THE POWER OF BEING UNDERSTOOD

AUDIT | TAX | CONSULTING
CACUBO HIGHER EDUCATION ACCOUNTING WORKSHOP - 2017

Presented by RSM US LLP

May 15 & 16, 2017
Your Instructors

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Experience the Power of Being Understood

• On October 26, 2015 McGladrey LLP changed its name to RSM US LLP and united with fellow firms in its global network under the common brand – RSM

• We remain an independent member of the RSM International network globally, which encompasses:
  - 120 countries
  - 760 offices
  - 38,300 people internationally

• This is accelerating our vision to be the first-choice advisor to middle market leaders globally
RSM US LLP is the leading provider of audit, tax and consulting services focused on the middle market, with more than 9,000 people in 86 offices nationwide. RSM uses its deep understanding of the needs and aspirations of clients to help them succeed.
Introductions

• Name
• Institution
• Years at your current institution and in higher education in total
• One area of strategic focus for your institution within the next year
Industry Update

• Higher Education Reauthorization
• Political environment
• Federal/Regulatory scrutiny
• Enrollment issues
• The Business Model
• Measuring “profit” and “loss”
Business Trends

- Increase in computer technology
  - Textbooks
  - Online courses

- New recreational facilities

- Athletic department cuts

- Hiring freezes and furloughs
Business Challenges

- Developing new funding sources
- Declining enrollment
- Ensuring campus safety
- International competition
- Aging faculty
- Dependence on tuition
- Endowment values declining
- Securing computing facilities and managing computer networks
Opportunities

• Additional revenue streams
  – Renting facilities
  – Online education
  – Publishing or consulting
  – Licensing technology
Open forum/sharing

• What issues/concerns have you faced?
• Have you gained any efficiencies or best practices that would be good to share?
• Have you introduced any new revenue streams?
NONPROFIT FINANCIAL STATEMENTS – THE NEW STANDARD
Finally – a Statement

NAC Recommendations – Added to FASB Agenda
• 2011

Exposure Draft
• April 22, 2015

Comment Period
• 264 Comment Letters

Redeliberations
• Late fall 2015 decided to split project into two phases

ASU No. 2016-14
• Issued August 18, 2016
NOTE: Board removed NFP Other Financial Communications (MD&A) project from its research agenda in January 2014.
• The Board decided in October 2015 to divide its redeliberations of the proposed Update into two workstreams

• Phase I: Proposed changes issued as ASU 2016-14 in August 2016

• Phase II: Proposed changes that need consideration of alternatives not previously considered or are related to issues being addressed in other FASB projects
Phase I – ASU 2016-14

• Net asset classification scheme, including:
  – Combine temporarily and permanently restricted net assets into ‘net assets with donor restrictions’
  – Disclosure of board-designated funds
  – Underwater endowments – classify within net assets with donor restrictions
  – Placed-in-service approach for expirations of capital restrictions – eliminate over-time approach

• Expenses, including:
  – Expenses by nature and an analysis of expenses by function and nature
  – Netting of investment expenses against investment return
  – Disclosure of netted investment expenses
  – Enhanced disclosures about cost allocations
Phase I – ASU 2016-14

• Operating Measure – modest improvements to disclosure
• Liquidity – quantitative and qualitative disclosure to emphasize information about assets that are liquid and available at the balance sheet date
• Statement of Cash Flows
  – Continue to permit direct or indirect method
  – No longer require indirect reconciliation for NFP that chooses direct method
• Have you considered implication of ASU 2016-14 for your organization?
  – Yes
  – No
## ASU 2016-14 - Net asset classification

<table>
<thead>
<tr>
<th>Current GAAP</th>
<th>Revised GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Assets:</strong></td>
<td><strong>Net Assets:</strong></td>
</tr>
<tr>
<td>• Unrestricted</td>
<td>• Without Donor Restrictions</td>
</tr>
<tr>
<td>• Temporarily Restricted</td>
<td>• With Donor Restrictions</td>
</tr>
<tr>
<td>• Permanently Restricted</td>
<td></td>
</tr>
<tr>
<td><strong>Disclosure:</strong></td>
<td><strong>Disclosure:</strong></td>
</tr>
<tr>
<td>• Amount, purpose and type of board designations</td>
<td>• Amount, purpose and type of board designations</td>
</tr>
<tr>
<td>• Nature and amount of donor restrictions</td>
<td>• Nature and amount of donor restrictions</td>
</tr>
<tr>
<td><strong>“Underwater” Endowments</strong></td>
<td><strong>Net Assets:</strong></td>
</tr>
<tr>
<td>• Reduce unrestricted net assets</td>
<td>• Reflect in net assets with donor restrictions</td>
</tr>
<tr>
<td><strong>Disclosure:</strong></td>
<td><strong>Disclosure:</strong></td>
</tr>
<tr>
<td>• Aggregate of original gift amounts, fair value</td>
<td>• Aggregate of original gift amounts, fair value</td>
</tr>
<tr>
<td>• Board policy</td>
<td>• Board policy</td>
</tr>
</tbody>
</table>
### ASU 2016-14 – Donations of Long-lived assets

<table>
<thead>
<tr>
<th>Current GAAP</th>
<th>Revised GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Assets:</strong></td>
<td><strong>Net Assets:</strong></td>
</tr>
<tr>
<td>• Gifts of cash restricted for acquisition or construction of long-lived assets:</td>
<td>• All NFPs will be required to use placed-in service approach</td>
</tr>
<tr>
<td>• Implied time restriction, or</td>
<td>• Time restriction only if explicit by donor</td>
</tr>
<tr>
<td>• Placed-in-service approach</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Healthcare NFPs are already required to use placed-in service approach
• All NFPs required to disclose expenses by function and natural classification in notes or on face of statements

• New requirement to disclose methods used to allocate costs among programs and support functions
ASU 2016-14 – Expense reporting

• Cost allocation disclosure – an example

Certain expenses are attributable to more than one program or supporting function. These expenses are allocated consistently on the following bases:

- Depreciation, interest and occupancy costs are allocated based on square-footage used by each function.
- Salaries and benefits are allocated based on estimates of time and effort

• See FASB ASC 958-720-55-176 and 958-205-55-21 for other examples
ASU 2016-14 – Expense reporting

• Definition of management and general expenses:

Currently includes:
• Oversight
• Business management
• General recordkeeping
• Budgeting
• Financing
• Soliciting funds other than contributions and membership dues
• Disseminating information about use of funds
• Announcements concerning appointments
• Annual report costs

New ASU adds, specifically:
• Payroll
• Administering government, foundation and similar contracts including billing, collection and reporting
• Employee benefits management and oversight
ASU 2016-14 – Expense reporting

• New concept –
  – Direct conduct or direct supervision of a function should be allocated out of management and general

• Examples:
  – Information technology
  – Direct supervision of program by senior manager
  – Direct conduct of fundraising by CEO
ASU 2016-14—Liquidity and Availability of Resources

**Qualitative**

In notes

• How NFP manages its liquid available resources
• How NFP manages liquidity risks

**Quantitative**

In notes and/or on the face

• Information about the availability of financial assets at balance sheet date to meet cash needs for general expenditures within one year
ASU 2016-14 – Liquidity Disclosure, Qualitative

• The organization has a policy to maintain available cash and short-term investments to meet 90 days of normal operating expenses, which are, on average, approximately $1,250,000. Cash in excess of daily requirements is invested in various short-term investments with maturities designed to meet obligations as they come due. In addition the organization, as more fully described in note 11, has committed lines of credit of $100,000.

• See FASB ASC 958-210-55-5 through 958-210-55-8 for other examples
### ASU 2016-14 – Liquidity Disclosure, Quantitative

**Financial assets, at June 30, 2017**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets, at June 30, 2017</td>
<td>523,000</td>
</tr>
<tr>
<td>Less those unavailable for general expenditures within one year, due to:</td>
<td></td>
</tr>
<tr>
<td>Contractual or donor-imposed restrictions:</td>
<td></td>
</tr>
<tr>
<td>Restrictions by donor with time or purpose restrictions</td>
<td>(52,000)</td>
</tr>
<tr>
<td>Donor-restricted endowments**</td>
<td>(185,000)</td>
</tr>
<tr>
<td>Investments held in annuity trust</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Deposits with banks securing letters of credit</td>
<td>100,000</td>
</tr>
<tr>
<td>Board designations:</td>
<td></td>
</tr>
<tr>
<td>Quasi-endowment fund, primarily for long-term investing**</td>
<td>(125,000)</td>
</tr>
<tr>
<td>Amounts set aside for liquidity reserve</td>
<td>(10,000)</td>
</tr>
<tr>
<td><strong>Financial assets available to meet cash needs for general expenditures within one year</strong></td>
<td>243,000</td>
</tr>
</tbody>
</table>

*Total assets, less nonfinancial assets (e.g., PP&E, inventory, prepaids)*

**Excludes amounts that have been appropriated for next 12 months that do not have purpose restrictions**
## ASU 2016-14 – Presentation of investment return

<table>
<thead>
<tr>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment return will be shown net of external and direct internal investment expenses</td>
</tr>
<tr>
<td>May report in multiple lines (e.g. different portfolios, operating versus nonoperating)</td>
</tr>
<tr>
<td>Disclosure of investment expenses not required</td>
</tr>
<tr>
<td>Disclosure of investment return components no longer required</td>
</tr>
</tbody>
</table>
Do not include investment expenses in functional expense analysis – except for programmatic investments.

Net expenses that involve **direct conduct** or **direct supervision** of strategic and tactical activities involved in generating investment return:

Net direct and allocable costs. Do not net costs such as unitization or endowment recordkeeping.
For those nonprofits that utilize an operating measure and show governing board designations, appropriations, and similar actions (internal transfers) in the measure

- Must report these type of internal transfers appropriately *disaggregated and described by type* (either on the face of the financial statements or in the notes)
ASU 2016-14 – Effective Date and Transition

• **Effective date**: For fiscal years beginning after 12/15/2017 (e.g., CY 2018 or FY)
  – Interim financials the following year

• **Early Adoption**: Permitted, but must apply the regular transition provisions.

• **Transition:**
  – For year of adoption: apply all provisions.
  – For comparative years presented: apply all provisions, except can choose not be present:
    a) Analysis of expenses by nature and function, and/or
    b) Disclosures around liquidity and availability of resources
ASU 2016-14 – Early Adoption

• Advantages:
  – Simplify presentation in statement of activities and statement of financial position
  – Presentation of restrictions from donors more closely matches legal restrictions, in particular as it relates to underwater endowments, and the requirement to treat endowments as a single pool
  – Enables use of simplified statement of cash flows.
  – Financial statements will become easier to understand by users – boards, donors, funders, government.

