SC&H GROUP

EXPERTISE THAT WORKS

Accounting & Audit Update

Presented by: Mike Young, Director, SC&H Group

Accounting and Audit Update

AGENDA

- Net Assets and UPMIFA
- Proposed lease standard
- Update on Cashflow Presentation
- Other NFP resources and guidance
- Questions

NET ASSETS

- Unrestricted Net Assets
  - The part of net assets of a not-for-profit organization (NFP) that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations. The only restrictions on the use of unrestricted funds are through the following:
    - Nature of the NFP
    - Environment the NFP operates in
    - Purposes specified in the NFP’s charter/by-laws
    - Limits due to contractual obligations with suppliers and creditors
  - These type of net assets result from revenues providing services, producing and delivering goods, receiving unrestricted contributions, dividends/interest from investments less expenses incurred in providing services, producing and delivering goods, fundraising and administrative functions.

NET ASSETS

- Temporarily Restricted Net Assets
  - The part of the net assets of a NFP that results from:
    - Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed regulations that will either expire over time or expire based on actions done by the NFP that meet the purpose.
      - Expiration over time – a pledge that is over 5 years; every year a portion has met the restriction of time and can be released from temporarily restricted as long as there was no other restriction imposed by the donor.
      - Expiration of purpose – a contribution that was specified for a certain action by the NFP (a purchase of an asset, a salary of an employee, a program) can be released upon satisfaction of the restriction.
      - When a temporarily restricted gift is given the restriction is met in the same year, it can classified as unrestricted.
  - As restrictions are met, these amounts will be shown on the Statement of Activities as a release from restriction and will decrease temporarily restricted net assets and increase unrestricted net assets. This is done so that the revenue is recognized at the same time as the corresponding expense/expenditure in unrestricted net assets.

NET ASSETS

- Permanently Restricted Net Assets
  - The part of the net assets of a NFP that results from:
    - Contributions and other inflows of assets whose use by the NFP is limited by donor-imposed regulations that will neither expire over time or expire based on actions done by the NFP that meet the purpose.
  - Typically these type of contributions will stipulate how the investment income may be used, i.e. either with a specific restriction and thus making the investment income temporarily restricted or with no restriction and thus, can be used for operations or any other purpose deemed by the NFP.

REMINDERS FROM THE 2013 A&A GUIDE

- Chapter 11 in the A&A guide deals with Net Assets and the Reclassifications of Net Assets
  - When an expense is incurred and both unrestricted and temporarily restricted net assets are available, the TR net asset should be used first.
  - There is an implied time restriction when payments of promises to give are scheduled to occur over several periods regardless if the promise to give was for unrestricted usage.
  - If the gift is for construction or a purchase of a long-lived asset, the donor is supporting the activities in the period in which the asset is constructed or placed in service even if payments extend beyond that period. In this example the contribution is recorded when given and the restriction is considered met when the asset is placed in service/constructed rather than over the periods that the payments were made.

ENDOWMENT FUND

- An established fund of cash, securities, or other assets to provide income for the maintenance of an NFP. The use of the funds may be permanently restricted, temporarily restricted or unrestricted. Endowment funds are generally established by donor-restricted gifts.
  - A permanent endowment is set up in order to provide a permanent source of income to the NFP.
  - A term endowment is set up to provide income over a specified period.
- An NFP's governing board can establish an endowment from a portion of its unrestricted net assets (board designated endowment fund). This may be done to provide income for a long, but unspecified period of time.

UPMIFA

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA)
  - Replaced the Uniform Management of Institutional Funds Act from 1972 as a result of significant changes in investments and expenditures for charitable purposes.
  - Provides uniform and fundamental rules for the investment of funds held by NFPs and the expenditure of funds donated as endowment funds.
  - Allows endowments to invest in any kind of asset, to pool endowment funds for investment purposes (unitize the investments) and to delegate investment management to other professionals provided the governing board maintains ordinary business care and prudence over the decisions.

