. Assume the same facts as in the question above, except Number One Foundation is the trustee. When the trust is established, how much does the Foundation record as assets held in the charitable remainder trust?

    a. $0.

    b. $642,000.

    c. $1,200,000.

    d. $1,500,000.

GLOSSARY

Capital lease: A capital lease transfers substantially all the benefits and risks of ownership to the lessee and is recorded as if the lessee borrowed money to purchase the leased property.

Cash equivalents: Cash equivalents are short-term, highly liquid investments that (a) are readily convertible to known amounts of cash and (b) are so near to their maturity that they present an insignificant risk of changes in value because of changes in interest rates. Examples include Treasury bills, commercial paper, money market accounts that are not classified as cash, and other short-term investments whose original maturity is three months or less. (SFAS 95, par. 8) FASB ASC 230-10-20) (Equity securities never meet the definition of cash equivalents.)

Cash flows from financing activities: Financing activities include the following: a) Obtaining resources from owners and providing them with a return on, and a return of, their investment. b) Receiving restricted resources that by donor stipulation must be used for long-term purposes. c) Borrowing money and repaying amounts borrowed, or otherwise settling the obligation. d) Obtaining and paying for other resources from creditors on long-term credit.

Cash flows from investing activities: Investing activities include the following: a) Lending money and collecting on loans. b) Acquiring and selling or disposing of securities that are not cash equivalents. c) Acquiring and selling or disposing of productive assets that are expected to generate revenue over a long period of time. d) Receiving cash from contributions donor-restricted for long-term purposes for which the restrictions have not yet been satisfied and cash is still held.

Cash flows from operating activities: Cash flows from operating activities are defined by exception; operating activities include all transactions and events that are not investing or financing activities. Generally, however, operating activities meet the following three criteria: a) The amounts represent the cash effects of transactions or events. b) The amounts result from an organization's normal operations of providing services, making or receiving contributions, and delivering or producing goods for sale. c) The amounts are derived from activities that enter into the determination of the change in net assets.

Expenses: Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Extraordinary item: Extraordinary items are events or transactions that meet both of the following criteria: a) Unusual nature. The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates. (An event or transaction is not considered to be unusual merely because it is beyond the control of management.) b) Infrequency of occurrence. The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

Gains: Gains are increases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues.

Losses: Losses are decreases in net assets from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses.

Net assets: Net assets represent the difference between a nonprofit organization's assets and liabilities. Net assets are classified into one of the following three categories depending on the absence or presence and nature of donor-imposed restrictions: a) Unrestricted Net Assets, which are not restricted either by donors or by law. b) Temporarily Restricted Net Assets, whose use has been limited by donor-imposed time restrictions or purpose restrictions. c) Permanently Restricted Net Assets, which have been restricted by donor or by law to be maintained by the organization in perpetuity.

Noncash investing and financing activities: Investing and financing activities that do not involve cash receipts and payments. Noncash investing and financing activities include the following: acquiring assets by assuming liabilities, obtaining assets by entering into a capital lease, and exchanging noncash assets or liabilities for other noncash assets or liabilities.

Not-for-profit organization: An entity that possess the following characteristics not typically found in business enterprises: (SFAS 116, par. 209) (FASB ASC 958-10-20) 1. They receive contributions of significant resources from resource providers who do not expect a commensurate or proportionate monetary return. 2. They operate for purposes other than to make a profit. 3. There is an absence of ownership interests like those of business enterprises. Nonprofit organizations include the following: (FASB ASC 958-10-15-3) cemetery organizations, civic and community organizations, colleges and universities, elementary and secondary schools, federated fund-raising organizations, fraternal organizations, health care entities, labor unions, libraries, museums, other cultural organizations, performing arts organizations, political parties, political action committees, private and community foundations, professional associations, public broadcasting stations, religious organizations, research and scientific organizations, social and country clubs, trade associations, voluntary health and welfare organizations, and zoological and botanical societies.

Permanently restricted net assets: These are assets which have been restricted by donor or by law to be maintained by the organization in perpetuity.

Reclassifications: Reclassifications are simultaneous increases to one net asset class and decreases to another as a result of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations (Reclassifications do not involve inflows, outflows, or other changes in assets or liabilities.)

Revenues: Revenues are actual or expected cash inflows (or the equivalent) from delivering or producing goods, rendering services, or other activities that have occurred or will eventuate as a result of an entity's major or central operations.

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

Unrestricted net assets: Assets which are not restricted either by donors or by law.

Unusual or infrequent items: Events or transactions that are either unusual or infrequent, but not both (and therefore, do not meet the criteria for extraordinary items).

INDEX

COMPANION TO PPC'S GUIDE TO NONPROFIT GAAP

COURSE 2

SELECTED ACCOUNTING AND DISCLOSURE REQUIREMENTS FOR NONPROFIT FINANCIAL STATEMENTS (NPGTG102)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides an introduction to the accounting and disclosure requirements for inventory and investments, retirement and postemployment benefits, and related entities of nonprofit organizations.
PUBLICATION/REVISION DATE:	November 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Nonprofit GAAP*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting for nonprofit entities
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	Postmark by **November 30, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Inventory and Investments

Completion of this lesson will enable you to:
- Identify the accounting requirements for inventory of a nonprofit organization by focusing on the definition, valuation, and identification of inventory.
- Determine how a nonprofit organization should measure debt and equity securities, and the recognition and classification requirements of gains, losses, dividends, interest, and other investment income for these investments.
- Determine when a nonprofit organization should use the equity method to account for an investment and apply the method to appropriate investments.

Lesson 2—Retirement and Post-employment Benefits

Completion of this lesson will enable you to:
- Identify the specific accounting requirements for when a nonprofit organization has a defined benefit pension plan, including recognizing net periodic pension plan cost, and the recognition of assets and liabilities.
- Identify correct accounting for postretirement benefits other than pensions, including determining the net periodic postretirement benefit cost and obligation, and the recognition of assets and liabilities.
- Determine the unique requirements when an employer has more than one benefit plan or has settlements and curtailments of a benefit plan, and when the employer terminates benefits.
- Identify the definitions and accounting requirements for defined contribution plans, multiemployer plans, multiple-employer plans, foreign plans, and postemployment benefits.
- Determine the disclosure requirements for defined benefit pension plans, defined benefit postretirement plans, defined contribution plans, and multiemployer benefit plans.

Lesson 3—Related Entities and Related Party Disclosures

Completion of this lesson will enable you to:

- Determine a nonprofit organization's ownership interest in for-profit entities and financially related nonprofit organizations.
- Determine related party relationships and prepare disclosures for a nonprofit organization's related parties.

TO COMPLETE THIS LEARNING PROCESS:

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

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ADMINISTRATIVE POLICIES:

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

Lesson 1: Inventory and Investments

INTRODUCTION

This lesson covers the accounting requirements and disclosure requirements for recording inventory and investments on nonprofit financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the accounting requirements for inventory of a nonprofit organization by focusing on the definition, valuation, and identification of inventory.
- Determine how a nonprofit organization should measure debt and equity securities, and the recognition and classification requirements of gains, losses, dividends, interest, and other investment income for these investments.
- Determine when a nonprofit organization should use the equity method to account for an investment and apply the method to appropriate investments.

INVENTORY

SOURCE: FASB ASC 330

OVERVIEW

Inventories of nonprofit organizations usually consist of purchased or donated supplies, materials, publications, and other items used in the organization's activities or programs or held for resale to the public. Generally, inventory should be recorded at cost, which includes all direct and indirect costs incurred to prepare it for sale or use. However, in some cases, inventory should be stated at other than cost. For example, donated materials are measured at fair value at the date of donation. In addition, if inventory cost exceeds market value, inventory should be written down to market value and an unrealized loss should be recognized in the current period change in net assets. Also, inventory items may be stated above cost if certain conditions are met.

The primary objective when determining the sequence in which inventory costs are charged to cost of sales or other expense is to select the method that most accurately reflects the current change in net assets. GAAP essentially permits an organization to use the following methods to account for inventory:

- Specific identification
- First-in, first-out
- Average cost
- Last-in, first-out

GAAP recognizes certain variations of the above methods and allows them to be used when appropriate. (For example, the retail method is a variation of the average cost method.) In addition, different methods may be used to account for different components of inventory so long as the methods are applied consistently.

ACCOUNTING REQUIREMENTS

DEFINITION

Inventory is defined as personal tangible property that is:

a. held for sale or use in the ordinary course of business;

b. in the process of production for sale or use; or

c. consumed in the production of goods or services to be available for sale or use.

Long-term assets that are subject to depreciation (or will be subject to depreciation when they are put into use) are specifically excluded from the definition of inventory. In addition, depreciable assets that are retired from use and held for sale are not considered inventory. (FASB ASC 330-10-20) (formerly ARB 43, Ch. 4, par. 3)

INVENTORY VALUATION

Except as discussed in the paragraphs titled "Lower of Cost or Market Rule" and "Stating Inventories above Cost" later in this lesson, inventories should be recorded at cost. Although that rule may seem relatively straightforward, applying it in practice may be difficult. It involves (a) identifying product costs (that is, the costs that should be charged to inventory rather than current period expenses) and (b) determining how costs will be charged to cost of sales or other expense as inventory is sold or used in the organization's programs. (FASB ASC 330-10-30-1 and 30-2) (formerly ARB 43, Ch. 4, par. 5)

IDENTIFYING PRODUCT COSTS

An inventory item's product cost includes all direct and indirect costs incurred to prepare the item for sale. Thus, for a college bookstore, an item's product cost may include the purchase price, excise and sales taxes, freight, storage, insurance, etc. For items manufactured by a nonprofit organization, inventory typically includes the cost of the following:

a. Direct materials, including invoice cost, freight-in, and tooling charges from vendors

b. Direct labor, including payroll costs of personnel whose efforts directly result in the manufacture of the product

c. Indirect costs, including factory facility costs, utilities, and indirect manufacturing labor and related costs (Interest costs incurred to finance inventory and selling costs are not indirect product costs. Those costs should be expensed when incurred rather than included in inventory.)

Allocating indirect costs between inventory and period expense is a key factor in determining inventory cost. That process can be challenging given the number of considerations involved. For example, while variable production overhead is generally allocated to production units based on the actual use of the production facilities, fixed production overhead should be allocated based on the normal capacity of the production facilities. Unallocated overhead, as well as abnormal freight, handling costs, and spoilage should be charged to current period expense. Conversely, general and administrative costs, which usually are considered period expenses, should be allocated to inventory if they relate to purchasing or producing products for sale. In no case, however, should all overhead be excluded from inventory. (FASB ASC 330-10-30-3 through 30-8) (formerly ARB 43, Ch. 4, paras. 5 and 5A)

Methods Used to Charge Inventory to Cost of Sales or Other Expense

The primary objective in determining how inventory will be charged to cost of sales or other expense is to select a method that most accurately reflects the organization's change in net assets for the period. In some cases, it may be appropriate to apply one method to one portion of inventory and other methods to other portions of inventory. Generally accepted accounting principles essentially permit the following methods of determining the sequence of costs to be charged to cost of sales or other expense: (FASB ASC 330-10-30-9) (formerly ARB 43, Ch. 4, par. 6)

a. *Specific identification.* Under the specific identification method, the cost of each inventory item is tracked from the time of purchase through the time of sale or use in one of the organization's programs. When an item is sold or used, its specific cost is charged to cost of sales or other expense. Generally, organizations use the specific identification method when there are small numbers of easily identifiable inventory items, such as jewelry, art reproduction items, or large pieces of specialized equipment.

b. *First-in, first-out.* The first-in, first-out (FIFO) method assumes that items flow through inventory in the order they were purchased. That is, the first items purchased are the first items used or sold. The FIFO method produces an inventory account that more closely approximates replacement costs since inventory consists of the items that were purchased most recently. The FIFO cost flow method may be preferred in instances where spoilage or obsolescence is a concern because it more closely corresponds to the physical flow of goods.

c. *Average cost.* The average cost method values inventory based on the average cost of all similar items available during the period. Generally, average cost is determined using either the weighted-average method or the moving-average method.

(1) Under the weighted-average method, average cost is computed at the end of a period by dividing the cost of all items available for sale or use during the period by the number of units available for sale or use during the period. That result is multiplied by the number of items remaining in inventory to obtain the ending inventory's cost, and remaining product costs are charged to cost of sales or other expense.

(2) Under the moving-average method, a new average cost is computed after each purchase rather than at the end of the period. Thus, when an inventory item is sold or used, the average cost existing at that time is charged to cost of sales or other expense.

The weighted-average method generally is applied when a periodic inventory system is used, and the moving-average method is applied when a perpetual inventory system is used.

d. *Last-in, first-out.* The last-in, first-out (LIFO) method assumes that the most recently purchased inventory items are the first items to be sold or used. Because it results in the most recent purchases being charged to cost of sales or other expense, the LIFO method more closely matches current costs with current revenues. However, it also results in an inventory account that consists of old costs, which may or may not reflect the current value of the assets.

Exhibit 1-1 illustrates how inventory and cost of sales or other expense is calculated under the FIFO, average cost, and LIFO methods.

Exhibit 1-1

Illustrative Calculations under the FIFO, Average Cost, and LIFO Inventory Methods

Assume that XYZ Organization, which uses a periodic inventory system, made the following inventory purchases during the year:

	Units	Unit Cost	Total Cost
January 28	300	$ 1.00	$ 300
April 5	400	1.10	440
June 8	200	1.20	240
October 14	600	1.25	750
November 3	300	1.30	390
December 10	600	1.35	810
	2,400		$ 2,930

Assume further that XYZ Organization's beginning inventory contained 1,000 units at $.90 per unit and its ending inventory contains 1,200 units.

First-in, First-out

Under the FIFO method, ending inventory contains the most recently purchased items. Thus, ending inventory and cost of sales would be computed as follows:

	Units	Unit Cost	Total Cost
Ending inventory:			
December 10 purchase	600	$ 1.35	$ 810
November 3 purchase	300	1.30	390
October 14 purchase	300	1.25	375
	1,200		$ 1,575
Cost of sales:			
Beginning inventory (1,000 × $.90)			$ 900
Purchases			2,930
			3,830
Ending inventory			(1,575)
			$ 2,255

Weighted Average Cost

Under the weighted average cost method, inventory and cost of sales is based on the average cost per unit as follows:

	Units	Unit Cost	Total Cost
Beginning inventory	1,000	$ .90	$ 900
Purchases	2,400		2,930
	3,400		$ 3,830
Average cost per unit ($3,830 ÷ 3,400)			$ 1.13
Ending inventory (1,200 × $1.13)			$ 1,356
Cost of sales:			
Beginning inventory (1,000 × $.90)			$ 900
Purchases			2,930
			3,830
Ending inventory			(1,356)
			$ 2,474

Last-in, First-out

Under the LIFO method, the most recently purchased items are charged to cost of sales and inventory contains the oldest items. Thus, inventory and cost of sales would be computed as follows:

	Units	Unit Cost	Total Cost
Ending inventory:			
Beginning inventory	1,000	$ .90	$ 900
January 28 purchase	200	1.00	200
	1,200		$ 1,100

	Units	Unit Cost	Total Cost
Cost of sales:			
Beginning inventory (1,000 × $.90)			$ 900
Purchases			2,930
			3,830
Ending inventory			(1,100)
			$ 2,730

* * *

GAAP recognizes that in some cases, it may be preferable to use variations of the methods described in the preceding paragraph. (FASB ASC 330-10-30-13) (formerly ARB 43, Ch. 4, par. 6) For example, a museum gift shop whose inventories consist of large numbers of low-dollar value items may find it preferable to use a reversed mark-up procedure of inventory pricing, such as the retail inventory method. The retail method is an average cost method designed to approximate the lower of FIFO cost or market. It requires determining inventory at the end of the period at retail and converting it to cost using an average cost ratio as follows:

	Cost	Retail
Beginning inventory	$ 50,000	$ 62,500
Purchases	75,000	90,000
	$ 125,000	152,500
Sales		(100,000)
Ending inventory at retail		$ 52,500
Ratio of cost to retail ($125,000 ÷ $152,000)		82%
Ending inventory at cost ($52,500 × 82%)		$ 43,050

Although rarely used by nonprofit organizations, another method of accounting for inventories is the standard cost method. The standard cost method values inventory items based on predetermined unit costs for material, labor, and manufacturing overhead. The standard costs used approximate the ideal or expected costs based on past performance or other criteria. Differences between standard costs and actual costs are recorded in variance accounts and charged to current period expense rather than inventory. GAAP permits organizations to use the standard cost method, but only if standard costs are adjusted periodically to reflect the approximate cost under one of the recognized inventory cost methods discussed previously. (FASB ASC 330-10-30-12) (formerly ARB 43, Ch. 4, par. 6)

Lower of Cost or Market Rule

Obsolescence, deterioration, damage, changing prices, or other factors may cause an inventory's recorded cost to exceed its market value. In such cases, GAAP requires inventory to be written down to market value and an unrealized loss to be recognized in the current period change in net assets. Market value is considered to be current replacement cost, with the following limitations: (FASB ASC 330-10-35-1 through 35-5) (formerly ARB 43, Ch. 4, paras. 8–9)

a. Market value should not exceed the inventory's net realizable value, which is its estimated selling price less costs of completion and disposal. (In other words, net realizable value should be used to value inventory if it is lower than current replacement cost.)

b. Market value should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. (Thus, cost should be used to value inventory if net realizable value will provide for an approximately normal profit, even if current replacement cost is lower than historical cost.)

To illustrate, assume that an item costs $100, sells for $120 (which provides for a normal profit margin of $20) and its current replacement cost drops to $80.

- If the selling price is unaffected by the drop in current replacement cost (perhaps because of firm sales commitments), the item would continue to be carried at $100 since the selling price will recover cost plus the normal profit margin.

- If the selling price drops to $100, the item would be carried at $80. The current period statement of activities would report a loss of $20 for the loss in value.

- If the item's net realizable value drops to $40, the item would be stated at $40.

Generally, the lower of cost or market rule should be applied to each item in inventory. However, it may be applied to each inventory item, total inventory, or the total of the components of each major category of inventory depending on the method that most fairly presents the current period change in net assets. (FASB ASC 330-10-35-9 through 35-11) (formerly ARB 43, Ch. 4, paras. 11–13) For example, if the cost of a minor component of a finished product exceeds its current replacement cost but the cost of the finished product does not exceed market value, the cost of the component need not be reduced to market.

Stating Inventories above Cost

Precious metals that have a fixed monetary value with no substantial cost of marketing may be stated at that monetary value, even if it exceeds cost. Other inventory items may be stated above cost only if all of the following conditions are met:

- Appropriate approximate costs for the item cannot be determined.

- The item is immediately marketable at a quoted market price.

- The item is interchangeable.

In such cases, the items generally are stated at market price less disposal costs. Agricultural or mineral products are examples of inventories that may meet the preceding conditions. (FASB ASC 330-10-35-15 and 35-16) (formerly ARB 43, Ch. 4, par. 16)

Donated Inventories

Donated materials are recorded as contributions and inventory at fair value in the period received. GAAP also requires unconditional promises to give materials to be recorded as contributions, even though the nonprofit organization may not receive the assets until a future period. (Donations of inventory that simply pass through the organization to their intended beneficiaries with the organization acting only as an agent are not recorded, however.) If donated assets have questionable or uncertain value and no alternative use that adds to their value, they should not be recognized in the financial statements. Finally, materials donated for a specific use would be reported as restricted contributions. (FASB ASC 958-605-25-4; 958-605-30-2; 958-605-45-3) (formerly SFAS 116, paras. 8 and 19)

LOSSES ON FIRM PURCHASE COMMITMENTS

Expected losses on firm, noncancelable purchase commitments for inventory goods should be measured in the same manner as inventory losses and accrued through a charge to the current period change in net assets. However, there is no loss on such commitments when the sale of such items is protected by firm sales commitments or other circumstances that reasonably assure sales without price decline. (FASB ASC 330-10-35-17 and 35-18) (formerly ARB 43, Ch. 4, par. 17)

CONSIGNED INVENTORIES

Generally accepted accounting principles do not specifically address consigned inventories. However, a basic accounting concept is that an organization should not record an asset until it receives title to the asset, and it should not record a sale until title transfers to the customer. In traditional consignment arrangements, the consignor ships goods to the consignee but continues to own them until they are sold by the consignee. When the goods are sold, title passes directly from consignor to the purchaser—title never passes to the consignee. Under such arrangements, no entries are needed at the time of consignment. That is, consigned goods continue to be included in inventory in the consignor's financial statements and not in the consignee's financial statements. When the consigned goods are sold, however, an entry is needed on the consignor's books to record the sale and on the consignee's books to record commission income. (In some consignment arrangements, the consignee acquires title to the goods from the consignor at the time of the sale. In such cases, when the consigned inventory is sold, the consignee records the transaction as a sale to the purchaser rather than as commission income.)

DISCLOSURE REQUIREMENTS

An organization should include the following disclosures about inventories in its financial statements: (FASB ASC 235-10-50-4; 330-10-50-1 through 50-5) (formerly ARB 43, Ch. 4, paras. 14–15 and APB 22, par. 13)

a. Basis for stating inventories (for example, the cost basis)

b. Method of determining costs (for example, average cost; first-in, first-out; last-in, first-out)

c. If applicable, the fact that inventories are stated above cost.

d. Unusual losses resulting from lower of cost or market adjustments or losses on firm purchase commitments (If material, the losses should be disclosed separately from cost of goods sold in the statement of activities.)

SELF-STUDY QUIZ

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

1. Right Organization buys desks and chairs at estate and yard sales, makes any necessary repairs, and sells them at low cost to families in need so they can provide an appropriate area for their children to do schoolwork. Right Organization recently paid $20 for a desk, made repairs which cost $15 for materials and $30 in labor, and spent $5 for an ad in the Sunday newspaper highlighting this available desk. What is the total amount Right Organization will record as inventory for this desk?

   a. $0.

   b. $20.

   c. $65.

   d. $70.

2. Your client is a large nonprofit organization. To raise additional revenue, the organization has decided it will sell a line of t-shirts and sweatshirts with the organization's name and logo. The organization would like its inventory balance to be reported at an amount that closely approximates replacement costs. Which method of charging inventory to cost of goods sold should you recommend to your client?

   a. Specific identification.

   b. First-in, first out.

   c. Average cost.

   d. Last-in, first-out.

3. Green Hope, Inc. educates residents across the United States about the importance of sustainable living. The organization sells "green" products and uses a periodic inventory system. Green Hope's beginning inventory for 20X9 contained 2,000 units at $3.00 per unit, and at the end of 20X9 there were 2,500 units. The following inventory purchases were made during 20X9:

	Units	Unit Cost
January 20	700	3.05
April 15	800	3.10
July 1	1000	3.15
October 25	1000	3.20

   If the Green Hope uses the LIFO method for calculating inventory, what is Green Hope's inventory balance at the end of 20X9?

   a. $6,000.

   b. $7,525.

   c. $7,711.

   d. $7,900.

4. Green Hope, Inc. educates residents across the United States about the importance of sustainable living. The organization sells "green" products and uses a periodic inventory system. Green Hope's beginning inventory for 20X9 contained 2,000 units at $3.00 per unit, and at the end of 20X9 there were 2,500 units. The following inventory purchases were made during 20X9:

	Units	**Unit Cost**
January 20	700	3.05
April 15	800	3.10
July 1	1000	3.15
October 25	1000	3.20

How much does Green Hope charge to cost of goods sold?

a. $ 9,065.

b. $ 9,254.

c. $ 9,440.

d. $10,965.

5. The gift shop of the local zoo uses the retail inventory method to value its inventory. On January 1, 20X9, the beginning inventory was $60,000, and the retail value was $75,000. The purchases made during 20X9 cost $100,000, and the retail value was $120,000. The gift shop sold $175,000 worth of inventory during 20X9. What is the ending inventory at cost at the end of 20X9?

a. $16,400.

b. $18,285.

c. $20,000.

6. Caring, Inc. keeps an inventory of home medical equipment. Due to a newer technology, one of its items is not selling the way it has in the past. The item cost Caring $70, and sells it for $100. The replacement cost for the item is $60, and the organization will drop the selling price to $90. The net realizable value is $85. According to the lower of cost or market rule, at what amount will Caring state its inventory?

a. $60.

b. $70.

c. $85.

d. $90.

7. Which of the following will Caring Organization record as inventory?

a. Caring received inventory from Terri to be sold on consignment.

b. Phil donated inventory to Caring. There are no conditions to the donation.

c. Caring received donated inventory from Bethany. The inventory will be passed to its intended beneficiary, an affiliate of Caring.

8. Which of the following is **not** an example of a required disclosure a nonprofit organization must make regarding its inventory?

   a. The organization's inventory consists of t-shirts, reusable shopping bags, and books.

   b. The organization uses the cost basis.

   c. The organization uses the first-in, first-out method.

   d. The organization incurred a $20,000 loss from lower of cost or market adjustments.

SELF-STUDY ANSWERS

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

1. Right Organization buys desks and chairs at estate and yard sales, makes any necessary repairs, and sells them at low cost to families in need so they can provide an appropriate area for their children to do schoolwork. Right Organization recently paid $20 for a desk, made repairs which cost $15 for materials and $30 in labor, and spent $5 for an ad in the Sunday newspaper highlighting this available desk. What is the total amount Right Organization will record as inventory for this desk? **(Page 140)**

   a. $0. [This answer is incorrect. Inventory is defined as personal tangible property that held for sale, in the process of production for sale or use, or consumed in the production of goods or services to be available for sale or use. The desk will have an inventory value.]

   b. $20. [This answer is incorrect. Items that meet the definition of inventory will include all direct materials in its value. Other direct and direct costs are included in the value as well.]

   c. $65. [This answer is correct. The desk meets the definition of inventory. An inventory item's product cost includes all direct and indirect costs incurred to prepare the item for sale. This includes direct materials, direct labor, and certain indirect costs. Selling costs are not indirect product costs.]

   d. $70. [This answer is incorrect. Only certain indirect costs are included as indirect product costs when an item is considered as inventory. Selling costs, such as advertising, are one of the costs that are not indirect costs.]

2. Your client is a large nonprofit organization. To raise additional revenue, the organization has decided it will sell a line of t-shirts and sweatshirts with the organization's name and logo. The organization would like its inventory balance to be reported at an amount that closely approximates replacement costs. Which method of charging inventory to cost of goods sold should you recommend to your client? **(Page 140)**

   a. Specific identification. [This answer is incorrect. The specific identification method is generally used when an organization has a small number of easily identifiable inventory items, such as jewelry or large pieces of equipment.]

   b. First-in, first out. [This answer is correct. The FIFO method assumes that items flow through inventory in the order they were purchased. This method produces an inventory account that more closely approximates replacement costs since the inventory consists of items that were purchased most recently.]

   c. Average cost. [This answer is incorrect. The average cost method values inventory based on the average cost of similar items available during the period.]

   d. Last-in, first-out. [This answer is incorrect. The LIFO method assumes that the most recently purchased inventory items are the first items to be sold or used. The LIFO method more closely matches current costs with current revenues. However, it also results in an inventory account that consists of old costs, which may not reflect the current value of the assets.]

3. Green Hope, Inc. educates residents across the United States about the importance of sustainable living. The organization sells "green" products and uses a periodic inventory system. Green Hope's beginning inventory for 20X9 contained 2,000 units at $3.00 per unit, and at the end of 20X9 there were 2,500 units. The following inventory purchases were made during 20X9:

	Units	Unit Cost
January 20	700	3.05
April 15	800	3.10
July 1	1000	3.15
October 25	1000	3.20

If the Green Hope uses the LIFO method for calculating inventory, what is Green Hope's inventory balance at the end of 20X9? **(Page 141)**

a. $6,000. [This answer is incorrect. This is Green Hope's beginning inventory balance.]

b. $7,525. [This answer is correct. Under the LIFO method, the most recently purchased items are charged to cost of sales and inventory contains the oldest items. The value of ending inventory consists of the 2,000 units in beginning inventory and 500 units from the January purchase. (2,000 × $3.00) + (500 × $3.05) = $7,525.]

c. $7,711. [This answer is incorrect. This would be the balance if the weighted average method were used.]

d. $7,900. [This answer is incorrect. This would be the balance if the FIFO method were used.]