• Disadvantages:
  – For entities that do not currently present expenses by natural classification it will expand required disclosure
  – Additional required liquidity disclosure
  – Other disclosure modifications required
ASU 2016-14 – Implement half way?

- NFPs can incorporate many of the ideas from the ASU
- The following cannot be changed without formal adoption:
  1) Combining temporarily and permanently restricted net assets
  2) Accounting for underwater endowments in restricted net assets
  3) Eliminating disclosure of investment expenses and return components
  4) Eliminating current requirements for the cash flow reconciliation if the direct method is used
Question

• Will you consider implementing early?
  – Yes
  – No
Phase II Redeliberations

• Operating measures
  – Whether to require and how to define

• Statement of cash flows
  – Consideration of realignment of items

• Segment reporting for NFP healthcare entities

Timing – not yet determined
LEASES
ASU 2016-02 - Leases

• History
  – Proposed ASU in 2010
  – Revised proposed ASU in 2013
  – Significant changes to proposals in redeliberations
  – Final standard in February 2016

$1.25 trillion
of off-balance sheet operating lease commitments for SEC registrants*

* Estimate according to the 2005 SEC report on off-balance sheet activities
A lease contract provides the right to use an asset for a period of time from lessor to lessee.

New accounting is like owning the asset for a limited period of time, less than useful life, often less than useful life.

Will have significant impact to balance sheets

Could impact debt covenants
Identification of a lease

• Identified asset
  – The contract specifies an asset (explicitly or implicitly)
  – Supplies does not have a substantive right of substitution

• Control
  – Customer has the right to:
    • Obtain substantially all of the economic benefits from using the asset
    • Direct the use of the asset
Identification of a lease

- Scenario 1: Company A enters into a contract to use office space for 10 years. The office space is part of a larger building with many units.
  - Company A may use Unit A
  - Counterparty can require Customer A to relocate to a different unit of similar quality and specifications
  - Counterparty would benefit from relocating Company A only in the event that a new major tenant were to decide to occupy space and the rate would cover the costs of relocating Company A
    - Possible, but not likely
Identification of a lease

- Analysis
  - Identified asset? Answer = yes
    - Retail unit A is an identified asset, explicitly identified in contract
    - Counterparty has ability to substitute, but could only benefit in specific circumstances
  - Right to control? Answer = yes
    - Company A has the right to obtain substantially all of the economic benefits from use of Unit A
    - Company A has the right to direct use. Company A makes the decisions on how, and for what purpose, the Unit will be used

- Conclusion: Contract contains a lease
Identification of a lease

- Scenario 2: Company B enters into a contract with Power Supplier Inc. to purchase all of the power from a specific plant for five years.
  - Power Supplier cannot provide power from another plant
  - Contract specifies quantity and timing of power, and neither can be changed absent extraordinary circumstances
  - Power Supplier operates/maintains plant in accordance with industry-approved standards
Identification of a lease

• Analysis
  – Identified asset? Answer = yes
    • Power plant is an identified asset, explicitly identified in contract
    • Power Supplier does not have ability to substitute
  – Right to control? Answer = no
    • Company B has the right to obtain substantially all of the economic benefits from plant
    • Company B does not have the right to direct use. How and for what purpose the plant is used are predetermined in the contract

• Conclusion: Contract does not contain a lease
Lease and nonlease components

- Separate and allocate based on relative standalone selling price
- Any activities that do not transfer a good or service to lessee are not components
- Lessee accounting policy election
Lease classification

• Important definitions
  – Lease term
  – Lease payments
Lease term

Noncancellable period

Optional renewal period if lessee is *reasonably certain* to exercise

Periods covered by options to extend/not terminate exercisable by lessor

Periods after a termination option if lessee is *reasonably certain* **not** to exercise
Lease payments

- Fixed payments (including “insubstance”)
- Purchase options (if exercise is reasonably certain)
- Termination options (if exercise is reasonably certain)
- Residual value guarantees (if probable of being owed)
- Variable lease payments that depend on an index or rate
Lease classification

1. Does the lease transfer ownership to the lessee by the end of the lease term?
2. Does the lease contain a purchase option that the lessee is reasonably certain to exercise?
3. Is the lease term for the major part of the remaining economic life of the asset?
4. Is the sum of the present value of the lease payments and any residual value guaranteed by the lessee equal to or greater than substantially all of the fair value of the asset?
5. Is the underlying asset of a specific nature such that it would have no alternative use to the lessor?

Similar to current criteria, but without bright lines
Lease classification

• Lessees
  – If lease does not meet any of the criteria, it is classified as operating
  – If lease meets any of the criteria, it is a finance lease
  – Short-term leases election
    • Election available by class of asset
    • Lease term of 12 months or less
    • No lessee purchase option for which exercise is reasonably certain
    • Do not recognize ROU asset or lease liability
• Lessors
  
  – If the lease meets any of the criteria, it is a sales-type lease
  
  – If the lease does not meet any of the criteria, it is classified as:

  • Direct financing lease if (a) the present value of the sum of the lease payments plus any residual value guaranteed by the lessee or any other unrelated party equals or exceeds substantially all of the fair value of the underlying asset and (b) collectibility is probable

  • Operating lease
ASU 2016-02 - Leases

Operating Leases

- Balance Sheet:
  - Right-of-use asset
  - Liability
- Activities
  - Lease expense

Finance Leases

- Balance Sheet:
  - Right-of-use asset
  - Liability
- Activities
  - Interest expense
  - Amortization expense

Assets and liabilities should be recognized for all leases other than those with a lease term of 12 months or less
Lease accounting - recognition

• Balance sheet
  - Lease liability
  - ROU asset

• Income statement
  - Finance lease: Amortization and interest
  - Operating lease: Lease expense
Balance sheet: Lease liability initial measurement

Unpaid lease payments:
- Calculate as of lease commencement date
- Adjust for payments already made

\[ \text{X Discount rate} \times \text{Unpaid lease payments} = \text{Lease liability} \]

- Use rate implicit in the lease, unless not readily determinable
- Otherwise, use incremental borrowing rate
- Nonpublic business entities may use risk-free rate
Balance sheet: ROU asset initial measurement

Lease liability

+ Initial direct costs (redefined)

+ Prepaid lease payments

- Lease incentives received

= ROU asset
ROU asset – subsequent measurement

• Finance lease
  – Beginning balance
  – Adjust for:
    • Accumulated amortization
    • Impairments (if any)
  – Amortization will generally be straight line over shorter of lease term or useful life of ROU asset
  – Impairment—ROU asset is subject to impairment testing in ASC 360
• Operating lease
  – Lease liability balance
  – Adjust for:
    • Cumulative prepaid or accrued rents
    • Lease incentives received
    • Initial direct costs
    • Impairments
  – Balance sheet/income statement perspective
    • Determine amortization of ROU asset
    • Calculate interest on liability using discount rate
    • Subtract that amount from straight-line lease expense
Lease liability – subsequent measurement

• For both operating and finance leases, lessees will use the effective interest rate method
Lease accounting - modifications

- Modification
  - Change to contractual terms/conditions that leads to change in scope of/consideration for the lease
  - Should the lease modification be accounted for as a separate contract?
    - Was the lessee granted an additional ROU asset?
    - Is the price of that ROU asset commensurate with the standalone price?
  - If the modification is a new lease, apply the new requirements to the new lease
  - If not a new lease, reassess classification
    - Use modified terms and discount rate at modification date
## Subsequent measurement: Modification accounting

<table>
<thead>
<tr>
<th>Nature of modification</th>
<th>Lease accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Separate contract</td>
<td>• Account for separately</td>
</tr>
<tr>
<td>• Grants an additional ROU</td>
<td></td>
</tr>
<tr>
<td>• Changes lease term (other than via option exercise)</td>
<td></td>
</tr>
<tr>
<td>• Results in a change to lease consideration</td>
<td></td>
</tr>
<tr>
<td>• Reduces scope of original lease contract</td>
<td>• Revise lease liability using updates payments and rate at modification date</td>
</tr>
<tr>
<td></td>
<td>• Change in lease liability is an adjustment to ROU asset</td>
</tr>
<tr>
<td></td>
<td>• Revise lease liability using updates payments and rate at modification date</td>
</tr>
<tr>
<td></td>
<td>• Change in lease liability is recognized as a gain/loss</td>
</tr>
</tbody>
</table>
Lease liability - remeasurement

• Liability is remeasured when:
  – Lease is modified (and modification is not accounted for as a separate contract)
  – A change occurs in the assessment of
    • Lease term
    • Exercise of a purchase option
    • Amount probable of being owed under a residual value guarantee
  – A contingency is resolved such that some or all variable lease payments become fixed
Lessee accounting – Income statement effect

• Finance lease
  – Front loaded expense pattern
  – Interest (calculated using effective interest rate method)
  – Amortization of ROU asset (generally straight-line)

• Operating lease
  – Generally straight-line expense recognition
Lessor accounting - Recognition

• Balance sheet
  – Lease receivable
  – Unguaranteed residual
  – Deferred profit (direct finance lease)
Lessor accounting

• Sales-type/Direct financing leases
  – Derecognize underlying asset
  – Recognize
    • Net investment in lease
      – Lease receivable + unguaranteed residual asset
    • selling profit/loss from lease (for sales-type)
    • Initial direct costs = expense (unless there is no selling profit or loss; again, for sales-type)
  – Interest income accrued based on *implicit* rate
  – Use financial instruments guidance for impairment
• Operating leases
  - Leased asset remains on lessor’s books
  - Recognize lease payments as income (generally straight line)
Other issues - Subleases

Lessor
- Lessor accounting

Sublessor
- Lessee accounting for head lease; lessor accounting for sublease

Sublessee
- Lessee accounting
Other issues – Sale-leaseback transactions

• New model for all assets (including real estate)
• Applies to lessees and lessors
• Transaction must meet requirements in ASC 606

• A leaseback, by itself, does not preclude sale
  – Leaseback is not a finance or a sales-type lease
  – Substantive repurchase option?
Other issues – Sale-leaseback transactions

• If transaction qualifies as a sale:
  – Seller-lessee recognizes sale using revenue guidance
  – Derecognize asset sold
  – Record ROU asset/lease liability for leaseback
  – Buyer-lesser accounts for purchase of asset and classifies lease using lessor guidance

• If transaction does not qualify as a sale:
  – Buyer-lesser treats as a lending
  – Seller-lessee treats a borrowing
Lessee disclosures

