BROWNEDWARDS
certified public accountants

December 28, 2016

Education and Not-for-Profit Update

Are you Overwhelmed by Recently-issued Accounting Standards?

During the next four years, nonprofit organizations will face the daunting task of implementing three new accounting standards that will have a major impact on their financial reporting:

- ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. Most nonprofit organizations must apply the new standards for fiscal years beginning after December 15, 2018 (i.e., calendar year ending December 31, 2019, or fiscal years ending in 2020). Earlier adoption is permitted for any fiscal year beginning after December 15, 2016.

- ASU 2016-02, *Leases (Topic 842)*. Most nonprofit organizations must apply the new standards for fiscal years beginning after December 15, 2019 (i.e., calendar year ending December 31, 2020, or fiscal years ending in 2021). Earlier adoption is permitted.

- ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*. The new standards are effective for fiscal years beginning after December 15, 2017 (i.e., calendar year ending December 31, 2018, or fiscal years ending in 2019), with early adoption permitted.

With other competing priorities, such as increased demand for services, fund-raising and writing grant proposals, and new overtime standards for employees, it would be easy for a financial officer to be overwhelmed. This article is the first in a series designed to help you decide where to start.

First Things First

Because most nonprofit organizations have lean accounting staffs, it is unlikely that they are going to be able to work on the implementation of all three standards at the same time. So where should an organization start and, at the same time, keep from falling too far behind on the implementation of the other two standards?

ASU 2016-14 has the earliest effective date, so you may be tempted to start there. That could be a good answer; however, some implementation steps for the other two standards should start soon, and some organizations may need to begin with a different standard because of unique implementation complexities. This series will examine each of the three standards in a little more detail.





ASU 2014-09, Revenue Recognition

ASU 2014-09 applies to any entity that enters into contracts with customers to transfer goods or services. For nonprofit organizations, the standards may affect revenue recognition for items such as tuition, room and board, fee for service arrangements, membership dues, or special events. Because the rules affect only exchange transactions, accounting for items such as contributions and split-interest agreements won't change.

It still isn't clear how the new standards will affect grants. Organizations have struggled to determine which grants are contributions and which are exchange transactions since the issuance of contribution standards in 1996, and ASU 2014-09 doesn't provide any immediate answers. In April 2016, the FASB added a project to its agenda, with the goal of improving and clarifying the existing guidance on revenue recognition of grants and contracts by nonprofit organizations. The FASB recognized that although there has been a long-standing implementation problem prior to the issuance of ASU 2014-09, the new guidance placed renewed focus on that problem due to the elimination of the exchange transaction guidance in FASB ASC 958-605 and the disclosure requirements included in ASU 2014-09, which don't seem relevant to grant transactions.

Even for exchange transactions that are clearly within the scope of the new recognition standards, it isn't yet entirely clear how to apply the standards. In the past year, the FASB has deferred the implementation date of ASU 2014-09 and issued three additional standards clarifying or correcting the initial standards. In addition, during 2016, the FASB issued two exposure drafts of technical corrections to ASU 2014-09. Both the FASB and the AICPA have formed task forces to inform the FASB about potential implementation issues that could arise when entities implement the new standards and to help resolve those issues.

Most nonprofit organizations haven't determined how the standard will affect them. At this time, it could be unwise for nonprofit organizations to launch a full-scale implementation effort. However, organizations that are primarily supported by exchange transactions, such as nonprofit hospitals and membership organizations, should currently spend some time testing their existing recognition policies against the five-step recognition process in ASU 2014-09 and determine if there are any revenues for which new information systems need to be designed to implement the standards. Then, the organization will be ready when the clarification provided by additional new standards is available.

ASU 2016-02, Lease Accounting

ASU 2016-02 applies to any entity that enters into a lease (with a few exceptions that are unlikely to affect most nonprofit organizations). Although the new standards apply to both lessees and lessors, this article focuses only on the significant changes affecting lessees because most nonprofit organizations are in that position. (Lessor accounting remains substantially unchanged, except that there will no longer be special accounting for leveraged leases.)