4. Green Hope, Inc. educates residents across the United States about the importance of sustainable living. The organization sells "green" products and uses a periodic inventory system. Green Hope's beginning inventory for 20X9 contained 2,000 units at $3.00 per unit, and at the end of 20X9 there were 2,500 units. The following inventory purchases were made during 20X9:

	Units	Unit Cost
January 20	700	3.05
April 15	800	3.10
July 1	1000	3.15
October 25	1000	3.20

How much does Green Hope charge to cost of goods sold? **(Page 141)**

a. $ 9,065. [This answer is incorrect. This would be the cost of goods sold if the FIFO method were used.]

b. $ 9,254. [This answer is incorrect. This would be the cost of goods sold if the weighted average cost method were used.]

c. $ 9,440. [This answer is correct. To calculate cost of goods sold, subtract the balance of the LIFO ending inventory from the total cost of available inventory ($16,965).]

d. $10,965. [This answer is incorrect. This is the total cost of 20X9 purchases.]

5. The gift shop of the local zoo uses the retail inventory method to value its inventory. On January 1, 20X9, the beginning inventory was $60,000, and the retail value was $75,000. The purchases made during 20X9 cost $100,000, and the retail value was $120,000.The gift shop sold $175,000 worth of inventory during 20X9. What is the ending inventory at cost at the end of 20X9? **(Page 143)**

a. $16,400. [This answer is correct. The ratio of cost to retail of 82% ($160,000/$195,000) is multiplied by the ending inventory at retail of $20,000 ($195,000 − $175,000) to get the ending inventory at cost value. The retail method is an average cost method designed to approximate the lower of FIFO cost or market.]

b. $18,285. [This answer is incorrect. The denominator of the ratio of cost to retail is the total inventory available at retail value, not the amount of sales.]

c. $20,000. [This answer is incorrect. This is the ending inventory at retail.]

6. Caring, Inc. keeps an inventory of home medical equipment. Due to a newer technology, one of its items is not selling the way it has in the past. The item cost Caring $70, and sells it for $100. The replacement cost for the item is $60, and the organization will drop the selling price to $90. The net realizable value is $85. According to the lower of cost or market rule, at what amount will Caring state its inventory? **(Pages 143–144)**

a. **$60. [This answer is correct. Market value is considered to be current replacement value with limitations. Market value should not exceed the inventory's net realizable value, and should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. Thus, cost should be used to value inventory if net realizable value will provide for an approximately normal profit, even if current replacement cost is lower than historical cost.]**

b. $70. [This answer is incorrect. If the selling price did not drop, Caring would continue to carry the inventory at cost.]

c. $85. [This answer is incorrect. Net realizable value should be used to value inventory if it is lower than current replacement cost.]

d. $90. [This answer is incorrect. Since the selling price of the inventory dropped to $90, Caring will value the inventory at a different amount and report a loss of $10, but it will not value the inventory at $90.]

7. Which of the following will Caring Organization record as inventory? **(Page 144)**

   a. Caring received inventory from Terri to be sold on consignment. [This answer is incorrect. In traditional consignment arrangements, the consignor ships goods to the consignee but continues to own them until they are sold by the consignee. Caring cannot record inventory it does not own.]

   b. **Phil donated inventory to Caring. There are no conditions to the donation. [This answer is correct. Donated materials are recorded as contributions and inventory in the period received. GAAP also requires unconditional promises to give materials to be recorded as contributions, even though the nonprofit organization may not receive the assets until a future period.]**

   c. Caring received donated inventory from Bethany. The inventory will be passed to its intended beneficiary, an affiliate of Caring. [This answer is incorrect. Donations of inventory that simply pass through the organization to their intended beneficiaries with the organization acting only as agent are not recorded.]

8. Which of the following is **not** an example of a required disclosure a nonprofit organization must make regarding its inventory? **(Page 145)**

   a. **The organization's inventory consists of t-shirts, reusable shopping bags, and books. [This answer is correct. GAAP does not require an organization to disclose the components or types of inventory. However, no entity is precluded from including this information in its financial statements, whether on the face of the statement or in the notes.]**

   b. The organization uses the cost basis. [This answer is incorrect. The basis for stating inventory, such as cost basis or fair value for donated items, is a required disclosure.]

   c. The organization uses the first-in, first-out method. [This answer is incorrect. The method of determining costs (i.e., average cost, FIFO, or LIFO) is a required disclosure.]

   d. The organization incurred a $20,000 loss from lower of cost or market adjustments. [This answer is incorrect. Unusual losses resulting from lower or cost of market adjustments or losses on firm purchase commitments is a required disclosure. If material, the losses should be disclosed separately from cost of goods sold in the statement of activities.]

INVESTMENTS—DEBT AND EQUITY SECURITIES

SOURCE: FASB ASC 958-320

OVERVIEW

Investments in debt securities and equity securities with readily determinable fair values should be measured at fair value.

Gains, losses, dividends, interest, and other investment income generally should be reported on the statement of activities as increases or decreases in unrestricted net assets, unless their use is restricted by explicit donor stipulations or by law. Donor-restricted endowment funds have special accounting requirements related to reporting gains and losses.

ACCOUNTING REQUIREMENTS

Nonprofit organizations may hold a variety of assets as investments including equity and debt securities; interests in other nonprofit organizations; partnerships or joint ventures; and other property. The guidance in this lesson applies to all investments in debt securities and investments in equity securities that have readily determinable fair values.

Debt securities represent a creditor relationship with another entity. (FASB ASC Master Glossary) (formerly SFAS 115, par. 137) Examples include bonds, commercial paper, U.S. Treasury securities, convertible debt, and preferred stock that must be redeemed. *Equity securities* represent an ownership interest in another entity (or the right to buy or sell an ownership interest at a determinable price). (FASB ASC 958-320-20) (formerly SFAS 115, par. 137) Examples of equity securities include common and preferred stock, warrants, calls, and puts. Equity securities have readily determinable fair values if they meet one of the following criteria: (FASB ASC; 958-320-25-2) (formerly SFAS 124, par. 3)

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

(2) If traded only on a foreign market, the market is of a breadth and scope comparable to one of the U.S. markets referred to in (1).

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

RECOGNITION AND MEASUREMENT

Investments in equity securities with readily determinable fair values and debt securities initially should be recorded at acquisition cost (net of brokerage and other transaction fees) if purchased or measured at fair value if received by contribution or by agency transaction. (FASB ASC 958-320-30-1) (formerly 2008 Audit Guide, par. 8.08) Thereafter, nonprofit organizations should report such investments in debt and equity securities at fair value in the statement of financial position. (FASB ASC 958-320-35-1) (formerly SFAS 124, par. 7) A security's fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. (FASB ASC 958-320-20) (formerly SFAS 157, par. 5) Quoted prices in active markets provide the most reliable evidence of fair value and should generally be used to measure fair value whenever available. (FASB ASC 820-10-35-41) (formerly SFAS 157, par. 24)

GAINS AND LOSSES

Investment gains and losses can be unrealized or realized. Unrealized gains and losses occur when the fair value of investments change. They are derived by comparing an investment's current fair value, less any dividend and interest income earned but not yet received, to its carrying amount, exclusive of any write-down for impairment. Realized gains and losses occur when an investment is sold at other than its carrying value.

Unless explicitly restricted by donor stipulation or by law, realized and unrealized gains and losses on debt and equity investments should be reported in the statement of activities as increases or decreases in unrestricted net assets. If temporary donor restrictions are imposed on an asset's use, however, investment gains and losses should be recorded as increases or decreases in temporarily restricted net assets. Similarly, if the asset's use is permanently restricted, related gains and losses should be reported as increases or decreases in permanently restricted net assets. (FASB ASC 958-320-45-1 and 45-2) (formerly SFAS 124, paras. 8–9) Realized and unrealized losses on investments may be netted against realized and unrealized gains on the statement of activities. (FASB ASC 958-225-45-15) (formerly 2008 Audit Guide, paras. 8.20 and 13.29)

Donor-restricted investment income and gains whose restrictions are met in the same reporting period may be reported as unrestricted if the organization (a) reports consistently from period to period, (b) follows the same policy for reporting donor-restricted contributions, and (c) discloses its accounting policy. (FASB ASC 958-320-45-3) (formerly SFAS 124, par. 10)

CLASSIFYING GAINS AND LOSSES FROM DONOR-RESTRICTED ENDOWMENT FUNDS

A *donor-restricted endowment fund* is created when a donor stipulates that the contributed assets be invested for a specific period of time or in perpetuity (FASB ASC 958-320-20) (formerly SFAS 124, par. 112). Gains and losses on donor-restricted endowment funds should be reported as increases or decreases in unrestricted net assets unless restricted by explicit donor stipulations or by a law that extends the donor's asset restrictions to the gains and losses. In that event, they should be classified as increases or decreases in temporarily restricted or permanently restricted net assets depending on the nature of the restrictions. For example, if a donor contributes a specific investment security and requires that it be held in perpetuity, gains and losses on the security are subject to the same permanent restriction unless the donor explicitly states otherwise. On the other hand, if the donor allows the organization to choose suitable investment vehicles, gains should not be classified as permanently restricted unless otherwise explicitly restricted by the donor or by law. Instead, those gains should be classified as unrestricted if investment income is unrestricted, or temporarily restricted if investment income is temporarily restricted by the donor or by law. (FASB ASC 958-205-45-13; 958-205-45-17 through 45-19) (formerly SFAS 124, par. 11)

In some states, when there are no explicit donor stipulations and the state has not adopted a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), a nonprofit organization's governing board may be required to appropriate net appreciation under a statutorily prescribed standard of ordinary business care and prudence. Such legal limitations on net appreciation do not extend donor restrictions. Thus, net appreciation subject to those limitations should be reported as a change in unrestricted net assets. (FASB ASC 958-205-45-17) (formerly SFAS 124, par. 11) However, in states that have enacted a version of UPMIFA, the donor's restriction extends to the net appreciation on the endowment fund because the governing board must consider the duration and preservation of the fund when determining the amount of the fund that must be retained permanently. Thus, in the absence of explicit stipulations, the portion of a donor-restricted endowment fund that is not permanently restricted by the donor or by the board, consistent with the relevant law, should be classified as temporarily restricted net assets (time restricted) until appropriated for expenditure by the governing board. (FASB ASC 958-205-45-30) (FSP FAS 117-1, para. 8)

Unless donor stipulations or law require otherwise, net losses on investments held in donor-restricted endowment funds should first reduce (a) net gains from that fund earned in prior periods and held in temporarily restricted net assets and (b) temporarily restricted income earned by the investments in the donor-restricted endowment fund for which donor restrictions have not been met. Any loss in excess of those amounts should be recorded as a decrease in unrestricted net assets. Subsequent gains should be reported as increases in unrestricted net assets to the extent losses were charged to unrestricted net assets. (FASB ASC 958-205-45-22; 958-205-45-24) (formerly SFAS 124, paras. 12–13) Additional gains should be recorded in accordance with donor restrictions as discussed in the first paragraph of this topic. (FASB ASC 958-205-45-17) (formerly 2008 Audit Guide, par. 8.18)

INCOME AND EXPENSES

Investment Income

Investment income, such as dividends, interest, and royalties, should be recognized as it is earned and generally should be reported as an increase in unrestricted net assets. If a donor has placed temporary restrictions on the use of investment income, however, the income should be recorded as an increase in temporarily restricted net assets. Likewise, if permanent restrictions on the use of investment income have been imposed, investment income should be reported as an increase in permanently restricted net assets. (FASB ASC 958-320-45-2) (formerly SFAS 124, par. 8 and 2008 Audit Guide, par. 8.09)

Investment Expenses

Investment expenses consist of custodial fees and internal and external investment advisory costs. They may be netted against related investment income, gains, or losses on the statement of activities provided they are disclosed on the statement of activities or in the notes to the financial statements. (FASB ASC 958-225-45-14; 958-320-45-4) (formerly SFAS 117, par. 24) If the organization presents a statement of functional expenses, investment expenses netted against investment revenue should be reported by their functional classification. (FASB ASC 958-205-45-6) (formerly SFAS 124, par. 8 and Audit Guide, par. 13.27)

POOLING OF INVESTMENTS

Temporarily restricted or permanently restricted assets need not be invested and managed separately from unrestricted assets. In fact, many nonprofit organizations pool a portion or all of their investments for greater flexibility in managing their portfolios.

INVESTMENT REVENUE RECORDED ON A TOTAL RETURN BASIS

Some nonprofit organizations determine spendable amounts of endowment revenue based on a total return formula. Total return is a concept that focuses on the overall return on investments and includes both investment income and net appreciation. The total return formula calculates a *spending rate* that represents the percentage of the invested assets available to fund current operations. Organizations using a total return spending rate may segregate their unrestricted investment return into operating and nonoperating amounts, and present the operating portion (computed using the spending rate) as operating investment income on the face of the statement of activities or in the notes to the financial statements. (Organizations that select that presentation format also must make certain disclosures.) (FASB ASC 958-320-50-1) (formerly 2008 Audit Guide, paras. 8.21–.22)

DISCLOSURE REQUIREMENTS

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

a. For each statement of financial position presented, the aggregate carrying value of each major investments type. (FASB ASC 958-320-50-2) (formerly SFAS 124, par. 15)

b. For the most recent statement of financial position presented, the nature of and carrying value for each investment or group of investments that represents a significant concentration of market risk. (FASB ASC 958-320-50-3) (formerly SFAS 124, paras. 16 and 86)

c. For each statement of activities presented: (FASB ASC 958-320-50-1) (formerly SFAS 124, par. 14)

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

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

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

d. The amount of investment expenses reported on the statement of activities as a reduction of investment income, gains, and losses (FASB ASC 958-225-50-1; 958-320-50-1) (formerly SFAS 117, par. 24)

e. The policy for reporting restricted gains and investment income whose restrictions are met in the same reporting period if the organization chooses to show them as unrestricted support (FASB ASC 958-320-45-3) (formerly Audit Guide, par. 8.19)

Additional disclosures about significant concentrations of credit risk as described in FASB ASC 825-10-50-21 may be required. (FASB ASC 958-320-50-4) (formerly SFAS 107, par. 15A)

Some nonprofit organizations find it useful to present additional information about realized and unrealized gains and losses and historical costs of equity investments and investments in debt securities. For example, if a state adopted a law that allows nonprofit organizations to spend only realized gains or if an organization pays taxes on realized gains and losses, information that distinguishes between realized and unrealized amounts may be useful. GAAP does not preclude disclosing that information. (FASB ASC 958-320-50-5) (formerly SFAS 124, par. 89)

SELF-STUDY QUIZ

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

9. In 20X8, Martha donated 10,000 shares of publicly traded stock to her favorite charity. The stock cost Martha $5 per share. The stock was worth $100 per share on the day she donated it. On June 30, 20X9, the charity's statement of financial position date, the stock was worth $105 per share. What value is reported as the charity's investment in the stock on its June 30, 20X9 statement?

   a. $50,000.

   b. $1,000,000.

   c. $1,050,000.

10. The Love Organization purchased equity securities with a readily determinable fair value for $20,000 in 20X9. At Love's year end of December 31, 20X9, the securities had a fair value of $27,000. The organization intends on selling the securities when the value reaches $30,000, and plans on using the proceeds to build a new playground. Which of the following is true regarding how Love Organization reports any gain or loss on its 20X9 statement of activities?

    a. There is no gain or loss reported in 20X9 since the securities were not sold.

    b. Love should report a realized gain of $10,000 in unrestricted net assets.

    c. Love should report a $7,000 gain in temporarily restricted net assets.

    d. Love should report a $7,000 gain in unrestricted net assets.

11. On January 1, 20X9, Love Organization received $1,000,000 in securities to create an endowment fund to be invested in perpetuity. Earnings on the fund are limited for use in its "Love Your Neighbor" program. Any proceeds from the sale of the securities must be used to invest in other securities for the endowment fund. During 20X9, the organization earned $50,000 in dividends from the securities, $30,000 of which was used for the "Love Your Neighbor" program and the other $20,000 will be used for the program in the following year. At the end of 20X9, the securities had a fair value of $1,005,000. The organization did not sell any securities during the year. How much does Love report as investment income classified as temporarily restricted on its 20X9 statement of activities?

    a. $5,000.

    b. $30,000.

    c. $50,000.

    d. $1,000,000.

12. In 20X9, Organization A earned $20,000 in dividends on stocks that were donated to the organization ten years ago. The donor did not make any stipulations on the earnings of the stocks. Organization A paid $2,000 during the year for advisory costs related to these investments. Which of the following is true regarding these 20X9 transactions?

    a. The Organization may increase the value of the investment by $2,000.

    b. The Organization may report a $20,000 increase in temporarily restricted net assets.

    c. The Organization may report a decrease of $2,000 in permanently restricted net assets.

    d. The Organization may show $18,000 of net investment income.

SELF-STUDY ANSWERS

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

9. In 20X8, Martha donated 10,000 shares of publicly traded stock to her favorite charity. The stock cost Martha $5 per share. The stock was worth $100 per share on the day she donated it. On June 30, 20X9, the charity's statement of financial position date, the stock was worth $105 per share. What value is reported as the charity's investment in the stock on its June 30, 20X9 statement? **(Page 153)**

   a. $50,000. [This answer is incorrect. Martha's basis is not considered when the investment is reported. If the stock was purchased, rather than donated, the organization would have initially recognized the investment at acquisition cost.]

   b. $1,000,000. [This answer is incorrect. When the investment is initially recognized, the organization measures it at fair value because it was received by contribution.]

   c. $1,050,000. [This answer is correct. Investments in equity securities with readily determinable fair values are initially recorded at cost or fair value if received by contribution. Thereafter, organizations should report such investments at fair value on the statement of financial position. The fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.]

10. The Love Organization purchased equity securities with a readily determinable fair value for $20,000 in 20X9. At Love's year end of December 31, 20X9, the securities had a fair value of $27,000. The organization intends on selling the securities when the value reaches $30,000, and plans on using the proceeds to build a new playground. Which of the following is true regarding how Love Organization reports any gain or loss on its 20X9 statement of activities? **(Page 153)**

    a. There is no gain or loss reported in 20X9 since the securities were not sold. [This answer is incorrect. Unrealized gains and losses occur when the fair value of investments change, and are reported on the statement of activities.]

    b. Love should report a realized gain of $10,000 in unrestricted net assets. [This answer is incorrect. Love is planning on selling the securities when they reach a fair value of $30,000, thereby producing a $10,000 realized gain. However, the securities did not reach the $30,000 value; therefore the gain is not realized.]

    c. Love should report a $7,000 gain in temporarily restricted net assets. [This answer is incorrect. The gain is not temporarily restricted unless a donor imposes a restriction. Board imposed restrictions are not reflected on the statement of activities.]

    d. Love should report a $7,000 gain in unrestricted net assets. [This answer is correct. Unless explicitly restricted by donor stipulation or by law, realized and unrealized gains and losses on debt and equity investments should be reported in the statement of activities as increases or decreases in unrestricted net assets.]

11. On January 1, 20X9, Love Organization received $1,000,000 in securities to create an endowment fund to be invested in perpetuity. Earnings on the fund are limited for use in its "Love Your Neighbor" program. Any proceeds from the sale of the securities must be used to invest in other securities for the endowment fund. During 20X9, the organization earned $50,000 in dividends from the securities, $30,000 of which was used for the "Love Your Neighbor" program and the other $20,000 will be used for the program in the following year. At the end of 20X9, the securities had a fair value of $1,005,000. The organization did not sell any securities during the year. How much does Love report as investment income classified as temporarily restricted on its 20X9 statement of activities? **(Page 155)**

    a. $5,000. [This answer is incorrect. The $5,000 increase in the fair value of the investments is reported as permanently restricted because any sales of the securities must be re-invested in the endowment fund.]

b. $30,000. [This answer is incorrect. This is the amount of earnings that was used for the organization's program. This amount will be reported as a release of restrictions as a decrease under the temporarily restricted net assets classification and an increase in unrestricted net assets.]

c. $50,000. [This answer is correct. The organization reports $50,000 as income earned on the securities and is classified as temporarily restricted because the earnings must be used for a specific program. Since $30,000 was used for the program, Love will report a reclassification of that amount from temporarily restricted to unrestricted.]

d. $1,000,000. [This answer is incorrect. The securities donated are classified as permanently restricted because the organization cannot use the principal to support its programs. The principal must be invested in perpetuity.]

12. In 20X9, Organization A earned $20,000 in dividends on stocks that were donated to the organization ten years ago. The donor did not make any stipulations on the earnings of the stocks. Organization A paid $2,000 during the year for advisory costs related to these investments. Which of the following is true regarding these 20X9 transactions? **(Page 155)**

a. The Organization may increase the value of the investment by $2,000. [This answer is incorrect. The investment advisory costs are an expense. This amount cannot increase the value of the asset.]

b. The Organization may report a $20,000 increase in temporarily restricted net assets. [This answer is incorrect. Since there were no donor stipulations, earnings on the investment are reported as increases or decreases in unrestricted net assets.]

c. The Organization may report a decrease of $2,000 in permanently restricted net assets. [This answer is incorrect. Expenses are reported as a decrease in unrestricted net assets.]

d. The Organization may show $18,000 of net investment income. [This answer is correct. Investment expenses may be netted against related investment income, gains, or losses on the statement of activities provided they are disclosed on the statement of activities or in the notes to the financial statements.]

INVESTMENTS—EQUITY METHOD AND JOINT VENTURES

SOURCE: FASB ASC 323, 958-810

OVERVIEW

The equity method is used to account for an investment if a nonprofit organization (a) has the ability to significantly influence a for-profit entity's financial and operating policies, (b) has not elected to record the investment at fair value, and (c) is not required to consolidate the investment. Under the equity method, an investment is initially recorded at cost. Thereafter, the carrying amount of the investment is (a) increased for the organization's proportionate share of the entity's earnings and (b) decreased for the organization's proportionate share of the entity's losses or for dividends received from the entity. Other adjustments similar to those made in consolidated financial statements are also made, such as the elimination of interorganization gains and losses and amortization of the difference between the purchase price of the investment and the underlying equity in the entity's net assets. The investment generally is shown on the organization's statement of financial position as a single amount and earnings and losses from the investment are shown on the organization's statement of activities as a single amount. Because the organization's change in net assets and net assets at the end of the period are generally the same as if the investment had been consolidated, the equity method is sometimes referred to as a "one-line consolidation."

ACCOUNTING REQUIREMENTS

WHEN SHOULD THE EQUITY METHOD BE USED?

An organization should use the equity method to account for its noncontrolling interest in a *for-profit* entity if it has the ability to significantly influence the entity's operating and financial policies. *Absent predominant evidence to the contrary*, an organization is presumed to have the ability to significantly influence an entity if it owns (directly or indirectly) 20% or more of the entity's voting stock. (FASB ASC 323-10-15-8) (formerly APB 18, par. 17) A nonprofit organization should also generally use the equity method if it has a noncontrolling interest in a for-profit limited partnership, limited liability company, or a similar entity that is more than minor, unless that investment is reported at fair value. (FASB ASC 958-810-15-4) (SOP 94-3, par. 6)

An organization may choose to report its noncontrolling ownership interest in a for-profit entity at fair value if it measures its investment portfolio at fair value or if it elects the fair value option for eligible items. (FASB ASC 958-810-15-4) (formerly SOP 94-3, paras. 6–7)

Investments in Common Stock

An organization uses the equity method to account for investments in common stock or *in-substance common stock* (that is, investments whose risks and rewards are substantially similar to common stock). (FASB ASC 323-10-15-3) (formerly EITF 02-14)

Investments in In-substance Common Stock. In-substance common stock is an investment where the risk and reward characteristics are similar to the entity's common stock. A nonprofit organization should consider the following characteristics when determining if the investment is substantially similar to the entity's common stock: (FASB ASC 323-10-15-13) (formerly EITF 02-14, par. 6)

- *Subordination.* The investment should have subordination characteristics that are substantially similar to the entity's common stock.
- *Ownership Risks and Rewards.* The investment should have risks and rewards, such as the participation in earnings and losses and capital appreciation, which are substantially similar to common stock.
- *Obligation to Transfer Value.* If there is an expectation that the investee is to transfer substantive value to the investor that is not similar to common shareholders, the investment would not be substantially similar to common stock.

Partnership Interests

There is a general presumption of control by the general partner(s) in a limited partnership regardless of the extent of the general partner's ownership interest. However, if limited partners possess one or more of the following rights, the presumption is overcome and the general partner(s) should use the equity method to account for its investment (unless the organization has elected to report eligible investments at fair value): (FASB ASC 810-20-25-4 through 25-18) (SOP 94-3, par. 5; and EITF 04-5, paras. 6 and 10)

a. The substantive ability to liquidate the limited partnership or remove the general partners without cause (also known as kick-out rights)

b. Substantive participating rights

The effect of limited partner rights on the presumption of control by the general partner should be assessed when an investor first becomes a general partner. A reassessment should be made at each subsequent reporting period for the general partner's financial statements. (FASB ASC 810-20-25-6) (formerly EITF 04-5, par. 21)

APPLYING THE EQUITY METHOD

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

The investment is shown in the organization's statement of financial position as a single amount, and the organization's share of the for-profit entity's earnings is reported in the organization's statement of activities as a single amount. (See item d., however.) Use of the equity method generally results in the organization's net assets being the same as if the organization and for-profit entity were consolidated. The following are additional considerations for applying the equity method: (FASB ASC 323-10-30-2; 323-10-35-4; 323-10-45-1) (formerly APB 18, paras. 6, 10, and 11)

a. At acquisition, any difference between the cost of the investment and the organization's proportionate equity in the net assets of the for-profit entity should be accounted for as if the entity were a consolidated subsidiary. That is, the difference should be related to the entity's tangible and intangible assets based on their fair values. Any difference that cannot be related to specific assets should be considered to be goodwill. (FASB ASC 323-10-35-13) (formerly APB 18, par. 19)

b. Contingent consideration should only be included in the initial measurement of an equity investment if required by GAAP other than the requirements for business combinations in FASB ASC 805. If an equity method investment agreement involves a contingent consideration agreement where the fair value of the investor's share of the investee's net assets exceeds the initial cost, a liability should be recognized. The liability should be measured as the lesser of (1) the maximum contingent consideration not otherwise recognized or (2) the excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized) (FASB ASC 323-10-25-2A; 323-10-30-2A and 30-2B) (formerly EITF 08-6, paras. 5–6)

c. An organization's equity in the operating results of the for-profit entity should be based on the shares of common stock and in-substance common stock held. (FASB ASC 323-10-35-14) (formerly APB 18, par. 18)

d. Intra-entity profits and losses should be eliminated until realized as if the for-profit entity were consolidated. (FASB ASC 323-10-35-7) (formerly APB 18, par. 19)

e. An organization should report its share of a for-profit entity's extraordinary item (or prior period adjustment) as an extraordinary item (or prior period adjustment) unless the amount is immaterial. (FASB ASC 323-10-45-2) (formerly APB 18, par. 19) If a for-profit investee has items of other comprehensive income, the organization should adjust its investment by its share of those items.

f. Capital transactions of the for-profit entity that affect the organization's share of the entity's stockholders' equity should be accounted for on a step-by-step basis. (FASB ASC 323-10-35-15) (formerly APB 18, par. 19)

g. An organization should recognize a gain or loss on the sale of its investment equal to the difference between the selling price and the carrying amount of the investment at the time of sale. (FASB ASC 323-10-35-35) (formerly APB 18, par. 19)

h. An organization should recognize a loss for declines in an investment's value that are other than temporary. (FASB ASC 323-10-35-32) (formerly APB 18, par. 19)

i. An organization ordinarily should discontinue applying the equity method when its share of the entity's losses reduces the investment in and advances to the investee to zero. Thereafter, the organization should not provide for additional losses unless it has guaranteed obligations of the entity or is otherwise committed to provide further financial support for the entity. If the entity subsequently reports net income, the organization should resume applying the equity method only after its share of net income equals the share of net losses not recognized during the period the equity method was suspended. (There are instances, however, when an organization should *continue* to record its share of the investee's losses.) (FASB ASC 323-10-35-20 and 35-22) (formerly APB 18, par. 19)

j. Dividends on the entity's cumulative preferred stock should be deducted when computing the organization's share of earnings, regardless of whether they have been declared. (FASB ASC 323-10-35-16) (formerly APB 18, par. 19)

Exhibit 1-2 illustrates accounting for an investment under the equity method after the effective date of FASB ASC 350-10-65-1 (formerly SFAS 164, par. 93).

Exhibit 1-2

Example Equity Method Calculations

Assumptions:

- On June 30, 20X5, ABC Organization purchased 40% of for-profit XYZ Company for $55,000. On that date, XYZ Company had a total net book value of $100,000. The difference between the amount paid and 40% of XYZ Company's net book value is attributable to goodwill.

- XYZ Company reported earnings of $20,000 for the six months ended December 31, 20X5, and $45,000 for the year ended December 31, 20X6. In addition, XYZ Company declared and paid dividends totaling $10,000 during 20X6.