Extensive qualitative and quantitative disclosures

<table>
<thead>
<tr>
<th>Type</th>
<th>Example disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualitative</td>
<td>• Nature of leases</td>
</tr>
<tr>
<td></td>
<td>• Leases that have not yet commenced</td>
</tr>
<tr>
<td></td>
<td>• Variable payment arrangements</td>
</tr>
<tr>
<td></td>
<td>• Termination/purchase/renewal options options</td>
</tr>
<tr>
<td>Quantitative</td>
<td>• Amortization and interest for finance leases</td>
</tr>
<tr>
<td></td>
<td>• Operating lease cost</td>
</tr>
<tr>
<td></td>
<td>• Variable lease cost</td>
</tr>
<tr>
<td></td>
<td>• Short-term lease cost</td>
</tr>
<tr>
<td></td>
<td>• Maturity analysis of lease liabilities</td>
</tr>
<tr>
<td>Significant</td>
<td></td>
</tr>
<tr>
<td>judgments and assumptions</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Determining if a lease exists</td>
</tr>
<tr>
<td></td>
<td>• Standalone prices</td>
</tr>
</tbody>
</table>
## Lessor disclosures

### Extensive qualitative and quantitative disclosures

<table>
<thead>
<tr>
<th>Type</th>
<th>Example disclosures</th>
</tr>
</thead>
</table>
| Qualitative     | • Nature of leases  
|                 | • Variable payment arrangements  
|                 | • Termination/purchase/renewal options  
|                 | • Information about management of residual asset risk                                |
| Quantitative    | • Lease income (in tabular format)  
|                 | • Maturity analysis of undiscounted cash flows (segregated by finance/operating lease) |
Effective date

Public business entities
• Annual and interim periods in fiscal years beginning after 12/15/2018
• Early adoption permitted
• Modified retrospective transition
  – Certain reliefs

Nonpublic business entities
• Fiscal years beginning after 12/15/2019
• Interim periods in fiscal years beginning after 12/15/2020
• Early adoption permitted
• Modified retrospective transition
  – Certain reliefs
Transition

• Modified retrospective transition
  – Full retrospective adoption is prohibited
  – All comparative periods presented are restated
  – “Packaged” transition reliefs
    • Expired/existing contracts contain leases
    • Lease classification for expired/existing leases
    • Whether previously capitalized initial direct costs could still be capitalized

• Other transition relief
  • Hindsight can be used in determining lease term and assessing impairment of ROU assets
• Items of specific interest to not-for-profit entities
  – Discount rate: Risk-free discount rate may be used
  – Related party leases: Account for based on the legally enforceable terms and conditions
    • “Substance over form” guidance in current US GAAP will not be retained
  – Disclosure requirements: Many new disclosures
    • No relief planned for nonpublic business entities
ASU 2016-02 - Leases

• Effective date for NFPs for calendar year 2019 for those with public or conduit debt and one year later for others.

• This is one year after effective date for revenue recognition.

• Early adoption is permitted.
Ten year office lease - annual rent $50,000

Current disclosure:

Statement of financial position - NONE

Statement of activities:

Occupancy expense $ 50,000

Note:
Summarize terms of lease.

Lease commitments:

Year ending December 31:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>2018</td>
<td>50,000</td>
</tr>
<tr>
<td>2019</td>
<td>50,000</td>
</tr>
<tr>
<td>2020</td>
<td>50,000</td>
</tr>
<tr>
<td>2021</td>
<td>50,000</td>
</tr>
<tr>
<td>Thereafter</td>
<td>250,000</td>
</tr>
<tr>
<td>Total</td>
<td>$500,000</td>
</tr>
</tbody>
</table>
Future disclosure:

Statement of financial position:

Assets:
- Right of use asset - office lease $405,545

Liabilities:
- Lease obligation $405,545

Statement of activities:
- Occupancy expense $50,000

Note:

Summarize terms of lease and describe it as operating lease that has been discounted at a risk free rate of return of 4 percent based on treasury rates. Disclose total lease cost - $50,000, payable as follows:

<table>
<thead>
<tr>
<th>Year ending December 31:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>2018</td>
<td>50,000</td>
</tr>
<tr>
<td>2019</td>
<td>50,000</td>
</tr>
<tr>
<td>2020</td>
<td>50,000</td>
</tr>
<tr>
<td>2021</td>
<td>50,000</td>
</tr>
<tr>
<td>Thereafter</td>
<td>250,000</td>
</tr>
<tr>
<td>Total</td>
<td>500,000</td>
</tr>
</tbody>
</table>

Less discount at 4% per annum (94,455)

Lease obligation $405,545
Question

• Have you considered the impact the lease standard will have on your financial statements?
  – Yes
  – No
HIGHLIGHTS OF OTHER RECENT ASUS

Revenue Recognition (Topic 606)
Financial Instruments – Recognition and Measurement (Topic 825)
Financial Instruments – Credit Losses (Topic 326)
Not-for-Profit Entities – Consolidation (Subtopic 958-810)
Statement of Cash Flows (Topic 230)
Other: Simplification Initiative
ASU 2014-09 - Revenue recognition

• Final standard issued by FASB in May 2014
  – ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*

• Highlights
  – Substantial convergence achieved with IASB’s newly issued IFRS 15
  – Single revenue recognition model for contracts with customers that will affect almost all entities
    • Elimination of the vast majority of industry-specific U.S. GAAP on revenue recognition
ASU 2014-09: Scope

• Applies to all contracts with customers, except the following:
  - Lease contracts
  - Guarantees other than warranties
  - Insurance contracts
  - Financial instruments
  - Certain nonmonetary exchanges
  - Various contractual rights or obligations related to financial instruments

• Contracts not with customers excluded – Contributions, collaborative arrangements, etc.
ASU 2014-09: Scope – Impact on NFPs

• Contributions are excluded
• Unclear as to whether grants are within scope
  ▪ FASB has project to clarify that when benefit does not go back to granter it is non-reciprocal (contribution)
  ▪ Most revenue sources that are exchange transactions will be impacted, in particular those with impact beyond reporting period:
    ▪ Tuition and fees
    ▪ Membership dues
    ▪ Licenses and royalties
    ▪ Health care revenues
    ▪ Continuing care retirement communities
• Concept of exchange transaction
  − Goes away with effective date of ASU 2014-09/606

• Contributions are scoped out of 606 as they are not a contract with a customer

• Some transactions may be both contribution AND contract (i.e. Grants)
ASU 2014-09 - Government and other grants – Currently effective GAAP

• U.S. GAAP (FASB) focuses on:
  – Exchange vs Contribution (non-exchange)
  – Conditions vs. Restrictions

• New revenue recognition focuses on reciprocal transactions (exchange contracts with customers)

• Historical inconsistency in accounting for grants – especially those from the Government

• FASB to address issue largely through changes to existing terminology.

• FASB will also address clarification as to conditional contributions
ASU 2014-09 - Questions to consider regarding grants – Currently effective GAAP

• Are grants more akin to contributions or exchange transactions?

• What factors should be considered in making the determination regarding whether a grant is a contribution or an exchange transaction?

• Does it matter?
ASU 2014-09 - Grants discussion – Government and other

- Opportunity for a reset, not a restatement
- Contract with customer (potential right of return) or nonreciprocal transaction (no right of return)
- Provision of goods and services/fulfillment of a ‘known and explicit obligation’:
  - Fulfills an organization’s mission or for ‘societal benefit’, it is not an obligation
  - Ambiguity implies not an obligation
  - Definition of ‘obligation’ to be very narrow, supporting clarity
- Operationalize distinction between conditions and restrictions
Five-Step Revenue Model - Reminder

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) each performance obligation is satisfied
Effective Date – Extended by ASU 2015-14

• For public business entities, nonprofit entities that have public debt or are conduit debt obligors for public debt and certain employee benefit plans
  – Annual reporting periods beginning after December 15, 2017, including related interim periods
  – Early application is prohibited

• For all other entities
  – Annual reporting periods beginning after December 15, 2018 and interim periods thereafter
  – Early application is allowed; however, cannot adopt earlier than the effective date for public business entities would otherwise provide for
ASU 2014-09: Implementation

• FASB and IASB have established a joint Transition Resource Group (TRG)
  - Purpose is to provide feedback to the FASB and IASB about implementation issues raised by constituents to facilitate the FASB and IASB determining next steps
    • Purpose is not to issue guidance
    • Purpose is not to redeliberate guidance, but discuss how it should be applied

• The AICPA has formed sixteen industry task forces to help develop a new Accounting Guide on Revenue Recognition that will provide illustrative examples for how to apply the new standard. Includes health care and not-for-profit.
ASU 2014-09 - Nonprofit Implementation issues

• AICPA’s not-for-profit revenue recognition task force has identified the following implementation issues:
  – Tuition and Housing Revenue
  – Contributions
  – Government Grants
  – Subscriptions and Membership Dues
  – Bifurcation of Transactions Between Contribution and Exchange Components

• Separate task force for health care implementation issues
ASU 2016-01, Financial Instruments, Classification & Measurement

• Current requirement for entities with public debt (or conduit debt) or with assets of $100 million or any derivatives to present fair value of financial instruments that are not recognized at fair value in statement of financial position (FAS 107 disclosures)

• New requirement – public business entities only, so no longer required for any NFP
ASU 2016-01, Financial Instruments, Classification & Measurement

• All investments in equity securities to be carried at fair value (unless consolidated or equity method) – cost-based practical expedient for nonmarketable securities
  – cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment

• Effective for NFPs for years beginning after December 15, 2018 (Calendar year 2019 and fiscal years ending in 2020) Early adoption is permitted immediately for FAS 107 disclosure, and by one year only for other provisions
ASU 2016-13 - Financial instruments – Credit Losses

• Applies Current Expected Credit Loss Model (CECL) to recording of certain financial instruments
• Applies to programmatic loans including student loans
• Requirement to record such instruments at the net present value of the amount an entity expects to collect
• Does not apply to pledges receivable
ASU 2016-18 - Restricted cash

• Final update issued November, 2016
• Focused on reducing diversity in practice
• Practice issues identified:
  – Definition of restricted cash
  – Classification of changes in restricted cash
  – Requires restricted cash to be included in cash & cash equivalents on SOCF
• Effective date – Calendar 2019/Fiscal Year 2020
Amendments to the Consolidation Analysis

- Current guidance for nonprofits is separate model for limited partnerships and similar legal entities – rules related to VIEs do not generally apply to NFPs
  - Includes a presumption that the general partner controls, usually resulting in consolidation. Substantive kick-out or participating rights needed to overcome presumption

- New guidance (ASU 2015-02) eliminates presumption of control by general partner