UPMIFA

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA) – cont'd.
  - Assets are to be invested prudently in diversified investments that are striving for both growth and income and the appreciation of the assets. Earnings should be spent prudently in accordance with the endowment fund's purpose or purposes.
  - Prudence
    - Investments are made in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
    - Investment costs are monitored and should only be reasonable and appropriate.
    - Investment decisions should be made in relation to the overall resources of the NFP and its charitable purposes. Decisions should not be made in a vacuum, but rather in conjunction with the overall portfolio and within the investment strategy.
    - Assets should be diversified and reviewed on an ongoing basis to maintain the investment strategy and objectives.

UPMIFA

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA) – cont'd.
  - UPMIFA replaces the old trust law that stipulated only income (i.e. dividends and interest) could be spent and instead allows prudent expenditure of both appreciation and income.
  - NFPs may now appropriate for expenditure or accumulate so much of an endowment fund as the organization deems to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established.
  - Individual states may enact additional safeguards against excessive spending, i.e. draws do not exceed a specific threshold. While not a specific rule, generally the percentage of 7% calculated in an averaging formula over 3 years is considered the upper threshold for endowment draws.
  - NFPs may spend from an endowment whose market value has dropped below the original gift (underwater fund) as long as its prudent and, when funds are available, the original gift is made whole.

SC&H GROUP

UPMIFA

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA) – cont'd.
  - Expenditure criteria to be used by the NFP in regards to its yearly draw:
    - Duration and preservation of the endowment fund
    - The purposes of the NFP and its endowment fund
    - General economic conditions
    - Effect of inflation or deflation
    - Expected total return from income and the appreciation of investments
    - Other resources of the NFP
    - Investment policy of the NFP

UPMIFA

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA) – cont'd.
  - Release or modification of restrictions is allowed under UPMIFA. Sometimes a donor's intent/restriction becomes impracticable or may hinder the NFP's use of the funds. In such cases, a donor may consent to the release of the restriction if still alive or in cases where the donor is no longer available to consult, court approval may be requested as long as the court deems the modification to be in line with the donor's probable intent.
  - NFPs may modify a restriction on a small (under $25,000) and old (over 20 years) fund without going to court.
  - If a restriction becomes impracticable, the NFP may notify its state charitable regulator, wait 60 days and then unless there was an objection, modify the restriction in a manner consistent with the original intent.

INVESTMENT POLICY FOR ENDOWMENT FUNDS

Example:

In the event, the NFP receives donor-restricted endowment funds, determination of the net asset classification for the corpus and return on investments is based on the donor's intentions. In the event the NFP's Board designates certain non-donor funds as board-designated, those respective funds are classified as unrestricted and the returns on those funds are used to support the general program expenses of the NFP.

The endowment withdrawal policy of the NFP is designed within the following parameters:

- To maintain the purchasing power of the endowment over the long term.
- To provide greater certainty in constructing the operating budget.
- To enable the endowment managers to focus on "total rate of return" as their investment objective.
- To provide the endowment manager with advance notice of the cash withdraws from funds under their management.

INVESTMENT POLICY FOR ENDOWMENT FUNDS

Example – cont’d

The annual draw will equal a fixed percentage of a moving average of the fair value of the managed assets of the endowment as of December 31 for the three years prior to the fiscal year for which the draw is to be made. The targeted fixed percentage is 5%. The timing of the draws is based on the cashflow constraints of the NFP.

UPDATE ON LEASES

- Objective is to increase the transparency and comparability among organizations that lease assets.
- Recognition, measurement, and presentation of expenses and cash flows arising from the lease by a lessee would depend on whether the lessee is expected to consume more than an insignificant portion of the economic benefits included in the underlying asset (this would depend on the nature of the underlying asset).
- Lessee - Type A lease (most leases of assets other than property – i.e. equipment, aircraft, cars, trucks)
    - Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments.
    - Recognize the unwinding of the discount on the lease liability as interest separately from the amortization of the right-to-use asset.