- During 20X6, XYZ Company recognized a profit of $10,000 on the sale of inventory to ABC Organization. The inventory is included in ABC Organization's assets at December 31, 20X6.

- XYZ Company's effective tax rate is 30%.

Accounting for the investment on ABC Organization's books:

	Investment in XYZ Co.	Equity in XYZ Co.'s Earnings
Acquisition of 40% of XYZ Company	$ 55,000	$ —
Proportionate share of XYZ Company's earnings for the six months ended December 31, 20X5 ($20,000 × 40%)	8,000	8,000
December 31, 20X5 balances	63,000	$ 8,000
Proportionate share of XYZ Company's earnings for the year ended December 31, 20X6 ($45,000 × 40%)	18,000	$ 18,000
Dividends received ($10,000 × 40%)	(4,000)	—

	Investment in XYZ Co.	Equity in XYZ Co.'s Earnings
Deferral of XYZ Company's profits on sale of inventory to ABC Organization net of related income taxes incurred by XYZ Company {[$10,000 − ($10,000 × 30%)] × 40%}	(2,800)	(2,800)
December 31, 20X6 balances	$ 74,200	$ 15,200

* * *

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

If an investor organization (a) is not committed to provide further financial support for the investee, (b) has already reduced its investment in and advances to the investee to zero, and (c) has other investments in the investee, the organization should continue to report its share of the investee's losses up to the adjusted basis of those other investments. Examples of other investments include debt securities (including mandatorily redeemable preferred stock), preferred stock, or loans to the investee. (FASB ASC 323-10-35-23 and 35-24) (formerly EITF 98-13, par. 4) Accounting for the investee's losses is as follows: (FASB ASC 323-10-35-26) (formerly EITF 98-13, par. 5)

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

b. The adjusted basis of the organization's other investments in the investee should be determined. The adjusted basis of the other investments is the cost basis adjusted for any valuation allowances for investee loans and the cumulative investee losses applied to the other investments. The cost basis is the original cost of the other investments adjusted for changes in fair value for marketable equity securities and amortization of discounts or premiums on debt securities or loans. (FASB ASC 323-10-35-25) (formerly EITF 98-13, par. 4)

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

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

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

d. After the organization's share of investee income equals its share of previously unreported investee losses, subsequent investee income should be recorded as adjustments to the adjusted basis of the other investments in the reverse order of the application of the organization's share of the investee's losses. (FASB ASC 323-10-35-25) (formerly EITF 92-13, par. 4)

Exhibit 1-3 illustrates accounting for investee losses as adjustments to other investments in the investee.

Exhibit 1-3

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

Assumptions:

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

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

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

For the year ended	ABC's Operating Income (Loss)	Carrying Value of Loan under FASB ASC 310 (formerly SFAS No. 114)	Fair value of Preferred Stock
December 31, 20X2	$ (2,000)	$ 950	$ 900
December 31, 20X3	(4,000)	750	900
December 31, 20X4	4,000	600	500

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

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
December 31, 20X1 balances	$ —	$ 1,000	$ 1,000
20X2 activity:			
Proportionate share of ABC's loss ($2,000 × 40%)	—	—	(800)
Adjustment to carrying value of loan ($1,000 − $950)	—	(50)	—
Adjustment to carrying value of preferred stock ($1,000 − $800 − $900)	—	—	700
December 31, 20X2 balances	$ -0-	$ 950	$ 900

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

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

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

Note:

[a] Because the adjusted basis of the loan is now zero, there is no adjustment to record the reduction in carrying value under FASB ASC 310-10 (formerly SFAS No. 114).

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

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

	Carrying Value of Investment in Common Stock	Carrying Value of Loan	Carrying Value of Preferred Stock
December 31, 20X3 balances	$ —	$ —	$ 900
20X4 activity:			
Proportionate share of ABC's earnings [($4,000 × 40%) − $450 of previously unreported losses]	—	950	200
Adjustment to carrying value of loan ($950 − $600)	—	(350)	—
Adjustment to carrying value of preferred stock ($1,100 − $500)	—	—	(600)
December 31, 20X4 balances	$ -0-	$ 600	$ 500

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

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

* * *

An organization that has suspended equity method loss recognition may subsequently increase its investment in a way that does not result in increasing its ownership interest from one of significant influence to one of control. In such cases, the organization should recognize previously suspended losses up to the amount of the additional investment that represents funding of prior losses. Determining whether an additional investment represents funding of prior losses is a matter of judgment based on the existing facts. The organization also should reevaluate whether it has become committed to provide financial support for the investee. (FASB ASC 323-10-35-29 and 35-30) (formerly EITF 02-18, paras. 9–11)

Differences in Fiscal Years

An organization may recognize its share of the for-profit entity's earnings or losses based on the most recent available financial statements of the entity so long as the time lag in reporting periods is consistent from year to year. (FASB ASC 323-10-35-6) (formerly APB 18, par. 19) Thus, for example, if an organization and for-profit entity have different fiscal year ends, the organization generally may compute its share of the for-profit entity's earnings or losses based on the for-profit entity's financial statements for its fiscal year. A change in a previously existing difference in year ends should be reported as a change in accounting principle under FASB ASC 250-10 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*). (FASB ASC 810-10-45-13) (formerly EITF 06-9)

Income Taxes

Accounting for an investment under the equity method may cause temporary differences between amounts reported for financial and tax reporting. (FASB ASC 740-30-25-2) (formerly APB 23, par. 9)

Changing to or from the Equity Method

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

a. When an organization loses its ability to significantly influence the entity, it should stop accruing its share of the entity's earnings or losses and begin accounting for the investment under the cost method or at fair value. The investment's cost is its carrying amount on the date that it no longer qualifies for equity method accounting. (FASB ASC 323-10-35-36) (formerly APB 18, par. 19L and SOP 94-3, as amended, paras. 5 and 7)

b. When an investment in a for-profit entity previously accounted for under the cost method becomes eligible for equity method accounting, an organization should retroactively adjust its investment, the change in net assets, and net assets on a step-by-step basis (as if the equity method had been in effect during all periods the investment was held). For example, if ABC Organization purchased 10% of for-profit DEF Company's voting stock on January 1, 20X4, and another 15% on October 1, 20X5, its change in net assets for 20X5 would include (1) 10% of DEF Company's earnings for the nine months ended September 30, 20X5, and (2) 25% of DEF Company's earnings for the three months ended December 31, 20X5. ABC Organization would also restate its net assets to include 10% of DEF Company's undistributed earnings for the year ended December 31, 20X4. In addition, ABC Organization should compare the cost of each purchase with the underlying net assets of DEF Company and account for any differences as discussed in paragraph [OLDREF], item a. (FASB ASC 323-10-35-33) (formerly APB 18, par. 19M; ASU 2010-08)

Investee Capital Transactions

If an investee accounted for under the equity method issues additional shares, the investor should account for the transaction as if it had sold a proportionate share of its investment. Any resulting gain or loss should be recognized in the change in net assets. (FASB ASC 323-10-40-1) (formerly EITF 08-6, par. 9)

DISCLOSURE REQUIREMENTS

A nonprofit organization's financial statements should include the following disclosures about an investment in a for-profit entity accounted for under the equity method: (FASB ASC 323-10-50-2 and 50-3; 958-810-60-2) (formerly APB 18, par. 20)

a. Name of the for-profit entity

b. Percentage ownership of the entity's common stock

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

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

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

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

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

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

SELF-STUDY QUIZ

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

13. On January 1, 20x9, a nonprofit organization purchased 40% (10,000 shares) of the common stock of a for-profit entity for $1,000,000, and uses the equity method to account for this investment. The for-profit entity paid $100,000 in dividends during the year, and earned $275,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $105 per share. How much does the nonprofit entity report as its investment on its 20x9 statement of financial position?

    a. $1,000,000.

    b. $1,010,000.

    c. $1,050,000.

    d. $1,070,000.

14. On January 1, 20x9, a nonprofit organization purchased 40% (10,000 shares) of the common stock of a for-profit entity for $1,000,000, and uses the equity method to account for this investment. The for-profit entity paid $100,000 in dividends during the year, and earned $275,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $105 per share. On January 1 of the next year, the nonprofit organization sold its investment in the for-profit entity for $110 per share. How much gain does the nonprofit organization recognize?

    a. $30,000.

    b. $40,000.

    c. $50,000.

    d. $100,000.

15. At December 31, 20x8, First Organization owned 30% of Second, Inc. Recorded investee losses reduced the investment in Second to zero on December 31, 20x8. Other investments in Second are a $1,000 loan and $2,000 in Second's preferred stock. At the end of 20x9, the carrying value of the loan was $950 and the fair value of the preferred stock was $1,500. Second's loss in 20x9 was $10,000 (adjusted for interorganization transactions). What is the carrying value of the loan and preferred stock on December 31, 20x9, respectively?

    a. $0; $0.

    b. $0; $1,500.

    c. $950; $1,500.

    d. $1,000; $2,000.

16. ABC organization owns 40% of the common stock of XYZ, Inc. ABC has a year-end of June 30, and XYZ uses the calendar year. ABC can apply the equity method for reporting its investment in XYZ using calendar year financial statements.

    a. True.

    b. False.

17. DEF Organization purchased 10% of the common stock of TUV Company on January 1, 20X8 and accounted for the investment using the cost method. On September 1, 20x9, DEF purchased another 15% of the common stock of TUV. The undistributed net earnings of TUV on December 31, 20x8 was $10,000. Also, TUV's net income for 20x9 was $30,000; $20,000 attributable to the first eight months of the year, and $10,000 for the last four months. How much is included in DEF's change in net assets for 20x9, pertaining to its investment in TUV?

    a. $1,000.

    b. $3,500.

    c. $4,500.

    d. $7,500.

SELF-STUDY ANSWERS

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

13. On January 1, 20x9, a nonprofit organization purchased 40% (10,000 shares) of the common stock of a for-profit entity for $1,000,000, and uses the equity method to account for this investment. The for-profit entity paid $100,000 in dividends during the year, and earned $275,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $105 per share. How much does the nonprofit entity report as its investment on its 20x9 statement of financial position? **(Page 161)**

    a. $1,000,000. [This answer is incorrect. The investment is initially recorded at cost when the equity method is used. However, transactions of the for-profit entity will affect the carrying value.]

    b. $1,010,000. [This answer is incorrect. Only the nonprofit entity's portion of the dividends and income should increase or decrease the carrying value of the investment.]

    c. $1,050,000. [This answer is incorrect. This is the carrying value if the fair value measurement is used.]

    d. $1,070,000. [This answer is correct. The nonprofit entity initially records the investment at $1,000,000. It then reduces the carrying value by its proportionate share of dividends, and increases or decreases the carrying value by its proportionate share of net earnings or loss.]

14. On January 1, 20x9, a nonprofit organization purchased 40% (10,000 shares) of the common stock of a for-profit entity for $1,000,000, and uses the equity method to account for this investment. The for-profit entity paid $100,000 in dividends during the year, and earned $275,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $105 per share. On January 1 of the next year, the nonprofit organization sold its investment in the for-profit entity for $110 per share. How much gain does the nonprofit organization recognize? **(Page 161)**

    a. $30,000. [This answer is correct. An organization should recognize a gain or loss on the sale of its investment equal to the difference between the selling price ($1,100,000) and the carrying amount of the investment at the time of sale.]

    b. $40,000. [This answer is incorrect. The gain is not reduced to the percentage owned. The percentage owned is used to calculate the proportionate share of dividends and income that affect the carrying value of the investment.]

    c. $50,000. [This answer is incorrect. This would be the gain if fair value measurement was used.]

    d. $100,000. [This answer is incorrect. This is the realized gain. However, because the equity method is used, the carrying amount at December 31, 20x9 is not the initial cost.]

15. At December 31, 20x8, First Organization owned 30% of Second, Inc. Recorded investee losses reduced the investment in Second to zero on December 31, 20x8. Other investments in Second are a $1,000 loan and $2,000 in Second's preferred stock. At the end of 20x9, the carrying value of the loan was $950 and the fair value of the preferred stock was $1,500. Second's loss in 20x9 was $10,000 (adjusted for interorganization transactions). What is the carrying value of the loan and preferred stock on December 31, 20x9, respectively? **(Pages 163–164)**

    a. $0; $0. [This answer is incorrect. The nonprofit's proportionate share of the $3,000 loss does reduce the carrying value of the loan and the preferred stock. However, the adjusted basis of the other investments in the investee should be adjusted for other applicable accounting principles, such as SFAS No. 114 and SFAS No. 124.]

    b. $0; $1,500. [This answer is correct. Because the adjusted basis of the loan is now zero ($1,000 carrying value less $1,000 of the proportionate share of Second's loss), there is no adjustment to

record the reduction in carrying value under FASB ASC 310-10 (formerly SFAS No. 114). The preferred stock's carrying value is also reduced to zero ($2,000 carrying value less $2,000 of the proportionate share of Second's loss. Then the preferred stock carrying value is adjusted to its fair value of $1,500 according to FASB ASC 958-320 (formerly SFAS No. 124).]

c. $950; $1,500. [This answer is incorrect. The loan is not adjusted to its carrying value according to SFAS No. 114 because of the proportionate share of the loss recorded.]

d. $1,000; $2,000. [This answer is incorrect. Both valuation allowances required by SFAS No. 114 and fair value adjustments required by FASB ASC 958-320 (formerly SFAS No. 124), as well as the nonprofit organization's share of the loss, will affect the carrying values of the loan and preferred stock.]

16. ABC organization owns 40% of the common stock of XYZ, Inc. ABC has a year-end of June 30, and XYZ uses the calendar year. ABC can apply the equity method for reporting its investment in XYZ using calendar year financial statements. **(Page 165)**

a. True. [This answer is correct. If an organization and for-profit entity have different fiscal year ends, the organization generally may compute its share of the for-profit entity's earnings or losses based on the for-profit entity's financial statements for its fiscal year. A change in a previously existing difference in year ends should be reported as a change in accounting principle under FASB ASC 250-10 (formerly SFAS No. 154, *Accounting Changes and Error Corrections*).]

b. False. [This answer is incorrect. An organization may recognize its share of the for-profit entity's earnings or losses based on the most recent available financial statements of the entity so long as the time lag in reporting periods is consistent from year to year.]

17. DEF Organization purchased 10% of the common stock of TUV Company on January 1, 20X8 and accounted for the investment using the cost method. On September 1, 20x9, ABC purchased another 15% of the common stock of TUV. The undistributed net earnings of TUV on December 31, 20x8 was $10,000. Also, TUV's net income for 20x9 was $30,000; $20,000 attributable to the first eight months of the year, and $10,000 for the last four months. How much is included in DEF's change in net assets for 20x9, pertaining to its investment in TUV? **(Page 165)**

a. $1,000. [This answer is incorrect. DEF would restate its net assets to include 10% of TUV's undistributed earnings for the year ended December 31, 20x8.]

b. $3,500. [This answer is incorrect. For the remaining four months of the year, DEF owned a total of 25% of TUV, not 15%.]

c. $4,500. [This answer is correct. When an investment in a for-profit entity previously accounted for under the cost method becomes eligible for equity method accounting, an organization should retroactively adjust its investment, the change in net assets, and net assets on a step-by-step basis. For the first eight months of the year, DEF owned 10% of TUV, and for the remaining four months DEF owned a total of 25% of TUV. Therefore, the change in net assets for 20x9 includes $2,000 ($20,000 × 10%) plus $2,500 ($10,000 × 25%).]

d. $7,500. [This answer is incorrect. Since DEF only owned 25% of TUV for the last four months of the year, the 25% share is only applied to the net income for those last four months.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (NPGTG102)

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

1. Which nonprofit organization will record the vehicle in each answer choice as inventory?

   a. Organization A received a donated vehicle which will be used for transporting children to after school activities.

   b. Organization B receives donated vehicles, fixes them up, and sells them to individuals in need for little to no profit.

   c. Organization C received a donated vehicle which was used for general purposes of the organization, but has discontinued its use.

   d. Organization D purchases vehicles which are used as "good Samaritan vans". The vans are used in road side assistance.

2. The Nature Organization experienced $2,000 worth of inventory spoilage. How does Nature Organization account for this spoilage?

   a. As an indirect cost.

   b. As variable overhead.

   c. As fixed overhead.

   d. As a current period expense.

3. The Art for Everyone Organization's purpose is to provide art and enrichment classes to children in need. Every year the organization puts on a show of the children's artwork, and also sells art reproduction works and other works of art created by the organization's adult staff. The organization records the artwork as inventory. What is the best method for the organization to charge inventory to cost of sales for the artwork that is sold?

   a. Specific identification.

   b. First-in, first-out.

   c. Average cost.

   d. Last-in, first-out.

4. The Nature Organization sells reusable shopping bags and uses a periodic inventory system. Nature's beginning inventory for 20x9 contained 1,500 units at $2.50 per unit, and at the end of 20x9 there were 500 units. The following inventory purchases were made during 20x9:

	Units	Unit Cost
January 15	100	2.55
April 9	150	2.60
July 31	200	2.65
October 23	175	2.70

If the Nature Organization uses the FIFO method for calculating inventory, what is Nature's inventory balance at the end of 20x9?

a. $1,250.00.

b. $1,270.00.

c. $1,327.50.

d. $3,750.00.

5. The Nature Organization sells reusable shopping bags and uses a periodic inventory system. Nature's beginning inventory for 20x9 contained 1,500 units at $2.50 per unit, and at the end of 20x9 there were 500 units. The following inventory purchases were made during 20x9:

	Units	Unit Cost
January 15	100	2.55
April 9	150	2.60
July 31	200	2.65
October 23	175	2.70

How much does Nature charge to cost of goods sold?

a. $4,070.00.

b. $4,127.50.

c. $4,147.50.

d. $5,397.50.

6. The gift shop of your town's history museum uses the retail inventory method to value its inventory. On January 1, 20x9, the beginning inventory was $40,000, and the retail value was $60,000. The purchases made during 20x9 cost $90,000, and the retail value was $115,000.The gift shop sold $120,000 worth of inventory during 20x9. What is the ending inventory at cost at the end of 20x9?

   a. $10,000.

   b. $40,857.

   c. $50,769.

   d. $55,000.

7. Because the demand for environmentally unfriendly items has dramatically decreased, a nonprofit organization had to write down several items of inventory to market value. How does the organization account for the difference between the cost and market value?

   a. As a reduction in contribution revenue.

   b. As an extraordinary item.

   c. As an unrealized loss.

   d. As a variable cost.

8. A large manufacturer of t-shirts donated 5,000 of its shirts to Nature Organization. The shirts cost the manufacturer $2.00 each to produce and the fair value of each shirt is $2.80. How much will Nature record as inventory and contributions for these donated shirts?

   a. $0.

   b. $4,000.

   c. $10,000.

   d. $14,000.

9. *Debt securities* include which of the following?

   a. Warrants.

   b. Commercial paper.

   c. Common stock.

   d. Puts.

10. On March 1, 20x9, Local Youth, Inc. received a donation of equity securities with a readily determinable fair value of $10,000. The donor stipulated that any earnings or proceeds on the sale of the securities must be used for youth sports. Local Youth intends on selling the securities when it is ready to build a new little league field. On December 31, 20x9, Local Youth, Inc.'s year end, the securities have a fair value of $15,000. How is this unrealized gain reported on Local Youth's statement of activities?

    a. The statement of activities is not effected by unrealized gains and losses.

    b. As a $5,000 increase in unrestricted net assets.

    c. As a $5,000 increase in temporarily restricted net assets.

    d. As a $5,000 increase in permanently restricted net assets.

11. On January 1, 20x9, Local Youth received $1,000,000 to create an endowment fund to be invested in perpetuity. The first $50,000 of income from the fund is limited to developing the little league field and a concession stand. Any earnings after that can be used for other youth sports programs. During 20x9, the fund earned $100,000 of investment income and the fair value of the investments did not change. Local Youth will construct the little league field and concession stand during the next year. Which of the following will be reported on Local Youth's statement of activities in 20x9?

    a. $50,000 of investment income as an increase in permanently restricted net assets.

    b. $50,000 of investment income as an increase in unrestricted net assets.

    c. $100,000 of investment income as an increase in permanently restricted net assets.

    d. $100,000 of investment income as an increase in temporarily restricted net assets.

12. On January 1, 20x9, Local Youth received $1,000,000 to create an endowment fund to be invested in perpetuity. The first $50,000 of income from the fund is limited to developing the little league field and a concession stand. Any earnings after that can be used for other youth sports programs. During 20x9, the fund earned $100,000 of investment income and the fair value of the investments did not change. Local Youth will construct the little league field and concession stand during the next year. During the next year, Local Youth developed the little league field and concession stand and spent a total of $100,000. The endowment fund earned $150,000 of investment income, and the fair value of the investments was $1,025,000. Of the following, which is an accurate reporting of these transactions on Local Youth's statement of activities?

    a. $25,000 of investment income as an increase in permanently restricted net assets.

    b. $50,000 of investment income as an increase in permanently restricted net assets.

    c. $100,000 of investment income as an increase in unrestricted net assets.

    d. $150,000 of investment income as an increase in unrestricted net assets.

13. A nonprofit organization that helps feed and shelter the homeless owns 35% of the voting stock of a for-profit food distributor. The nonprofit organization has the ability to significantly influence the operating and financial policies of the food distribution company. Which method should the nonprofit organization use to account for this investment, assuming it has not elected to account for investments under another method?

    a. Cost method.

    b. Equity method.

    c. Consolidation.

    d. Do not select this answer choice.

14. On January 1, 20x9, a nonprofit organization purchased 45% (1,000 shares) of the common stock of a for-profit entity for $20,000 and uses the equity method to account for this investment. The for-profit entity paid $10,000 in dividends during the year, and earned $75,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $15 per share. How much does the nonprofit entity report as this investment on its 20x9 statement of financial position?

    a. $15,000.

    b. $20,000.

    c. $49,250.

    d. $53,750.

15. On January 1, 20x9, a nonprofit organization purchased 45% (1,000 shares) of the common stock of a for-profit entity for $20,000 and uses the equity method to account for this investment. The for-profit entity paid $10,000 in dividends during the year, and earned $75,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $15 per share. During the next year, the for-profit entity suffered a loss of $200,000 and did not pay out any dividends. The nonprofit organization has not guaranteed any obligations of the for-profit entity and is not committed to provide further financial support. At the end of the year, the for-profit's share price dropped to $2 per share. What amount is reported as the nonprofit's investment in the for-profit entity?

    a. $0.

    b. $2,000.

    c. ($36,250).

    d. ($40,750).

16. On January 1, 20x9, a nonprofit organization purchased 45% (1,000 shares) of the common stock of a for-profit entity for $20,000 and uses the equity method to account for this investment. The for-profit entity paid $10,000 in dividends during the year, and earned $75,000. On December 31, 20x9, the nonprofit organization's year end, the for-profit's share price was $15 per share. During the next year, the for-profit entity suffered a loss of $200,000 and did not pay out any dividends. The nonprofit organization has not guaranteed any obligations of the for-profit entity and is not committed to provide further financial support. At the end of the year, the for-profit's share price dropped to $2 per share. The nonprofit entity also owns preferred stock in the for-profit entity. The stock cost $60,000 and the fair value at the end of the year is $50,000. What is the carrying amount of the preferred stock at the end of the nonprofit organization's second year of ownership in the for-profit entity?

    a. $0.

    b. $9,250.

    c. $19,250.

    d. $50,000.

17. ABC Organization owns 40% of XYZ, Inc. and had used the equity method to account for this investment. On December 31, 20x9, ABC loses its ability to significantly influence the XYZ. On that date, the carrying amount of the investment was $100,000 and the fair market value was $150,000. The investment originally cost ABC $200,000. If ABC uses the cost method to account for the investment, what will ABC report as its investment in XYZ on December 31, 20x9?

    a. $0.

    b. $100,000.

    c. $150,000.

    d. $200,000.

Lesson 2: Retirement and Post-employment Benefits

INTRODUCTION

This lesson covers the accounting requirements and disclosure requirements for recording retirement and post– employment benefits on nonprofit financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the specific accounting requirements for when a nonprofit organization has a defined benefit pension plan, including recognizing net periodic pension plan cost, and the recognition of assets and liabilities.
- Identify correct accounting for postretirement benefits other than pensions, including determining the net periodic postretirement benefit cost and obligation, and the recognition of assets and liabilities.
- Determine the unique requirements when an employer has more than one benefit plan or has settlements and curtailments of a benefit plan, and when the employer terminates benefits.
- Identify the definitions and accounting requirements for defined contribution plans, multiemployer plans, multiple-employer plans, foreign plans, and postemployment benefits.
- Determine the disclosure requirements for defined benefit pension plans, defined benefit postretirement plans, defined contribution plans, and multiemployer benefit plans.

RETIREMENT BENEFITS

SOURCE: FASB ASC 715, 958-715

OVERVIEW

Retirement benefits can encompass a variety of employee-related benefits that employees receive after they are no longer actively employed. This lesson covers two broad categories of retirement benefits: pension plans and postretirement benefits other than pensions. A pension plan provides benefits to participants upon the occurrence of a covered event, such as retirement, death, disability, or termination of employment. Similarly, a postretirement benefit plan provides a variety of health and welfare benefits to participants upon the occurrence of the same covered events. A pension plan or other postretirement benefit plan may be broadly classified as either a defined benefit plan or a defined contribution plan. As the names imply, a plan's classification depends on whether it specifies benefit payments or contribution amounts. That is, a defined benefit plan provides specified benefits to participants while a defined contribution plan provides an account for each participant and describes how contributions to the accounts are determined.

DEFINED BENEFIT PLANS

The employer's primary objectives when accounting for a defined benefit plan are to (a) charge pension costs to expense over the period employee services are rendered and (b) charge liabilities and credit assets when retirement benefits are paid. That objective is accomplished by a combination of current accruals and amortization of prior results. The resulting annual benefit cost of a defined benefit plan consists of the following components:

a. Service cost

b. Interest cost

c. Actual return on plan assets

d. Amortization of prior service cost or credit

e. Gains and losses

f. Amortization of the net asset transition or obligation

The funded status of a defined benefit pension plan is measured as the difference between the fair value of plan assets and the projected benefit obligation. The funded status of a defined benefit other postretirement plan is measured as the difference between the fair value of plan assets and the accumulated benefit obligation. The overfunded or underfunded status of a single-employer defined benefit plan is recognized as an asset or liability and the changes in that funded status are recognized in changes in unrestricted net assets in the year they occur. The funded status is ordinarily measured at the statement of financial position date.

Employers may be required to record gains and losses, prior service costs or credits, and the unrecognized net transition asset or obligation that arose previously if a plan settlement or curtailment occurs. A plan settlement eliminates the employer's responsibility for its pension or other postretirement benefit obligation. Examples of settlements include purchasing annuity or insurance contracts covering vested benefits or making lump sum distributions to participants in exchange for their rights to receive future benefits. A plan curtailment occurs when a portion of future pension or other postretirement benefits are reduced for current participants (for example, by suspending the plan).

Some employers pay benefits to employees when employment is terminated. The cost of the termination benefits is the total of any lump-sum payments made and the present value of any future payments. Termination benefits that are considered special termination benefits should be accrued when the amount of benefits can be reasonably estimated and the employee accepts the employer's offer to provide the benefits. Those that are considered contractual benefits should be accrued (a) when it is probable that employees will be entitled to benefits and (b) the amount of benefits can be reasonably estimated.

DEFINED CONTRIBUTION PLANS

Under a defined contribution plan, the employer and participants contribute amounts to accounts maintained by the plan for each participant. A participant receives benefits equal to (a) the amounts contributed to his or her account, (b) income earned on the investment of those amounts, and (c) forfeitures of amounts contributed to the accounts of other participants who terminated employment before vesting in the plan that may be allocated to the participant's account. The pension or other postretirement benefit expense that should be recorded by the employer is the contribution that applies for the period, accounted for on the accrual basis.