- ASU 2017-02 reinstated presumption only for NFPs

- Effective for NFPs for years beginning after December 15, 2016 (Calendar year 2017 and fiscal years ending in 2018)

- NFPs that already have adopted the amendments in ASU 2015-02 are required to apply the amendments in ASU 2017-02 retrospectively to all relevant prior periods beginning with the fiscal year in which the amendments in ASU 2015-02 initially were applied.
ASU 2017-04, Intangibles – Goodwill and Other: Simplifying the Test for Goodwill Impairment

- Simplification to the way a company measures goodwill impairment charge
- Elimination of Step 2 from impairment test
- Impairment charge now = carrying value – reporting unit’s fair value
- Also elimination of requirements for any reporting unit with zero or negative carrying amount to perform qualitative assessment.
- Qualitative assessment (Step 0) still permitted
ASU 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

• Requires service cost component of net benefit cost in the same line item or items as other compensation costs
• All other items of net benefit cost to be presented separately from service cost and outside of a subtotal for income from operations, if one is presented
• Effective for annual periods beginning after December 13, 2018.
• Early adoption is permitted as of the beginning of an annual period for which financial statements have not been issued or made available for issuance.
• Retrospective presentation required. Information from prior year financial statements can be used as a practical expedient.
Simplification Initiative—ASUs Issued

• Eliminating the Concept of Extraordinary Items (ASU 2015-01)
• Presentation of Debt Issuance Costs (ASU 2015-03)
• Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement (ASU 2015-05)
• Disclosures for Investments in Certain Entities That Calculate NAV per Share (ASU 2015-07)
• Measurement of Inventory (ASU 2015-11)
• Employee Benefit Plan Reporting (part 1) (ASU 2015-12)
• Measurement-Period Adjustments (ASU 2015-16)
• Balance Sheet Classification of Deferred Taxes (ASU 2015-17)
• Equity Method of Accounting (ASU 2016-07)
• Employee Share-Based Payments (ASU 2016-09)
• Income Taxes on Intra-Entity Transfers of Assets (ASU 2016-16)
AICPA

- AICPA has no GAAP writing authority
- Audit Guides continue to be most readable information readily available to assist in applying GAAP
- New AICPA Not-for-Profit Section
- AICPA Not-for-Profit Certificate Program
Gain timely insights on your industry and business issues.
Information fueled by our experience and customized to your needs.

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Email Address*

Assurance, tax and consulting resources
- **Financial Reporting Insights**
  - Assurance
  - A timely resource for recent financial reporting developments and practice issues.
- **Tax Alerts**
  - Tax
  - Regular notification of recent tax developments and legislative updates.
- **Technology Bulletins**
  - Technology
  - Quarterly information to help you make critical technology decisions for the stability and growth of your organization.
- **Microsoft Dynamics Community News**
  - Consulting
  - Technology announcements and special promotions from Microsoft and the Microsoft Dynamics Business Solution Suite.
- **Risk Bulletins**
  - Consulting
  - Key insights to help your organization manage risk.

Industry focus
- **Compliance News**
  - Financial Institutions
  - Quarterly regulatory compliance ideas, education and updates for financial institutions.
- **Construction Quarterly**
  - Construction
  - Quarterly newsletter covering issues ranging from accounting standards to operational improvements critical to construction professionals.
- **Consumer Products Commentary & More**
  - Consumer Products
  - Monthly commentary offering insights into the latest trends in the marketplace, tackling topics such as supply chain management, consumer behavior, international sourcing and distribution.
- **Financial Institutions Insights**
  - Financial Institutions
  - Information newsletter on key issues ranging from IT security to regulatory compliance to operational improvements.
- **Investment Industry Insights**
  - Financial Services: Investment
  - More
  - Private Clubs
  - Non-Profit
  - Manufacturing and Distribution

www.rsmus.com/subscribe
QUESTIONS AND ANSWERS?
CONTRIBUTIONS – WHAT COUNTS AND WHAT DOESN’T
Contributions

• Definition of a contribution (accounting language)
  - An **unconditional** transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a **voluntary nonreciprocal** transfer by another entity acting other than as an owner. Financial Accounting Standards Board (FASB) Accounting Standards Codification 958-605

• Common forms of contributions
  - Cash, promises to give, split-interest agreements, in-kind contributions

• Items not covered by contribution accounting
  - Exchange transactions (in-substance purchases)
  - Agency transactions
  - Tax exemptions, tax incentives, and tax abatements
Donor-imposed condition = stipulation that specifies a future and uncertain event whose occurrence or failure to occur gives the donor the right of return of the assets or releases the donor from the obligation to transfer the assets.

However, if possibility that the condition will not be met is remote, considered unconditional.

Assets received with a condition are recorded as a liability (refundable advance) until the conditions are met.

Revenue is recognized as the condition is met, which could be in stages, depending on the condition (e.g. a $1 for $1 matching gift).

It can be difficult to distinguish between a condition and a restriction – communicate with the donor if ambiguous!
Restricted vs. Unrestricted

• Restrictions by a **donor** provide specific guidelines on how, when and where the funds are to be used.

• Can be unrestricted, permanently restricted or temporarily restricted due to time, purpose, or both.

• Restrictions can be explicit (stated by donor) or implicit (e.g. response to capital campaign for new building).

• Restrictions are released once satisfied by passage of time or actions of the donee.

• Identification and tracking of restrictions is key!
Intentions to Give

• Intentions to give are NOT recorded

• Determining promise or intention may require judgment
  – Look to the language (“promise” or “pledge” vs “intend” or “plan”)
  – If the donor won’t commit it to writing, likely an intention
  – Notice of inclusion in a will prior to probate is an intention

• Be careful of wording in your solicitations
  – Wording like “information to be used for budget purposes only” or that clearly allow donors to rescind are intentions

• Comes down to legal enforceability
Promises to Give

- **Promise to give** = written or oral agreement to contribute cash or other assets to another entity.

- Can be conditional or unconditional

- Unconditional promises recognized when promise is **made**

- Get pledge and terms in writing
  - Oral promises acceptable, but hard to substantiate
  - Pledges without clear payment terms acceptable, but difficult to account for.

- Initially temporarily or permanently restricted

- Released when purpose met or pledge **due**
Promises to Give (continued)

• Can be paid over a number of years
• Revenue is recognized based on PV of estimated future cash flow using appropriate discount rate (other valuation techniques available under ASC 820)
• Need to consider allowance for uncollectible pledges
Discount Rate

• If PV techniques are used to measure FV
  – Discount rate should be consistent with the general principles of present value measurement discussed in ASC 820-10-55-5
  – Not donor’s borrowing rate because their ability to honor promise considered in estimated cash flows
  – Discount rate should not be revised subsequently (unless entity has elected fair value treatment for this assets)
Split-Interest Agreements

• Defined
  – Trust or other arrangement
  – Benefits split between NPO and other beneficiary/beneficiaries

• Gift directly to NPO (as trustee) or to a trust
  – If third-party trustee has variance power, do not record

• Revocable or irrevocable – important distinction

• To record irrevocable interest, must have reliable and verifiable evidence that the interest exists
  – Copy of executed trust agreement, a statement from trustee, or other information
  – Sufficient information about the trust in order to value it
Variance Power

• **Unilateral** power to redirect the use of the transferred assets to an entity or individual other than the specified beneficiary

• If a donor **explicitly** grants a recipient organization variance power and names an **unaffiliated** beneficiary, the recipient organization is a donee and recognizes contribution revenue.
Common Split-Interest Agreements

• Charitable lead trust
  - NPO receives distributions during the agreement’s term
  - CLATs (annuity trusts) and CLUTs (unitrusts)

• Charitable remainder trust
  - NPO receives all or a portion of the assets remaining at the end of the agreement’s term
  - Fixed amounts, CRATs (annuity trusts), CRUTs (unitrusts)

• Perpetual Trust
  - NPO receives distributions of income earned on assets in perpetuity, but never receives the actual assets

• Charitable Gift Annuity
  - NPO receives assets up front & in exchange agrees to pay fixed amounts for a specified time to individuals or entities designated by the donor.
  - Assets are general assets of NPO, liability is general obligation
Charitable Lead Trust (NPO not trustee)

• Initial recording:
  – Recognize beneficial interest in the assets at fair value along with corresponding temporarily or permanently restricted revenue
  – Measured at present value of future distributions using appropriate discount rate

• Subsequent measurement
  – Record cash received / reduce beneficial interest
  – Reclassify revenue to unrestricted from temp restricted
  – Remeasure fair value based on passage of time, donor’s life expectancy, and current discount rate assumptions.
    • NOTE: remeasurement recorded in separate temp restricted account on statement of activities called “changes in value of split interest agreement”
Charitable Remainder Trust (NPO not trustee)

• Initial recording:
  − Recognize beneficial interest in the remainder assets at fair value along with corresponding temporarily or permanently restricted revenue (similar calculation as lead interest)
  − Measured at present value of remainder payment using appropriate discount rate

• Subsequent measurement
  − Remeasure fair value based on passage of time, donor’s life expectancy, and current discount rate assumptions and record to changes in value of split interest agreement account

• Termination or trust
  − Asset received, receivable removed and difference goes to changes in value of split interest agreement
Beneficial Interest in Perpetual Trust Held by Third Party

• Initial recording:
  - Recognize beneficial interest in perpetual trust at fair value (fair value can generally be measured at fair value of assets contributed to the trust).
  - Contribution revenue is permanently restricted

• Subsequent measurement
  - Record income from the trust by appropriate restriction based on donor’s wishes
  - Record gain or loss in permanently restricted revenue for changes in fair value of asset
Gift Annuity

• **Initial recording:**
  - Assets recognized at fair value
  - Liability recognized at fair value using present value
  - Contribution revenue is the difference

• **Subsequent measurement**
  - Record annuity payment to beneficiary
  - Adjust liability and “change in value of split interest” account for amortization of discount and change in life expectancy of beneficiary

• **Termination of annuity**
  - Remove liability and adjust change in value of split interest
Disclosure of Split-Interest Agreements

• Disclosure
  – Assets and liabilities disclosed separately from other assets and liabilities
  – Contribution revenue and changes also reported separately or in notes
  – Notes include
    • Description of general terms of split-interest agreements
    • Basis used for recognized assets
    • Discount rate and actuarial assumptions used for PV techniques
    • Disclosures required for fair value standards (e.g. Level 1,2,3) if valued at fair value on a recurring basis (beneficial interests and perpetual trusts)
Final Tips on Split-Interest Agreements

• Managing these agreements are complex, take resources and carry risks - know what you have received

• Importance of a gift acceptance policy
  – Compliance with State regulations
  – Specify the types of assets that will be accepted
  – Establish a minimum gift amount
  – Follow industry standards for suggested rates
  – Ensure gift designations are honored

• Use software for calculating values but be careful
  – Many are for purposes of tax deduction and may not result in appropriate GAAP fair value
Resources

- AICPA Fair Value White Paper
  - [http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/FV andDisclosures_NFP.aspx](http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/FV andDisclosures_NFP.aspx)
  - Free to all AICPA members

- AICPA Audit and Accounting Guides

- AICPA Technical Practice Aids

- AICPA Government Audit Quality Center

- Websites
  - [acga-web.org](http://acga-web.org) (American Council on Gift Annuities)
  - [foundationcenter.org](http://foundationcenter.org)
  - [nonprofitquarterly.org](http://nonprofitquarterly.org)
QUESTIONS AND ANSWERS?
FUNCTIONAL EXPENSES AND FUNDRAISING
Why allocate expenses

- Manage costs/programs
- Donors may require a specific percentage
- GAAP requires it
- Form 990 requires it
- Benchmarking for the NFP sector
Functional classification of expenses

• To help donors, creditors, and others in assessing an NFP's service efforts, including the costs of its services and how it uses resources

• Statement of activities or notes to financial statements shall provide information about expenses reported by their **functional classification**
  - Program services
  - Supporting services
Financial reporting

• NFPs must report their expenses by function, such as major classes of program services and supporting activities.

