

# MaherDuessel

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# Restricted Net Assets

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DUSTIN STARR

# Agenda

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- ❑ Background on Net Assets and Classifications
- ❑ Financial Statement Presentations
- ❑ Footnote Disclosures
- ❑ Internal Controls
- ❑ Audit Considerations

# What are Net Assets?

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- ❑ “The excess or deficiency of assets over liabilities, which is divided into two mutually exclusive classes according to the existence or absence of donor-imposed restrictions”
- ❑ “Equity” of the entity
- ❑ Reports how residual earnings can be used for future activities

# Common Categories

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- ❑ Without Donor Restrictions
  - Undesignated
  - Investment in fixed assets
  - Board designated
  
- ❑ With Donor Restrictions
  - Temporary
  - Permanent

# Without Donor Restrictions

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- ❑ Do not have external restrictions (both time and purpose)
- ❑ Includes board-designated restrictions
- ❑ Can be used for any future activity management/board approves
- ❑ Fixed assets can inflate and should be considered

# With Donor Restrictions

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- Temporary
  - Time restrictions
    - Future fiscal year(s)
    - Multi-year pledges
  - Purpose
    - Program
    - Capital
  
- Permanent
  - Endowments

# Reclassification of Net Assets

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- ❑ “The simultaneous increases in one net asset class and decreases in another”
- ❑ “Reflects that the relationship between a donor-restricted contribution and an expense that it supports because the restriction generally does not happen in the year received”
- ❑ Applicable for the following events:
  - Fulfillment of purposes of which net assets were restricted
  - Restrictions expire with passage of time
  - Death of split interest agreement beneficiary
  - Donor withdraws or court action removes

# Expiration of Donor-Imposed Restrictions

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- ❑ Net asset reclassification in the period in which the restriction expires
- ❑ If more than one restriction, reclassification is reflected once last has expired
- ❑ Donor stipulations carry more weight than implied restrictions



# Use of Net Assets

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- ❑ What if restricted and unrestricted net assets are available for the same purpose?
  - Use restricted first unless another revenue source is directly attributable (double dipping)
  - Keep internal budgeting/earmarking separate from reclassification
  - Time restrictions may cause net assets to be unavailable until the time restriction has expired

# Unconditional Promises to Give

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- ❑ Include an implied time restriction
- ❑ Reasonable to assume that by specifying future payment dates donors indicate the gift is to support activities in each period the payment is scheduled
  - Unless another time period is inherent in the restriction
- ❑ Explicit purpose restrictions carry more weight than an implied time restriction

# Restrictions on Gifts of Long-lived Assets

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- ❑ Restricted use of property and equipment for specific period of time
- ❑ Excludes contributions of cash restricted for purchase of long-lived assets
- ❑ Reclassified as the restriction expires
- ❑ May or may not equal the amount of the asset's depreciation

# Contributions Made And Restrictions Met In The Same Year

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- ❑ May be reported as Without Donor Restrictions
  - Included along with unrestricted grants
  - Is not reported within the release from restrictions
  - Is not reported within related footnote disclosures
- ❑ Required to disclose as an accounting policy if elected

# Endowment Funds

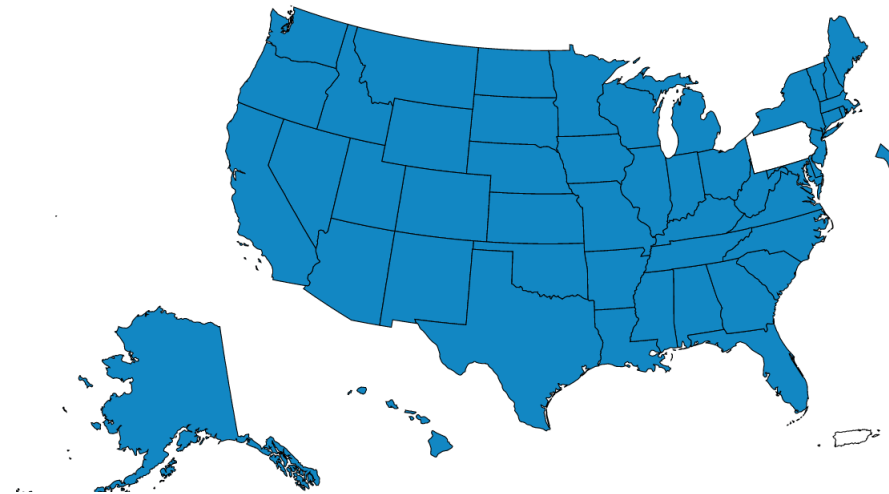
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- ❑ Board designated
  - Reported as Net Assets Without Donor Restricted
  - Governed by board actions and internal policies
  
- ❑ With Donor Restriction
  - Held in perpetuity
  - Term Endowment
  - Governed by applicable law

# UPMIFA

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- ❑ Uniform Prudent Management of Institutional Funds Act
  - Established by the Uniform Law Commission
  - Governs the management of funds donated with modern investment and expenditures practices
  - Not adopted in PA!