ACCOUNTING REQUIREMENTS

TYPES OF PLANS

A postretirement benefit plan is a mutually understood arrangement between an employer and its employees that provides employees specified benefits after retirement in exchange for services over a specified time period, upon reaching a specified age, or both. (FASB ASC 715-10-05-7; 715-60-05-2) (formerly SFAS 106, par. 7) Pension plans provide benefits to participants upon retirement, death, disability, termination of employment, or the occurrence of another covered event. Most commonly, postretirement benefit plans provide health care and life insurance benefits to retirees, their beneficiaries, and covered dependents. However, they may provide other benefits as well, such as tuition assistance, day care, legal services, or housing subsidies. The following are the two basic types of pension and other postretirement benefit plans:

a. *Defined benefit plans.* A defined benefit plan provides specified benefits to plan participants. The benefits are based on a variety of factors including a participant's age, years of service, and compensation. (FASB ASC 715-30-20; 715-60-5-4) (formerly SFAS 87, par. 264 and SFAS 106, par. 18) For example, a pension plan might provide a participant with an annual retirement benefit equal to 2% of the participant's annual salary for the five years preceding retirement for each year of employment, up to a maximum of 30 years. A *defined benefit postretirement plan* may provide specified benefits stated in terms of (a) monetary amounts (for example, $100,000 of life insurance) or (b) benefit coverage (for example, 80% of the cost of certain medical procedures). (FASB ASC 715-60-20) (formerly SFAS 106, par. 16)

b. *Defined contribution plans.* A *defined contribution plan* provides an individual account for each participant and specifies how contributions to the individual's account are to be determined. Unlike defined benefit plans, defined contribution plans do not define specific benefit amounts that participants are to receive. Instead, they provide benefits based solely on (a) the amount contributed to a participant's account, (b) the returns earned on the investment of those contributions, and (c) forfeitures of other participants' benefits that may be allocated to the participant's account. (FASB ASC 715-70-20) (formerly SOP 99-3, par. 34) Examples of defined contribution plans include profit sharing plans, money purchase plans, 403(b) plans, and individual postretirement health care plans.

Determining whether a plan is a defined contribution or a defined benefit plan is important because different measurement and disclosure requirements apply. As an example, the annual cost of a defined contribution plan usually is the contribution related to that year, but the cost charged to expense for a defined benefit plan generally differs from the annual contribution. The substance of a plan, not its form, governs whether it is a defined contribution or a defined benefit plan. For example, a plan may provide prescribed benefits but base contributions on wages per hour. In that case, the plan should be considered a defined benefit plan.

ACCOUNTING FOR DEFINED BENEFIT PENSION PLANS

Recognizing Net Periodic Pension Cost

Over the life of a defined benefit pension plan, pension cost equals benefits paid less investment earnings. That net cost is charged to expense during the time a plan participant is employed. However, it is accomplished through a combination of current accruals and amortization of prior results that when considered together (a) charge the organization's expenses and credit its liabilities for the cost during the period employee services are rendered and (b) charge the organization's liabilities and credit its assets as retirement benefits are paid. Specifically, the annual net pension cost of a defined benefit pension plan consists of the following six components: (FASB ASC 715-30-35-4) (formerly SFAS 87, par. 20)

Related primarily to employee service rendered during the period:

a. Service cost

b. Interest cost on the projected benefit obligation

c. Actual return on plan assets

Related primarily to prior period results:

a. Amortization of prior service cost or credit

b. Gains and losses

c. Amortization of the net transition asset or obligation

For defined benefit pension plans, this annual cost is referred to as the *net periodic pension cost.*

Service Cost. *Service cost* relates only to employee service rendered during the year and is computed as the actuarial present value of benefits attributed by the pension benefit formula to employee service during the period. It requires assumptions about the attrition of present participants and future changes in their compensation and ignores participants that may be added to the plan in the future. (FASB ASC 715-30-20; 715-30-35-6 and 35-7) (formerly SFAS 87, paras. 16, 21, and 264)

In some instances, a plan's benefit formula may attribute all or a disproportionate share of total pension benefits to later years of service. For example, a plan may provide no benefits for the first 20 years of service and a $25,000 vested benefit at the beginning of year 21. (A vested benefit is one that an employee is entitled to receive and is not contingent on the employee's future service.) Because such a plan is substantially the same as a plan that provides $1,250 per year for the first 20 years of service and requires 20 years of service to become vested, the projected benefit should accumulate in proportion to the ratio of completed years of service to the number of years that will have been completed when the benefit first becomes fully vested. In other cases, a plan's benefit formula may not address how benefits relate to employee services provided. In such cases, the benefit should be assumed to accumulate as follows: (FASB ASC 715-30-35-38) (formerly SFAS 87, par. 42)

a. If the benefit is includable in vested benefits, the benefit amount should be included in proportion to the ratio of the completed years of service to the number of years that will be completed when the benefit becomes fully vested.

b. If the benefit is not includable in vested benefits, the benefit amount should be included in proportion to the ratio of completed years of service to total projected years of service. (An example of a benefit that is not includable in vested benefits is a death or disability benefit that is payable only if the employee's death or disability occurs during active service.)

Service cost for the period should consider automatic benefit changes required by plan terms, such as cost-of-living increases, or that result from plan amendments already in effect. (FASB ASC 715-30-35-35) (formerly SFAS 87, par. 48) In addition, employers that have a history of providing plan benefits that are greater than those defined in writing should base their pension accounting on the "substantive commitment." (FASB ASC 715-30-35-34) (formerly SFAS 87, par. 41)

Interest Cost. Interest cost reflects interest for the year on the plan's obligation to provide benefits. The information needed to compute interest cost is (a) the projected benefit obligation and (b) an assumed discount rate. (FASB ASC 715-30-35-8 and 35-11) (formerly SFAS 87, par. 22) The projected benefit obligation is the actuarial present value of benefits expected to be paid to current plan participants in the future. The projected benefit obligation requires assumptions about the attrition rates and future compensation levels for current participants but does not consider that additional employees will become plan participants in future years. (FASB ASC 715-30-35-1A) (formerly SFAS 87, par. 17) As discussed, the discount rate is based on current market conditions and, therefore, may vary from year to year.

Actual Return on Plan Assets. *Actual return on plan assets* generally represents realized and unrealized investment gains and losses as well as any interest and dividends received. The actual return on plan assets is computed as the fair value of plan assets at the beginning of the year plus contributions during the year minus benefits paid during the year and minus the fair value of plan assets at the end of the year. (FASB ASC 715-30-20) (formerly SFAS 87, paras. 23 and 264) A net return on plan assets decreases pension cost for the period.

Amortization of Prior Service Cost or Credit. The cost of providing benefits related to services rendered before a plan was adopted or amended should be recognized as a separate line item (or included in one line item with gains and losses and the remaining transition asset or obligation) within changes in unrestricted net assets, apart from expenses, at the date of adoption or amendment. That prior service cost should be amortized over the remaining service lives of participants who are active at the date of the plan adoption or amendment. If most of the plan's participants are inactive, however, unrecognized prior service cost should be amortized over the expected remaining lives of the inactive participants. The amortization of prior service cost is recognized by reclassifying a portion of the prior service costs or credits that were previously recognized in net periodic pension cost. The resulting contra adjustment should be reported in the same line item within changes in unrestricted net assets, apart from expenses, as the initially recognized amounts. (FASB ASC 715-30-35-10 and 35-11) (formerly SFAS 87, paras. 24–25)

So long as it is applied consistently, an alternative amortization method that amortizes prior service cost more rapidly may be used. For example, to reduce the complexity of the amortization calculations, it may be preferable to amortize prior service cost over the *average* remaining service period of all active participants using the straight-line method. Also, if the period that economic benefits are expected to be realized by the employer from a retroactive plan amendment is shorter than the remaining future service lives of active participants, prior service cost should be amortized over the future periods expected to benefit from the amendment. (FASB ASC 715-30-35-13 and 35-14) (formerly SFAS 87, paras. 26–27)

Plan amendments that decrease the cost of providing pension benefits also decrease the projected benefit obligation. Decreases in the projected benefit obligation should be recognized as a prior service credit in a line item within changes in unrestricted net assets, apart from expenses. These decreases should first be used to reduce any remaining prior service cost that has previously been included in changes in unrestricted net assets but has not yet been reclassified as a component of net periodic pension cost. The excess, if any, should be amortized on the same basis as increases in prior service cost (that is, amortized over the remaining service period of employees expected to receive benefits). (FASB ASC 715-30-35-17) (formerly SFAS 87, par. 28)

Gains and Losses. Gains and losses arise when the following occur: (FASB ASC 715-30-20; 715-30-35-18, 35-20, and 35-22) (formerly SFAS 87, paras. 29–31 and 264)

a. *Assumptions Used to Compute the Projected Benefit Obligation Change.* The gain or loss is the difference between the projected value of the year-end pension obligation based on beginning-of-year assumptions and the actual year-end obligation based on end-of-year assumptions.

b. *Actual Results Differ from the Expected Return on Plan Assets.* The gain or loss is the difference between the actual and expected return on plan assets. The following discuss how the actual and expected returns on plan assets are determined:

   (1) As discussed, the actual return on pension plan assets is computed as the difference between the fair value of plan assets at the beginning and end of the period, adjusted for contributions and benefit payments made during the period.

   (2) The *expected return on plan assets* is computed by multiplying the plan's expected long-term rate of return by the beginning of the year market-related value of plan assets. The market-related value of plan assets is determined by using either the fair value of plan assets or by computing a value that recognizes changes in the fair value of plan assets systematically over a period not to exceed five years. For example, rather than using fair value, an organization may compute market-related value by recognizing changes in value over five years. Assuming market-related value at the beginning of the year is $1,200 and net asset gains and losses over the past five years are $580, the market-related value of plan assets at the end of the year would be computed as follows: (Expected long-term rate of return and amounts for contributions and benefit payments are assumed.)

Market-related value at beginning of year	$ 1,200
Expected return on assets for the year ($1,200 × 10% expected long-term rate of return)	120
Net gain (loss) to be included in market-related value ($580 B 5 years)	116
Employer contributions	400
Benefit payments	(200)
Market-related value at end of year	$ 1,636

   Market-related value may be computed differently for each class of plan assets; however, the method of computing market-related value for each class should be used consistently from year to year. For example, an employer may use the fair value for equity securities and a five-year moving average for bonds and other debt securities.

Generally, the gains and losses discussed in the preceding paragraph (frequently referred to as actuarial gains and losses) are not required to be included in pension expense in the period they arise. Instead, they may be recognized as a separate line item (or included in one line item with the amortization of prior service cost or credit and the amortization of the remaining transition asset or obligation) within changes in unrestricted net assets, apart from expenses. Amortization is required in any year in which the beginning of the year net gain or loss that has previously been recognized in the changes in unrestricted net assets but has not yet been reclassified as a component of net periodic pension cost exceeds the greater of 10% of the projected benefit obligation or the market-related value of plan assets. In such years, the amount of net gain or loss that must be included in net pension cost is the excess net gain or loss (i.e., amount greater than 10% of projected benefit obligation or market-related value) divided by the average remaining service lives of active employees (or, if substantially all plan participants are inactive, the average remaining lives of inactive participants). (FASB ASC 715-30-35-19; 715-30-35-21; 715-30-35-24) (formerly SFAS 87, paras. 29 and 32)

An alternative amortization method may be used so long as it (a) reduces the net gain or loss that has previously been recognized in the changes in unrestricted net assets but has not yet been reclassified as a component of net periodic pension cost by an amount in excess of that resulting from the minimum amortization method, (b) is applied similarly to both gains and losses, and (c) is systematic and used consistently. (FASB ASC 715-30-35-25) (formerly SFAS 87, par. 33)

Amortization of Net Transition Obligation or Asset. Rather than require an employer to immediately recognize the difference between the fair value of plan assets and the projected benefit obligation as of the date SFAS No. 87 was originally adopted, an employer was allowed to amortize the difference to expense over future years. As it is amortized, an amount is reclassified to net periodic pension cost with a resulting contra adjustment reported in the same line item within changes in unrestricted net assets, apart from expenses, as the initial transition obligation or asset when SFAS No. 158 was initially adopted. The difference should be amortized using the straight-line method, and the amortization period should be the average remaining service period of participants that were employed when SFAS No. 87 was adopted, except in the following circumstances: (Grandfathered) (formerly SFAS 87, par. 77)

a. An employer may have chosen to amortize the difference over 15 years if the remaining service period of plan participants was less than 15 years.

b. An employer may be amortizing the difference over the expected remaining lives of plan participants when SFAS No. 87 was adopted if substantially all of the participants were not employed at that date.

Recognition of Liabilities and Assets

The funded status of pension benefit plans should be recognized in the statement of financial position and measured as the difference between the fair value of plan assets and the projected benefit obligation. If the projected benefit obligation exceeds the fair value of plan assets, a liability (unfunded projected benefit obligation) should be recognized. If the fair value of plan assets exceeds the projected benefit obligation, an asset (overfunded projected benefit obligation) should be recognized. (FASB ASC 715-30-25-1) (formerly SFAS 87, par. 35) If the fair value of plan assets exceeds the projected benefit obligation, an asset should be recognized. In a classified statement of financial position, the liability for an underfunded plan may be presented as current, noncurrent, or a combination of both, depending upon the circumstances. Generally, the liability is current to the extent the present value of benefits payable in the next 12 months exceeds the fair value of plan assets. However, the asset for an overfunded plan must always be classified as noncurrent. (FASB ASC 715-20-45-3) (formerly SFAS 106, par. 44B) If the funded status of a plan is remeasured, or when net gains or losses, prior service costs or credits, or the net transition asset or obligation are amortized to pension expense, the related balances should be reclassified to net periodic pension cost, with a resulting contra adjustment being reported in the same line item or items within unrestricted net assets, apart from expenses, as the initially recognized amounts. (FASB ASC 715-30-25-4) (formerly SFAS 87, par. 38)

Measurement Date. Plan assets and pension obligations should be measured as of the employer's financial statement date. However, a different date may be used if the plan is sponsored by a subsidiary that is consolidated using a fiscal period different from its parent's or the plan is sponsored by an investee that is accounted for using the equity method and has a different fiscal period than its investor's. In those cases, the subsidiary's plan assets and pension obligations should be measured as of the date used to consolidate the subsidiary's statement of financial position, and the investee's plan assets and pension obligations should be measured as of the date of the investee's financial statements used to apply the equity method. (FASB ASC 715-30-20; 715-30-35-62 and 35-63) (formerly SFAS 87, par. 52)

Annuity Contracts. Employers who sponsor defined benefit plans sometimes enter into irrevocable contracts with insurance companies to cover benefit obligations. The contracts, which are referred to as *annuity* or *allocated* contracts, transfer the risk of providing benefits from the employer and plan to the insurance company. (For purposes of applying the accounting requirements for pension plans, the definition of an annuity contract is not met if there is a reasonable doubt that the insurer will meet its obligation or if the contract is with a captive insurance company, that is, one that does business primarily with the employer and its related parties.) If a plan is funded through annuity contracts that cover all plan obligations, the insurance premium is the pension cost the employer should charge to expense, and the organization and the plan would have no plan assets or projected benefit obligation. If annuity contracts cover only a portion of the benefit obligation, however, the employer still has a responsibility to fund the uncovered obligation. In that case, the uncovered obligation would be accounted for following the guidance in the preceding paragraphs of this lesson. (FASB ASC 715-30-20; 715-30-35-53 through 35-55) (formerly SFAS 87, paras. 57–60)

Annuity contracts may be participating contracts. In a participating contract, the insurer pays to the purchaser a portion of the income it receives from investing the premiums. Usually, the payments are in the form of dividends and are used to reduce the plan's costs. Participating contracts generally cost more than nonparticipating contracts. The cost difference relates to the participation right and should be recorded as a plan asset. In subsequent years, the participation right should be measured at fair value. If fair value is not reasonably estimable, the asset should be recorded at cost and amortized over the dividend period under the contract. (FASB ASC 715-30-25-7; 715-30-35-57 and 35-58) (formerly SFAS 87, paras. 58 and 61)

Business Combinations. When a single-employer defined benefit pension plan is acquired as part of a business combination an asset or liability should be recognized for the funded status of the plan. The amount recognized should reflect any necessary changes in assumptions about future events but exclude the effects of expected plan amendments, terminations, or curtailments the acquirer is not obligated to make. (FASB ASC 805-20-25-23; 805-20-30-15) (formerly SFAS 87, par. 74)

SELF-STUDY QUIZ

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

18. Up Ward People (UWP) Organization provides its pension plan participants with an annual retirement benefit equal to 3% of the participant's annual salary for the five years preceding retirement for each year of employment, up to a maximum of 30 years. UWP's pension plan is a defined contribution plan.

    a. True.

    b. False.

19. Up Ward People (UWP) Organization provides its pension plan participants with an annual retirement benefit equal to 3% of the participant's annual salary for the five years preceding retirement for each year of employment, up to a maximum of 30 years. Which of the following components related primarily to employee service rendered during the period will UWP use to accrue the annual pension cost?

    a. Actual return on plan assets.

    b. Gains and losses.

    c. Forfeitures of other participants' benefits.

20. Which of the following is needed to compute interest cost for a defined benefit plan?

    a. Fair value of plan assets.

    b. Employee service during the period.

    c. Remaining service lives of plan participants.

    d. Projected benefit obligation.

21. A nonprofit organization computes market-related value by recognizing changes in value over five years. Market related value at the beginning of the year is $2,000 and net asset gains and losses over the past five years are $700. The employer contributions during the year were $500, benefit payments were $300, and the expected long-term rate of return is 10%. What is the market-related value at the end of the year?

    a. $2,540.

    b. $3,100.

    c. $3,140.

    d. $4,340.

22. A nonprofit organization has a defined benefit plan. The projected benefit obligation is $100,000 and the fair value of the plan assets is $75,000. How is the funded status of the pension benefit plan presented in the nonprofit organization's financial statements?

    a. As an expense.

    b. As an asset.

    c. As a liability.

23. A nonprofit organization has a defined benefit plan. The plan is funded through annuity contracts that cover all plan obligations. The insurance premium for 20X9 was $10,000, the benefit obligation is $200,000 and the fair value of the annuity contracts is $150,000. Which of the following must the nonprofit organization report on its financial statements regarding the annuity contracts?

    a. The nonprofit organization does not report information regarding the annuity contracts.

    b. $10,000 of pension cost charged to expense.

    c. $50,000 of unfunded liability.

    d. $150,000 of plan assets.

SELF-STUDY ANSWERS

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

18. Up Ward People (UWP) Organization provides its pension plan participants with an annual retirement benefit equal to 3% of the participant's annual salary for the five years preceding retirement for each year of employment, up to a maximum of 30 years. UWP's pension plan is a defined contribution plan. **(Page 178)**

    a. True. [This answer is incorrect. A defined contribution plan provides an individual account for each participant and specifies how contributions to the individual's account are to be determined.]

    b. False. [This answer is correct. This is a defined benefit plan. A defined benefit plan provides specified benefits to plan participants. The benefits are based on a variety of factors including a participant's age, years of service, and compensation.]

19. Up Ward People (UWP) Organization provides its pension plan participants with an annual retirement benefit equal to 3% of the participant's annual salary for the five years preceding retirement for each year of employment, up to a maximum of 30 years. Which of the following components related primarily to employee service rendered during the period will UWP use to accrue the annual pension cost? **(Page 179)**

    a. Actual return on plan assets. [This answer is correct. The three components of the annual pension cost of a defined benefit pension plan that are related primarily to employee service rendered during the period are service cost, interest cost on the projected benefit obligation, and actual return on plan assets.]

    b. Gains and losses. [This answer is incorrect. This is one of the six components of the annual pension cost of a defined benefit pension plan, but gains and losses are related primarily to prior period results.]

    c. Forfeitures of other participants' benefits. [This answer is incorrect. This is a component of a plan participant's benefits in a defined contribution plan.]

20. Which of the following is needed to compute interest cost for a defined benefit plan? **(Page 180)**

    a. Fair value of plan assets. [This answer is incorrect. The fair value of plan assets at the beginning of the year is needed to compute the *actual return on plan assets*.]

    b. Employee service during the period. [This answer is incorrect. This information is needed to compute service cost.]

    c. Remaining service lives of plan participants. [This answer is incorrect. This information is needed to compute the amortization of prior service cost.]

    d. Projected benefit obligation. [This answer is correct. The information needed to compute interest cost is (a) the projected benefit obligation and (b) an assumed discount rate.]

21. A nonprofit organization computes market-related value by recognizing changes in value over five years. Market related value at the beginning of the year is $2,000 and net asset gains and losses over the past five years are $700. The employer contributions during the year were $500, benefit payments were $300, and the expected long-term rate of return is 10%. What is the market-related value at the end of the year? **(Page 181)**

    a. $2,540. [This answer is correct. The market-related value at the end of the year is calculated by adding the market related value at the beginning of the year to the *expected return on plan assets* for the year, plus the net gain (loss) to be included in market related value, plus employer contributions, less benefit payments ($2,000 + ($2,000 × 10%) + ($700 × 5) + 500 − 300).]

    b. $3,100. [This answer is incorrect. The net gain (loss) to be included in market-related value is the average of net gains (losses) over the five year period.]

    c. $3,140. [This answer is incorrect. Benefit payments reduce the market-related value.]

    d. $4,340. [This answer is incorrect. The expected return on assets for the year is the market value at the beginning of the year multiplied by the expected rate of return.]

22. A nonprofit organization has a defined benefit plan. The projected benefit obligation is $100,000 and the fair value of the plan assets is $75,000. How is the funded status of the pension benefit plan presented in the nonprofit organization's financial statements? **(Page 182)**

    a. As an expense. [This answer is incorrect. The funded status of pension benefit plans should be recognized in the statement of financial position.]

    b. As an asset. [This answer is incorrect. If the fair value of plan assets exceeds the projected benefit obligation, an asset should be recognized.]

    c. As a liability. [This answer is correct. If the projected benefit obligation exceeds the fair value of the plan assets, a liability should be recognized. In a classified statement of financial position, the liability for an underfunded plan may be presented as current, noncurrent, or a combination of both.]

23. A nonprofit organization has a defined benefit plan. The plan is funded through annuity contracts that cover all plan obligations. The insurance premium for 20X9 was $10,000, the benefit obligation is $200,000 and the fair value of the annuity contracts is $150,000. Which of the following must the nonprofit organization report on its financial statements regarding the *annuity* contracts? **(Page 182)**

    a. The nonprofit organization does not report information regarding the annuity contracts. [This answer is incorrect. Although the contracts transfer the risk of providing benefits from the employer and plan to the insurance company, certain information amounts are included in the financial statements of the nonprofit organization.]

    b. $10,000 of pension cost charged to expense. [This answer is correct. If a plan is funded through *annuity* contracts that cover all plan obligations, the insurance premium is the pension cost the employer should charge to expense, and the organization and plan have no plan assets or projected benefit obligation.]

    c. $50,000 of unfunded liability. [This answer is incorrect. If *annuity* contracts cover only a portion of the benefit obligation, the employer has a responsibility to fund the uncovered obligation, and should, therefore, report a liability.]

    d. $150,000 of plan assets. [This answer is incorrect. The fair value of plan assets is used to calculate the funded status of the benefit plan. The organization has no plan assets when the plan is funded through *annuity* contracts that cover all plan obligations.]

Employers with More Than One Defined Benefit Plan

Employers with more than one plan are required to separately determine net periodic pension cost, liabilities, and assets for each plan sponsored. Thus, an employer may not offset a liability related to one plan with an asset related to another unless the employer has the right to use the assets of one plan to pay the liabilities and benefits of another. (FASB ASC 715-30-25-6) (formerly SFAS 87, par. 55)

Settlements and Curtailments of Defined Benefit Pension Plans

As previously discussed, SFAS No. 87 allowed for the delayed recognition of net gains and losses, prior service costs, and the net transition asset or obligation that arose when that Statement was adopted. Those amounts carried forward and are included in the change in unrestricted net assets at the adoption of SFAS No. 158. However, all or part of those amounts may become recognized in a pension plan settlement or curtailment. (FASB ASC 715-30-05-9) (formerly SFAS 88, summary and par. 24)

a. A *settlement* essentially eliminates the plan's obligation for benefits. To be considered a settlement, the transaction should (FASB ASC 715-30-20) (formerly SFAS 88, par. 3):

    (1) be an irrevocable action;

    (2) relieve the organization (or the plan) of primary responsibility for a pension benefit obligation; and

    (3) eliminate significant risks related to the obligation and the assets used to effect the settlement.

    Examples of settlements are purchasing annuity contracts or making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits. (FASB ASC 715-30-15-6) (formerly SFAS 88, par. 3)

b. A *plan curtailment* generally prevents the pension benefit obligation from growing for future services of present employees. Examples of a curtailment are (1) terminating employee services through closing a facility or discontinuing a program and (2) terminating (or suspending) a plan. In both situations, the plan's obligation is not relieved, but generally will not increase. (FASB ASC 715-30-15-6; 715-30-20) (formerly SFAS 88, par. 6)

A settlement or curtailment may occur together or as separate transactions. For example, when the expected future years of service of certain employees are reduced due to a layoff but the plan continues to exist, a curtailment has occurred but not a settlement. If the employer's defined benefit pension plan is terminated without replacement, and settlement of the plan obligation occurs, a curtailment and settlement have resulted. Finally, when the employer settles all or a portion of its plan obligation and still provides defined benefits to employees for their future service, a settlement has taken place but not a curtailment. (FASB ASC 715-30-35-74; 715-30-35-76 through 35-78) (formerly SFAS 88, par. 7)

Settlements. Since plan settlements involve eliminating an obligation, a gain or loss should be recognized at the time of settlement. If the employer settles the entire pension obligation, the gain or loss can be viewed as the balancing entry needed to record any plan assets reverting back to the employer plus the adjustment needed to eliminate any amounts previously recognized as changes in unrestricted net assets but that have not yet been reclassified to net periodic pension cost. In such cases, the maximum gain or loss on plan settlement should be recognized. That amount is based on balances measured as of the settlement date and equals the total of (a) any net gain or loss previously recognized but not yet reclassified to net periodic pension cost and (b) any net transition asset remaining from the initial adoption of SFAS No. 87. (FASB ASC 715-30-35-79) (formerly SFAS 88, par. 9)

It is not uncommon for participants who are partially vested to withdraw from a plan because of voluntary or involuntary termination of employment, and then to be "cashed out" of the plan as of the withdrawal date. Also, some plans may purchase annuity contracts each year to cover the year's benefit accruals. In such cases, gain or loss on settlement should be determined as follows: (FASB ASC 715-30-35-79 and 35-82) (formerly SFAS 88, paras. 9 and 11 and QA 88, par. 45)

a. If only a portion of the pension obligation is settled, the employer should recognize a prorata portion of the maximum gain or loss. For example, if a settlement results in a 30% reduction of the projected benefit obligation, only 30% of the maximum gain or loss should be recognized.

b. If the cost of all settlements in a year are less than or equal to the sum of the service cost and interest cost components of the year's net periodic pension cost, gain or loss may be recognized following the guidance in item a. (Gain or loss recognition is not required, however.) Once adopted, the accounting policy for small settlements should be used consistently.

   The cost of a settlement is the amount paid to relieve the employer of its obligation to provide benefit payments. For example, (1) the cost of a settlement paid in cash is the amount of cash paid to the employee, (2) the cost of a settlement made by purchasing a nonparticipating annuity contract is the cost of the contract, and (3) the cost of a settlement made by purchasing a participating annuity contract is the cost of the contract net of the amount paid for the participation right. (FASB ASC 715-30-35-83) (formerly SFAS 88, par. 11)

Exhibit 2-1 illustrates calculating the gain or loss on a partial plan settlement.

Exhibit 2-1

Calculating the Gain or Loss on Partial Settlement

Assumptions

1. On December 31, 20X5, ABC Organization purchased nonparticipating annuity contracts to cover the benefits of all retired participants.

2. On December 30, 20X5, the plan's projected benefit obligation was comprised of the following:

Cost of settling retirees' benefits (cost of purchasing nonparticipating annuities)	$ 50,000
Benefits not settled (active employees)	35,000
	$ 85,000

3. On December 30, 20X5, the organization's statement of financial position reflected the following:

Net plan asset, consisting of:	
Projected benefit obligation	$ (85,000)
Plan assets	100,000
Amounts previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost:	
Prior service costs	12,000
Net loss	10,000
Net obligation at the time SFAS No. 87 was adopted	(25,000)

Maximum gain (loss) on settlement

Net loss prior to settlement	$ (10,000)
Net obligation at the time SFAS No. 87 was adopted	25,000
Maximum gain recognizable	$ 15,000

Reduction in the projected benefit obligation as a result of the settlement

$$\frac{\text{Projected benefit obligation settled}}{\text{Total projected benefit obligation}} = \frac{\$\,50{,}000}{\$\,85{,}000} = 58.8\%$$

Settlement gain

Maximum gain recognizable	$ 15,000
Reduction in projected benefit obligation	× 58.8 %
Settlement gain	$ 8,820

* * *

Settlement gains and losses generally do not meet the criteria for treatment as extraordinary items. Consequently, they are reported in the statement of activities as an ordinary gain or loss.