By requiring that essentially all leases be reported as assets (right-to-use assets) and liabilities (lease obligations), the financial statements of many, if not most, nonprofit organizations will change dramatically. Although a lessee is permitted to make an accounting policy election, by class of underlying asset, not to recognize lease assets and lease liabilities for leases for periods of 12 months or less, the relief afforded by that election is limited because it isn't available if there is an option to extend the lease beyond 12 months and the organization is reasonably certain to exercise that option. The election also isn't available if the lease includes an option to purchase the underlying asset and the organization is reasonably certain to exercise that option.

Although the new standards still distinguish between capital leases (now called finance leases) and operating leases, the distinction affects recognition in the statement of activities. Both lease types create right-of-use assets and lease liabilities that are initially measured at the present value of the lease payments.

For most nonprofit organizations, determining the effort necessary to implement the standard requires locating all the leases. Capital leases and their terms are probably tracked currently, but operating leases will require a larger effort because the existing disclosures don't require organizations to track the lease terms that are necessary to implement the new standards. Further, capital leases of smaller dollar value items (copiers, computers, and similar other equipment) may have been dismissed in the past as immaterial, but the impact of those leases on financial statements will need to be reassessed under the new standards. Locating all the necessary leases may also be compounded if the organization operates from multiple locations without a central accounting function. Reviewing the activity in general ledger accounts for rent expense, equipment rental, and similar expense accounts is a good place to start. Then, move to the statement of financial position accounts for deferred or prepaid rent and capital lease obligations.

After the leases are located, the relevant terms from the leases have to be extracted in order to complete the complex present value calculations that determine the amounts to be recognized for the lease assets and liabilities. Spreadsheets are the typical way that most organizations track leases, and templates will have to be developed (or purchased). Then, accountants will have to manually enter the relevant lease terms and check their work.

There are a few practical expedients that can reduce the effort, but they come with some risks. First, the organization can elect to use the risk-free rate rather than the rate implicit in the lease (or the incremental borrowing rate if the implicit rate can't be readily determined). Because a risk-free rate will be lower than those other two rates, the resulting lease assets and lease liabilities will be larger. The second expedient allows organizations to elect not to separate lease components from nonlease components (such as utilities or services included in the lease payment). Using that expedient also results in larger lease assets and liabilities. The final expedient, referred to as the modified retrospective method of initial implementation, in effect, permits an organization to account for leases that commence before the effective date of ASU 2016 -02 in accordance with previous GAAP except that the right-of-use asset and a lease liability for all operating leases must be recognized at each reporting date. This expedient, which may make the information gathering stage easier, might also cause financial statement comparability concerns in future years when renewing or modifying lease contracts.

Because applying the new lease standards results in new assets and liabilities in the financial statements, nonprofit organizations with debt will need to assess the effects of those new assets and liabilities on debt covenants. It is necessary to make a rough estimate of the effects of implementation on financial covenants as soon as possible, and then stress test those covenants to see how sensitive they are to changes that might occur, such as a decrease in pledges or the signing of a new lease. It may be necessary talk to lenders about adjusting the covenants for the new standards, and it is best to do that as soon as possible.

- ASU 2016-14, New Financial Reporting Model
- ASU 2016-14 will affect every nonprofit organization, but it is important to remember that the new standards are an update, not an overhaul.

An Action Plan

Given the significant reporting and disclosure changes involved, all financial officers and auditors involved with nonprofit organizations should start preparing now. Educate yourself about the new standards, and then consider whether the following is the best plan for your organization:

- If the organization is primarily supported by exchange transactions, determine whether recognition point(s) will change and whether new systems to support the new recognition point (s) are needed. Involve all stakeholders, especially the information technology department.
- Determine whether additional systems are needed to identify and gather all leases. Create internal controls so that copies of all leases are sent to the controller's department.
- Implement the new financial reporting model.
- Implement the revenue recognition standards.
- Implement the new lease standards.