# PA Act 141 of 1998

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- ❑ Intended to find a balance for both the long-term preservation of the assets and the Organization's need to fulfill its mission
- ❑ Defined income for distribution purposes as a fixed percentage (2%-7%)
- ❑ Adoption of investment policy to meet total return objectives

# Spending Example

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- ❑ Value of endowment assets = average of FMV over a three-year period
  - 2022 FMV = \$1,300,000
  - 2021 FMV = \$1,250,000
  - 2020 FMV = \$1,000,000
  - Average = \$1,183,333
  
- ❑ Distribution = Value X Spending Percentage (2%-7%)
  - \$1,183,333 X 5% = \$59,167



# PA Act 71 of 2020

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- ❑ Revised PA Act 141 in response to COVID-19
  - Only applicable to funds governed by Act 141
  - Increases distributions to maximum of 10%
  - Specific spending policies must remain in effect
  - Only applicable for calendar years 2020-2022

# Community Endowments

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- ❑ Often transfer “Variance Power”
  - Variance Power – The unilateral power to redirect the use of transferred assets to another beneficiary
- ❑ Are not reported as assets of the transferee/beneficiary
- ❑ Distributions are reported by the recipient as received
- ❑ Footnote disclosure required

# Reporting of Net Assets – Pancake Format

<b>Support and Revenues:</b>		
Grants		\$ 100,000
Contributions		200,000
Program service revenue		30,000
Other income		1,000
Net assets released from restrictions		25,000
Total support and revenues		356,000
<b>Expenses:</b>		
Program		300,000
Management and general		40,000
Fundraising		10,000
Total expenses		350,000
<b>Change in Net Assets Without Donor Restrictions</b>		6,000
<b>Change in Net Assets With Donor Restrictions:</b>		
Grants		50,000
Assets with donor restrictions released for operations		(25,000)
Total change in net assets with donor restrictions		25,000
<b>Change in Net Assets</b>		31,000
<b>Net Assets:</b>		
Beginning of year		100,000
End of year		\$ 131,000

# Reporting of Net Assets – Columnar Format

	Without Donor Restrictions	With Donor Restrictions		Total With Donor Restrictions	Total
		Purpose and Time Restrictions	Perpetual in Nature		
<b>Revenues and Other Support:</b>					
Gifts and grants	\$ 5,000,000	\$ 100,000	\$ 1,000,000	\$ 1,100,000	\$ 6,100,000
Government grants and contracts	250,000	-	-	-	250,000
Fee revenue	300,000	-	-	-	300,000
Interest	50,000	-	-	-	50,000
Investment income, net	-	-	50,000	50,000	50,000
Other income	20,000	-	-	-	20,000
<b>Net assets released from restrictions</b>	<b>50,000</b>	<b>(50,000)</b>		<b>(50,000)</b>	<b>-</b>
Total revenues and other support	5,670,000	50,000	1,050,000	1,100,000	6,770,000
<b>Expenses:</b>					
Program	4,000,000	-	-	-	4,000,000
Management and general	1,000,000	-	-	-	1,000,000
Fundraising	500,000	-	-	-	-
Total expenses	5,500,000	-	-	-	5,000,000
<b>Change in Net Assets</b>	<b>170,000</b>	<b>50,000</b>	<b>1,050,000</b>	<b>1,100,000</b>	<b>1,770,000</b>
<b>Net Assets:</b>					
Beginning of year	1,000,000	100,000	1,000,000	1,100,000	2,100,000
End of year	\$ 1,170,000	\$ 150,000	\$ 2,050,000	\$ 2,200,000	\$ 3,870,000

# Footnote Disclosures

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- ❑ Restricted net assets available at year-end
- ❑ Category
  - Temporary
  - Held in perpetuity
- ❑ Time restriction
- ❑ Purpose restriction

# Footnote Disclosures

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## Basis of Presentation

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

Without donor restrictions - Net assets that are not subject to donor-imposed stipulations.

With donor restrictions – Net assets subject to donor-imposed stipulations that may or will be met either by actions of the Organization and/or the passage of time. Other donor restrictions are perpetual in nature, whereby the donor has stipulated the funds be maintained in perpetuity.

Revenues are reported as increases in net assets without donor restrictions unless the use of the related assets is limited by donor-imposed restrictions. Expenses are reported as decreases in net assets without donor restrictions. Gains and losses on investments and other assets or liabilities are reported as increases or decreases in net assets without donor restrictions unless their use is restricted by explicit donor stipulation or by law. Expirations of restrictions on net assets (i.e., the donor-stipulated purpose has been fulfilled and/or the stipulated time period has elapsed) are reported as reclassifications between the applicable classes of net assets. Contributions received with donor-imposed restrictions that are met in the same year in which the contributions are received are classified as contributions without donor restrictions.

