Article from *The FASB Report,* January 2007

FASB Guidance of Interest to Not-for-Profit Organizations

By Jeffrey Mechanick

The FASB is committed to setting high-quality U.S. accounting standards for all non-governmental entities, including business entities and not-for-profit organizations. I was hired in February 2006 as part of the FASB's continued commitment to not-for-profit organizations. In my role, I liaise with the various sectors of the not-for-profit community and help ensure that accounting and reporting issues relevant to not-for-profit organizations are given appropriate consideration in the FASB's general and not-for-profit specific standard-setting activities. This article is the first in a series of regular, periodic updates in *The FASB Report*. The updates will highlight developments in U.S. generally accepted accounting principles (GAAP) that are relevant to the not-for-profit community.

In addition to the two Exposure Drafts, *Not-for-Profit Organizations: Mergers and Acquisitions* and *Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition,* that the FASB issued October 2006 (see *The FASB Report,* November 2006), there are several other recent and pending FASB pronouncements that are applicable to all non-governmental entities that will be of interest to preparers, auditors, and users of not-for-profit financial statements.

Postretirement Benefits

FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* issued September 2006, applies to all not-for-profit organizations with single-employer defined benefit pension, health, or other postretirement plans. Organizations whose retirement plans consist solely of defined contribution plans and/or multi-employer defined benefit plans (which generally cover union employees) are excluded from the scope of the Statement. Statement 158 requires that the organization (1) report the funded status of its plans, measured as the difference between the fair value of the plan assets and the benefit obligation, directly on its balance sheet (recognition provisions) and (2) align the measurement date for plan assets and benefit obligations with the organization's fiscal year-end rather than continuing to permit a measurement date up to three months prior to fiscal year-end (measurement date provisions).

Statement 158 provides extensive guidance on how not-for-profit organizations should report, within changes in their unrestricted net assets, the various amounts that business entities would report in other comprehensive income under the provisions of the Statement. The guidance focuses especially on reporting with respect to performance indicators and other intermediate measures of operations that organizations may present in their statements of activities. The Statement also contains a comprehensive not-for-profit example in Appendix A (Implementation Guidance).

Organizations must adopt the recognition provisions of Statement 158, and some related disclosure provisions, no later than their fiscal year ending after June 15, 2007, and adopt the measurement date provisions no later than their fiscal year ending after December 15, 2008. Early adoption is permitted.

Fair Value Measurements

FASB Statement No. 157, *Fair Value Measurements,* also issued September 2006, provides guidance for fair value measurements whenever they are required or permitted under U.S. GAAP. This is a very important pronouncement with wide applicability to not-for-profit organizations. For example:

- FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made,* requires all contributions to be recorded initially at fair value, with the exception of certain collections and contributed services.
- FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations,* requires most investments to be carried at fair value.
- FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others,* requires assets held in a trust to be carried at fair value by a not-for-profit beneficiary.

Additionally, with an expanded array of financial instruments that may be carried at fair value in the future (see below), as well as the proposed requirement of the acquisition method in the two not-for-profit Exposure Drafts, fair value measurements will likely become even more commonplace in not-for-profit financial statements.

An especially important aspect of Statement 157 is the guidance concerning the effect of donor restrictions on the fair value of assets. Over the years, members of the not-for-profit community have often asked: Under what circumstances would a donor restriction be reflected in the fair value of an asset and not just in the classification of the associated net assets? Other than noting that in unusual circumstances assets (and not just net assets) may be restricted, the accounting literature has not previously provided an answer. Statement 157 places donor restrictions within the framework of contractual limitations and, consistent with the document's market participant focus, indicates

that donor restrictions would be reflected in fair value measurement only if those restrictions would extend to subsequent holders of the asset. Statement 157 provides an example (Example 9) illustrating this principle in its Implementation Guidance (Appendix A).

Statement 157 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted.

Financial Instruments

Two FASB pronouncements, one issued in early 2006 and the other pending, offer not-for-profit organizations the opportunity to simplify their accounting for important financial assets and liabilities such as multi-year contributions receivable and obligations to beneficiaries under split-interest agreements (charitable gift annuities and charitable trusts).

FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments,* issued February 2006, permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation (accounting for an embedded derivative at fair value and accounting separately for the remainder of an instrument at cost or amortized cost). Derivatives Implementation Group Issue B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement,* specifies that all split-interest agreements with period-certain, variable payments fall within that category. This includes a lead interest in a charitable remainder unitrust and a remainder interest in a charitable lead trust that are for a fixed period of time (as opposed to a beneficiary's lifetime). Not-for-profit organizations that report such instruments will likely find such an option—achieved, for example, by using a current discount rate in a present-value-based calculation of the obligation—to be easier administratively than bifurcation. Such an option is effective for years beginning after September 15, 2006, but may be adopted earlier and applied to instruments existing at the time of adoption as long as financial statements have not been issued for that period.

