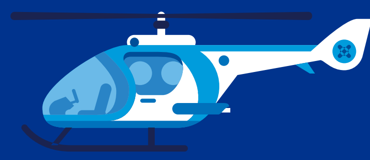
KPMG



Defining Issues®

FASB proposes to clarify how not-for-profits and others account for grants and similar transactions

August 4, 2017

KPMG reports on a proposed ASU[1] that would clarify the scope and accounting guidance for contributions received and made.

Applicability

The proposal would primarily affect not-for-profit (NFP) entities, including healthcare entities. However, the guidance would apply to all entities that receive or make contributions of cash or other assets.

Key facts

The proposed ASU would address practice issues by helping entities evaluate whether they should account for a grant (or similar contract) as a contribution or as an exchange transaction.

In an exchange transaction, a resource provider receives 'commensurate value' in return for the resources transferred. The proposed ASU would clarify how an entity determines whether a resource provider is receiving commensurate value. The proposed ASU states that indirect benefit to the public, or a benefit that the resource provider gains from carrying out its mission, would not constitute commensurate value.

The proposed ASU also would clarify and expand the criteria for determining whether a contribution is conditional. Contributions would be considered conditional if the agreement includes:

- either a right of return of assets transferred or a release of a promisor from its obligation to transfer assets; and
- a barrier that must be overcome before a recipient is entitled to the assets transferred or promised.

Comments are due November 1.

Key impacts

Some grants that are considered exchange transactions today would be accounted for as conditional contributions under the proposed ASU. The effect of this change may be limited to the net asset classification of grant revenue (and presentation of net assets released).

Some grants that are considered unconditional contributions under current US GAAP would be considered conditional under the proposed ASU, which would delay recognition of contribution revenue and expenses.

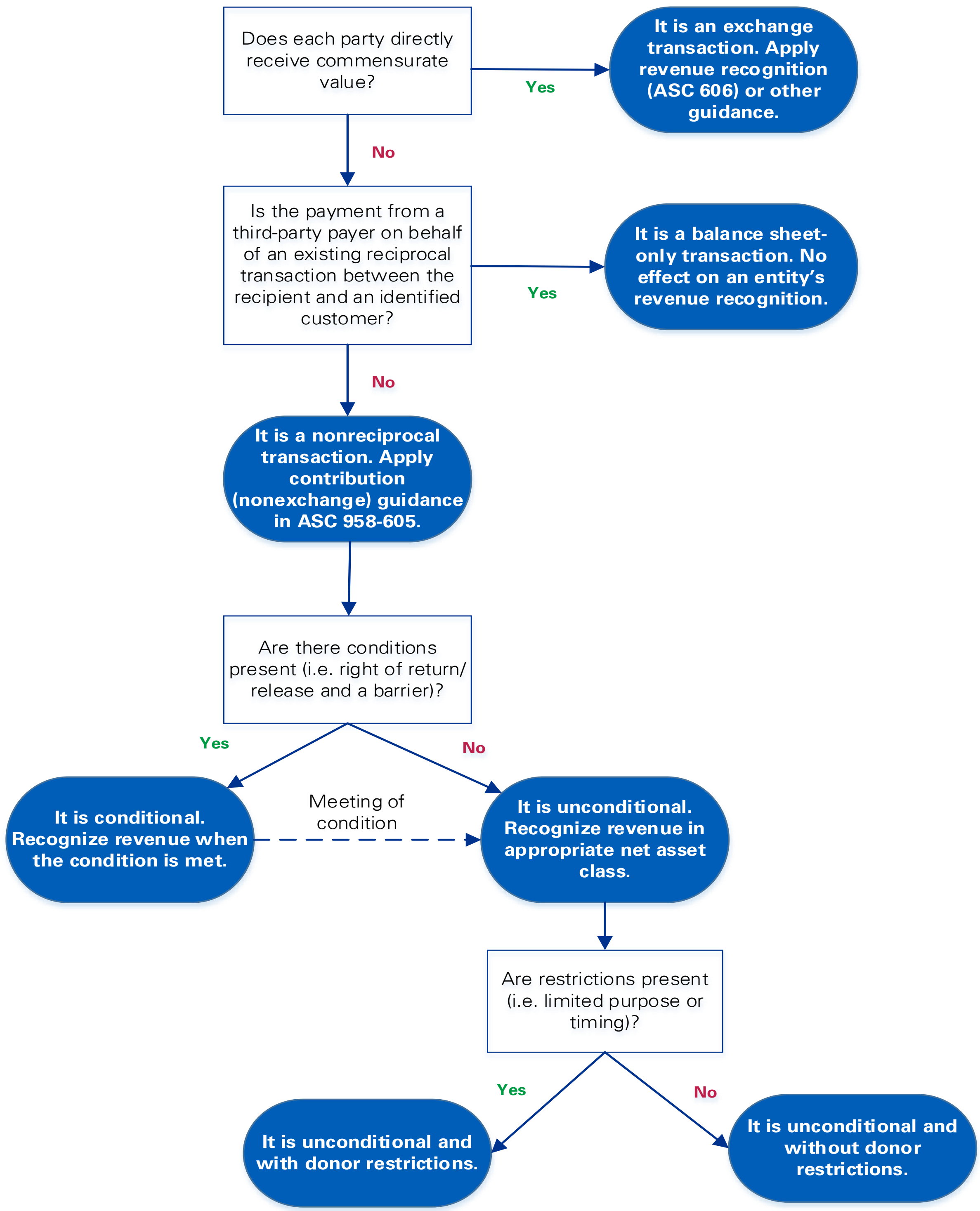
The proposed ASU is intended to reduce diversity in practice and enhance comparability among entities. It would mostly affect NFPs for which grants are a significant source of revenue and those NFPs, such as foundations, whose primary activity is making grants.