UPDATE ON LEASES

- Lessee - Type B lease (most leases of property i.e. land and/or building or part of a building):
  - Recognize the right-of-use asset and a lease liability, initially measured at the present value of lease payments.
  - Recognize a single lease cost, combining the unwinding of the discount on the lease liability with the amortization of the right-of-use asset, on a straight-line basis.
- Lessor - Type A lease:
  - Derecognize the underlying asset and recognize a right to receive lease payments (lease receivable) and a residual asset (representing the rights the lessor retains relating to the underlying asset)
  - Recognize the unwinding of the discount on both the lease receivable and the residual asset as interest income over the lease term.
  - Recognize any profit relating to the lease at the commencement date.
- Lessor – Type B lease:
  - Continue to recognize the underlying asset
  - Recognize lease income over the lease term typically on a straight-line basis.

UPDATE ON LEASES

- Status
  - Comments on the exposure draft were due mid September 2013.
  - A final decision by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) is expected during 2014

DIRECT METHOD OF CASH FLOW PRESENTATION

- October 23, 2013 - the FASB decided to change how NFPs will be preparing their financial statements.
  - NFPs will be required to use the direct cash flow method vs. the indirect method previously used. This presentation calls for a separate reporting of cash receipts and payments tied to operating activities. There will not be a requirement to include a reconciliation using the indirect method.
  - The Board modified the cash flow categories to better align with the change to the direct presentation.
    - Cash gifts with donor-imposed restrictions that can be used to purchase or construct a long-lived asset for operating purposes would be classified as an inflow from operating activities vs. an inflow from financing activities.
    - Cash payments to purchase or construct a long-lived asset for operating purposes will be classified as an outflow from operating activities vs. an outflow from investing activities.
    - Cash dividends and interest income would be classified as an inflow from investing activities vs. an inflow from operating activities.
    - Cash payments of interest expense would be classified as an outflow from financing activities rather than an outflow from operating activities.

DIRECT METHOD OF CASH FLOW PRESENTATION

- To date this has only been approved by the FASB board and has not been incorporated in the codification. It is expected to be made final in conjunction with the overhaul of the financial statement presentation for NFPs by the FASB.

FASB NET ASSET PROJECT

- As part of the overhaul to the financial statements of NFPs, FASB is looking into the presentation, classification and disclosure of information surrounding net assets.
- Recommendations from the FASB staff to the board are:
  - Replacing the existing requirements to present totals for each of the 3 net asset classes on the face of the statement of financial position and changes in those classes on the face of the statement of activities with similar requirements for two classes of net assets – with donor-imposed restrictions and without donor-imposed restrictions.
  - Retain the current requirement to provide information about the nature and amounts of different types of donor-imposed restrictions but modify the requirement to (1) remove the set distinction between temporarily and permanent restrictions and (2) focus instead on describing the differences in the nature with a focus on both how and when the resources (net assets) can be used.
  - Require disclosure of information about designated amounts and their purposes if any portion of net assets without donor-imposed restrictions has been board-designated or otherwise authorized for particular use.

SC&H GROUP

FASB NET ASSET PROJECT

- As with the cash flow changes, to date this has only been approved by the FASB board and has not been incorporated in the codification. It is expected to be made final in conjunction with the overhaul of the financial statement presentation for NFPs by the FASB.

OTHER NFP RESOURCES AND GUIDANCE

Resourceful websites containing recently issued guidance, technical Q&A's, practice bulletins, webinars, podcasts, and CPE courses:

- www.fasb.org
- www.aicpa.org
- www.ifrs.com
- www.gasb.com
- www.guidestar.org
- www.irs.gov

QUESTIONS

Thank you for the opportunity to introduce SC&H Group.
Please feel free to contact us with any questions.

Mike Young
Director
410-403-1513
myoung@scandh.com

POWERFUL MINDS
PASSIONATE TEAMS
PROVEN RESULTS