# Endowment Disclosures - Classification

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The Organization's endowment was awarded by a grantor for general operating purposes and is reported as net assets with donor restrictions on the statement of financial position. The grant is to be utilized as a permanent endowment and withdrawals are to be used for general expenditures. As required by accounting principles generally accepted in the United States of America (GAAP), net assets associated with endowment funds, including funds designated by the Board to function as endowments, are classified and reported based on the existence or absence of donor-imposed restrictions.

## Interpretation of Relevant Law

The Board of the Organization has interpreted Pennsylvania State Act 141 of 1998 (Act) as requiring the preservation of the fair value of the original gift as of the gift date of the donor-restricted endowment funds, absent explicit donor stipulations to the contrary. As a result of this interpretation, the Organization classifies as net assets to be held in perpetuity (a) the original value of the first donation to the permanent endowment, (b) the original value of subsequent gifts to the permanent endowment, and (c) accumulations to the permanent endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added to the fund.

# Endowment Disclosures – Return and Spending Policies

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## Return Objectives and Risk Parameters

Endowment assets include those assets of donor-restricted funds that the Organization must hold in perpetuity or for a donor-specified period(s). The Organization has adopted policies and guidelines for endowment funds. The endowment objective is to earn an average annual total return of at least 5% per year above management fees, inflation, and replacement funds to maintain the endowment over the long-term.

The timing and amount of distributions from the endowment are determined by the Board annually. The Organization has a policy of appropriating for distribution each year 5% of the value of the endowment, including all interest, capital gains, dividends, and distributions realized over time. The value is determined by averaging the value of the endowment over a three-year period (or fewer if the expenditure is drawn within the first three years of the grant).

Distributions from the endowment will not be made to the operating budget of the Organization except to fulfill the purposes described in this policy. Distributions from the endowment shall be made using a “Total Return Policy” that incorporates a designated percentage of the corpus, which will be available for expenditure annually.

In an unanticipated event that the endowment falls below the initial gift value, the Organization would cease to draw on the fund until it reaches the initial value and will not impair the principal. Additionally, the Board may, from time-to-time, adjust the minimum endowment value that would trigger replenishment.



# Endowment Disclosure - Rollforward

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Investment Return:	
Investment income	\$ 200,000
Net (depreciation) appreciation	1,000,000
Investment fees	<u>(50,000)</u>
Total investment return	<u>1,150,000</u>
Contributions	100,000
Distribution	<u>(50,000)</u>
Total change in endowment funds	<u>1,200,000</u>
Endowment assets:	
Beginning of year	<u>1,000,000</u>
End of year	<u>\$ 2,200,000</u>

# Fiduciary Responsibilities – Internal Controls

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- ❑ Use of resources effectively and efficiently
  - How would you like your contributions being spent?
- ❑ Method of tracking donor-imposed restrictions
  - Spreadsheets
  - Accounting software
  - Bank accounts

# Fiduciary Responsibilities – Internal Controls

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- ❑ Interdepartmental communication
  - Development
  - Program
  - Finance
- ❑ Cost allocation procedures
- ❑ Independent review

# Audit Considerations - Presentation

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Select Control Objectives</i>
<b><i>Presentation and Disclosure</i></b>		
Rights and obligations; Classification and understandability	Net assets are used and accounted for in accordance with the presence or absence of donor restrictions.  Net assets with donor restrictions are reclassified as net assets without donor restriction in the statement of activities when donor-imposed restrictions have been fulfilled.	Management monitors compliance with donor restrictions.  Controls ensure that reclassification of net assets with donor restrictions occurs when donor-imposed restrictions have been fulfilled.  Management reviews the balances of net assets with donor restrictions to ensure that the net assets are restricted (including unconditional promises to give due in future periods).

# Audit Considerations - Transactions

<i>Financial Statement Assertions</i>	<i>Specific Audit Objectives</i>	<i>Select Control Objectives</i>
<b>Classes of Transactions</b>		
Completeness, Classification	Net assets with donor restrictions are reclassified as net assets without donor restriction in the statement of activities when donor-imposed restrictions have been fulfilled.	<p>Management monitors compliance with donor restrictions.</p> <p>Controls ensure that reclassification of net assets with donor restrictions occurs when donor-imposed restrictions have been fulfilled.</p>

# Audit Considerations – Account Balances

Account Balances		
Classification, Presentation	Net assets are used and accounted for in accordance with the presence or absence of donor restrictions.	Management monitors compliance with donor restrictions.
	Net assets are classified as with donor restrictions or without donor restrictions based on the presence or absence of donor restrictions.	Management reviews the balances of net assets with donor restrictions to ensure that the net assets are restricted (including unconditional promises to give due in future periods).

# Questions?

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- Sources
  - AICPA Nonprofit Audit Guide – Chapter 11
  - PA Act 141