[1] Proposed ASU, Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made; issued August 3, 2017

Analyzing transactions under the proposed ASU

The flowchart from the proposed ASU illustrates:

- how to determine whether a transaction is a contribution or an exchange transaction;
- how to determine whether a contribution is conditional or unconditional; and
- when a contribution is unconditional, whether it is donor-restricted.



Is a transaction a contribution or an exchange transaction?

A **contribution** is an unconditional transfer of cash or other assets to an entity, or a settlement or cancellation of a liability in a voluntary **nonreciprocal** transfer by another entity that is not acting as an owner.

This definition distinguishes contributions from **exchange transactions**, which are **reciprocal** transactions in which each party receives and sacrifices **commensurate value**. The proposed ASU would provide additional guidance about determining what constitutes commensurate value.

The proposed ASU would clarify that indirect benefit to the general public that results from assets that the resource provider (including a government agency) transfers would not be evidence that the resource provider received value. The benefit that the resource provider gains by executing its mission or positive sentiment that it receives by acting as a donor also would not constitute commensurate value.

The FASB's contribution guidance does not apply to transfers of assets from government units to business entities. However, NFPs must evaluate all transfers, including those from government units, to determine whether they are contributions. NFPs may receive contributions from many sources including private individuals, private foundations, corporate foundations and federal, state and local governments. The type of resource provider does not override the substance of the transaction.

KPMG observation

There is longstanding diversity in practice in the treatment of grants. Many NFPs treat grants from government entities as exchange transactions because they view the benefit to the public as a benefit to the government. Some NFPs also treat grants from nongovernment grantors, such as foundations, as exchange transactions because the grant is furthering the grantor's mission and the NFP believes this benefit equals commensurate value. Other NFPs treat the same (or similar) transactions as contributions.

The revenue recognition standard[2] eliminated the exchange transaction guidance in the NFP industry guidance[3]. This change has caused NFPs that account for certain government and other grants as exchange transactions to reconsider whether these transactions fit the exchange transaction definition and represent the type of activity that should be accounted for under the revenue standard. By clarifying what is meant by commensurate value, the proposed ASU would reduce diversity in practice and result in many transactions that are accounted for as exchange transactions under the current guidance being accounted for as contributions under the proposed ASU. NFPs would not be required to call these transactions 'contributions' in the financial statements but could continue to use 'grant' or other relevant terminology.

Determining whether a transaction is a payment from a third-party payer

Entities must consider the facts and circumstances when determining whether a transaction represents a payment from a third party on behalf of an existing reciprocal transaction between the recipient and a customer. This type of transfer would not be considered additional revenue by the recipient, i.e. neither a contribution nor an exchange transaction. The transfer would flow through the balance sheet only.