• It is optional to report information about expenses by their natural classifications (such as salaries, rent, electricity, interest expense, depreciation, awards and grants to others, and professional fees), in a matrix format in a separate financial statement called a statement of functional expenses.

• 2 FASB ASC 958-720-45-16 states that other NFPs are encouraged, but not required, to provide information about expenses by their natural classification.
Statement of functional expenses

• To the extent that expenses are reported by other than their natural classification (such as salaries included in cost of goods sold or facility rental costs of special events reported as direct benefits to donors), they should be reported by their natural classification if a statement of functional expenses is presented.
  
  • For example, salaries, wages, and fringe benefits that are included as part of the cost of goods sold on the statement of activities should be included with other salaries, wages, and fringe benefits in the statement of functional expenses.

• Expenses that are netted against investment revenues should be reported by their functional classification on the statement of functional expenses (if the NFP presents that statement).
Functional Classification

• Method of grouping expenses according to the purpose for which the costs are incurred

• The primary functional classifications are:
  – Program services
  – Supporting activities
    • Management and general
    • Fundraising
Program services

• Activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists

• Components of total program expenses shall be evident from the details provided on the face of the statement of activities, unless provided in the notes to financial statements
Supporting activities

- Management and general activities
- Fundraising activities
- Membership development activities
Management and general

- Oversight and business management
- General recordkeeping
- Budgeting
- Financing
- Marketing (not development)
- Administering government, foundation or similar contracts including billing and collecting fees
- Disseminating information to inform the public of the stewardship of contributed funds
- Producing and disseminating the annual report
- Generally include the salaries and expenses of the governing board, the chief executive officer of the NFP, and the supporting staff. (If a portion of their time is spent directly supervising program services or categories of other supporting services, then their salaries and expenses shall be allocated among those functions.)
Fundraising

• Publicizing and conducting fundraising campaigns
• Maintaining donor mailing lists
• Conducting special fundraising events
• Preparing and distributing fundraising manuals, instructions, and other materials
• Conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.
• Soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions.
Fundraising vs advertising

- Difference between fundraising and advertising
  - In order to be considered fundraising, it must be an activity that involves inducing potential donors to contribute to your organization.
  - Advertising is an activity of attracting public attention to your organization but does not necessarily need to include solicitations.
Membership development activities

Soliciting for prospective members and membership dues

Membership relations
Primary functional expense classifications

• Scholarships and Fellowships
• Instruction
• Institutional Support
• Student Services
• Academic Support
• Auxiliary Enterprises
Primary functional expense classifications

- Public Service
- Research
- Hospitals
- Independent Operations
Ways to Classify Expenses

• Direct Identification
  – Preferred method for charging expenses to various functions as it viewed as the most accurate
  – If an expense can be specifically identified with a program or a supporting service, it should be assigned to that function

• Allocation
  – Assigning indirect costs to individual programs
Indirect Costs

• Indirect costs are those for activities or services that benefit more than one project or activity.
• They’re not readily identified with a particular grant, contract, project function, or activity but are necessary for the general operation of the organization.
Other cost allocations

• Interest costs
  – Shall be allocated to specific programs or supporting services to the extent possible
  – If cannot be allocated shall be reported as part of the management and general function

• Costs of occupancy and maintenance
  – Occupying and maintaining a building is not a separate supporting service
## Allocation methodologies

<table>
<thead>
<tr>
<th>Standalone Joint Cost</th>
<th>Physical Units</th>
<th>Relative Direct Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specific costs of activities</td>
<td>Square footage</td>
<td>Other expense categories (salaries)</td>
</tr>
<tr>
<td></td>
<td>Time study</td>
<td></td>
</tr>
</tbody>
</table>
Substantiating Allocations

- Organizations should maintain documentation supporting:
  - Allocation methodology
  - Calculations used to do the actual allocation and to support disclosures in the financial statements
  - Basis of calculations (for example: time studies with signed time cards, head count of FTEs by department/function, square footage of a shared facility and each functional area within the facility, etc.)
  - Reasonableness of the allocations: may include industry information/comparables, trend information for prior years and analysis of this information with respect to current year allocations
  - Support for the original transactions that make up the expenses that are allocated
  - Use of consistent methodology during the period and from year to year
  - Internal controls surrounding expense allocations
Required disclosures

• Total fundraising expenses
• Total program expenses and information about why total program expenses disclosed in the notes do not articulate with the statement of activities. Pursuant to paragraph 958-720-45-5, this disclosure is only required if the components of total program expenses are not evident from the details provided on the face of the statement of activities (for example, if cost of sales is not identified as either program or supporting services).
• The amount of income tax expense and the nature of the activities that generated the taxes, which is only required if the NFP incurs income tax expense.
Required disclosures – joint costs

• The types of activities for which joint costs have been incurred
• A statement that such costs have been allocated
• The total amount allocated during the period and the portion allocated to each functional expense category.
• An NFP is also encouraged, but not required, to disclose the amount of joint costs for each kind of joint activity, if practical.
Required disclosures – Affiliates

• Disclosure of services received by a not-for-profit entity from personnel of an affiliate.
Common Issues

• Difficulty maintaining general ledger on a functional basis, particularly overhead costs

• Establish a means of tracking separately and then allocating management and general costs to various cost centers based on a percentage of staff time charged to a particular cost center or some other reasonable method

• Use of a fixed percentage to allocate costs rather than a basis more accurately representing true cost allocations

• Financial reports that are not truly representative of the related functions
Best Practices

• Have a written cost allocation plan
• Use account codes for direct cost identification
• Track space usage or FTE to allocate indirect expenses
• Evaluate allocations at least annually
• Management and employees that spend time on both program and non-program activities should keep track of how their time is spent by maintaining time records
• Use floor plans and leases to assess the use of the organization’s space and calculate square-footage allocations
INVESTMENT FAIR VALUE LEVELS AND NAV
Agenda

• Fair Value Measurements
• Alternative Investments
• NAV as a Fair Value Measurement
Summary of ASC 820

• Consistent definition of fair value - exit price to a market participant based on market conditions on the measurement date
• Framework to measure fair value
• Disclosures required
Fair Value – “The Price”

• Exit price – price received to sell an asset or paid to transfer a liability in an orderly transaction

• Principal market – market with the greatest volume and level of activity

• If no principal market then most advantageous market

• Price does not include transaction costs.
Valuation techniques

- Market approach – prices and other data generated by market transactions of identical or similar assets or liabilities
- Income approach – converts future amounts to a single present amount (discounted cash flow or earnings)
- Cost approach – cost to replace
• Observable inputs - based on market data from sources independent of the reporting entity
• Unobservable inputs – reporting entity’s own assumptions about market inputs based on its own data
• Can’t disregard market-based data that is reasonably available
Fair Value Hierarchy

Level 1

- Quoted prices in an active market for identical assets or liabilities.
- Most reliable – should be used whenever available
- Often include – exchange traded equity securities, exchange traded mutual funds, and US Treasuries
Level 2

- Observable inputs other than quoted prices as outlined in Level 1
- Quoted prices for similar assets and liabilities
- Quoted prices for identical assets or liabilities in markets that are not active
- Interest rates and yield curves that are observable
- Market corroborated data
- Often include – corporate bonds, agency bonds, mortgage backed securities, interest rate swaps
Level 3

- Little, if any market activity, or
- Unobservable inputs which reflect the entity’s own assumptions about the assumptions that market participants would use in pricing the asset or liability. Data should be developed to support the assumptions.
- Often include alternative investments and sometimes real estate if appraisals are discounted based on management judgment
Models

• The use of models is not automatically Level 3. Can be Level 2 if observable inputs are used. If all observable inputs are used but one unobservable then consider how significant that one unobservable is to the valuation. If significant effect then Level 3 if not could be Level 2.
An active market?

- **Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly** provides additional guidance on (originally FAS 157-4):
  - Determining when the volume and level of activity for an asset or liability has significantly decreased
  - Identifying circumstances in which a transaction is not orderly and
  - Understanding the fair value implications of both above
Is there an Active market?

- Factors supporting significant decrease in volume
  - Few recent transactions
  - Price quotes are not based on current information and vary substantially
  - Indexes that previously were highly correlated with FVs are now uncorrelated with recent indications of FV
  - Significant increase in implied liquidity risk premiums, yields, or performance indicators
  - Wide bid-ask spread or significant increase in bid-ask spread
  - Significant decline or absence of new issuances
  - Little information is released publicly
What does no active market mean?

- Further analysis is needed and a significant adjustment to prices obtained may be necessary
- Objective doesn’t change still – exit price to a market participant based on market conditions at measurement date
- Could still be orderly transactions to use
Are there orderly transactions?