Curtailments. A curtailment generally prevents the projected benefit obligation from growing for all or a portion of the plan's participants. It may eliminate coverage for certain participants, eliminate future defined benefit accruals (e.g., freezing the plan), or both. The following two components comprise the effects of a plan curtailment: (FASB ASC 715-30-35-92) (formerly SFAS 88, par. 12)

a. *Decrease in Prior Service Cost Previously Recognized in Changes in Unrestricted Net Assets But Not Yet Reclassified to Net Periodic Pension Cost.* For purposes of applying FASB ASC 715 (formerly SFAS 88) to curtailments, prior service cost includes any net transition obligation remaining from the initial adoption of SFAS No. 87 as well as any prior service cost previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost. Such costs should be written off in proportion to the reduction in the remaining future years of service at the date of the curtailment. For example, if a plan curtailment eliminates 30% of the estimated future years of service of active employees receiving prior service credit, the loss on curtailment related to prior service cost is 30% of the combined unrecognized prior service cost and remaining net transition obligation. Note that the amount of loss recognized on the decrease in prior service cost is not part of the gain or loss on plan curtailment (see item b. below) but it is included in the total effects of a plan curtailment.

b. *Curtailment Gain or Loss.* Gains and losses should be recognized for changes in the projected benefit obligation that result from curtailments. If a curtailment causes a plan's projected benefit obligation to decrease (for example, because the effects of future salary increases are eliminated), a gain would result. Conversely, a loss results if a curtailment causes the projected benefit obligation to increase (for example, because a plan's benefit formula creates additional benefits for employees who retire early). To compute a curtailment gain or loss, the employer first should determine the decrease or increase in the projected benefit obligation resulting from the curtailment (excluding increases arising from termination benefits). The employer then should compare that amount to the total of any net gain or loss previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost plus any net transition asset remaining from the initial adoption of SFAS No. 87. (FASB ASC 715-30-35-93) (formerly SFAS 88, par. 13)

   (1) If the change in the projected benefit obligation is a decrease (gain) and a net loss has previously been recognized but not yet reclassified to net periodic pension cost, a curtailment gain exists to the extent the decrease in the projected benefit obligation exceeds the net loss.

   (2) If the change in the projected benefit obligation is a decrease (gain) and there is no net loss previously recognized that has not been reclassified to net periodic pension cost, a curtailment gain exists equal to the entire decrease in the projected benefit obligation.

   (3) If the change in the projected benefit obligation is an increase (loss) and a net gain has previously been recognized but not yet reclassified to net periodic pension cost, a curtailment loss exists to the extent the increase in the projected benefit obligation exceeds the net gain.

   (4) If the change in the projected benefit obligation is an increase (loss) and there is no net gain previously recognized that has not been reclassified to net periodic pension cost, a curtailment loss exists equal to the entire increase in the projected benefit obligation.

If the total effect of a pension plan curtailment (that is, the sum of items a. and b. in the preceding paragraph) results in a loss, the loss should be recognized when it is probable that the curtailment will occur and the effects of the curtailment can be reasonably estimated. If the total effect of a curtailment results in a gain, the gain should be recognized when the affected employees terminate or when the employer adopts the plan suspension or amendment. (FASB ASC 715-30-35-94) (formerly SFAS 88, par. 14) Curtailment gains and losses are reported in the employer's statement of activities as ordinary gains and losses. Exhibit 2-2 presents several examples of computing a curtailment gain or loss based on the preceding measurement criteria.

Exhibit 2-2

Calculating the Effect of Curtailments

Example 1

Decrease in prior service cost as a result of the curtailment	$ (2,000)
Combined gain (loss) at date of curtailment:	
Net loss previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost	$ (7,000)
Net transition asset remaining from the time SFAS No. 87 was adopted	6,500
Combined loss	$ (500)
Increase (loss) in projected benefit obligation as a result of the curtailment	$ (6,000)

Because there is no net gain previously recognized that has not been reclassified to net periodic pension cost, a curtailment loss exists equal to the entire $6,000 increase in the projected benefit obligation. The total effect of the curtailment is an $8,000 loss ($2,000 loss due to the decrease in prior service cost plus the $6,000 curtailment loss). The loss should be recognized when it is probable that the curtailment will occur.

Example 2

Decrease in prior service cost as a result of the curtailment	$ (2,000)
Combined gain at date of curtailment:	
Net gain previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost	$ 9,000
Net transition asset remaining from the time SFAS No. 87 was adopted	6,500
Combined gain	$ 15,500
Increase (loss) in projected benefit obligation as a result of the curtailment	$ (6,000)

No curtailment loss exists because the combined gain exceeds the increase in the projected benefit obligation. The total effect of the curtailment is a $2,000 loss (the $2,000 loss due to the decrease in prior service cost). The loss should be recognized when it is probable that the curtailment will occur.

Example 3

Decrease in prior service cost as a result of the curtailment	$ (2,000)
Combined gain at date of curtailment:	
Net gain previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost	$ 7,000
Net transition asset remaining from the time SFAS No. 87 was adopted	6,500
Combined gain	$ 13,500
Decrease (gain) in projected benefit obligation as a result of the curtailment	$ (6,000)

Because there is no net loss, a curtailment gain exists equal to the entire $6,000 decrease in the projected benefit obligation. The total effect of the curtailment is a $4,000 gain ($2,000 loss due to the decrease in prior service cost plus the $6,000 curtailment gain). The gain should be recognized when the affected employees terminate or when the employer adopts the plan suspension or amendment.

Example 4

Decrease in prior service cost as a result of the curtailment	$ (2,000)
Combined gain (loss) at date of curtailment:	
Net loss previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost	$ (9,000)
Net transition asset remaining from the time SFAS No. 87 was adopted	6,500
Combined loss	$ (2,500)
Decrease (gain) in projected benefit obligation as a result of the curtailment	$ 6,000

A curtailment gain exists since the decrease in the projected benefit obligation exceeds the combined loss. The curtailment gain is equal to the excess of the decrease in the projected benefit obligation over the combined loss or $3,500 ($6,000 − $2,500). The total effect of the curtailment is a $1,500 gain ($2,000 loss due to the decrease in prior service cost plus the $3,500 curtailment gain). The gain should be recognized when the affected employees terminate or when the employer adopts the plan suspension or amendment.

* * *

Termination Benefits

Employers sometimes provide benefits to employees when employment is terminated. Such termination benefits are often in the form of periodic future payments, lump-sum payments, or both. Furthermore, benefits may be paid from the employer's unrestricted net assets, an existing employee benefit plan, a newly formed plan, or a combination of all three. The cost of termination benefits that should be recognized by the employer is the lump-sum payments made and/or the present value of future payments. (FASB ASC 715-30-25-9 through 25-11) (formerly SFAS 88, par. 15)

The date on which termination benefits should be accrued depends on whether the benefits are special or contractual termination benefits.

- *Special Termination Benefits.* Termination benefits that are offered for only a short period of time are referred to as "special termination benefits." Special termination benefits should be accrued when an employee accepts the employer's offer and the amount of benefits can be reasonably estimated. (FASB ASC 715-30-25-10; 715-30-55-186) (formerly SFAS 88, par. 15 and QA 88, par. 61)

- *Contractual Termination Benefits.* As its name implies, contractual termination benefits are those required by the terms of a separate agreement or the terms of an existing employee benefit plan. Contractual termination benefits are provided only as the result of a specified event. Examples of such events include the closing of a facility or the early retirement of employees. Recognition of contractual termination benefits occurs in the employer's financial statements when (a) it is probable that employees will be entitled to benefits and (b) the amount of benefits to be provided can be reasonably estimated. (FASB ASC 715-30-55-189) (formerly QA 88, par. 60)

SELF-STUDY QUIZ

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

24. A nonprofit organization has a defined benefit plan. At the end of 20X8 it had a pension benefit obligation of $100,000. On January 1, 20X9, the organization purchased annuity contracts that cover the entire obligation. Which of the following will be a result of this transaction on the organization's 20X9 financial statements?

    a. The pension benefit obligation is not relieved.

    b. A gain or loss will be recognized as a balancing entry.

    c. A gain will be recognized when the employer adopts the plan suspension.

    d. A loss will be recognized when it is probable that the curtailment will occur.

25. On December 31, 20X9, ABC Organization purchased nonparticipating annuity contracts to cover the benefits of all retired participants. On December 30, 20X9, the plan's projected benefit obligation was comprised of $70,000 of cost to settle retirees' benefits and $30,000 of benefits not settled. Also, the net loss previously recognized but not yet reclassified to net periodic pension cost was $12,000, and the net obligation at the time SFAS No. 87 was adopted was $20,000. What is ABC's settlement gain?

    a. $5,600.

    b. $8,000.

    c. $22,400.

    d. $100,000.

26. A nonprofit organization has a defined benefit plan. On December 31, 20X9, the organization amended its plan to create additional benefits for employees who retire early. The decrease in prior service cost as a result of the curtailment is $3,000, and the increase in projected benefit obligation is $4,000. The net loss previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost is $6,000, and the net transition asset remaining from the time SFAS No. 87 was adopted is $5,000. What is the total effect of the curtailment?

    a. $1,000 loss.

    b. $3,000 loss.

    c. $4,000 loss.

    d. $7,000 loss.

SELF-STUDY ANSWERS

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

24. A nonprofit organization has a defined benefit plan. At the end of 20X8 it had a pension benefit obligation of $100,000. On January 1, 20X9, the organization purchased annuity contracts that cover the entire obligation. Which of the following will be a result of this transaction on the organization's 20X9 financial statements? **(Page 189)**

    a. The pension benefit obligation is not relieved. [This answer is incorrect. The plan's obligation is not relieved in a *curtailment*.]

    b. A gain or loss will be recognized as a balancing entry. [This answer is correct. Purchasing annuity contracts is an example of a settlement. Since plan settlements involve eliminating an obligation, a gain or loss should be recognized at the time of settlement. If the employer settles the entire pension obligation, the gain or loss can be viewed as the balancing entry needed to record any plan assets reverting back to the employer plus the adjustment needed to eliminate any amounts previously recognized as changes in unrestricted net assets but that have not yet been reclassified to net periodic pension cost.]

    c. A gain will be recognized when the employer adopts the plan suspension. [This answer is incorrect. If the total effect of a *curtailment* results in a gain, the gain should be recognized when the affected employees terminate or when the employer adopts the plan suspension or amendment.]

    d. A loss will be recognized when it is probable that the curtailment will occur. [This answer is incorrect. If the total effect of a pension plan curtailment results in a loss, the loss should be recognized when it is probable that the *curtailment* will occur and the effects of the curtailment can be reasonably estimated.]

25. On December 31, 20X9, ABC Organization purchased nonparticipating annuity contracts to cover the benefits of all retired participants. On December 30, 20X9, the plan's projected benefit obligation was comprised of $70,000 of cost to settle retirees' benefits and $30,000 of benefits not settled. Also, the net loss previously recognized but not yet reclassified to net periodic pension cost was $12,000, and the net obligation at the time SFAS No. 87 was initially adopted was $20,000. What is ABC's settlement gain? **(Pages 189–190)**

    a. $5,600. [This answer is correct. If only a portion of the pension obligation is settled, the employer should recognize a prorata portion of the maximum gain or loss. This settlement resulted in a 70% reduction of the projected benefit obligation, so only 70% of the maximum gain or loss should be recognized.]

    b. $8,000. [This answer is incorrect. The portion of the pension obligation that has been settled is also included in the settlement gain calculation.]

    c. $22,400. [This answer is incorrect. The net loss prior to settlement reduces the amount of maximum gain.]

    d. $100,000. [This answer is incorrect. This is the projected benefit obligation before the settlement. This amount is used to calculate the percent reduction of the projected benefit obligation.]

26. A nonprofit organization has a defined benefit plan. On December 31, 20X9, the organization amended its plan to create additional benefits for employees who retire early. The decrease in prior service cost as a result of the curtailment is $3,000, and the increase in projected benefit obligation is $4,000. The net loss previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost is $6,000, and the net transition asset remaining from the time SFAS No. 87 was initially adopted is $5,000. What is the total effect of the curtailment? **(Pages 191–192)**

    a. $1,000 loss. [This answer is incorrect. That is the combined loss.]

    b. $3,000 loss. [This answer is incorrect. This would be the total effect if there was a combined gain that exceeded the increase in the projected benefit obligation.]

    c. $4,000 loss. [This answer is incorrect. Because there is no net gain previously recognized that has not been reclassified to net periodic pension cost, a curtailment loss exists equal to the entire $4,000 increase in the projected benefit obligation. However, this is not the entire total effect of the curtailment.]

    d. $7,000 loss. [This answer is correct. Because there is no net gain previously recognized that has not been reclassified to net periodic pension cost, a curtailment loss exists equal to the entire $4,000 increase in the projected benefit obligation. The total effect of the curtailment is a $7,000 loss ($3,000 loss due to the decrease in prior service cost plus the $4,000 curtailment loss). The loss should be recognized when it is probable that the curtailment will occur.]

ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

Determining the Net Periodic Postretirement Benefit Cost and Obligation

The cost of providing postretirement benefits should be charged to expense during the period related employee services are rendered. That is accomplished through a combination of current accruals and amortization of prior results. Thus, the annual cost of a postretirement benefit plan consists of the following components: (FASB ASC 715-60-35-7; 715-60-35-9) (formerly SFAS 106, paras. 45–46)

Related primarily to employee service rendered during the period:

a. Service cost

b. Interest cost on the plan's obligation to provide benefits

c. Actual return on plan assets

Amortization of prior period results:

d. Amortization of prior service cost or credit

e. Gains and losses

f. Amortization of the net transition asset or obligation

For defined benefit postretirement plans other than pensions, this annual cost is referred to as the *net periodic postretirement benefit cost.*

Service Cost. *Service cost* relates only to employee service rendered during the year and is computed as the actuarial present value of benefits attributed by the postretirement benefit formula to employee service during the period. It requires assumptions about the attrition of present participants and future changes in their compensation and ignores participants that may be added to the plan in the future. (FASB ASC 715-60-20; 715-60-35-10) (formerly SFAS 106, par. 47)

Generally, an equal amount of a participant's expected postretirement benefit obligation should be attributed to each year in the attribution period. The attribution period typically begins on the employee's date of hire and ends when the employee has performed all of the services necessary to become fully eligible for benefits under the plan. In some cases, however, a plan's benefit formula may (a) require a participant to work for a specified period before benefits accrue or (b) attribute a disproportionate share of the expected benefit obligation to the participant's early years of service. In such cases, the estimated postretirement benefit obligation should be attributed to years of service in accordance with the plan's benefit formula. (FASB ASC 715-60-35-62 through 35-64 , 35-66, and 35-68) (formerly SFAS 106, paras. 43, 44, and 411–412; QA 106, par. 18)

Service cost for the period should consider automatic benefit changes required by plan terms, such as cost-of-living increases, or that result from plan amendments already in effect. In addition, employers that have a history of providing plan benefits greater than those defined in writing should base their accounting on the *substantive commitment* and disclose those commitments in their financial statements. (FASB ASC 715-60-35-56; 715-60-35-58) (formerly SFAS 106, paras. 26 and 28)

Interest Cost. Interest cost reflects interest for the year on the plan's obligation to provide benefits. The information needed to compute interest cost is (a) the accumulated benefit obligation and (b) an assumed discount rate. The accumulated benefit obligation is the actuarial present value of benefits expected to be paid to current plan participants in the future. (FASB ASC 715-60-35-11) (formerly SFAS 106, par. 48) The accumulated benefit obligation requires assumptions about the attrition rates and future compensation levels for current participants but does not consider that additional employees will become plan participants in future years. (FASB ASC 715-60-35-3) (formerly SFAS 106, par. 12) The discount rate is based on current market conditions and, therefore, may vary from year to year.

Actual Return on Plan Assets. *Actual return on plan assets* generally represents the after tax effects of realized and unrealized investment gains and losses and any interest or dividends received. The actual return on plan assets is computed as the fair value of plan assets at the beginning of the year plus contributions during the year minus (a) benefits paid during the year, (b) the fair value of plan assets at the end of the year, and (c) the tax effects of those amounts (if the fund holding the plan assets is subject to income taxes). A net return on plan assets decreases postretirement benefit cost for the period. (FASB ASC 715-60-20) (formerly SFAS 106, paras. 49 and 518)

Amortization of Prior Service Cost or Credit. The cost of providing benefits related to services rendered before a plan was adopted or amended should be recognized as a separate line item (or included in one line item with gains and losses and the remaining transition asset or obligation) within changes in unrestricted net assets, apart from expenses, at the date of the adoption or amendment. That prior service cost should be amortized over the remaining years of service to full eligibility for benefits of participants who are active at the date of the plan adoption or amendment but not yet fully eligible for benefits. If most of the plan's participants are fully eligible for benefits, however, prior service cost should be amortized over the expected remaining lives of the participants. The amortization of prior service cost is recognized by reclassifying a portion of the prior service costs or credits that were previously recognized in net periodic postretirement benefit cost. The resulting contra adjustment should be reported in the same line item within changes in unrestricted net assets, apart from expenses, as the initially recognized amounts. (FASB ASC 715-60-35-17) (formerly SFAS 106, par. 52)

So long as it is applied consistently, an alternative amortization method that amortizes prior service cost more rapidly may be used. For example, to reduce the complexity of the amortization calculations, it may be preferable to amortize prior service cost over the average remaining service period to full eligibility for benefits of all active participants using the straight-line method. Also, if the period that benefits are expected to be realized from a retroactive plan amendment is shorter than the remaining future service period of active participants, prior service cost should be amortized over the future periods expected to benefit from the amendment. (FASB ASC 715-60-35-18 and 35-19) (formerly SFAS 106, paras. 53–54)

Plan amendments that decrease the cost of providing postretirement benefits also decrease the accumulated benefit obligation. Decreases in the accumulated benefit obligation should be recognized as a prior service credit in a separate line item within changes in unrestricted net assets, apart from expenses. These decreases should first be used to reduce any remaining prior service cost that has previously been included in changes in unrestricted net assets but has not yet been reclassified as a component of net periodic postretirement benefit cost, then to reduce any transition obligation that has previously been included in changes in unrestricted net assets but has not yet been reclassified as a component of net periodic postretirement benefit cost. The excess, if any, should be amortized on the same basis as increases in prior service cost (that is, amortized over the remaining years of service to full eligibility of active plan participants). (FASB ASC 715-60-35-20) (formerly SFAS 106, par. 55)

Gains and Losses. *Gains and losses* arise when the following occur: (FASB ASC 715-60-20; 715-60-35-23 through 35-27) (formerly SFAS 106, paras. 56–58 and 518)

a. *Assumptions Used to Compute the Accumulated Benefit Obligation Change.* The gain or loss is the difference between the projected value of the year-end postretirement benefit obligation based on beginning-of-year assumptions and the actual year-end obligation based on end-of-year assumptions.

b. *Actual Results Differ from the Expected Return on Plan Assets.* The gain or loss is the difference between the actual and expected return on plan assets. The following discuss how the actual and expected returns on plan assets are determined:

   (1) As discussed, the actual return on plan assets is computed as the difference between the fair value of plan assets at the beginning and end of the period, adjusted for contributions and benefit payments made during the period.

   (2) The expected return on plan assets is computed by multiplying the plan's expected long-term rate of return by the beginning of the year *market-related value of plan assets*. The market-related value of plan assets is determined by using either the fair value of plan assets or by computing a value that recognizes changes in the fair value of plan assets systematically over a period not to exceed five years. For example, rather than using fair value, an organization may compute market-related value

by recognizing changes in value over five years. Assuming market-related value at the beginning of the year is $1,200 and net asset gains and losses over the past five years are $580, the market-related value of plan assets at the end of the year would be computed as follows: (Expected long-term rate of return and amounts for contributions and benefit payments are assumed.)

Market-related value at beginning of year	$	1,200
Expected return on assets for the year ($1,200 × 10% expected long-term rate of return)		120
Net gain (loss) to be included in market-related value ($580 ÷ 5 years)		116
Employer contributions		400
Benefit payments		(200)
Market-related value at end of year	$	1,636

Market-related value may be computed differently for each class of plan assets; however, the method of computing market-related value for each class should be used consistently from year to year. For example, an employer may use the fair value for equity securities and a five-year moving average for bonds and other debt securities.

Generally, the gains and losses discussed in the preceding paragraph (frequently referred to as actuarial gains and losses) are not required to be included in postretirement benefit expense in the period they arise. Instead, they may be recognized as a separate line item (or included in one line item with the amortization of prior service cost or credit and the amortization of the remaining transition asset or obligation) within changes in unrestricted net assets, apart from expenses. Amortization is required in any year in which the beginning of the year net gain or loss that has previously been recognized in the changes in unrestricted net assets but has not yet been reclassified as a component of net periodic postretirement benefit cost exceeds 10% of the greater of (a) the accumulated benefit obligation or (b) the market-related value of plan assets. In such years, the amount of net gain or loss that must be included in net postretirement benefit cost is the excess net gain or loss (i.e., amount greater than 10% of accumulated benefit obligation or market-related value) divided by the average remaining service period of active participants (or, if substantially all plan participants are inactive, the average remaining lives of inactive participants). (FASB ASC 715-60-35-29 and 35-30) (formerly SFAS 106, par. 59)

An alternative amortization method may be used so long as it (a) reduces the net gain or loss that has previously been recognized in the changes in unrestricted net assets but has not yet been reclassified as a component of net periodic postretirement benefit cost by an amount in excess of that resulting from the minimum amortization method, (b) is applied similarly to both gains and losses, and (c) is systematic and used consistently. (FASB ASC 715-60-35-31) (formerly SFAS 106, par. 60)

Amortization of Net Transition Obligation or Asset. SFAS No. 106 gave an employer the option of either (a) immediately recognizing the difference between the fair value of plan assets and the accumulated benefit obligation as of the date SFAS No. 106 was adopted as a cumulative effect adjustment (to unrestricted net assets) or (b) amortizing the difference to expense over future years. (SFAS 106, par. 110) If amortized, that amortization continued after adoption of SFAS No. 158. As it is amortized, an amount is reclassified to net periodic postretirement benefit cost with a resulting contra adjustment reported in the same line item within changes in unrestricted net assets, apart from expenses, as the initial transition obligation or asset when SFAS No. 158 was initially adopted. The difference should be amortized using the straight-line method, with the amortization period being the average remaining service period of participants that were employed when SFAS No. 106 was adopted, with the following exceptions:

a. An employer may have chosen to amortize the difference over 20 years if the remaining service period of plan participants was less than 20 years.

b. An employer may be amortizing the difference over the expected remaining lives of plan participants when SFAS No. 106 was adopted if substantially all of the participants were not employed at that date.

c. An employer may have accelerated the amortization of the difference if cumulative benefit payments after adopting SFAS No. 106 exceeded cumulative postretirement benefit costs accrued after adopting SFAS No. 106. The additional amount that should be amortized is the excess cumulative benefit payments over cumulative benefit costs. When applying that requirement, cumulative benefit payments after adopting SFAS No. 106 should be reduced by any plan assets or any recognized postretirement benefit obligation at the date the Statement was adopted. In addition, payments made as part of a settlement should be included in the amount of cumulative benefits paid after adopting the Statement. (FASB ASC 715-60-35-39) (formerly SFAS 106, par. 112)

Retrospective Adjustments. An employer may temporarily change a plan's cost-sharing provisions to increase or decrease its share of the benefit costs incurred in current or past periods. For example, a postretirement health care plan may require retirees to pay, in the subsequent year, any shortfalls that result when current year benefit payments exceed current year employer cost and retiree contributions. If the shortfall in a single year is large, however, the employer may decide to deviate from the plan and absorb the shortfall so that retiree contributions do not increase significantly. When an employer temporarily changes a plan's cost-sharing provisions, the resulting gain or loss should be recognized immediately. (FASB ASC 715-60-35-35) (formerly SFAS 106, par. 61)

Recognition of Liabilities and Assets

The funded status of postretirement benefit plans should be recognized in the statement of financial position and measured as the difference between the fair value of plan assets and the accumulated postretirement benefit obligation. If the accumulated postretirement benefit obligation exceeds the fair value of plan assets, a liability should be recognized. If the fair value of plan assets exceeds the accumulated postretirement benefit obligation, an asset should be recognized. In a classified statement of financial position, the liability for an underfunded plan may be presented as current, noncurrent, or a combination of both, depending upon the circumstances. Generally, the liability is current to the extent the present value of benefits payable in the next 12 months exceeds the fair value of plan assets. However, the asset for an overfunded plan must always be classified as noncurrent. (FASB ASC 715-20-45-3; 715-60-25-1; and 715-60-35-5) (formerly SFAS 106, paras. 44A–44B)

Measuring Plan Assets. *Plan assets* consist of stocks, bonds, and other investments that have been segregated (usually in a trust) and restricted to the payment of postretirement benefits. Assets not restricted solely to provide postretirement benefits are not plan assets, even though the employer may intend to use them to satisfy its postretirement benefit obligation. Furthermore, plan assets do not include contributions that have been accrued but not paid. (FASB ASC 715-60-20) (formerly SFAS 106, paras. 63–64)

For disclosure purposes, plan investments should be measured at their fair values. (FASB ASC 715-60-35-107) (formerly SFAS 106, par. 65)

Plan assets used in plan operations, such as buildings or equipment, should be measured at cost less accumulated depreciation or amortization. (FASB ASC 715-60-35-107) (formerly SFAS 106, par. 66)

Insurance Contracts. Employers who sponsor defined benefit plans sometimes enter into irrevocable contracts with insurance companies to cover benefit obligations. The contracts transfer the risk of providing benefits from the employer and plan to the insurance company. (FASB ASC 715-60-20) (formerly SFAS 106, par. 518) Benefits covered by insurance contracts are not included in the accumulated postretirement benefit obligation. In addition, except for the cost of participation rights in a participating insurance contract, the insurance contracts are not included in plan assets. For purposes of applying the accounting requirements for postretirement benefit plans, the definition of an insurance contract is not met if there is a reasonable doubt that the insurer will meet its obligation or if the contract is with a captive insurance company (that is, one that does business primarily with the employer and its related parties). (FASB ASC 715-60-35-109 and 35-110) (formerly SFAS 106, par. 67)

Insurance contracts may be participating contracts. In a participating contract, the insurer pays to the purchaser a portion of the income it receives from investing the premiums. Usually, the payments are in the form of dividends and are used to reduce the plan's costs. Participating contracts generally cost more than nonparticipating contracts. The cost difference relates to the participation right and should be recorded as a plan asset. In subsequent years, the participation right should be measured at fair value. If fair value is not reasonably estimable, the asset should be recorded at cost and amortized over the dividend period under the contract. (FASB ASC 715-60-35-114 through 35-116) (formerly SFAS 106, paras. 68–69)

To the extent insurance contracts are purchased during the period to cover benefits attributed to service in the current period, the insurance premium is the postretirement benefit cost that should be charged to expense for the period. If the insurance contracts cover only a portion of the benefit obligation, however, the employer still has a responsibility to fund the uncovered obligation. In that case, the uncovered obligation would be accounted for following the guidance in the preceding paragraphs. (FASB ASC 715-60-35-118) (formerly SFAS 106, par. 70)

Measurement Date. Plan assets and benefit obligations should be measured as of the employer's financial statement date. However, a different date may be used if the plan is sponsored by a subsidiary that is consolidated using a fiscal period different from its parent's or the plan is sponsored by an investee that is accounted for using the equity method and has a different fiscal period than its investor's. In those cases, the subsidiary's plan assets and postretirement benefit obligations should be measured as of the date used to consolidate the subsidiary's statement of financial position, and the investee's plan assets and postretirement benefit obligations should be measured as of the date of the investee's financial statements used to apply the equity method. (FASB ASC 715-60-35-121 and 35-122) (formerly SFAS No. 106, par. 72)

Business Combinations. When a single employer defined benefit postretirement plan is acquired as part of a business combination, an asset or liability should be recognized for the funded status of the plan. The amount recognized should reflect any necessary changes in assumptions about future events but exclude the effects of expected plan amendments, terminations, or curtailments the acquirer is not obligated to make. (FASB ASC 805-20-25-25; 805-20-30-15) (formerly SFAS 106, par. 86)

SELF-STUDY QUIZ

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

27. Which of the following is true regarding the *service cost* component of a postretirement benefit plan?

    a. It includes participants that may be added to the plan in the future.

    b. The attribution period begins when the employee is fully eligible for benefits under the plan .

    c. Automatic benefit changes required by plan terms should be considered.

    d. An assumed discount rate is needed.

28. ABC Organization has a net return on plan assets for its postretirement benefit plan. How does this affect ABC's financial information?

    a. It increases the postretirement benefit cost for the period.

    b. It is used to compute the gain or loss component of the postretirement benefit plan.

    c. It is used to compute the expected return on plan assets.

    d. It is recognized as a separate line item within changes in unrestricted net assets.