For example, if the federal government awards a Pell Grant to a student to pay for a portion of the student's university tuition, the proposed ASU clarifies that the university should account for the payment as a balance sheet-only transaction. In this example, the university recognizes revenue for the full amount of the tuition as a result of its exchange transaction with the student. The payment from the government would reduce the university's tuition receivable balance for the student.

[2] ASU 2014-09, Revenue from Contracts with Customers

[3] ASC 958-605, Not-for-Profit Entities – Revenue Recognition

Determining whether a contribution is conditional

Revenue from conditional contributions is recognized when the conditions on which the contribution depends are substantially met and the promise becomes unconditional.

Contributions must satisfy two thresholds to be considered conditional under the proposed ASU:

- a right of return to the promisor for the transferred assets, **or** a right of release of the promisor from its obligation to transfer assets; **and**
- a barrier that must be overcome for the recipient to be entitled to the funds.

It must be determinable from the agreement or another document referenced in the agreement that the recipient is entitled to the transferred assets or to a future transfer of assets only if it has overcome the barrier.

Indicators of a barrier to entitlement

The proposed ASU includes a list of indicators to help entities determine whether an agreement contains a barrier that must be overcome for the recipient to be entitled to the funds. Some indicators might be more significant than others, but the existence of a single indicator would not necessarily mean that a contribution is conditional. Entities would need to consider the individual facts and circumstances of each agreement.

The proposed ASU would remove from current US GAAP the assessment of 'remote' as a separate step when determining whether a contribution is conditional.

Indicator of a barrier	Additional details
Measurable performance-related barrier	This indicator would include situations in which the contribution must be spent or used to achieve a specified level of service, an identified number of units of output or a specific outcome.
Measurable other barrier	This indicator would include situations in which the recipient is entitled to the funds only if an identified event occurs (e.g. a matching requirement).
Stipulation is related to the purpose of the agreement	This indicator generally would exclude administrative tasks and trivial stipulations.
Limited discretion by the recipient	The recipient would have limited discretion over how the funds should be spent. This indicator would exclude situations in which the recipient has broad discretion on how to use the assets (e.g. the only stipulation is that the funds be spent for general operating purposes, which could include amounts restricted for ongoing programs or activities).
Additional actions required by the recipient	The recipient would have to undertake additional action(s), for either a new or existing activity, that it otherwise would not have taken to be entitled to the contribution.

KPMG observation

Under current US GAAP, it is difficult to distinguish between unconditional and conditional contributions. If an entity determines that a contribution is conditional, it must also determine whether the likelihood of failing to meet the condition is remote. Typically, conditional contributions are not recognized until the condition is met but, if the likelihood of failing to meet the condition is deemed remote, the contribution can be recognized immediately.

The remote notion is applied inconsistently today. Some recipients believe that only trivial conditions, such as completing an administrative form, meet this threshold, while others assume that any factor within their control is likely to be met. Similarly, some resource providers interpret the remote notion as applying to only trivial conditions, while others view most conditions as likely to

KPMG observation

be met by the recipient (or unlikely to be enforced by the resource provider) given advance due diligence and historical expectations. This inconsistency has resulted in different timing of revenue (and expense) recognition for similar transactions.

The FASB considered requiring entities to conduct a probability assessment, and treat the contribution as conditional only in those instances in which the condition is not deemed likely to be met (for the recipient), or the right of return or release from obligation is likely to be enforced (for the resource provider). However, the FASB rejected this approach because it could have continued the diversity in practice that exists today when applying the notion of remote.

Instead of a probability assessment, the proposed ASU emphasizes a right of return or release from obligation and a barrier to entitlement. These concepts are expected to decrease subjectivity and produce more consistent judgments. While the proposed ASU indicates that trivial stipulations are not considered barriers to entitlement, removing the remote notion is intended to make clear that neither the resource provider nor the recipient should perform a probability assessment.

Example 1: Grant accounted for as exchange transaction under current US GAAP is a conditional contribution under the proposed ASU

Background

- University A was awarded a three-year grant from the National Institutes of Health (NIH) to fund diabetes research.
- The terms of the grant include a line-item budget that requires University A to incur certain qualifying expenses to be entitled to the funds. University A must follow all relevant rules and regulations established by the NIH, the Department of Health and Human Services and the Office of Management and Budget.
- University A forfeits funds not used within the three-year period.
- University A retains the rights to the research findings.