- If significant decrease in volume and level of activity some transactions may not be orderly.
- Then institution must evaluate the weight of evidence to determine if a transaction is orderly.
Indications that a transaction is not orderly

• Not adequate exposure to the market for a period prior to measurement date to allow for market activities that are usual and customary

• There was a usual and customary marketing period but seller marketed to a single market participant

• Seller is distressed such as in or near bankruptcy or receivership or the seller was required to sell by regulatory or legal requirements

• Transaction price is an outlier when compared to other recent transactions
Most Common Fair Value Disclosure Requirements

• General fair value framework
• Fair value hierarchy
• A description of the valuation methodologies used and the general classification of such instruments in the valuation hierarchy
• A description of any significant changes in valuation techniques from prior year
• Numerical depiction of all assets and liabilities measured at fair value, their fair value hierarchy and grouped in categories that are representative of the totality
• A description of any significant transfers between Levels
Most Common Fair Value Disclosure Requirements

• A rollforward of Level 3 assets and liabilities and related disclosures

• For fair value measurements categorized within Level 3 of the fair value hierarchy:
  - The valuation processes used by the reporting entity
  - A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, if any. (not applicable to nonpublic entities)
Alternative investment definition

- Investments for which a readily determinable fair value does not exist (that is, investments not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or NASDAQ). These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA A&A Guide Investment Companies, such as:
  - hedge funds
  - private equity funds
  - real estate funds,
  - venture capital funds,
  - commodity funds,
  - offshore fund vehicles, and
  - funds of funds, as well as bank common/collective trust funds.
Other types

• The unique ones you may not see elsewhere
  – Privately held stock
  – Artwork
  – Real estate
  – CSV of Life Insurance
An investment company is a separate legal entity whose business purpose and activity comprise all of the following:
- Investing in multiple substantive investments
- Investing for current income, capital appreciation, or both
- Investing with investment plans that include exit strategies.

Accordingly, investment companies do not either:
- Acquire or hold investments for strategic operating purposes
- Obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to noninvestor entities that are not related parties to the investee.

Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.
Use of alternative investments

• Investors in alternative investments include, but are not limited to, colleges and universities, hospitals, pension plans, and investment companies – including funds of funds.

• Some of these investors invest in a single alternative investment, while other investors have portfolios of hundreds of alternative investments.

• In addition, the underlying investments of the alternative investments can range from marketable securities to complex and/or illiquid investments.
Types of Alternative Investments

• Hedge funds
• Private equity funds
• Real estate investment trusts
• Private investment funds/private mutual funds created by a bank or trust department
Hedge fund

- A private fund that pools investors capital in order to invest in securities
- The term “private fund” means an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act.
- An investor in a private fund should be an accredited investor.
Hedge funds

• Not allowed to advertise and cannot make public offering

• Traditional hedge funds include:
  – Long/short equity
  – Debt
  – Fund of funds
  – Private equity/venture capital
Private equity fund

• A collective investment fund used for making investments in various equity (and to a lesser extent debt) securities according to one of the investment strategies associated with private equity. Private equity funds are typically limited partnerships with a fixed term of 10 years (often with annual extensions). At inception, institutional investors make an unfunded commitment to the limited partnership, which is then drawn over the term of the fund.

• A private equity fund is raised and managed by investment professionals of a specific private equity firm (the general partner and investment advisor). Typically, a single private equity firm will manage a series of distinct private equity funds and will attempt to raise a new fund every 3 to 5 years as the previous fund is fully invested.
Venture capital fund

• Pooled investment vehicle that primarily invests in early-stage, high-potential, growth companies

• Similar to a private equity fund
Commodity funds

• Also known as “pools”
• Invest in futures contracts, options on futures contracts, etc.
Real estate investment trust (REIT)

• An entity investing is real estate. Actually a tax designation with the purpose of reducing or eliminating corporate tax. In return, REITs are required to distribute 90% of their taxable income into the hands of investors.

• The REIT structure was designed to provide a real estate investment structure similar to the structure mutual funds provide for investment in stocks.

• REITs can be publicly or privately held. Public REITs may be listed on public stock exchanges.

• REITs can be classified as equity, mortgage or a hybrid.

• The key statistics to examine in a REIT are NAV, funds from operations (FFO), adjusted funds from operations (AFFO) and cash available for distribution (CAD).
• Mutual fund created for a bank’s own clients

• Often to meet a specific goal:
  - Large, mid, small cap equities
  - International
  - Fixed rate
  - High yield
  - Balanced
Other alternative investment terms

• Practical expedient – methodology for valuation where NAV can be used for FV if certain criteria are met
• Capital commitment (unfunded commitment) - a legal right of an investment firm to demand a portion of the money promised to it by an investor.
• Capital calls – the investment firm requesting money promises as a capital commitment
• Redemption period – period of time an investor has to give notice to get out of a fund
• Benchmarks/Benchmarking – comparison of fund’s return to similar funds or indices
Other alternative investment terms

• Claw back - Obligation on the part of the investment manager to return previously received incentive allocations to the investment fund due to subsequent losses. In most instances, the obligation would be reflected as a deduction from the investment manager’s capital account.

• Side pocket agreements - A type of account used in hedge funds to separate illiquid assets from other more liquid investments. Once an investment enters a side pocket account, only the present participants in the hedge fund will be entitled to a share of it. Future investors will not receive a share of the proceeds in the event the asset's returns get realized.
Other alternative investment terms

- **Lock-up periods** – Window of time in which investors of a hedge fund or other closely-held investment fund are not allowed to redeem or sell shares. The lock-up period helps portfolio managers avoid liquidity problems while capital is put to work in sometimes illiquid investments.

- **Notice periods** – Period of time required that investor must give notice to redeem a portion or all of their shares of the fund.

- **Holdbacks** – Portion of redemption that is held for a period of time.
Other alternative investment terms

• Suspension of redemptions ("gates") – A restriction placed on a hedge fund limiting the amount of withdrawals from the fund during a redemption period. The implementation of a gate on a hedge fund is up to the hedge fund manager. The purpose of the provision is to prevent a run on the fund, which could cripple its operations, as a large number of withdrawals from the fund would force the manager to sell off a large number of positions.

• Fund of funds - An investment fund that invests in other funds.
Alternative investment challenges

• Alternative investments can present challenges with respect to obtaining sufficient appropriate audit evidence in support of the existence and valuation assertions, because of the lack of a readily determinable fair value for these investments and the limited investment information generally provided by fund managers.
Management’s responsibilities

• Ensuring that the portfolio of alternative investments exists.

• Management should have controls and procedures in place to ensure a sufficient understanding of the investment portfolio, including the reasonableness and reliability of the sources used for their valuations.

• Controls include:
  – Upfront due diligence
  – Ongoing monitoring
  – Financial reporting
Which has more risk?

- A fund created by “Well Known Regional” bank for its trust customers that is invested in common stock that is all exchange traded and per the fund’s audit are all Level 1. The investment in the fund can be cashed out monthly.

- A private equity fund created by “Never Heard of Them” Fund that invests in IT and healthcare businesses (both established and startup). The client cannot remove their money from the fund for 12 years and have future capital call commitments. NAV of the fund is provided by the fund manager on a 5 month delay.
Risk Assessment

• Potential risks related to alternative investments
  – Valuation – complex/hard to value investments, significant Level 3
  – Controls not established by management to value alternative investments
  – Management (or specialist engaged) lacks valuation knowledge or experience
Internal controls related to valuation

- Management’s process used to determine fair value
- Availability of information used in determining fair value
- The nature of the underlying investments (complexity, liquidity, frequency)
- Quantity and nature of interaction between management and the fund manager
- The competence and experience of the entity’s personnel assigned to monitor and estimate fair value.
- The availability of SOC reports at a service provider
- The availability of audited financial statements
- Use of investment advisor to monitor alt inv, including underlying investments, and/or monitor markets and performance benchmarks, etc.
Unique valuation issues

- Artwork, Real estate and CSV of Life Insurance
- Can elect cost – just like they can with the other types as long as they apply it consistently.
- If use fair value – need regular appraisals to support the value. (only applies to artwork and real estate that are held for investment purposes… if held as a collection or capital asset then can’t use fair value).
- They have some options as a NFP that commercial clients don’t have in terms of valuing their alternatives.
Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) (EITF)

- Investments for which the fair value is measured at net asset value (NAV) per share (or its equivalent) **using the practical expedient** should **not** be categorized in the fair value hierarchy.

- Investments that calculate NAV per share (or its equivalent), but **for which the practical expedient is not applied** will continue to be **included** in the fair value hierarchy.

- Sufficient information must be provided to permit reconciliation of the fair value of assets categorized within the fair value hierarchy to the amounts presented in the statement of financial position.
ASU 2015-07, Fair Value Measurement

• Effective for NFPs for years beginning after December 15, 2016 (Calendar year 2017 and fiscal years ending in 2018) Early adoption is permitted. Retrospective application to all prior periods presented
### 2015 Fair Value Measurements Using

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What is NAV and why is it a measure of fair value?

• Net asset valuation, member units, ownership interest in partner’s capital
  – Interest in the investee fund itself, not the underlying investments

• Investee’s underlying investments are valued at fair value at the investor’s measurement date
  – NAV likely would be determinative of fair value when an investor holds a redeemable investment that is not subject to any redemption restrictions at the measurement date and the investee is transacting with other investors at net asset value per share
Practical expedient

• A reporting entity is permitted, as a practical expedient, to estimate the FV of an investment using NAV, if the NAV is calculated in a manner consistent with Topic 946 as of the reporting entity’s measurement date.

• If the NAV obtained from the investee is not as of the reporting entity’s measurement date or is not calculated in a manner consistent with the measurement principles of Topic 946 then the reporting entity shall consider whether an adjustment to the most recent NAV is necessary.

• Determined on an investment-by-investment basis

• If it is probable at the measurement date that the reporting entity will sell a portion of an investment at an amount different from NAV then the reporting entity shall account for the portion of the investment that is being sold in accordance with this Topic 820-10-35-62.
Practical expedient - hierarchy

- If using practical expedient then consider the following in determining level hierarchy:
  - If a reporting entity has the ability to redeem its investment with the investee at NAV at the measurement date, the FV measurement of the investment shall be a Level 2.
  - If a reporting entity will never have the ability to redeem its investment with the investee at NAV, the FV measurement of the investment shall be a Level 3.
  - If a reporting entity cannot redeem its investment with the investee at NAV at the measurement date but the investment may be redeemable at a future date, the reporting entity shall consider the length of time until the investment will become redeemable in determining whether the FV measurement of the investment shall be a Level 2 or a Level 3.
Topic 946

• NAV must be calculated in a manner consistent with measurement principles of Topic 946, Financial Services – Investment Companies
  • Management is required to independently evaluate the fair value measurement process utilized by the fund manager
  • Determine investee fund manager has an effective process and internal controls related to its valuation process
    - Initial due diligence
    - On-going monitoring
    - Financial reporting controls
• Key factors to support that the entity followed Topic 946 could include:
  - Investee funds fair value estimation process and control environment and if any changes are made
• Examples of when an adjustment to the last reported NAV may be necessary include:
  – NAV is not as of the reporting entity’s measurement date; or
  – NAV is not calculated in a manner consistent with the measurement principles of FASB ASC 946 (which requires, among other things, measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820);
  – Or both.
Adjustments Due to Measurement Dates

- Request an updated valuation from Investee Fund
- Perform a rollforward or rollback
  - Value at last valuation date (valued consistently with ASC 946)
  - Plus capital contributions/subscriptions
  - Less distributions, redemptions and withdrawals
  - Adjust for changes in valuations (market changes)
- You must be able to estimate market changes to use a value rolled forward. In some cases you might have an index that can be used; in some cases you won’t be able estimate and therefore will have to wait for the updated valuation from the Investee Fund
• Various reasons why the NAV is not valued consistent with ASC 946 – consider why

• Can a fair value based NAV be obtained from the investee manager?