SELF-STUDY ANSWERS

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

27. Which of the following is true regarding the *service cost* component of a postretirement benefit plan? **(Page 198)**

    a. It includes participants that may be added to the plan in the future. [This answer is incorrect. The calculation of *service costs* requires assumptions about the attrition of present participants and future changes in their compensation and ignores participants that may be added to the plan in the future.]

    b. The attribution period begins when the employee is fully eligible for benefits under the plan . [This answer is incorrect. The attribution period typically begins on the employee's date of hire and ends when the employee has performed all of the services necessary to become fully eligible for benefits under the plan.]

    c. Automatic benefit changes required by plan terms should be considered. [This answer is correct. *Service cost* for the period should consider automatic benefit changes required by plan terms, such as cost-of-living increases, or that result from plan amendments already in effect (FASB ASC 715-60-35-58) (formerly SFAS 106, par. 28).]

    d. An assumed discount rate is needed. [This answer is incorrect. The information needed to compute interest cost is the accumulated benefit obligation and an assumed discount rate.]

28. ABC Organization has a net return on plan assets for its postretirement benefit plan. How does this affect ABC's financial information? **(Page 199)**

    a. It increases the postretirement benefit cost for the period. [This answer is incorrect. A net return on plan assets *decreases* postretirement benefit cost for the period (FASB ASC 715-60-20) (formerly SFAS 106, par. 49).]

    b. It is used to compute the gain or loss component of the postretirement benefit plan. [This answer is correct. Gains or losses arise when actual results differ from the expected return on plan assets. The gain or loss is the difference between the actual and expected return on plan assets.]

    c. It is used to compute the expected return on plan assets. [This answer is incorrect. The expected return on plan assets is computed by multiplying the plan's expected long-term rate of return by the beginning of the year *market-related value of plan assets*.]

    d. It is recognized as a separate line item within changes in unrestricted net assets. [This answer is incorrect. The cost of providing benefits related to services rendered before a plan was adopted or amended should be recognized as a separate line item within changes in unrestricted net assets, apart from expenses, at the date of the adoption or amendment.]

Employers with More Than One Defined Benefit Postretirement Plan

Generally, an employer with more than one defined benefit postretirement plan should measure each plan separately. Postretirement health care plans may be aggregated and measured as one plan, however, if they meet the following criteria: (FASB ASC 715-60-35-129 and 35-130) (formerly SFAS 106, paras. 75 and 76)

a. The plans are unfunded (i.e., they have no assets).

b. The plans provide different benefits to the same group of employees or the same benefits to different groups of employees.

Similarly, an employer may separately aggregate plans that provide postretirement benefits other than health care benefits if they meet the preceding criteria.

Settlements and Curtailments of Defined Benefit Postretirement Plans

As discussed, SFAS No. 106 allowed for the delayed recognition of net gains and losses, prior service costs, and the net transition asset or obligation that arose when that Statement was adopted. Those amounts carried forward and are included in the change in unrestricted net assets at the adoption of SFAS No. 158. However, all or part of those amounts may become recognized in a postretirement benefit plan settlement or curtailment.

a. A *settlement* essentially eliminates the plan's obligation for benefits. To be considered a settlement, the transaction should (FASB ASC 715-60-20) (formerly SFAS 88, par. 3):

   (1) be an irrevocable action;

   (2) relieve the organization (or the plan) of primary responsibility for a benefit obligation; and

   (3) eliminate significant risks related to the obligation and the assets used to effect the settlement.

   Examples of settlements are purchasing long-term nonparticipating insurance contracts or making lump-sum cash payments to plan participants in exchange for their rights to receive specified benefits. (FASB ASC 715-60-15-16) (formerly SFAS 106, par. 90)

b. A *curtailment* generally prevents the postretirement benefit obligation from growing for future services of present employees. Examples of a curtailment are (1) terminating employee services earlier than expected, possibly as a result of closing a facility or discontinuing a program and (2) terminating (or suspending) a plan. In both situations, the plan's obligation is not relieved, but generally will not increase. (FASB ASC 715-60-15-17; 715-60-20) (formerly SFAS 106, par. 96)

A settlement or curtailment may occur together or as separate transactions. For example, when the expected future years of service of certain employees are reduced due to a layoff but the plan continues to exist, a curtailment has occurred but not a settlement. If the employer's defined benefit postretirement plan is terminated without replacement, and settlement of the plan obligation occurs, a curtailment and settlement have resulted. Finally, when the employer settles all or a portion of its plan obligation and still provides defined benefits to employees for their future service, a settlement has taken place but not a curtailment. (FASB ASC 715-60-35-172 through 35-175) (formerly SFAS 106, par. 100)

Settlements. Since plan settlements involve eliminating an obligation, a gain or loss should be recognized at the time of settlement. If the employer settles the entire benefit obligation, the maximum gain or loss can be viewed as the balancing entry needed to record any plan assets reverting back to the employer plus the adjustment needed to eliminate any amounts previously recognized as changes in unrestricted net assets but that have not yet been reclassified to net periodic postretirement benefit cost. In such cases, the maximum gain or loss on plan settlement should be recognized. That amount is based on balances measured as of the settlement date and equals the total of (a) any net gain or loss previously recognized but not yet reclassified to net periodic postretirement benefit cost and (b) any net transition asset from the adoption of SFAS No. 106 remaining in unrestricted net assets. (FASB ASC 715-60-35-150 and 35-151) (formerly SFAS 106, paras. 92 and 484)

It is not uncommon for some, but not all, participants to withdraw from a plan because of voluntary or involuntary termination of employment. Also, some plans may purchase insurance contracts each year to cover the year's benefit accruals. In such cases, gain or loss on settlement should be determined as follows:

a. If only a portion of the benefit obligation is settled, the employer should recognize a prorata portion of the maximum settlement gain over any remaining transition obligation or a pro rata portion of the maximum settlement loss. For example, if a settlement results in a 30% reduction of the accumulated benefit obligation, only 30% of the maximum gain or loss should be recognized. (FASB ASC 715-60-35-153) (formerly SFAS 106, par. 93)

b. If participating insurance contracts are purchased to settle the obligation, the maximum gain (but not loss) should be reduced by the cost of the participation right. (FASB ASC 715-60-35-156) (formerly SFAS 106, par. 94)

c. If the cost of all settlements in a year is less than or equal to the sum of the service cost and interest cost components of the year's net periodic postretirement benefit cost, gain or loss may be recognized. (Gain or loss recognition is not required, however.) Once adopted, the accounting policy for such settlements should be used consistently. (FASB ASC 715-60-35-158) (formerly SFAS 106, par. 95)

   The cost of a settlement is the amount paid to relieve the employer of its obligation to provide benefit payments. For example, (1) the cost of a settlement paid in cash is the amount of cash paid to the employee, (2) the cost of a settlement made by purchasing a nonparticipating insurance contract is the cost of the contract, and (3) the cost of a settlement made by purchasing a participating insurance contract is the cost of the contract net of the amount paid for the participation right. (FASB ASC 715-60-35-157) (formerly SFAS 106, par. 95)

Curtailments. A *curtailment* generally prevents the accumulated benefit obligation from growing for all or a portion of the plan's participants. It may eliminate coverage for certain participants, eliminate future defined benefit accruals (e.g., freezing the plan), or both. (FASB ASC 715-60-20) (formerly SFAS 106, par. 96) The following two components comprise the effects of a plan curtailment: (FASB ASC 715-60-35-164 through 35-166) (formerly SFAS 106, par. 97)

a. *Decrease in Prior Service Cost Previously Recognized in Changes in Unrestricted Net Assets But Not Yet Reclassified to Net Periodic Postretirement Benefit Cost.* For purposes of applying FASB ASC 715 (formerly SFAS No. 106) to curtailments, prior service cost includes any net transition obligation remaining from the initial adoption of SFAS No. 106 as well as any prior service cost previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic postretirement benefit cost. Such costs should be written off in proportion to the reduction in the remaining future years of service at the date of the curtailment. For example, if a plan curtailment eliminates 30% of the estimated future years of service of active employees receiving prior service credit, the loss on curtailment related to prior service cost is 30% of the combined unrecognized prior service cost and remaining net transition or obligation. Note that the amount of loss recognized on the decrease in prior service cost is not part of the gain or loss on plan curtailment (see item b. below) but it is included in the total effects of a plan curtailment. (FASB ASC 715-60-35-106) (formerly SFAS 106, par. 97)

b. *Curtailment Gain or Loss.* Gains and losses should be recognized for changes in the accumulated benefit obligation that result from curtailments. If a curtailment causes a plan's accumulated benefit obligation to decrease (for example, because the effects of future salary increases are eliminated), a gain would result. Conversely, a loss results if a curtailment causes the accumulated benefit obligation to increase (for example, because a plan's benefit formula creates additional benefits for employees who retire early). To compute a curtailment gain or loss, the employer first should determine the decrease or increase in the accumulated benefit obligation resulting from the curtailment (excluding increases arising from termination benefits). The employer then should compare that amount to the total of any net gain or loss previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic postretirement benefit cost plus any net transition asset remaining from the initial adoption of SFAS No. 106. (FASB ASC 715-60-35-169 and 35-170) (formerly SFAS 106, paras. 98–99)

(1) If the change in the accumulated benefit obligation is a decrease (gain) and a net loss has previously been recognized but not yet reclassified to net periodic postretirement benefit cost, a curtailment gain exists to the extent the decrease in the accumulated benefit obligation exceeds the net loss.

(2) If the change in the accumulated benefit obligation is a decrease (gain) and there is no net loss previously recognized that has not been reclassified to net periodic postretirement benefit cost, a curtailment gain exists equal to the entire decrease in the accumulated benefit obligation.

(3) If the change in the accumulated benefit obligation is an increase (loss) and a net gain has previously been recognized but not yet reclassified to net periodic postretirement benefit cost, a curtailment loss exists to the extent the increase in the accumulated benefit obligation exceeds the net gain.

(4) If the change in the accumulated benefit obligation is an increase (loss) and there is no net gain previously recognized that has not been reclassified to net periodic postretirement benefit cost, a curtailment loss exists equal to the entire increase in the accumulated benefit obligation.

If the total effect of a plan curtailment (that is, the sum of items a. and b. in the preceding paragraph) results in a loss, the loss should be recognized when it is probable that the curtailment will occur and the effects of the curtailment can be reasonably estimated. If the total effect of a curtailment results in a gain, the gain should be recognized when the affected employees terminate or when the employer adopts the plan suspension or amendment. (FASB ASC 715-30-25-10; 715-60-35-171) (formerly SFAS 106, par. 99)

Termination Benefits

Employers sometimes provide benefits to employees when employment is terminated. The recognition of termination benefits related to defined benefit pension and postretirement plans is the same. Special or contractual termination benefits related to defined benefit postretirement plans are recognized in accordance with the rules previously discussed for defined benefit pension plans. (FASB ASC 715-60-25-4) (formerly SFAS 106, par. 101) The date on which termination benefits should be accrued depends on whether the benefits are special or contractual termination benefits. (FASB ASC 715-30-25-9 through 25-11) (formerly SFAS 88, par. 15 and QA 88, par. 61)

- *Special Termination Benefits.* Termination benefits that are offered for only a short period of time are referred to as *special termination benefits*. Special termination benefits should be accrued when an employee accepts the employer's offer and the amount of benefits can be reasonably estimated. (FASB ASC 715-30-55-186) (formerly QA 88, par. 60)

- *Contractual Termination Benefits.* As its name implies, contractual termination benefits are those required by the terms of a separate agreement or the terms of an existing employee benefit plan. Contractual termination benefits are provided only as the result of a specified event. Examples of such events include the closing of a facility or the early retirement of employees. Recognition of contractual termination benefits occurs in the employer's financial statements when (a) it is probable that employees will be entitled to benefits and (b) the amount of benefits to be provided can be reasonably estimated. (FASB ASC 715-30-55-189) (formerly QA 88, par. 60)

Accounting Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) introduces a prescription drug benefit under Medicare Part D and provides a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit actuarially equivalent to Medicare Part D. Specific accounting guidance applies to the sponsor of a single-employer defined benefit postretirement health care plan for which (a) prescription drug benefits are actuarially equivalent to Medicare Part D and (b) the expected subsidy will offset or reduce the employer's share of the cost of the underlying prescription drug coverage. The effects of the subsidy on the plan's accumulated postretirement benefit obligation, as well as the effects of changes in the estimated amount of the expected subsidy in future periods, are accounted for as actuarial gains or losses. The effect of the subsidy on net periodic benefit cost is a reduction in the service cost component. If a plan is amended to provide an actuarially equivalent benefit, the combined effect of the amendment and any resulting subsidy on the accumulated postretirement benefit obligation is accounted for as an actuarial gain if it reduces the benefit obligation or as prior service cost if it increases the benefit obligation. The combined effects of plan amendments that reduce benefits below amounts that are actuarially equivalent and disqualify the subsidy are accounted for as prior service cost. (FASB ASC 715-60-05-9; 715-60-15-11; 715-60-35-137 through 35-141; 740-10-55-57) (formerly FSP FAS 106-2, paras. 3, 5, and 14–19)

ACCOUNTING FOR DEFINED CONTRIBUTION PLANS

As discussed, a *defined contribution plan* does not specify a defined benefit amount. Instead, it specifies how contributions to the plan are determined. The plan provides a separate account for each participant, which is increased by employer and/or participant contributions, returns earned on the investment of those amounts, and forfeitures of amounts contributed to the accounts of other participants who terminated employment before vesting in the plan. Defined contribution plan benefits are equal to the value of each individual participant's account balance. (FASB ASC 715-70-20) (formerly SOP 99-3, par. 34)

The benefit cost to be recorded as expense normally should be the contribution that applies to that period accounted for on the accrual basis. Required contributions for periods after the employee retires or terminates should be estimated and accrued during the employee's service period. (FASB ASC 715-70-35-1) (formerly SFAS 106, par. 105) Therefore, an organization preparing financial statements for the year ended December 31, 20X6 would report pension costs equal to the contribution allowable for 20X6 salaries, and the difference between that and deposits made to the plan during the year would be reflected in the organization's December 31, 20X6 statement of financial position either as a prepaid expense or an accrued liability.

MULTIEMPLOYER PLANS

A *multiemployer plan* is a plan to which two or more unrelated employers make contributions, usually as the result of a collective-bargaining agreement. (FASB ASC 715-80-5-1) (formerly SFAS 87, par. 67) In a multiemployer plan, the assets contributed by one participating employer may be used to provide benefits to employees of other participating employers. Therefore, the assets contributed by an employer are not segregated in a separate account or restricted to pay benefits only to that employer's employees. An example of a multiemployer plan is a union contract that requires organizations with union employees to contribute to the union's plan. The plan, in turn, assumes the liability for paying benefits to participants. Employers who participate in multiemployer plans should record net (benefit pension or other postretirement) cost equal to the required contribution for the period. Any contributions due but not paid should be recognized as a liability. (FASB ASC 715-80-20; 715-80-35-1) (formerly SFAS 106, paras. 81 and 518)

An employer who withdraws from a multiemployer plan may have a liability for a portion of the plan's unfunded benefit obligation. If it is probable or reasonably possible that (a) the employer will withdraw under circumstances that would give rise to an obligation or (b) the employer's contribution to the plan will be increased during the remaining contract period to make up for a shortfall in the funds necessary to maintain the negotiated level of benefit coverage, FASB ASC 450 (formerly SFAS 5), should be followed. (FASB ASC 715-80-35-2; 715-80-50-2) [formerly SFAS 132(R), par. 13] That is, if (a) it is probable that the employer will incur a liability by withdrawing from the plan and (b) the amount of the liability can be reasonably estimated, the employer should accrue a liability and record it as a loss. If one or both of those conditions are not met but it is reasonably possible that a liability has been incurred, the contingency should be disclosed. In those circumstances, FASB ASC 275 (formerly SOP 94-6), also may require disclosures.

MULTIPLE-EMPLOYER PLANS

Multiple-employer plans are similar to multiemployer plans in that they consist of two or more unrelated employers. However, multiple-employer plans are in substance an aggregation of single-employer plans that are combined to allow assets to be pooled for investment purposes and to reduce plan administration costs. Multiple-employer plans often permit participating employers to have different benefit formulas, allowing an employer's contributions to be based on the formula it selects. (FASB ASC 715-80-15) (formerly SFAS 106, par. 84) Each employer participating in the plan is required to account for its respective interest in the plan as if that interest were a separate plan. An example of a multiple-employer plan is an association of private schools that contribute to a plan administered by the association. Each school retains the obligation for its own employees and assumes no responsibility for the obligation to employees of other schools.

FOREIGN PLANS

The guidance in this lesson applies to pension and other postretirement benefit arrangements outside the U.S. that are similar in substance to U.S. plans. (GAAP does not place any additional accounting requirements on such plans.) In addition, in some countries it is customary to provide employee benefits upon voluntary or involuntary termination of employment. The guidance in this lesson also applies to those arrangements if they are in substance pension or other postretirement benefit plans (for example, if benefits are paid for virtually all employee terminations). (FASB ASC 715-10-15-6) (formerly SFAS 106, par. 85, and SFAS 87, par. 72)

SELF-STUDY QUIZ

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

29. On December 15, 20X8, a nonprofit organization, with a postretirement benefit plan, offers special benefits to its employees in connection with their voluntary termination of their employment. An additional 5 years of service will be credited, and eligibility for early retirement benefits will be granted for employees who are age 60 or older with more than 20 years of service and who elect to retire. Normal early retirement is at age 65. The employees have until January 15, 20X9 to accept the offer. As of January 15, 20X9, employees representing ten percent of the workforce accepted the offer. Which of the following regarding these termination benefits is true?

    a. This type of benefit is not permitted under ERISA.

    b. The benefits should be accrued in 20X9 if the amount of benefits can be reasonably estimated.

    c. The benefits should be recognized when it is probable that employees will be entitled to benefits.

30. A nonprofit organization has a *defined contribution plan*. There are 10 participants in the plan, each with an account balance of $10,000. The plan benefits for this defined contribution plan are $100,000.

    a. True.

    b. False.

31. A U.S. nonprofit organization has a subsidiary in a foreign country where it is customary to pay postretirement benefits to all employees that terminate. The organization must follow the applicable accounting principles of that country regarding these payments.

    a. True.

    b. False.

SELF-STUDY ANSWERS

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

29. On December 15, 20X8, a nonprofit organization, with a postretirement benefit plan, offers special benefits to its employees in connection with their voluntary termination of their employment. An additional 5 years of service will be credited, and eligibility for early retirement benefits will be granted for employees who are age 60 or older with more than 20 years of service and who elect to retire. Normal early retirement is at age 65. The employees have until January 15, 20X9 to accept the offer. As of January 15, 20X9, employees representing ten percent of the workforce accepted the offer. Which of the following regarding these termination benefits is true? **(Page 207)**

    a. This type of benefit is not permitted under ERISA. [This answer is incorrect. ERISA establishes minimum standards of pension plans, however, special termination benefits does not violate ERISA.]

    b. The benefits should be accrued in 20X9 if the amount of benefits can be reasonably estimated. [This answer is correct. Termination benefits that are offered for only a short period of time are referred to as special termination benefits. Special termination benefits should be accrued when an employee accepts the employer's offer and the amount of benefits can be reasonable estimated.]

    c. The benefits should be recognized when it is probable that employees will be entitled to benefits. [This answer is incorrect. Recognition of *contractual* termination benefits occurs in the employer's financial statements when it is probable that employees will be entitled to benefits and the amount of benefits to be provided can be reasonably estimated.]

30. A nonprofit organization has a *defined contribution plan*. There are 10 participants in the plan, each with an account balance of $10,000. The plan benefits for this defined contribution plan are $100,000. **(Page 208)**

    a. True. [This answer is correct. A *defined contribution plan* provides a separate account for each participant, which is increased by employer and participant contributions, returns earned on the investment of those amounts, and forfeitures of amounts contributed to the accounts of other participants who terminated employment before vesting in the plan (FASB ASC 715-70-20) (formerly SOP 99-3, par. 34).]

    b. False. [This answer is incorrect. Defined contribution plan benefits are equal to the value of each individual participant's account balance.]

31. A U.S. nonprofit organization has a subsidiary in a foreign country where it is customary to pay postretirement benefits to all employees that terminate. The organization must follow the applicable accounting principles of that country regarding these payments. **(Page 209)**

    a. True. [This answer is incorrect. U.S. GAAP applies to pension and postretirement benefit arrangements outside the U.S. that are similar in substance to U.S. plans.]

    b. False. [This answer is correct. U.S. GAAP applies to arrangements, such as providing employee benefits upon voluntary or involuntary termination of employment, that are in substance pension or other postretirement benefit plan.]

DISCLOSURE REQUIREMENTS

DEFINED BENEFIT PENSION AND POSTRETIREMENT PLANS

The following disclosures are required for employers that sponsor one or more defined benefit pension or other postretirement benefit plan. (Instead of those disclosures, nonpublic entities may provide the reduced disclosures discussed later.) The disclosures may be combined for all plans or presented in groups, whichever is more useful. Disclosures about plans with assets in excess of the accumulated benefit obligation can be aggregated with plans with accumulated benefit obligations in excess of assets. Disclosures for pension plans should not be combined with other postretirement benefit plans, however. Disclosures related to plans outside the U.S. should not be combined with U.S. plans if their benefit obligations are significant relative to the total employer benefit obligation and they use significantly different assumptions. Amounts related to the organization's change in net assets should be disclosed for each period for which a statement of activities is presented. Amounts related to the organization's financial position, unless otherwise indicated, should be disclosed as of the date of each statement of financial position presented. (FASB ASC 715-20-50-1 through 50-5) [formerly SFAS 132(R), paras. 5–8]

Disclosure Requirements for Public Entities

The following information should be disclosed for defined benefit pension and postretirement plans: (FASB ASC 715-20-50-1; 958-715-50-1) [formerly SFAS 132(R), par. 5]

a. A reconciliation of the beginning and ending benefit obligation (*projected* benefit obligation for defined benefit pension plans, *accumulated* postretirement benefit obligation for defined postretirement plans), separately showing, if applicable, the effects of the following:

    (1) Service cost

    (2) Interest cost

    (3) Contributions by plan participants

    (4) Actuarial gains and losses

    (5) Foreign currency exchange rate changes (for plans of a foreign operation whose functional currency is not the reporting currency)

    (6) Benefits paid

    (7) Plan amendments

    (8) Business combinations

    (9) Divestitures

    (10) Curtailments

    (11) Settlements

    (12) Special contractual and termination benefits

b. A reconciliation of the beginning and ending fair value of plan assets, separately presenting the following, if applicable:

    (1) Actual return on plan assets

    (2) Foreign currency exchange rate changes (for foreign operations whose functional currency is not the reporting currency)

    (3) Employer contributions

(4) Plan participant contributions

(5) Benefits paid

(6) Business combinations

(7) Divestitures

(8) Settlements

c. The funded status of the plans (and the amounts recognized in the statement of financial position showing separately the assets and current and noncurrent liabilities

d. The accumulated benefit obligation (for defined benefit pension plans)

e. The benefits expected to be paid in each of the next five fiscal years following the date of the latest statement of financial position presented, and in the aggregate for the five years thereafter

f. Contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented

g. Net benefit cost recognized during the period, showing separately each of the following components:

(1) Service cost

(2) Interest cost

(3) Expected return on plan assets

(4) Transition obligation or asset

(5) Gains and losses

(6) Prior service cost or credit

(7) Gain or loss recognized due to a settlement or curtailment

h. Separately, the net gain or loss and net prior service cost or credit recognized in the statement of activities, apart from expenses, for the period and previously recognized amounts reclassified to net periodic benefit cost for the period (including amortization of the transition asset or obligation)

i. The amounts previously recognized in unrestricted net assets that have not yet been recognized in net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation

j. On a weighted-average basis, the assumed discount rate, rate of compensation increase for pay-related plans, and expected long-term rate of return on plan assets specifying, in tabular format, the assumptions used to determine the benefit obligation and net benefit cost

k. Assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges), a general description of the direction and pattern of change in the assumed trend rates thereafter, and the ultimate trend rate(s) and when that rate is expected to be achieved

l. Effect of a one-percentage-point increase and decrease in the assumed health care cost trend rates on the following (assuming all other assumptions are held constant and the effects are measured based on the substantive plan that is the basis for the accounting):

   (1) The aggregate of the service and interest cost components of net periodic postretirement health care benefit cost

   (2) Accumulated postretirement benefit obligation for health care benefits

m. If applicable, the amounts and types of related party or employer securities included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by related parties or the employer, and any significant transactions between related parties or the employer and the plan during the period

n. If applicable, any alternative amortization method used to amortize prior service amounts or net gains and losses

o. If applicable, any substantive commitment used as the basis for accounting for the benefit obligation (such as past practice or a history of regular benefit increases)

p. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event

q. A description of any other significant change in the benefit obligation or plan assets

r. The amounts previously recognized in unrestricted net assets that are expected to be recognized in net period benefit cost in the fiscal year following the most recent statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation

s. The amount and timing of any plan assets expected to be returned to the employer in the 12 months (or longer operating cycle) following the most recent statement of financial position presented

t. If the beginning of year weighted-average expected long-term rate of return on plan assets changes due to a subsequent interim measurement of both plan assets and obligations, the beginning of year and most recent assumed rate or a weighted combination of the two. (FASB ASC 715-20-50-8) (formerly QA 87, par. 79)

If disclosures about plans with assets in excess of the accumulated benefit obligation have been combined with disclosures about plans with accumulated benefits obligations in excess of assets, the following should be disclosed separately: (FASB ASC 715-20-50-3) [formerly SFAS 132(R), par. 6]

a. The aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets

b. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets

Disclosures about plan assets should describe (a) how investment allocation decisions are made, including the factors important to understanding investment policies and strategies, (b) classes of plan assets, (c) inputs and valuation techniques used to measure the fair value, (d) effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period, and (e) significant concentrations of risk within plan assets. Classes of plan assets should be based on the nature and risks of assets in the plan such as cash and equivalents; equity securities (segregated by industry, company size, or investment objective); debt securities (corporate and government); asset-backed securities; structured debt; derivatives on a gross basis (segregated by underlying risk); investment funds (separated by fund); and real estate. In meeting those objectives, the following information about plan assets should be disclosed: (FASB ASC 715-20-50-1) [formerly SFAS 132(R), par. 5; ASU 2010-06]

a. A description of investment policies and strategies, including target allocation percentages or ranges considering the classes of plan assets as of the latest statement of financial position presented (on a weighted-average basis for employers with more than one plan) and other factors, such as investment goals, risk management practices, permitted and prohibited investments, diversification, and the relationship between plan assets and benefit obligation (for investment funds, significant investment strategies for those funds should be disclosed)

b. Fair value of each class of plan assets

c. A description of how the overall expected long-term rate-of-return on plan assets was determined, considering the classes of plan assets

d. For each annual period, the following information about fair value measurement for each major category of plan assets:

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

   (2) For measurements using significant Level 3 inputs, a reconciliation of the beginning and ending balances, separately presenting changes attributable to (a) actual return on plan assets (with separate identification of amounts relating to assets still held and assets sold); (b) purchases, sales, and settlements (net); and (c) transfers in or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

   (3) The valuation technique(s) and inputs used in measuring fair value and a discussion of any changes in valuation techniques and inputs during the period

Reduced Disclosure Requirements for Nonpublic Entities

A nonpublic entity may elect to make the following reduced disclosures for all of its defined benefit and postretirement pension plans (FASB ASC 715-20-50-5; 958-715-50-1) [formerly SFAS 132(R), par. 8]:

a. The benefit obligation, fair value of plan assets, and funded status of the plan

b. Employer and participant contributions and benefits paid during the period

c. The accumulated benefit obligation (for defined benefit pension plans)

d. The benefits expected to be paid in each of the next five fiscal years following the date of the latest statement of financial position presented, and in the aggregate for the five years thereafter

e. Contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented

f. The amounts recognized in the statement of financial position, showing separately the postretirement benefit assets and current and noncurrent postretirement benefit liabilities

g. Separately, the net gain or loss and net prior service cost or credit recognized in the statement of activities, apart from expenses, for the period and previously recognized amounts reclassified to net periodic benefit cost for the period (including amortization of the transition asset or obligation)

h. The amounts previously recognized in unrestricted net assets that have not yet been recognized in net periodic benefit cost, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation

i. On a weighted-average basis, the assumed discount rate, rate of compensation increase for pay-related plans, and expected long-term rate of return on plan assets specifying, in tabular format, the assumptions used to determine the benefit obligation and net benefit cost

j. Assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges), a general description of the direction and pattern of change in the assumed trend rates thereafter, and the ultimate trend rate(s) and when that rate is expected to be achieved

k. If applicable, the amounts and types of related party or employer securities included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by related parties or the employer, and any significant transactions between related parties or the employer and the plan during the period

l. The nature and effect of significant nonroutine events (such as amendments, combinations, divestitures, curtailments, and settlements)

m. The amounts previously recognized in unrestricted net assets that are expected to be recognized in net period benefit cost in the fiscal year following the most recent statement of financial position presented, showing separately the net gain or loss, net prior service cost or credit, and net transition asset or obligation

n. The amount and timing of any plan assets expected to be returned to the employer in the 12 months (or longer operating cycle) following the most recent statement of financial position presented

o. Amount of net periodic benefit cost recognized.

p. If the beginning of year weighted-average expected long-term rate of return on plan assets changes due to subsequent interim measurement of both plan assets and obligations, the beginning of year and most recent assumed rate or a weighted combination of the two. (FASB ASC 715-20-50-8) (formerly QA 87, No. 79)

If disclosures about plans with assets in excess of the accumulated benefit obligation have been combined with disclosures about plans with accumulated benefit obligations in excess of assets, the following should be disclosed separately: (FASB ASC 715-20-50-3) [formerly SFAS 132(R), par. 6]

a. The aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets.

b. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets.