Requirements for Section 501(c)(3) Status

An organization must satisfy several fundamental requirements in order to be tax-exempt under **IRC Sec 501(c)(3)**. Two of these are as follows:

- It must be *organized* exclusively for exempt purposes.
- It must be *operated* exclusively for exempt purposes.

These requirements are broad in scope and strictly construed. Failure to meet either requirement prevents exempt status.

Exempt purposes include, among other things, religious, charitable, scientific, and educational purposes. An organization is not organized and operated exclusively for an exempt purpose unless it serves a public rather than a private interest. It must demonstrate that it is neither organized nor operated for the benefit of designated individuals, the creator or his family, shareholders of the organization, or persons (entities) controlled directly or indirectly by those private interests.

Organizational Test

The organizational test is an objective standard. An entity's articles of organization must (1) specifically limit its purposes to one or more exempt purposes and (2) not expressly empower it to engage in activities that do not further its stated purposes (other than as an insubstantial part of its activities). The definitive authority is **Better Business Bureau of Washington DC,** in which the Supreme Court declared that the presence of a substantial, single non-exempt purpose prevents exemption regardless of the number or importance of exempt purposes.

Recent IRS rulings illustrate the organizational test. In Ltr. Rul. 201615017, entity X was set up to engage in several activities promoting a newly-developed dog breed.

Although X's articles of incorporation stated that X was organized exclusively for educational purposes within the meaning of Section 501(c)(3), the articles also authorized X to create a parent club for the new breed. Since creation of a parent club is not a Section 501(c)(3) purpose, X failed the organizational test.

The entity in Ltr. Rul. 201548021 was organized to feed the hungry, which certainly can be a charitable purpose. It also conducted other activities that were presumably entirely charitable in nature. However, its articles of incorporation did not expressly limit its activities to exclusively Section 501(c)(3) purposes. Consequently, it failed the organizational test.

The IRS had little difficulty in rejecting the exemption application of an organization created to raise funds for the medical treatment of a designated individual. The reason for the organization's creation is a clear violation of the organizational test (Ltr. Rul. 201648019).

IRS Pub. 557 (Tax-Exempt Status for Your Organization) provides several drafting guidelines to observe to ensure that the organizational test provisions are satisfactory.

Location of Language.The required language must be in the organization's articles of organization. Inclusion only in the bylaws or other governing rules, even if actual operations are solely for exempt purposes, does not satisfy the organizational test.

Reference an Exempt Purpose.A statement in the articles that the organization shall engage only in charitable activities within the meaning of **IRC Sec. 501(c)(3)** or that its purposes are limited exclusively to those permitted by **IRC Sec. 501(c)(3)** is satisfactory without further additional detail.

Avoid Ambiguous Language.A provision that the organization's purposes are charitable, philanthropic, and benevolent, while sounding good, will not satisfy the organizational test. The terms *philanthropic* and *benevolent* have no generally accepted legal meaning, and therefore, the stated purposes may, under the laws of the state of incorporation, permit activities that are broader than those allowable under **IRC Sec. 501(c)(3)** .

Operational Test

Section 501(c)(3) status is precluded if more than an insubstantial part of an organization's activities do not further an exempt purpose [**Reg. 1.501(c)(3)-1(c)(1)**]. Just like the organizational test, private letter rulings illustrate the operational test.

In Ltr. Rul. 201548021, entity Y's president owned Company C. C was the incorporator of Y and also sold a certain food product. Y's name and logo were similar to C's. Y sponsored two types of fundraiser programs for nonprofit organizations, such as schools, community groups, and religious groups. Both programs centered around the purchase of Y's food product.

Y sought to deal with C at arm's length by adopting a conflict of interest policy. Its independent board members were the primary interface between Y and C.

The IRS concluded that more than an insubstantial part of Y's activities were devoted to non-exempt private purposes-Y was operating for the private benefit of C. Entity Y was providing C with a sales outlet to market its food product. As owner of C, Y's president was profiting from this relationship.