• Consider whether the specific data needed to adjust the reported NAV can be obtained and properly utilized to estimate a fair value based NAV.
  
  • Reported NAV is on a cash basis. The reporting entity could estimate the fair value of each underlying investment as of the measurement date by obtaining additional information from the investee manager.
• Reported NAV utilizes blockage discounts taken on securities valued using level 1 inputs, which is not consistent with FASB ASC 820. The reporting entity could estimate the adjustment to reported NAV required to remove the blockage discount based on additional information from the financial statements or from the investee manager.

• Reported NAV has not been adjusted for the impact of unrealized carried interest or incentive fees. The reporting entity could estimate the impact of carried interest or incentive fees and adjust reported NAV.
Adjustments When Not Valued Consistent with Guidance

• If adequate information cannot be obtained to adjust NAV, NAV cannot be used as a practical expedient for fair value. In these cases, the general measurement principles of ASC 820 should be followed.
Disclosures – Assets Valued Using NAV

- The fair value of the investments in the major category, and a description of the significant investment strategies of the investee(s) in the major category.

- For each major category of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity’s estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.

- The amount of the reporting entity’s unfunded commitments related to investments in the major category.
Disclosures – Assets Valued Using NAV (con’t)

- A general description of the terms and conditions upon which the investor may redeem investments in the major category
- The circumstances in which an otherwise redeemable investment in the major category might not be redeemable (for example, investments subject to a lockup or gate). Also, for those otherwise redeemable investments that are restricted from redemption as of the reporting entity’s measurement date, the reporting entity shall disclose its estimate of when the restriction from redemption might lapse. If an estimate cannot be made, the reporting entity shall disclose that fact and how long the restriction has been in effect.
- Any other significant restriction on the ability to sell investments in the major category at the measurement date
If a reporting entity determines that it is probable that it will sell an investment(s) for an amount different from net asset value per share (or its equivalent), the reporting entity shall disclose the total fair value of all investments and any remaining actions required to complete the sale.

If a group of investments would otherwise meet the criteria in paragraph 820-10-35-62 but the individual investments to be sold have not been identified (for example, if a reporting entity decides to sell 20 percent of its investments in private equity funds but the individual investments to be sold have not been identified), so the investments continue to qualify for the practical expedient in paragraph 820-10-35-59, the reporting entity shall disclose its plans to sell and any remaining actions required to complete the sale(s).
Alternative Investments Resources

• Great Resources:
  – AICPA Technical Practice Aid, *Alternative Investments – Audit Considerations*
QUESTIONS AND ANSWERS?
ENDOWMENT AND UPMIFA
• Uniform Prudent Management of Institutional Funds Act (UPMIFA)
  - Enacted at the State level
  - Legislates prudence for the investment of endowments and the spending of endowment earnings

• Defines Endowment Fund as an institutional fund or a part of an institutional fund not wholly expendable by the institution on a current basis due to terms (restrictions) in a gift instrument.

• Applies only to donor restricted endowments.

• Quasi endowments are not subject to the legislation.
Spending (appropriation) - Subject to the intent of a donor expressed in the gift instrument an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established.
UPMIFA – The Law

• Prudent person considering the following:
  – Duration and preservation of the fund
  – Purpose of the institution and endowment fund
  – General economic conditions
  – Possible effects of inflation and deflation.
  – Expected total return from income including appreciation
  – Other resources of the institution
  – Investment policy of the organization
Endowment fund defined as:

- An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted.

- Donor-restricted gifts and bequests to endowment include:
  - Permanent endowment
  - Term endowment
Endowment fund continued:

• Permanent endowment – funds are held in perpetuity with earnings used for the benefit of the college or its students.
  – Classified as permanently restricted net assets.

• Term endowment – funds are held for a donor designated specified term with earnings used for the benefit of the college or its students
  – Classified as temporarily restricted net assets.

• Quasi (or Board designated endowment) – funds designated by the Board to function similar to endowment funds with the earnings used for the benefit of the college or its students
  – Classified as unrestricted net assets
Endowment Fund

- Assets included in endowment funds include but aren’t limited to:
  - Cash
  - Investments (both marketable and alternatives)
  - Charitable remainder trusts and perpetual trusts IF the use of the funds the college receives is restricted to the endowment or the remainder interest to be received by the college will become a part of the endowment fund

- We should be able to reconcile any differences between permanently restricted net assets and the amount in the footnote showing as permanently restricted.
Endowment Fund

- Donor-restricted endowment fund defined as
  - Amount to be retained permanently – explicit donor stipulation
  - In the absence of such stipulations, the amount the organizations governing board determines must be retained “preserved” permanently consistent with relevant law.

- Portion of the fund not classified as permanently restricted will be classified as temporarily restricted net assets until appropriated for expenditure.
  - May include those amounts the board deemed appropriate to spend (the corpus) of existing endowment. Key is Board’s definition of what they will include in permanently restricted net assets.
Donor restriction that can no longer be fulfilled

• Situations can arise where a donor’s restriction can no longer be fulfilled
  – If donor is still alive, contact them to change restriction.
  – If donor is not alive…
    • Small, old gifts may require only notice to the state attorney general – check your state’s requirements
    • Larger or newer gifts may require taking the matter before the court for approval of a change in restriction
Endowment Fund

• Debits & Credits
  – Board determines historic dollar value is what should be permanently restricted
    • Year 1 only - Accumulated earnings and appreciation sitting in unrestricted were reclassified to temporary during year of implementation
    • Earnings and unrealized gains run through temporarily restricted for those endowment funds that are above water
    • Losses on investments shall reduce temporarily restricted net assets to the extent that the fund is above water.
    • Spending against underwater endowments runs through unrestricted
Endowment Fund

• Debits & Credits
  – Board determines something other than HDV should be permanently restricted
    • Year 1 only - Accumulated earnings and appreciation sitting in unrestricted were reclassified to temporary during year of implementation
    • Year 1 only - Difference b/w HDV and what is determined should be PR was reclassified to TR during year of implementation
    • Earnings and unrealized gains run through temporarily restricted for the endowment funds above water
    • Losses on investments shall reduce temporarily restricted net assets to the extent that the fund is above water.
    • Spending against underwater endowments would be released from restriction in temporarily restricted
Endowment Fund

• Appropriation - Appropriation for expenditure is deemed to occur upon approval for expenditure, unless approval is for a future period, in which case appropriation is deemed to occur when that period is reached.
  − Time restriction expires to the extent of the amount appropriated and, in the absence of any purpose restrictions.
  − Amount is released from restrictions once time and purpose restrictions are released.
  − If the appropriated amount is not spent they can’t “pull it out” of the endowment fund. i.e. for a future period
  − Would include all spending not just spending policy
Required Disclosures

- Description of the Board’s interpretation of the law that underlines the entity’s net asset classification.
- Spending policy
- Investment policy which would include return objectives and risk parameters, how those objectives relate to the spending policy
- Composition of endowment by net asset class.
Required Disclosures

• Reconciliation of the beginning and ending balance of endowment in total, by net asset class
  - Investment return
    • Income
    • Net appreciation/depreciation
    • Contributions
    • Spending policy
    • Reclassifications

• Nature of permanent and temporary restrictions
Required Disclosures

- Aggregate amount of deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulation or law – underwater.
Borrowing from the Endowment

• Consider ability to repay
  – Should be a source of last resort
  – Consider effects

• Board approval required

• Formal agreement in place including a reasonable interest rate and repayment plan

• If significant, may require footnote disclosure.
QUESTIONS AND ANSWERS?
TITLE IV
COMPLIANCE ISSUES
FOR THE BUSINESS OFFICER
“Big Picture” Changes

• More rules and regulations
  – Cash management
  – Gainful employment
  – Additional debt relief options proposed
  – FAFSA timing changes
  – Student information security reminders

• Perkins close-out

• New administration
Other new guidance

• Department of Education Audit Guide issued September 2016 effective for proprietary schools


• Uniform Guidance (last year)
Common Audit Findings

1. Repeat Finding – Failure to Take Corrective Action
2. NSLDS Roster Reporting – Inaccurate/Untimely Reporting
3. Return of Title IV (R2T4) Calculation Errors
4. R2T4 Made Late
5. Verification Violations

Common Audit Findings (continued)

6. Pell Overpayment/Underpayment R2T4 Calculation Errors
7. Student Credit Balance Deficiencies
8. Entrance/Exit Counseling Deficiencies
9. Qualified Auditor’s Opinion Cited in Audit
10. G5 Expenditures Untimely/Incorrectly Reported

ED Program Reviews – How are institutions selected?