Disclosures about pension and postretirement benefit plans are not repeated in interim financial statements, except that contributions paid, and expected to be paid, to the plan during the current fiscal year should be disclosed if significantly different from amounts disclosed in prior annual financial statements. (FASB ASC 715-20-50-7) [formerly SFAS 132(R), par. 10]

Disclosures about postretirement benefit plan assets should describe (a) how investment allocation decisions are made, including the factors important to understanding investment policies and strategies, (b) classes of plan assets, (c) inputs and valuation techniques used to measure the fair value, (d) effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period, and (e) significant concentrations of risk within plan assets. Classes of plan assets should be based on the nature and risks of assets in the plan such as cash and equivalents; equity securities (segregated by industry, company size, or investment objective); debt securities (corporate and government); asset-backed securities; structured debt; derivatives on a gross basis (segregated by underlying risk); investment funds (separated by fund); and real estate. In meeting those objectives, the following information about plan assets should be disclosed: (FASB ASC 715-20-50-5) [formerly SFAS 132(R), par. 8; ASU 2010-10]

a. A description of investment policies and strategies, including target allocation percentages or ranges considering the classes of plan assets as of the latest statement of financial position presented (on a weighted-average basis for employers with more than one plan) and other factors, such as investment goals, risk management practices, permitted and prohibited investments, diversification, and the relationship between plan assets and benefit obligation (For investment funds, significant investment strategies for those funds should be disclosed)

b. Fair value of each class of plan assets

c. A description of how the overall expected long-term rate-of-return on plan assets was determined, considering the classes of plan assets

d. For each annual period, the following information about fair value measurement for each class of plan assets:

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

   (2) For measurements using significant Level 3 inputs, a reconciliation of the beginning and ending balances, separately presenting changes attributable to (i) actual return on plan assets (with separate identification of amounts relating to assets still held and assets sold); (ii) purchases, sales, and settlements (net); and (iii) transfers in or out of Level 3 (for example, transfers due to changes in the observability of significant inputs)

   (3) The valuation technique(s) and inputs used in measuring fair value and a discussion of any changes in valuation techniques and inputs during the period

MEDICARE PRESCRIPTION DRUG, IMPROVEMENT AND MODERNIZATION ACT OF 2003

For the first period in which the effects of the Medicare subsidy are included in measuring the accumulated postretirement benefit obligation and net periodic postretirement benefit cost, disclosure should be made of the following: (FASB ASC 715-60-50-3) (formerly FSP FAS 106-2, par. 21)

a. Reduction in the accumulated postretirement benefit obligation for the subsidy related to benefits attributed to past service.

b. Effect of the subsidy on the measurement of net periodic postretirement benefit cost for the current period.

c. Any other disclosures required by FASB ASC 715-20-50-1 [formerly SFAS 132(R), par. 5].

For the sponsor of a single-employer defined benefit postretirement health care plan for which (a) prescription drug benefits are actuarially equivalent to Medicare Part D and (b) the expected subsidy will offset or reduce the employer's share of the cost of the underlying prescription drug coverage, the disclosures should include gross benefit payments including prescription drug benefits (paid and expected), and separately the gross amount of the subsidy receipts (received and expected). (FASB ASC 715-60-50-4) (formerly FSP FAS 106-2, par. 22)

Until it is determined whether benefits provided by the plan are actuarially equivalent to Medicare Part D, the following should be disclosed in all periods presented: (FASB ASC 715-60-50-6) (FSP FAS 106-2, par. 20)

a. Existence of the Medicare Prescription Drug, Improvement, and Modernization Act

b. The fact that the accumulated postretirement benefit obligation and net periodic postretirement benefit cost do not include amounts associated with the subsidy because a conclusion has not been made whether the benefits provided by the plan are actuarially equivalent to Medicare Part D

DEFINED CONTRIBUTION PLANS

An employer that sponsors a defined contribution postretirement plan should disclose the following items separately from disclosures about its defined benefit plans: (FASB ASC 715-70-50-1) [formerly SFAS 132(R), par. 11]

a. Defined contribution plan cost recognized during the period

b. The nature and effect of any significant changes during the period affecting comparability (such as a change in the rate of employer contributions, a business combination, or a divestiture)

MULTIEMPLOYER BENEFIT PLANS

Multiemployer plans should disclose the following for each annual period where statement of activities is presented: (FASB ASC 715-80-50-1) [formerly SFAS 132(R), par. 12]

a. Contributions during the period (An employer may combine amounts attributable to pension and other postretirement benefit plans.)

b. The nature and effect of any changes affecting comparability (such as a change in the rate of employer contributions, a business combination, or a divestiture)

If it is either probable or reasonably possible that either of the following might occur, disclosures required by FASB ASC 450 (formerly SFAS 5) should be made: (FASB ASC 715-80-50-2) [formerly SFAS 132(R), par. 13]

a. An employer would withdraw from the plan giving rise to an obligation

b. An employer's contribution would be increased during the remainder of the contract period to make up a shortfall necessary to maintain the negotiated level of benefit coverage

SELF-STUDY QUIZ

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

32. A nonprofit entity is preparing the disclosures required for its defined benefit pension plan. The organization will present a statement of activities for the years ended December 31, 2007, 2008, and 2009. It will also present a statement of financial position for December 31, 2008 and 2009. Based on this information, which of the following regarding the organization's defined benefit pension plan financial statement disclosures is true?

    a. Contributions that were expected to be paid to the plan during 2009 should be disclosed.

    b. The benefits expected to be paid for 2010, 2011, 2012, 2013, and 2014 must be disclosed.

33. An organization has union employees that contribute to the union's benefit plan (a multiemployer benefit plan). Which of the following must the organization disclose regarding this plan?

    a. The contributions due but not paid.

    b. The amount of benefits that were paid to another employer's employees.

    c. The contributions made during the period.

SELF-STUDY ANSWERS

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

32. A nonprofit entity is preparing the disclosures required for its defined benefit pension plan. The organization will present a statement of activities for the years ended December 31, 2007, 2008, and 2009. It will also present a statement of financial position for December 31, 2008 and 2009. Based on this information, which of the following regarding the organization's defined benefit pension plan financial statement disclosures is true? **(Page 216)**

    a. Contributions that were expected to be paid to the plan during 2009 should be disclosed. [This answer is incorrect. Contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position presented must be disclosed.]

    b. The benefits expected to be paid for 2010, 2011, 2012, 2013, and 2014 must be disclosed. [This answer is correct. The benefits expected to be paid in each of the next five fiscal years following the date of the last statement of financial position presented, and in the aggregate for the five years thereafter, must be disclosed.]

33. An organization has union employees that contribute to the union's benefit plan (a multiemployer benefit plan). Which of the following must the organization disclose regarding this plan? **(Page 219)**

    a. The contributions due but not paid. [This answer is incorrect. The contributions due but not paid are recognized as a liability, but this amount does not need to be disclosed.]

    b. The amount of benefits that were paid to another employer's employees. [This answer is incorrect. In a multiemployer plan, the assets contributed by one participating employer may be used to provide benefits to employees of other participating employers. Therefore, the assets contributed by an employer are not segregated in a separate account or restricted to pay benefits only to that employer's employees.]

    c. The contributions made during the period. [This answer is correct. Multiemployer plans should disclose contributions during the period (an employer may combine amounts attributable to both pension and other postretirement benefit plans) and the nature and effect of any changes affecting comparability per FASB ASC 715-80-50-1 (formerly SFAS 132(R), par. 12).]

POSTEMPLOYMENT BENEFITS

SOURCE: FASB ASC 712

OVERVIEW

Postemployment benefits should be accrued if—

a. they relate to services already performed;

b. they vest or accumulate;

c. it is probable they will be paid; and

d. their amount is reasonably estimable.

Postemployment benefits that do not meet all of the preceding criteria should be accounted for as contingencies.

ACCOUNTING REQUIREMENTS

Organizations often provide benefits to former or inactive employees, their beneficiaries, and covered dependents after employment but before retirement. Such postemployment benefits include cash or other consideration paid as a result of disability, layoff, death, or other specified events. The benefits frequently are paid immediately when the employee terminates employment; however, they may be paid over a specified period of time. (FASB ASC 712-10-15-3) (formerly SFAS 43, par. 6; SFAS 112, par. 4)

An employer should accrue a liability for postemployment benefits if all of the following conditions are met: (FASB ASC 710-10-25-1; 712-10-25-4) (formerly SFAS 43, par. 6; SFAS 112, par. 6)

a. The employee's right to the benefits is attributable to services he or she already has performed.

b. The employee's right to be paid postemployment benefits vests or accumulates.

c. It is probable the benefits will be paid.

d. The amount that will be paid is reasonably estimable.

Postemployment benefits that do not meet the preceding criteria should be accounted for as contingencies. (FASB ASC 450-20-25-2; 712-10-25-5) (formerly SFAS 5, paras. 8 and 59; SFAS 112, par. 6) That is, they should be—

a. accrued if (1) information available before the financial statements are available to be issued indicates it is probable a liability has been incurred at the statement of financial position date and (2) the amount of the liability can be reasonably estimated.

b. disclosed, but not accrued, if (1) it is probable a liability exists but the amount of the liability cannot be reasonably estimated or (2) it is reasonably possible (but not probable) a liability exists.

Authoritative literature does not specifically address how to measure the postemployment benefit obligation. It does state, however, that employers may refer to the guidance on measuring pension obligations and obligations for postretirement benefits other than pensions to the extent similar issues apply to the postemployment benefit plan. (FASB ASC 712-10-35-1) (formerly SFAS 112, par. 23)

DISCLOSURE REQUIREMENTS

If a liability for postemployment benefits is not accrued only because the amount cannot be reasonably estimated, that fact should be disclosed. (FASB ASC 712-10-50-2) (formerly SFAS 112, par. 7)

SELF-STUDY QUIZ

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

34. The Right Organization, founded in 20X7, provides postemployment benefits to employees that become disabled or laid off after an employee has been employed by the organization for ten years. The benefits are provided one year for every two years of service. How does Right Organization treat these benefits in its 20X9 financial statements?

    a. The amount of benefits paid in 20X9 is disclosed in the notes or on the face of the statements.

    b. Disclosure should be made, but no accrual of the postemployment benefits.

    c. Accrue a liability for postemployment benefits.

SELF-STUDY ANSWERS

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

34. The Right Organization, founded in 20X7, provides postemployment benefits to employees that become disabled or laid off after an employee has been employed by the organization for ten years. The benefits are provided one year for every two years of service. How does Right Organization treat these benefits in its 20X9 financial statements? **(Page 223)**

    a. The amount of benefits paid in 20X9 is disclosed in the notes or on the face of the statements. [This answer is incorrect. No postemployment benefits would have been paid in 20X9 because the organization was founded in 20X7 and employees must work for the organization for at least ten years before they are eligible for these benefits.]

    b. Disclosure should be made, but no accrual of the postemployment benefits. [This answer is correct. The organization does not have to accrue the postemployment benefits because, as of 20X9, no employees have the right to be paid the benefits. However, the organization should disclose information about the benefits since it is reasonably possibly that a liability will exist.]

    c. Accrue a liability for postemployment benefits. [This answer is incorrect. The organization does not meet all the criteria for accruing a liability in 20X9 since the employees have not been employed for the required length of time in order to receive postemployment benefits.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (NPGTG102)

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

18. Animal Rights Organization provides a defined contribution plan for its employees. Animal Rights uses the accrual basis of accounting. Which of the following is a factor that will determine the amount that Animal Rights will record as pension expense?

    a. Service cost.

    b. The employer's contribution.

    c. Actual return on plan assets.

    d. Amortization of the net asset transition or obligation.

19. Blue Organization, a nonprofit organization, has a history of providing plan benefits that are greater than those defined in writing. Which of the following is true regarding Blue's pension accounting?

    a. Blue should re-write its pension plan to include the substantive commitments and base the pension accounting on the new re-written plan.

    b. Blue should base the pension accounting based on its written plan, but include pro forma information in the notes to the financial statements.

    c. Blue should base the pension accounting based on its written plan, but disclose the commitments in the notes to the financial statements.

    d. Blue should base the pension accounting on the substantive commitment and disclose those commitments in its financial statements.

20. Where is the contra adjustment reported on a nonprofit's financial statements when amortization of prior service cost is recognized by reclassifying a portion of the prior service costs that were previously recognized in net periodic pension cost?

    a. Within accumulated amortization.

    b. Within contributions.

    c. Within changes in unrestricted net assets.

    d. Within net assets.

21. A nonprofit organization computes market-related value by recognizing changes in value over five years. Market related value at the beginning of the year is $3,000 and net asset gains and losses over the past five years are $1,400. The employer contributions during the year were $700, benefit payments were $500, and the expected long-term rate of return is 10%. What is the market-related value at the end of the year?

    a. $3,780.

    b. $4,280.

    c. $4,900.

    d. $6,480.

22. A nonprofit organization has a defined benefit plan. At the end of the current year, the fair value of the plan is $1,000,000 and the projected benefit obligation is $750,000. How is the funded status of the pension benefit plan shown on the nonprofit organization's financial statements?

    a. As a $250,000 noncurrent asset.

    b. As a $250,000 current asset.

    c. As a $250,000 noncurrent liability.

    d. As a $250,000 current liability.

23. ABC Organization has a defined benefit plan and the plan sponsor is Pension Co. ABC is an investor in Pension, Co. and uses the equity method to account for its investment. ABC uses the calendar year and Pension Co. uses a fiscal of June 30. ABC's plan assets and pension obligations can be measured as of June 30.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

24. A nonprofit organization has two defined benefit plans. Plan A has an overfunded balance of $2,000, and Plan B has an underfunded balance of $3,000. The organization does not have the right to use the assets of one plan to pay the liabilities and benefits of another plan. How should the organization report these over- and underfunded balances on its statement of financial position?

    a. As a $1,000 asset.

    b. As a $2,000 asset, and a $3,000 liability.

    c. As a $3,000 asset, and a $2,000 liability.

    d. As a $1,000 liability.

25. On December 31, 20X9, XYZ Organization purchased nonparticipating annuity contracts to cover the benefits of all retired participants. On December 30, 20X9, the plan's projected benefit obligation was comprised of $60,000 of cost to settle retirees' benefits and $40,000 of benefits not settled. Also, the net gain previously recognized but not yet reclassified to net periodic pension cost was $10,000, and the net obligation at the time SFAS No. 87 was adopted was $30,000. What is XYZ's settlement gain?

    a. $12,000.

    b. $20,000.

    c. $24,000.

    d. $40,000.

26. A nonprofit organization has a defined benefit plan. On December 31, 20X9, the organization amended its plan to eliminate the effects of future salary increases. The decrease in prior service cost as a result of the curtailment is $4,000, and the decrease in projected benefit obligation is $5,000. The net gain previously recognized in changes in unrestricted net assets but not yet reclassified to net periodic pension cost is $6,000, and the net transition asset remaining from the time SFAS No. 87 was adopted is $5,000. What is the total effect of the curtailment?

    a. $4,000 loss.

    b. $1,000 gain.

    c. $5,000 gain.

    d. $11,000 gain.

27. When does a nonprofit organization charge the cost of providing postretirement benefits to expense?

    a. The period the prior service cost is amortized.

    b. The period the actual results differ from the expected return on plan assets.

    c. The period the obligation is known.

    d. The period related employee services are rendered.

28. The accumulated postretirement obligation of QRS Organization is $100,000, and the fair value of the plan assets is $150,000. QRS should recognize the funded status of the postretirement benefit plan in its statement of activities.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

29. A nonprofit organization has two postretirement health care plans. The plans provide the same benefits, but to different groups of employees. Both plans are unfunded. Which of the following is true regarding how the nonprofit organization can treat these plans?

    a. The organization is not allowed to have separate plans.

    b. The assets and liabilities of the plans can offset each other.

    c. Each plan should be measured separately.

    d. The organization can aggregate and measure the plans as one plan.

30. Marcie is a participant in a *defined contribution plan*. At the end of 20X8, Marcie's account balance in the plan was $10,000. During 20X9, Marcie contributed $3,000 to her account and her employer contributed $2,000 on her behalf. Also, a colleague of Marcie's left the organization before he vested in the plan. The organization had contributed $2,000 on his behalf, $500 of which will be transferred to Marcie's account. Marcie's account earned $250 on her investments during 20X9. What is Marcie's account balance at the end of 20X9?

    a. $12,750.

    b. $15,500.

    c. $15,750.

    d. $17,250.

31. At the end of 20X9, a nonprofit organization withdrew from a multiemployer plan. It is probable that the organization will have a $20,000 liability for a portion of the plan's unfunded benefit obligation. Which of the following is a requirement of the organization regarding this liability?

    a. The organization should accrue the liability.

    b. The organization should disclose the possibility of the liability.

    c. The organization should offset the liability with net pension cost.

    d. Do not select this answer choice.

32. New Organization has a defined benefit pension plan. As a nonpublic entity, which of the following is New Organization **not** required to disclose in its financial statements?

    a. Employer and participant contributions and benefits paid during the period.

    b. The accumulated benefit obligation.

    c. A reconciliation of the beginning and ending projected benefit obligation.

    d. A description of how the overall expected long-term rate of return on plan assets was determined.

33. New Organization has a defined benefit pension plan. New is presenting a statement of activities and a statement of financial position for 2008 and 2009. New Organization also has a defined contribution plan. Which of the following is true regarding the disclosures New will make for the defined contribution plan?

    a. New can combine the disclosures for its defined benefit plan and defined contribution plan.

    b. New must provide a general description of its defined contribution plan.

    c. New must disclose the contributions expected to be paid during 2010.

    d. New must disclose the defined contribution plan cost recognized during 2008 and 2009.

34. Best Organization provides postemployment benefits to its employees, but does not meet the conditions to accrue the benefits. How should Best account for these benefits?

    a. As an extraordinary item.

    b. As a contingency.

    c. As a decrease in unrestricted net assets.

    d. As a defined contribution plan.

Lesson 3: Related Entities and Related Party Disclosures

INTRODUCTION

This lesson covers the accounting requirements and disclosure requirements for recording related entities and related parties on nonprofit financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine a nonprofit organization's ownership interest in for-profit entities and financially related nonprofit organizations.
- Determine related party relationships and prepare disclosures for a nonprofit organization's related parties.

RELATED ENTITIES

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

OVERVIEW

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

An organization generally should consolidate the activities of a related but separate nonprofit entity into its financial statements if the organization has one of the following:

- A controlling financial interest through ownership of a majority voting interest or sole corporate membership
- An economic interest and control through means other than ownership of a majority voting interest or sole corporate membership

An organization may choose to consolidate an economic interest in another nonprofit entity in which it has control by contract, affiliation agreement, or other means.

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

ACCOUNTING REQUIREMENTS

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

OWNERSHIP INTEREST IN FOR-PROFIT ENTITIES

How a nonprofit organization reports its ownership interest in a for-profit entity generally depends on whether it has a controlling financial interest in the entity. The guidance for reporting investments in for-profit entities is summarized as follows (FASB ASC 958-810-15-4) (formerly SOP 94-3, paras. 5–7; 2008 Audit Guide, par. 8.36):

a. An organization with a controlling financial interest through direct or indirect ownership of a majority voting interest generally should consolidate the investee.

b. An organization that holds less than a majority voting interest in the investee (that is, it owns 50% or less of the voting stock) is required to report the investment at fair value if the equity securities have *readily determinable fair values*. If an organization is not required to report the investment at fair value it may still be permitted to make an election to do so under certain conditions; otherwise, it should use the equity method to report the investment.

c. An organization that is a general partner in a for-profit limited partnership or similar entity should consolidate the investee if it controls the partnership. GAAP provides guidance for determining whether the general partner has control. If the organization does not control the partnership as defined in GAAP, it should use the equity method to report the investment. Rather than consolidating the partnership or using the equity method of accounting, it also may be permitted to elect to report the investment at fair value.

d. An organization with a noncontrolling interest in a real estate partnership, real estate limited liability company, or similar real estate entity that is more than minor should use the equity method to report its investment. It also may be permitted to elect to report the investment at fair value.

The following paragraphs discuss how the appropriate reporting method is determined. The flowchart in Exhibit 3-1 summarizes that guidance.

Controlling Financial Interest

Generally, a nonprofit organization should consolidate the activities of a for-profit entity in which it directly or indirectly owns a controlling financial interest. (FASB ASC 958-810-15-4) (SOP 94-3, par. 5) A controlling financial interest usually is evidenced by ownership of a majority voting interest. Thus, as a general rule, an organization that directly or indirectly owns more than 50% of the outstanding shares of a for-profit entity should account for its investment through consolidation. Consolidation is also required when control exists through other means. For example, control may exist even though there is a smaller percentage of ownership if it is obtained through a contract, a lease, an agreement with other shareholders, or by court decree. It may also reside with the limited partners in a limited partnership if the presumption that control rests with the general partner is overcome. (FASB ASC 810-10-15-8 and 15-10) (formerly APB 18, par. 3; ARB 51, paras. 2–3)

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

a. control does not rest with the organization as majority owner (for example, if a subsidiary is in legal reorganization, bankruptcy, or operates under foreign exchange or governmental restrictions so severe that they cast significant doubt on the organization's ability to control the subsidiary) (FASB ASC 810-10-15-10) (formerly ARB 51, par. 2), or

b. noncontrolling shareholders have certain approval or veto rights that restrict the majority shareholder's powers to control the investee's operations or assets. (FASB ASC 810-10-15-10) (formerly EITF 96-16)

If a controlling financial interest is consolidated, nonprofit organizations should apply the guidance presented in FASB ASC 810-10, *Consolidation—Overall*. (Nonprofit organizations are not subject to the requirements in the Variable Interest Entities subsections of that topic, however.) (FASB ASC 958-810-15-4) [formerly SOP 94-3, par. 5; FIN 46(R), par. 4]

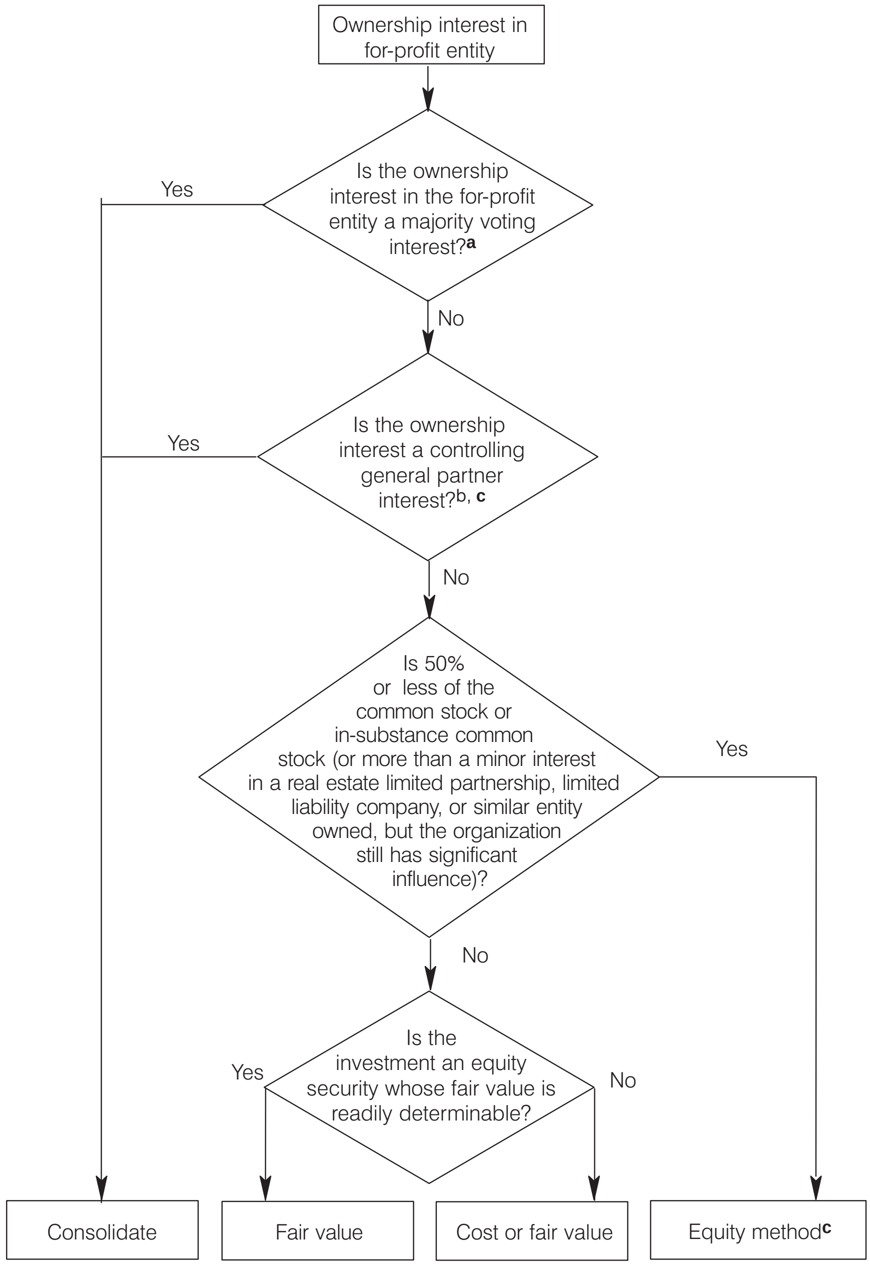
Control of Limited Partnerships and Similar Entities. A nonprofit organization that is a general partner of a for-profit limited partnership or a similar entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) should evaluate the existence of control within the limited partnership to determine whether it should consolidate that partnership's activities. (FASB ASC 958-810-15-4) There is a general presumption of control by the general partner(s) in a limited partnership regardless of the extent of the general partner's ownership interest. However, if the limited partners possess one or more of the following rights, the presumption is overcome and general partners should use the equity method to account for their investment (unless the organization has elected to report eligible investments at fair value): (FASB ASC 810-20-25-3 and 25-5) (formerly EITF 04-5, paras. 6 and 10)

a. The substantive ability to liquidate the limited partnership or remove the general partners without cause

b. Substantive participating rights

Exhibit 3-1

Accounting for Ownership Interests in For-profit Entities



Notes:

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

[b] There is a general presumption of control by the general partner in a limited partnership, but that presumption can be overcome.

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

* * *

Special-purpose-entity Lessors. An organization that has a lease with a special-purpose-entity (SPE) lessor should consolidate the lessor if the following conditions exist: (FASB ASC 958-810-25-8) (formerly SOP 94-3, par. 3; EITF 90-15, discussion)

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

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

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

If the SPE was created for both the construction and subsequent lease of an asset, and the conditions described in the previous paragraph exist, consolidation of the lessee should begin at the date of the lease agreement or commitment (that is, the lease inception) rather than at the beginning of the lease term. (FASB ASC 958-810-25-10) (formerly EITF 90-15, discussion)

Less Than a Majority Voting Interest

If a nonprofit organization owns common stock in a for-profit entity and has 50% or less of the voting interest but can exercise significant influence over that entity, the organization generally should report its interest using the equity method of accounting unless that investment is reported at fair value. (FASB ASC 958-810-15-4) (formerly SOP 94-3, par. 6) *Absent evidence to the contrary*, an organization is presumed to have the ability to significantly influence an entity if it directly or indirectly owns 20% or more of the entity's voting stock. (FASB ASC 323-10-15-8) (formerly APB 18, par. 17)

The nonprofit organization should also generally use the equity method if it has a noncontrolling interest in a for-profit real estate limited partnership, limited liability company, or a similar entity that is more than minor. (FASB ASC 958-810-15-4) (formerly SOP 94-3, par. 6A) (Although there is a general presumption of control if the nonprofit organization is the general partner in a limited partnership, see the discussion about when control would not rest with the general partner.)