The IRS emphasized that the critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive. Rather, the entire enterprise must not be conducted in such a manner that the for-profit entity benefits substantially from the operation of the nonprofit entity [***Church by Mail, Inc***]. Consequently, any financial integration between the operations of a nonprofit entity and a for-profit entity controlled by the nonprofit's directors jeopardizes Section 501(c)(3) status for the non-profit.

In Ltr. Rul. 201548025, entity Z was created to train educators and other child servicing professionals in the use of a comprehensive program (CP) for promoting emotional and social competencies in elementary school-aged children. The effectiveness of CP was acknowledged by unrelated child-services agencies. Two members of Z's board

received royalties for each CP unit sold. One of them was compensated by Z as a CP coordinator/trainer. Consequently, the fact that related parties received financial benefits from the CP sales was deemed by the IRS to be a non-exempt purpose of serving private interests that precluded exemption under **IRC Sec. 501(c)(3)** .

Activities and Exempt Purpose

Not all activities conducted by an entity are deemed to further its exempt purpose, even if those activities appear to be charitable.

A Charitable Class - In order for an organization to fulfill a charitable purpose, the beneficiaries of its activities must be restricted to members of a charitable class. The class must be large or indefinite (i.e., charity begins where certainty of the beneficiary ends). Consequently, the class must not be so defined that only certain designated persons will benefit.

Ltr. Rul. 201509039 makes it clear that the benefitted class must, in fact, be a charitable class. The entity (W) in this ruling was organized to assist small businesses in areas impacted by natural or man-made disasters by helping them to secure operating capital during the recovery period. W provided services and benefits to all applicants within a disaster area.

The IRS noted, however, that small businesses in disaster areas are not a charitable class per se, since some businesses may have sufficient cash reserves to rebuild their operations. W only verified that the small businesses were legal entities, without further investigating their financial need. Therefore, W did not qualify for Section 501(c)(3) status because it did not benefit a defined charitable class.

Commercial Operations - Offering services that are similar to those provided by for-profit entities is generally not an exempt activity. There is an exception to this general rule when an organization provides services at substantially below cost exclusively to tax-exempt entities (**Rev.Rul.71-529**). In this situation, the organization must cover its operating deficit through contributions. Providing services at cost to unrelated organizations is not an exempt activity **(Rev.Rul.72-369)**

The entity (W) in Ltr. Rul. 201509039 (discussed previously) proposed to generate fees from small businesses prior to the occurrence of a disaster by registering them in its data base and by charging an annual fee to keep registration current. These fees provided the majority of W's revenue. The IRS concluded that W had a non-exempt commercial purpose rather than a charitable purpose because its fee structure was designed to cover nearly all of its costs (i.e., it was not providing services at substantially below cost) and was competing with for-profit entities.

Grant Control.A Section 501(c)(3) entity violates the operational requirement if it does not exercise control over funds it grants to other organizations that are not Section 501(c)(3) entities **(Rev Rul 68-489)** grantor must ensure that donated funds are used only for its exempt purposes.

The entity (W) in Ltr. Rul. 201509039 proposed to donate a portion of its registration fee income to the local chambers of commerce of the registered small businesses without retaining control over how the funds were ultimately spent. Since a chamber of commerce can spend money on political campaign intervention while a Section 501(c)(3) entity cannot, W would be deemed to operate for a non-exempt purpose by allowing another entity to potentially expend W's income for a non-exempt purpose.

Form 1023-EZ Report Card

Since July 1, 2014, smaller organizations have been able to apply for Section 501(c)(3) status electronically using Form 1023-EZ. Consisting of only 2½ pages, Form 1023-EZ eliminates the complexity and intimidation factor of the lengthy and tedious Form 1023. The basic eligibility requirements for using Form 1023-EZ include organization in the U.S., annual gross receipts of $50,000 or less (for the past three years and projected for the next three years), and total assets having a fair market value of no more than $250,000.