The FASB also is expected to issue a final Statement for Phase I of its project on fair value option early this year. The final Statement will apply to most of the financial instruments that already are not carried at fair value. While the Statement will enable not-for-profit health care providers (like their for-profit counterparts) to achieve offset accounting (within their performance indicator) for interest rate swaps and related indebtedness without having to apply complex hedge accounting provisions, the Statement will benefit a wide array of not-for-profit organizations by allowing fair value measurement for obligations to beneficiaries under split-interest agreements **without** embedded derivatives, as well as for other key financial instruments such as most multi-year contributions receivable. Currently, not-for-profit organizations initially record such amounts at fair value and subsequently amortize them at the same discount rate used in the initial fair value calculation, in accordance with the provisions of APB Opinion No. 21, *Interest on Receivables and Payables.* The need to track and use an array of historical discount rates complicates the recordkeeping required for subsequent accounting and reporting, especially for split-interest agreements that may not mature for many years. As with the instruments covered by Statement 155, not-for-profit organizations may find it easier administratively to elect such an option rather than continue to amortize such amounts under APB 21. Before making such election, however, organizations will need to weigh the administrative advantages against the possibility of increased volatility in their changes in net assets that might accompany measurement of such assets and liabilities at fair value. The final Statement will be effective for years beginning after November 15, 2007, with early adoption permitted if Statement 157 has been adopted in its entirety either previously or concurrently.

Uncertainty in Income Taxes

The last major pronouncement of interest to many not-for-profit organizations is FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes.* The document, an interpretation of FASB Statement No. 109, *Accounting for Income Taxes,* gives a framework for assessing how a tax position taken or expected to be taken in a tax return should be reflected in an organization's financial statements. The framework assumes that the tax position will be examined by the appropriate taxing authority that has full knowledge of all relevant information and requires organizations to assess whether the position more likely than not will ultimately be sustained. If not, the organization may reflect only the maximum benefit that is more likely than not to be sustained.

Not-for-profit organizations with for-profit subsidiaries and/or with income reported as unrelated business income (or that might be classified as such by the taxing authorities) will need to apply this framework in accounting for income taxes associated with those subsidiaries or activities. In addition, because the definition of a **tax position** in paragraph 4 of Interpretation 48 includes "[a] decision to classify a transaction, entity, or other position in a tax return as tax exempt," **all** tax-exempt not-for-profit organizations must consider whether there are any significant issues that could jeopardize such status and, if so, how that would affect the financial statements.

Interpretation 48 is effective for fiscal years beginning after December 15, 2006. Earlier application is encouraged if an organization has not issued financial statements for the year or any interim period thereof.

Other Pronouncements

One recent FASB Staff Position of particular note is FASB Staff Position FAS 126-1, *Applicability of Certain Disclosure and Interim Reporting Requirements for Obligors for Conduit Debt Securities.* FSP FAS 126-1 clarifies that entities that are obligated for repayment of publicly traded debt securities issued on their behalf by state and local governments are considered "public" for purposes of applying certain FASB and AICPA pronouncements, including Statement 109, FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Retirement Benefits,* and APB Opinion No. 28, I*nterim Financial Reporting.* Those pronouncements have more extensive disclosure requirements for public entities than they do for nonpublic entities. Many not-for-profit organizations, especially in the health care and higher education sectors, enter into conduit debt arrangements to fund their capital needs and will be considered "public" by FSP 126-1 unless such debt is privately placed. FSP 126-1 is effective for fiscal periods beginning after December 15, 2006.

One recent EITF Issue of particular note, especially to colleges and universities, is EITF Issue No. 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43." Issue 06-2 requires accrual for sabbaticals when an employee is entitled to paid time off after working for an organization for a specified period of time, and during the sabbatical the individual will continue to be a compensated employee but will not be required to perform any duties for the organization. Issue 06-2 is effective for fiscal periods beginning after December 15, 2006.

Not-for-profit organizations that collect and remit significant amounts of sales, use, value added, or excise taxes in connection with their revenue producing activities also should take note of EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)." Issue 06-3 does not indicate a preference for gross reporting (inclusion in revenues and costs) or net reporting (exclusion from revenues) but does clarify that the choice of method is an accounting policy decision that should be disclosed. Issue 06-3 is effective for fiscal periods beginning after December 15, 2006.

* * *

Members of the not-for-profit community should read each of these pronouncements to gain a more thorough understanding of their requirements and how to implement them.

Jeffrey Mechanick is an FASB project manager.
Contact: jdmechanick@fasb.org