If the nonprofit organization's noncontrolling ownership interest in a for-profit entity is minor, it should report the investment at fair value or by using the cost method. Fair value measurement is required if the investment is in the form of equity securities with readily determinable fair values. Equity securities that do not have readily determinable fair values, and other investments such as partnership interests, are generally reported using the cost method.

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

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

- An organization that holds an investment described in items b.–d. at the first paragraph of "Ownership Interest in For-Profit Entities" may be allowed to report that investment at fair value in accordance with the provisions in FASB ASC 958-325, *Not-for-Profit Entities—Investments—Other*.

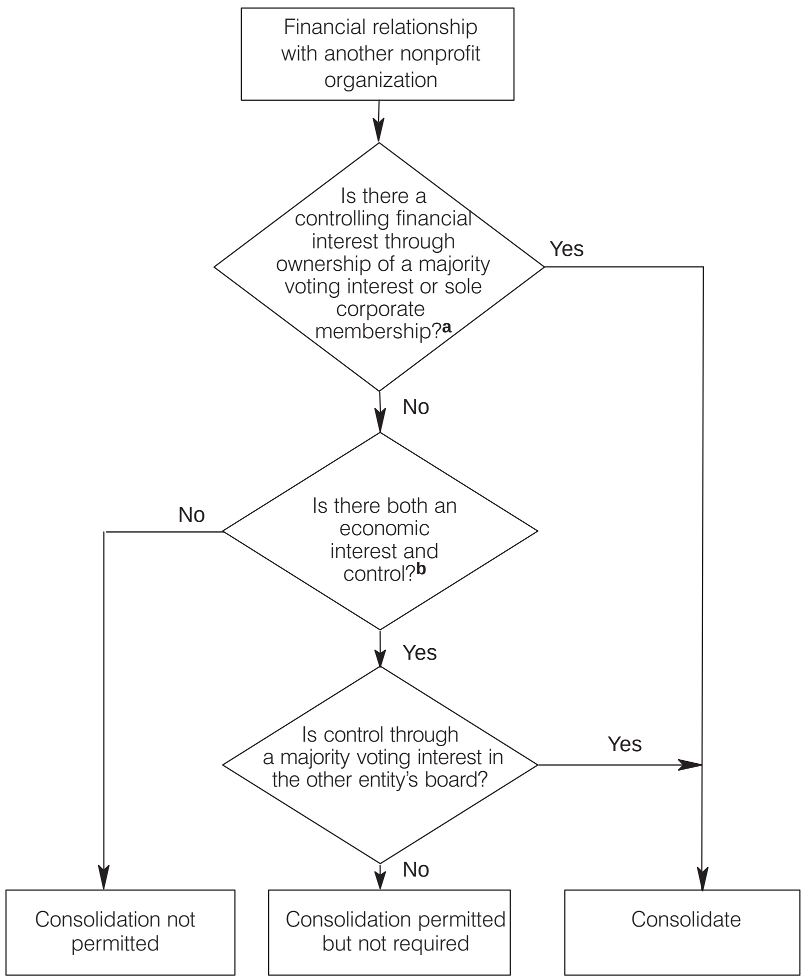
FINANCIALLY RELATED NONPROFIT ORGANIZATIONS

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

In determining how to report a financial relationship with another nonprofit organization, an organization should evaluate whether it has a controlling financial interest or an economic interest and control. Exhibit 3-2 presents a flowchart that summarizes the reporting guidance when a nonprofit organization has a financial relationship with another nonprofit organization. The following paragraphs discuss the various types of financial relationships and whether they result in consolidation.

Exhibit 3-2

Accounting for Financial Relationships With Other Nonprofit Organizations



Notes:

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

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

* * *

Controlling Financial Interest

Generally, a nonprofit organization that has either a direct or indirect controlling financial interest in another nonprofit organization through ownership of a majority voting interest or sole corporate membership should consolidate the other organization's activities into its financial statements. An exception to the general rule is if ownership of the majority voting interest or sole corporate membership does not give the organization control (for example, because the related entity is in legal reorganization or bankruptcy). (FASB ASC 958-810-25-2) (formerly SOP 94-3, par. 10)

The existence of supermajority voting requirements by the board of directors to approve certain actions may, however, be sufficient to overcome the presumption of control by the holder of the majority voting interest. Judgment is required to determine if those voting requirements are so restrictive as to call into question whether the investor has a controlling financial interest, or if they have little or no effect on the ability to control the investee's assets or operations. (FASB ASC 958-810-25-2A; 958-810-55-4A) (formerly SOP 94-3, par. 10)

Economic Interest and Control

An organization has control over another entity when it has the direct or indirect ability to determine the direction of the entity's management and policies. An organization has an *economic interest* in another entity when (FASB ASC 958-810-20):

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

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

For example, if another organization solicits funds in the name of the organization or if the organization provides funds to another organization, an economic interest is present. An economic interest is also present if an organization has the right to, or a responsibility for, the operating results of another entity, or if it is entitled to the net assets, or is responsible for any deficit, of another entity upon dissolution. (FASB ASC 958-810-55-6) (formerly SOP 94-3, par. 20; 2008 Audit Guide, par. 3.22)

If an organization has an economic interest without control, or control without an economic interest, it should *not* consolidate the activities of the other entity. (FASB ASC 958-810-25-5) (formerly SOP 94-3, par. 13) When both control and an economic interest are present, reporting the relationship with the other nonprofit organization varies depending on whether there is— (FASB ASC 958-810-25-1)

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

Economic Interest and Control through Majority Voting Interest in the Board. A nonprofit organization that has both an economic interest and control of another nonprofit organization through a majority voting interest in the other organization's board or sole corporate membership should consolidate that entity's activities into its financial statements unless the majority voting interest does not give the organization control. (FASB ASC 958-810-25-3) (formerly SOP 94-3, par. 11)

To have control through a majority voting interest in the board, an organization must have the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board, including any vacant board positions. Simply having a majority interest in the related organization's board without the ability to *require* that the majority of the members be appointed by the organization does not meet the criteria for control. (FASB ASC 958-810-25-3; 958-810-55-5) (formerly SOP 94-3, par. 20)

Economic Interest and Control by Other Means. Nonprofit organizations sometimes have control over, and economic interests in, other nonprofit organizations without having a majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity. This type of control could be obtained as a result of a contract, affiliation agreement, or other means. In such cases, consolidation is permitted but not required. The guidance states, however, that consolidation is encouraged if (FASB ASC 958-810-25-4) (formerly SOP 94-3, paras. 12 and 16):

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

b. Consolidation would be meaningful

Certain disclosures are required if an organization does not consolidate its interest in another nonprofit organization in which it has an economic interest and control by other than a controlling financial interest or a majority voting interest. (FASB ASC 958-810-50-2) (formerly SOP 94-3, par. 12)

DISCLOSURE REQUIREMENTS

If an organization is permitted to consolidate a financially related nonprofit entity but chooses *not* to, the following disclosures are required: (FASB ASC 958-810-50-2) (formerly SOP 94-3, par. 12)

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

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

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

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

If a nonprofit organization has either control of, or an economic interest in, another nonprofit entity (but not both), the organization should provide the related party disclosures required by FASB ASC 850-10-50-1 through 50-6. (FASB ASC 958-810-50-3) (formerly SOP 94-3, par. 13)

SELF-STUDY QUIZ

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

35. A nonprofit organization, Organization A, owns 55% of the voting common stock of Bee Company, a for-profit entity. How should Organization A account for its investment in Bee Company?

    a. Cost method.

    b. Consolidation.

    c. Equity method.

    d. Fair value.

36. Which nonprofit organization should use the equity method to report its investment in a for-profit entity?

    a. Organization A owns 80% of the voting common stock of Tree, Inc. The organization has control over Tree, Inc.

    b. Organization B owns 10% of the voting common stock of Leaf, Inc. The fair value of Leaf, Inc. is readily determinable.

    c. Organization C owns 15% of the voting common stock of Yellow, Inc. The fair value of Yellow, Inc. is not readily determinable.

    d. Organization D owns 25% of the voting common stock of Red, Inc. The fair value of Red, Inc. is not readily determinable.

37. Which nonprofit organization is permitted, but not required, to consolidate the activities of another nonprofit organization?

    a. Organization A has a controlling financial interest in Square Organization through ownership of the majority voting interest in Square.

    b. Organization B has control of Circle Organization, but does not have an economic interest in Circle.

    c. Organization C has control over and economic interests in Rectangle Organization through affiliation agreements.

    d. Organization D has an economic interest and control of Triangle Organization through a majority voting interest in Triangle's board.

38. Junior Organization, a fundraising organization, solicits funds on behalf of Senior Organization. An economic interest exists between these organizations.

    a. True.

    b. False.

SELF-STUDY ANSWERS

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

35. A nonprofit organization, Organization A, owns 55% of the voting common stock of Bee Company, a for-profit entity. How should Organization A account for its investment in Bee Company? **(Pages 232–233)**

    a. Cost method. [This answer is incorrect. If Organization A owned less than 50% of Bee Company, did not have a significant influence over Bee Company, and the fair value is not readily determinable, the cost method can be used to account for the investment.]

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

    c. Equity method. [This answer is incorrect. If Organization A owned less than 50% of Bee Company, but had a significant influence over Bee Company, the equity method can be used.]

    d. Fair value. [This answer is incorrect. If Organization A owned less than 50% of Bee Company, did not have a significant influence over Bee Company, but the fair value of Bee Company is readily determinable, the fair value method can be used.]

36. Which nonprofit organization should use the equity method to report its investment in a for-profit entity? **(Pages 233–234)**

    a. Organization A owns 80% of the voting common stock of Tree, Inc. The organization has control over Tree, Inc. [This answer is incorrect. Organization A should consolidate Tree, Inc.]

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

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

    d. Organization D owns 25% of the voting common stock of Red, Inc. The fair value of Red, Inc. is not readily determinable. [This answer is correct. If a nonprofit organization owns common stock in a for-profit entity and has 50% or less of the voting interest but can exercise significant influence over that entity, the organization should generally report its interest using the equity method of accounting unless that investment is reported at fair value. An organization is presumed to have the ability to significantly influence an entity if it owns 20% or more of the entity's voting stock.]

37. Which nonprofit organization is permitted, but not required, to consolidate the activities of another nonprofit organization? **(Pages 235–236)**

    a. Organization A has a controlling financial interest in Square Organization through ownership of the majority voting interest in Square. [This answer is incorrect. Organization A must consolidate the activities of Square Organization.]

    b. Organization B has control of Circle Organization, but does not have an economic interest in Circle. [This answer is incorrect. Organization B is not permitted to consolidate Circle Organization, but it should disclose the relationship.]

    c. Organization C has control over and economic interests in Rectangle Organization through affiliation agreements. [This answer is correct. Nonprofit organizations sometimes have control over, and economic interests in, other nonprofit organizations as a result of contracts, affiliation agreements, or other means. In such cases, consolidation is permitted but not required.]

    d. Organization D has an economic interest and control of Triangle Organization through a majority voting interest in Triangle's board. [This answer is incorrect. Organization D should consolidate the activities of Triangle Organization, unless the majority voting interest does not give the organization control.]

38. Junior Organization, a fundraising organization, solicits funds on behalf of Senior Organization. An economic interest exists between these organizations. **(Page 236)**

   a. True. [This answer is correct. An economic interest exists when the other entity holds or uses the significant resources to directly or indirectly produce income for or provide services to the organization, or the organization is responsible for another entity's liabilities (FASB ASC 958-810-20).]

   b. False. [This answer is incorrect. If the other organization solicits funds in the name of the organization or if the organization provides funds to the other organization, an economic interest is present.]

RELATED PARTY DISCLOSURES

SOURCE: FASB ASC 850

OVERVIEW

Material related party transactions (other than compensation arrangements, expense allowances, and similar items occurring in the normal course of business) should be disclosed. Generally, the disclosures include the nature of the relationships, a description of the transactions and their amounts, and the terms and manner of settling the transactions.

Common control relationships also should be disclosed, even if no related party transactions occurred, if the relationships could significantly affect the reporting entity's financial position or change in net assets.

DISCLOSURE REQUIREMENTS

DEFINITION OF A RELATED PARTY

A *related party* is an entity that can control or significantly influence the management or operating policies of another entity to the extent one of the entities may be prevented from pursuing its own interests. A related party may be any party the entity deals with that can exercise that control. Examples of related parties include (a) affiliates, (b) investments accounted for under the equity method, (c) trusts for the benefit of employees (for example, pension or profit-sharing trusts), and (d) members of management, the governing board, and their immediate families. (FASB ASC 850-10-20) (formerly SFAS 57, par. 24)

Transactions between related parties should be recorded in the same manner as transactions between unrelated parties. That is, their substance, rather than their form, generally should govern the accounting. The following are examples of common related party transactions: (FASB ASC 850-10-5-3 through 05-5) (formerly SFAS 57, par. 1)

- Sales, purchases, and transfers of property
- Services provided or received
- Property and equipment leases
- Loans or guarantees
- Maintenance of compensating bank balances for the benefit of a related party
- Allocations of common costs
- Filing annual group information and tax returns (for organizations that have established their tax-exempt status under a group exemption letter)

Common related party transactions of nonprofit organizations include (a) purchases of goods or services from board members, (b) payments to or receipts from affiliates, (c) office space leased from or donated by board members or related entities, and (d) guaranteed or pledged personal assets by organization board members. Unrecorded transactions between related parties, such as services provided or received at no charge, are still considered related party transactions and should be disclosed in accordance with the guidance in this lesson or recorded as contributions revenue, if appropriate.

DISCLOSURES

The following information about material related party transactions (other than compensation arrangements, expense allowances, and similar items occurring in the normal course of business) should be disclosed: (The disclosures apply to the separate financial statements of each combined or consolidated entity as well as to the combined or consolidated financial statements. However, separate financial statements that are presented with the combined or consolidated financial statements need not duplicate the disclosures. Also, consolidated or combined financial statements need not disclose related party transactions that were eliminated in consolidation or combination.) (FASB ASC 850-10-50-1 and 50-4) (formerly SFAS 57, par. 2)

a. Nature of the relationship involved (If necessary to an understanding of the relationship, the name of the related party also should be disclosed.)

b. Description of the transactions, including those for which no or nominal amounts were recorded, for each period for which a statement of activities is presented (The disclosure should include any other information necessary to understand the transactions' financial statement effects.)

c. Dollar amounts of the transactions for each period for which a statement of activities is presented (The disclosure also should include the effects of any change in terms from the terms used in the prior period.)

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

e. For an organization that is part of a group that files annual group information and tax returns, the following should be disclosed in the organization's separately issued financial statements: (FASB ASC 740-10-50-17) (formerly SFAS 109, par. 49)

    (1) Aggregate amount of current and deferred unrelated business income tax or excise tax expense for each statement of activities presented

    (2) Amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented

    (3) Principal provisions of the method by which the group amount of unrelated business income tax or excise tax expense is allocated to members of the group

    (4) Nature and effect of any changes in the method of allocating current and deferred unrelated business income tax or excise tax expense to members of the group and in determining the related balances due to or from affiliates during each year for which the disclosures in a. and b. are presented

Receivables from officers, directors, employees, or affiliates should be shown separately rather than presented under a general heading such as notes receivable or accounts receivable. If the organization presents a classified statement of financial position, amounts due from affiliated organizations or subsidiaries should be classified as current only if it is the organization's practice to liquidate them periodically and the current financial position of the affiliate or subsidiary warrants that treatment.) (FASB ASC 850-10-50-2) (formerly ARB 43, Ch. 1A, par. 5)

If the change in net assets or financial position could be significantly different as a result of common ownership or management control of the reporting entity and other entities, the nature of the ownership or management control also should be disclosed, even if there are no transactions between the entities. (FASB ASC 850-10-50-6) (formerly SFAS 57, par. 4)

Because related party transactions cannot be presumed to be conducted under competitive, free-market conditions, the preceding disclosures should not imply that the transactions were made on an arm's-length basis unless that representation can be substantiated. (FASB ASC 850-10-50-5) (formerly SFAS 57, par. 3)

SELF-STUDY QUIZ

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

39. Single Parents Organization is a large, national nonprofit organization that offers programs for single parents and their children. The organization provides after school programs for the children of working parents. Which of the following relationships is a *related party* of Single Parents?

    a. Mike works for Single Parents as a driver for children that need transportation to the after school programs, and he also runs some of the after school activities.

    b. Single Parents owns 2% of the common stock of GEM, Inc., a publicly traded corporation.

    c. Janis is a major donor to Single Parents. Without her support, the organization would have to cancel many of its programs.

    d. An organization in the UK has been performing similar services to Single Parents. The UK organization became an affiliate of Single Parents.

40. Which of the following transactions does **not** require disclosure as a related party transaction in the financial statements of Hero Organization?

    a. Jack, a board member of Hero Organization, owns an office park and charges $1,000 per month for the organization to rent space. The fair market value of the office space is $2,000 per month.

    b. Bob is a retired police officer. He now spends 40 hours per week volunteering at Hero, working with children in foster care.

    c. Andrea is a CPA and the wife of Todd, director of Hero Organization. Andrea prepares Hero's tax return at no charge.

    d. Hero Organization sold a piece of equipment to S.A.V.E. Organization, an affiliate of Hero. The equipment was sold at a gain.

SELF-STUDY ANSWERS

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

39. Single Parents Organization is a large, national nonprofit organization that offers programs for single parents and their children. The organization provides after school programs for the children of working parents. Which of the following relationships is a *related party* of Single Parents? **(Page 242)**

    a. Mike works for Single Parents as a driver for children that need transportation to the after school programs, and he also runs some of the after school activities. [This answer is incorrect. Mike's relationship with the organization is not considered as a related party because Mike is not a member of management or the governing board. If he is an immediate family member of management or governing board, then he would be a related party of Single Parents.]

    b. Single Parents owns 2% of the common stock of GEM, Inc., a publicly traded corporation. [This answer is incorrect. Investments accounted for under the equity method are related parties.]

    c. Janis is a major donor to Single Parents. Without her support, the organization would have to cancel many of its programs. [This answer is incorrect. Even though Single Parents is economically dependent upon Janis' support, she is not considered a related party. However, Single Parents may need to disclose its economic dependence.]

    d. An organization in the UK has been performing similar services to Single Parents. The UK organization became an affiliate of Single Parents. [This answer is correct. A related party is an entity that can control or significantly influence the management or operating policies of another entity to the extent one of the entities may be prevented from pursuing its own interests. A related party may be any party the entity deals with that can exercise that control. (FASB ASC 850-10-20) (formerly SFAS 57, par. 24)]

40. Which of the following transactions does **not** require disclosure as a related party transaction in the financial statements of Hero Organization? **(Page 242)**

    a. Jack, a board member of Hero Organization, owns an office park and charges $1,000 per month for the organization to rent space. The fair market value of the office space is $2,000 per month. [This answer is incorrect. As a board member, Jack is a related party. Both portions of the office space rental, the portion Hero pays and the portion donated, should be disclosed by Hero.]

    b. Bob is a retired police officer. He now spends 40 hours per week volunteering at Hero, working with children in foster care. [This answer is correct. Bob does not fit the criteria of a related party because it does not appear he can exercise any control over Hero Organization. Although he spends an entire work week volunteering at Hero, the type of service he donates does not meet the requirement to record contribution revenue. Hero may wish to disclose the amount of hours volunteers like Bob donate to the organization, as this is valuable to the organization.]

    c. Andrea is a CPA and the wife of Todd, director of Hero Organization. Andrea prepares Hero's tax return at no charge. [This answer is incorrect. Andrea is a related party because she is an immediate family member of a member of management. The value of the tax return preparation should be recorded as contribution revenue, and disclosed as a related party transaction.]

    d. Hero Organization sold a piece of equipment to S.A.V.E. Organization, an affiliate of Hero. The equipment was sold at a gain. [This answer is incorrect. An affiliate is a related party. The fact that the equipment was sold at a gain does not change the substance of the transaction.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (NPGTG102)

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

35. Good Organization, a nonprofit organization, owns 2,000 of the 3,000 outstanding shares of the voting common stock of Bad Company. The fair value of Bad Company is readily determinable. How should Good Organization account for its investment in Bad Company?

    a. Fair value method.

    b. Cost method.

    c. Equity method.

    d. Consolidation.

36. Good Organization is a general partner and owns 10% of the interest of Better LP. The limited partners of Better have the ability to liquidate the partnership, or can remove Good Organization as general partner without cause. How should Good Organization account for its investment in Better LP?

    a. Equity method.

    b. Consolidation.

    c. Cost method.

    d. Fair value method.

37. Shelter the Homeless Organization provides beds and other housing facilities to individuals in need. Shelter the Homeless Organization has relationships with several other nonprofit organizations. In which of the following situations is there the existence of an economic interest between Shelter the Homeless and another organization?

    a. Shelter the Homeless receives donated clothing from Clothe the Homeless, if Cloth the Homeless has any left available to donate to the Shelter.

    b. Shelter the Homeless loaned money to Educate the Children. Educate the Children paid back Shelter the Homeless with interest.

    c. Shelter the Homeless shares its facility with Feed the Hungry. Feed the Hungry operates out of Shelter's kitchen and provides food to the individuals that stay at the Shelter.

    d. Do not select this answer choice.

38. Talent Organization has economic interest in Show Organization and control of Show as a result of a contract between the organizations. Talent has decided not to consolidate the activities of Show in its financial statements. Which of the following is true based on this decision?

    a. Talent is not in accordance with GAAP.

    b. Talent must disclose its relationship with Show.

    c. Talent must include the financial statements of Show in Talent's note disclosures.

    d. Talent must disclose the reason why it chose not to consolidate Show.

39. The National Bird Society conserves the earth's natural resources. Which of the following relationships is a related party of the organization?

    a. Helen occasionally donates money to the National Bird Society. Helen is the ex-spouse of Bill, the director of National Bird Society.

    b. National Bird Society receives a discount on the supplies it purchases from its major supplier.

    c. National Bird Society owns 45% of the voting common stock of Bird Seed, Inc.

    d. National Bird Society maintains a defined contribution plan for its employees.

40. Jeffrey is the director of a national nonprofit organization. Which of the following should be disclosed as a related party transaction in the nonprofit organization's financial statements?

    a. Jeffrey receives an expense allowance of $200 per month for the use of his personal car for purposes of the organization's programs.

    b. Jeffrey receives an annual salary of $200,000, and will be paid a bonus of $20,000 if unrestricted contribution revenue increases by 10% over the previous year.

    c. Jeffrey traveled five times over the course of the year. His travel expenses were $10,000 for transportation and lodging, and $2,000 for meals and entertainment.

    d. Jeffrey guaranteed a loan of the organization. The outstanding balance at the end of the year is $100,000. However, the organization has made all required payments to-date.

GLOSSARY

Accumulated benefit obligation: An estimate of the present value of an employee's pension which assumes that the employee ceases to work for the company at the time the estimation is made. For a company the ABO is an estimate of the pension liability.

Consolidation: Combining assets, equity, liabilities and operating accounts of a parent firm and its subsidiaries into one financial statement.

Contingency: An existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) that will ultimately be resolved when one or more future events occur or when such event or events fail to occur.

Cost method: Financial recording and reporting method in which a parent firm's investment in a subsidiary is shown at cost, without indicating the effect of the subsidiary's profit or loss on the investment.

Defined benefit plan: A company retirement plan, such as a pension plan, in which a retired employee receives a specific amount based on salary history and years of service, and in which the employer bears the investment risk.

Defined contribution plan: A company retirement plan, such as a 401(k) plan or 403(b) plan, in which the employee elects to defer some amount of his/her salary into the plan and bears the investment risk.

Endowment fund: A permanent fund bestowed upon an individual or institution, such as a university, museum, hospital, or foundation, to be used for a specific purpose.

Equity method: An accounting method used to determine income derived from a company's investment in another company over which it exerts significant influence. Under the equity method, investment income equals a share of net income proportional to the size of the equity investment.

Equity securities: An instrument that signifies an ownership position (called equity) in a corporation, and represents a claim on its proportional share in the corporation's assets and profits.

Fair value: A valuation, in accordance with standard methodology, that is reasonable to all parties involved in a transaction in light of all pre-existing conditions and circumstances.

First-in, First-out (FIFO): A method of valuing the cost of goods sold that uses the cost of the oldest items in inventory first.

General partner: A partner with unlimited legal responsibility for the debts and liabilities of a partnership.

Indirect cost: Expenses (such as for advertising, computing, maintenance, security, supervision) incurred in joint usage and, therefore, difficult to assign to or identify with a specific cost object or cost center (department, function, program).

Inventory: A company's merchandise, raw materials, and finished and unfinished products which have not yet been sold. These are considered liquid assets, since they can be converted into cash quite easily.

Investment income: Capital gains, dividends, interest, and rent generated by investment, and not by trading activities.

Last-in, First-out (LIFO): A method of valuing inventory in which the items acquired last are treated as the ones sold first.

Market value: The price that an interested but not desperate buyer would be willing to pay and an interested but not desperate seller would be willing to accept on the open market assuming a reasonable period of time for an agreement to arise. A security's last reported sale price (if on an exchange) or its current bid and ask prices (if Over-the-Counter); i.e. the price as determined dynamically by buyers and sellers in an open market.

Multiemployer plan: A Multi-Employer Plan is a retirement plan sponsored by several employers under collective bargaining agreements that meets certain other requirements. A participant who changes jobs from one sponsoring employer to another stays within the same plan.

Periodic inventory system: One that does not require a day-to-day record of inventory changes. Costs of materials used and costs of goods sold cannot be calculated until ending inventories, determined by physical count, are subtracted from the sum of opening inventories and purchases (or costs of goods manufactured in the case of a manufacturer).

Permanently restricted net assets: Assets that are restricted by outside agencies or persons, as contrasted with assets over which the entity has control and discretion. An example of a permanently restricted asset is donated property on which the donor has placed a restriction on its use.

Retail inventory method: Ending-inventory value estimation method based on the relationship between cost and retail price.

Significant influence: Influence exerted (or presumed to be exerted) by a firm over a second firm whose 20 to 50 percent of shares are owned by the first firm. Significant influence usually translates into participation in the financial and operating policies without necessarily having full control over them. Firms holding such equity stakes are required to declare and account for them in their financial statements.

Specific identification: Inventory valuation method in which the actual cost of the purchased and issued (used or sold) items is identified by purchase date or a serial number.

Temporarily restricted net assets: Funds whose use is restricted by outside parties until some event occurs. For example, a not-for-profit organization may have received donated assets that are restricted by the donor until some time period has elapsed.

Unrestricted net assets: In government accounting assets with no external restriction as to use or purpose. They can be employed for any purpose designated by the governing board, as distinguished from funds restricted externally for specific purposes.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Nonprofit GAAP—Course 1—Selected Financial Statements for Nonprofit Entities (NPGTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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

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   NPGTG101 Self-study CPE
   36786 Treasury Center
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   Please allow a minimum of three weeks for grading.

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

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

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

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

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

EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Nonprofit GAAP—Course 1—Selected Financial Statements for Nonprofit Entities (NPGTG101)

Price $79

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Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	13.	○	○	○	○	24.	○	○	○	○	35.	○	○	○	○
2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
5.	○	○	○	○	17.	○	○	○	○	28.	○	○	○	○	39.	○	○	○	○
6.	○	○	○	○	18.	○	○	○	○	29.	○	○	○	○	40.	○	○	○	○
7.	○	○	○	○	19.	○	○	○	○	30.	○	○	○	○	41.	○	○	○	○
8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

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Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Nonprofit GAAP—Course 1—Selected Financial Statements for Nonprofit Entities

Course Acronym: NPTG101

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Accounting and Disclosure Requirements for Nonprofit Financial Statements (NPGTG102)

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Accounting and Disclosure Requirements for Nonprofit Financial Statements (NPGTG102)

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Please indicate your answer by filling in the appropriate circle as shown: Fill in like this not like this .

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1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
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Expiration Date: November 30, 2011

Self-study Course Evaluation

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Course Title: Companion to PPC's Guide to Nonprofit GAAP—Course 2—Selected Accounting and Disclosure Requirements for Nonprofit Financial Statements

Course Acronym: NPGTG102

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
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Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
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7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
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