The Positives

From inception through June 2016, the IRS has processed 87,954 Forms 1023-EZ (compared to 73,416 Forms 1023). Only five applications were denied for failure to meet the organizational or operational test. There were only 4,152 applications rejected (primarily for procedural reasons). Of those rejected, 1,722 subsequently reapplied, with 1,239 doing so on Form 1023-EZ. Of the 1,239 reapplications, 1,172 were approved. Overall, 94% of all Forms 1023 processed through June 30, 2016, have been approved.

Good News/Bad News

The average processing time for Form 1023-EZ has been 14 days. In contrast, the average processing time for Form 1023 has been 97 days. Efficiencies gained from the use of Form 990-EZ have allowed the Exempt Organizations (EO) operations to shift 31 determination agents to EO: Examinations. So the bad news is that organizations that are operational can expect more examinations of their annual information returns.

Lessons Learned

The second leading cause of rejection (29%) was an invalid employer identification number (EIN). This is somewhat shocking, since this is so basic to an organization's activities. Tax examiners now conduct additional research of IRS records to locate a correct EIN for the applicant, greatly reducing this reason for rejection. Another procedural change made based upon experience to date is to follow up requests for additional information with telephone calls. This has been an effective means of getting a response.

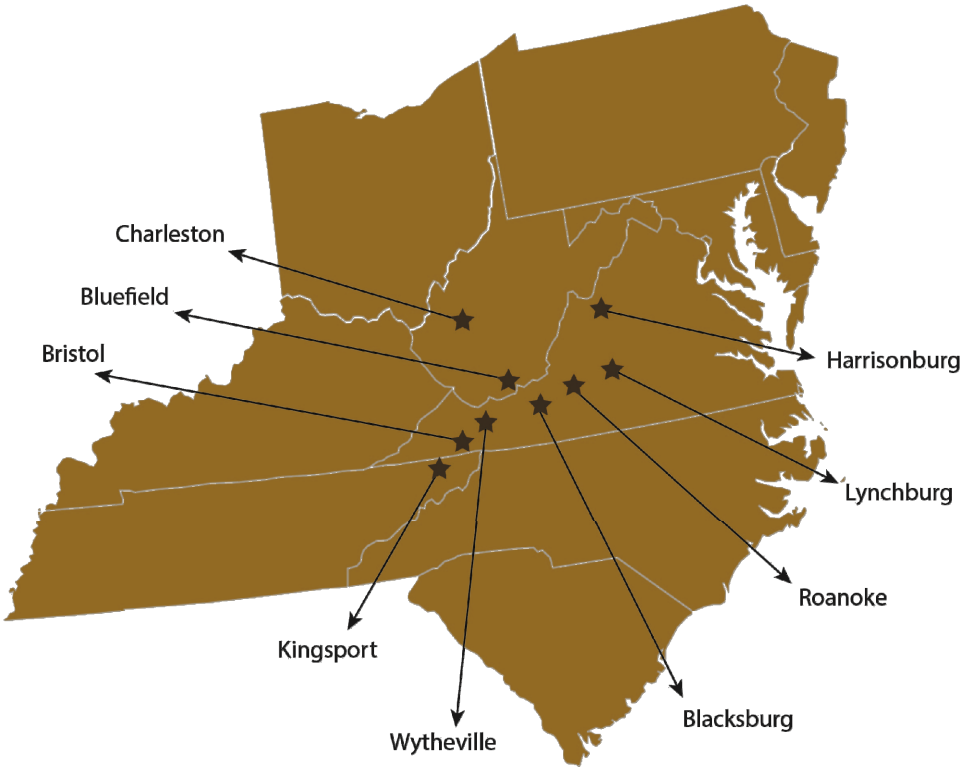
BROWNEDWARDS

certified public accountants

Education and Not-for-Profit Update

presented by the

Brown Edwards Education & Not-for-Profit Service Team



Your Success Is Our Focus