- 20 USC 1099c-1(a)(2): [The Secretary] shall give priority for program review to institutions of higher education that are institutions with:
  - High cohort default rate or dollar volume of default (25%+)
  - Significant fluctuations in Federal Pell Grant or loan volume
  - Reported deficiencies or financial aid concerns by the state or accrediting agency
  - High annual drop out rates, or
  - Any other institution the Department determines may pose significant risk of failure to comply with administrative capability or financial responsibility requirements
ED Program Reviews

• Focus on administrative capability
• Focus on areas where fines and penalties can be assessed
• Program reviewers have leniency and can influence follow-up based on if they truly think something is an error (vs intentional) and size of the institution
Common Program Review Findings

1. Verification Violations
2. R2T4 Calculation Errors
3. Student Credit Balance Deficiencies
4. Entrance/Exit Counseling Deficiencies
5. Crime Awareness Requirements Not Met
6. Satisfactory Academic Progress Policy Not Adequately Developed/Monitored

7. NSLDS Roster Reporting – Inaccurate/Untimely Reporting
8. Inaccurate recordkeeping
9. Drug abuse prevention program requirements not met
10. Consumer Information Requirements Not Met
11. R2T4 Made Late

Crime Awareness Requirements not met

- Department of Education focus
- Policies and procedures regarding campus security not in accordance with requirements
- Annual report not published and/or not distributed annually to current students/employees by deadline of Oct 1
- Failure to develop a system to log all required categories of crimes

Regulations: 34 CFR 668.41 and 668.46
• Must be distributed to all employees and students by October 1 of the following year and must include:
  - Crime statistics – for the three most recent calendar years must report the following: Criminal homicide, Sex offenses, Robbery, Aggravated assault, Burglary, Motor vehicle theft, Arson, and Arrests for liquor law violations, drug law violations, and illegal weapons possession.
    • An institution must report, by category of prejudice, any hate crimes.
    • Must breakdown crimes by on campus (including breakout of those in dormitories), noncampus, and public property.
  - A description of the school’s policies concerning campus security and emergency response and evacuation procedures and a statement of the enforcement authority of campus security personnel and their relationship with State and local police.
Violence Against Women Act changes

• Changes to Clery Act for Violence Against Women Reauthorization Act of 2013
  – Requires institutions to compile statistics for certain crimes that are reported to campus security or local police including sexual assault and domestic violence.
  – Also requires the institutions to include certain policies, procedures, and programs pertaining to these crimes in their annual security report.
  – Effective for annual reports issued by 10/1/14 for calendar years 2011-2013.
  – Since final regulations were still in process during 2013, Dept. expected institutions to make a good faith effort to comply starting with statistics for calendar year 2013.
Crime awareness suggestions

• Review *Handbook for Campus Safety and Security Reporting* -

• Review *Information Required to be Disclosed Under the Higher Education Act: Suggestions for Dissemination*

• FSA Assessments: Schools – Consumer Information – Activity 5: Clery/Campus Security Act

• Review HEOA additional requirements- Emergency response, timely warnings, fire safety, missing persons
Why is accurate crime reporting important?

- A university in Michigan fined $357,500, paid $350,000
- A school in Virginia fined $55,000 and appealed
- A university in Washington fined $82,500
- A university in Texas fined $137,500
- A university in Iowa fined $27,500 per infraction for underreporting
Other Consumer Reporting

• Annual information regarding completion or graduate rates and transfer-out rates of certificate or degree-seeking full-time undergraduate students.
• Annual report on intercollegiate athletics, if applicable.
• Fire Safety Log and Report
• Missing Persons Procedures and policies that encourage complete timely reporting of all crimes to campus policy and appropriate law enforcement agencies.
• Review of drug and alcohol abuse prevention program
• Gainful employment (for-profit schools and nondegree programs only)
Consumer Reporting – Completion/graduate rates

• Also known as Student Right-to-Know Disclosures
• Must be made by July 1 of each year and must include:
  – Completion or graduation rates and, if applicable, transfer-out rates for certificate- or degree-seeking, full-time, first-time undergraduate students.
  – If offer athletically related student aid, the same for student athletes
• Must make available by July 1, 2015, the rates for the cohort for which the 150% of the normal time for completion elapsed between September 1, 2013 and August 31, 2014.
• Reporting to ED is done through the IPEDS report
• Schools must disseminate through appropriate publications, mailings, or electronic
Consumer Reporting – Intercollegiate athletics

• Annual report on intercollegiate athletics - Equity in Athletics Disclosure Act (EADA) so known as the EADA report

• To make students and public aware of a school’s commitment to providing equitable athletic opportunities. The report contains participation rates, financial support, and other information on men’s and women’s intercollegiate athletic programs. Officially, it is *The Report on Athletic Program Participation Rates and Financial Support Data*.

• Must publish this report by October 15 and make it available upon request to students, prospective students, and the public in easily accessible places.
Consumer Reporting

• Fire Safety Log and Report – in addition to Campus Safety Report

• Missing Persons Procedures - students must be able to register a confidential contact person to be contacted if they are missing for more than 24 hours and must have procedures for identifying when an on-campus student is missing for more than 24 hours

• Policies that encourage complete timely reporting of all crimes to campus policy and appropriate law enforcement agencies.

• Review of drug & alcohol abuse prevention program – must include the number of drug & alcohol-related violations/fatalities that occur on-campus or at a school’s activities and the sanctions that are imposed
Gainful employment

- For-profit schools and nondegree programs only
- Requires reporting to ED of individual students
- Requires disclosures (summary) to students and prospective students on website
- Procedures for approval of new programs
Cash management changes

• Federal Register published October 30, 2015
• Most of the new rules effective July 1, 2016 with some exceptions
• Overall intention is to make sure that students have access to Title IV funds without charge and are not forced to open a particular account to receive their aid
Cash management changes

• School must maintain Title IV funds in federally-insured accounts
  – Accounts can not be included in a nightly sweep to a noninsured account (can not be any risk of loss)
  – Must be separate account with federal funds in the title (no other funds)
  – Institution can keep up to $500 in interest per year (up from $250)

• Restrictions on ability to charge for books and supplies as tuition and fees
Cash management changes

• **T1 arrangement** – agreement between school and 3rd party servicer to process Title IV aid, which it then disburses to the contracted account or provide information to the student about the contracted account

• **T2 arrangement** – agreement where the school works with a provider (bank or other financial institution) that is not a 3rd party servicer and the provider markets its products directly to students
Cash management changes

• For all T1 and T2 arrangements school is required to:
  − Establish a student choice menu (can’t force students to open a particular account including allowing them to use a pre-existing account)
  − Have reasonable access to fee-free or surcharge-free ATM network
  − Disallow automatically opened or preselected accounts for students
  − Set privacy restrictions
  − Disclose the contract on the school’s website no later than 60 days following the most recently completed award year (effective 9/1/16)
T1 arrangements

• School must have:
  – Convenient access to funds for students (ATM network) with at least one way to access funds without charge
  – Fee restrictions in place (charges or fees for transactions or withdrawals exceeding the balance are not allowed)
  – The best financial interest of students in mind when negotiating terms (must be consistent with or below market rates)
  – Cost disclosures if the school has 30 or more Title IV credit balance students in the prior award year (average cost incurred by the account holder) – (effective 9/1/17)
T2 arrangements

• If school has had an average for the last three years of 500 or more students receiving Title IV credit balance refunds or if average of Title IV credit balances is greater than 5%, school must:
  – Disallow ATM fees and charges on all POS transactions or overdrafts
  – Represent the best financial interests of the students when negotiating terms (must be consistent with or below market rates)
  – Cost disclosures if the school has 30 or more Title IV credit balance students in the prior award year (average cost incurred by the account holder) – (effective 9/1/17)
Cash management changes

• Just-in-time payment method is eliminated
• If on reimbursement or HCM, must pay credit balances prior to asking for funds.
• Clarification of current year and prior year in allowing current year funds to pay for *de minimus* ($200) of prior year charges
• Allows a repeated course to be considered in enrollment status (one time per course)
• Clock-to-credit hour conversion changes
Cash management changes

• Schools should make sure that contracts prohibit sharing of student PII

• Schools will need to have processes in place to update annually to make sure fees are at or below prevailing rates and still in the best interest of the students
FAFSA timing change

• Two major changes to the FAFSA process:
  - Students and families can begin submitting FAFSAs on October 1 beginning with the 2017–2018 financial aid application cycle. Therefore, students will be able to file a 2017–2018 FAFSA beginning on October 1, 2016.
  - Beginning with the 2017–2018 FAFSA, income information will be collected from one tax year earlier – referred to as the "prior-prior year." This means that, on the 2017–2018 FAFSA, the Department will collect tax year 2015 income information and not 2016 income information. As a result of this change, most students will be able to complete their FAFSAs using information from an already completed tax return and will be able to electronically transfer their income tax return information from the Internal Revenue Service (IRS) into the FAFSA using the IRS Data Retrieval Tool (IRS DRT).
With the transition from prior year income to prior-prior year income, financial aid administrators (FAAs) may see an increase in requests from students to consider making adjustments to their income to more accurately reflect the students' and families' current financial circumstances. Any action taken by FAAs in this regard is commonly known as the use of professional judgment.

Section 479A of the HEA gives FAAs the authority to make case-by-case adjustments of the data items used to calculate a student's EFC, based on adequate documentation to address current circumstances not reflected on a student's FAFSA.

A professional judgment adjustment may be warranted if a family member experienced a significant change of income, either upward or downward. The Department encourages FAAs to use their professional judgment when appropriate to adjust income and other financial information used to determine the EFC.
• The Department expects that there will be some increased uses of professional judgment. For the 2017–2018 and future award years, the Department will make appropriate adjustments to its risk-based model as it reviews and analyzes the use of professional judgment and will continue to monitor and enforce requirements for appropriate use of professional judgment.

• In exercising professional judgment, FAAs must obtain and maintain documentation of the changed circumstances supporting the professional judgment decision.

• Professional judgment must only be used to address special circumstances, which are conditions that apply to an individual student, rather than to a class of students.

• When FAAs submit professional judgment changes to a student's information to the Department's Central Processing System (CPS), they must set the Professional Judgment Flag to 1 (EFC Adjustment Processed) to indicate that the submission was the result of a professional judgment determination.
Conclusion

• Compliance with Title IV regulations is a School issue not a Financial Aid issue
• If you are seeing issues with Financial Aid get involved even if it is not a department you oversee
  – Help others recognize the importance of compliance
  – Create a top down message of expectation of compliance
  – Improve communication
  – Work with your auditors
  – Don’t wait until major issues force your involvement
QUESTIONS AND ANSWERS?
AUDIT COMMITTEE GUIDANCE
Audit committee guide

• The audit committee charter
  – Duties assigned to the audit committee
  – Audit committee responsibilities
  – Control environment
  – Risk management systems
  – Monitoring
  – COSO Internal Control – Integrated Framework
  – Fraud risk

• Budget and financing considerations

• Understanding and overseeing the financial reporting process
Audit committee guide

• Understanding and overseeing the compliance reporting process
  – Grant compliance
  – Tax reporting

• Understanding and overseeing the audit process
  – Internal audit process
  – Independent audit process
  – Communications with audit committees

• Selection of an independent audit firm
Audit committee guide

• **Enterprise risk management and data privacy and security concerns**
  - Enterprise risk management
  - Data privacy and security

• **Considering the requirements of the Sarbanes-Oxley Act**
  - Reduce fraud and increase accountability
  - Tighten up financial reporting processes

• **Resources for the audit committee**
  - The AICPA audit committee toolkit
  - Publications
  - Websites
  - Regulatory agency and trade association websites
QUESTIONS AND ANSWERS?
THANK YOU FOR YOUR TIME AND ATTENTION