Analysis under current US GAAP

- University A concludes that the NIH receives commensurate value through the societal benefit to the public from the research.
- University A accounts for this grant as an exchange transaction and records unrestricted[4] revenue as it incurs expenses.

Analysis under the proposed ASU

- The NIH would not have received commensurate value from this agreement. The proposed ASU clarifies that societal benefit to the public does not represent value to the government resource provider. University A concludes that this transaction is a voluntary, nonreciprocal transaction that meets the definition of a contribution.
- The grant requirement to incur certain qualifying expenses would be a measurable barrier that University A must overcome to be entitled to the funds. The federal rules and regulations also impose limited discretion on the university. The agreement also releases the NIH from its obligation to pay University A if the university does not incur qualifying expenses within the three-year period. University A concludes that this grant is a conditional contribution.
- The contribution is donor-restricted because its use would be limited to funding diabetes research, which is narrower than University A's purpose, the environment in which it operates, or the purposes specified in its articles of incorporation or bylaws.
- University A would record grant revenue in temporarily restricted net assets as it incurs qualifying expenses. At the same time, University A would record net assets released from

[4] Terminology used in the examples is based on current US GAAP before adoption of ASU 2016-14, Presentation of Financial Statements of Not-for-Profit Entities

Example 1: Grant accounted for as exchange transaction under current US GAAP is a conditional contribution under the proposed ASU

restriction because incurring the qualifying expenses on diabetes research would fulfill this restriction.

— Alternatively, if University A has an existing policy to report as unrestricted the contributions and investment return whose restrictions are met in the same reporting period, it would record the revenue from the NIH grant as unrestricted grant revenue as it incurs qualifying expenses. Under this policy, there would be no release from restriction presented on the statement of activities.

Example 2: Grant accounted for as unconditional contribution under current US GAAP is a conditional contribution under the proposed ASU

Background

— NFP A is awarded a 2-year $100,000 grant from Foundation X to provide meals to children and single mothers in need.

— The grant requires NFP A to use the funds to provide 200,000 meals. The agreement specifies that there is a pro rata right of return for meals not served within the 2-year period.

Analysis under current US GAAP

— NFP A concludes that this transaction is a voluntary, nonreciprocal transaction that meets the definition of a contribution. Any benefit gained by Foundation X from furthering its mission through the grant to NFP A is not deemed commensurate value. NFP A routinely serves 1 million meals annually to children and single mothers in need. While NFP A views the requirement to serve 200,000 meals as a condition, the likelihood of not meeting the condition is deemed remote and the contribution is deemed unconditional.

— Because the grant is limited to providing meals, NFP A concludes that the contribution is donor-restricted as this restriction is narrower than NFP A's overall mission, which is to provide meals, housing and other services to children and single mothers in need.

— NFP A accounts for this transaction as an unconditional contribution and records temporarily restricted revenue for $100,000 when it receives the grant agreement.

Analysis under the proposed ASU

— NFP A maintains its conclusion that the transaction is a donor-restricted contribution.

— NFP A concludes that the requirement to provide 200,000 meals is a barrier that must be overcome for NFP A to be entitled to the funds. The agreement also includes a right of return. NFP A concludes that this grant is a conditional contribution.

— NFP A would record a liability for any funds received in advance and record temporarily restricted revenue as the meals are served (i.e. pro rata as it overcomes the barrier). At the same time, NFP A would record net assets released from restriction because serving the meals would fulfill the purpose restriction.

Effective dates and transition	Public business entities and NFPs with conduit debt*	All other entities
Annual periods – in fiscal years beginning after	December 15, 2017	December 15, 2018
Interim periods – in fiscal years beginning after	December 15, 2017	December 15, 2019
Transition approach	— The proposed ASU would be applied on a modified prospective basis in the first set of financial statements after the effective date to all agreements that are either: (1) not completed at the effective date or (2) entered into after the effective date. – Completed agreements would be those for which all revenues (for a recipient) or expenses (for a resource provider) have been recognized before the effective date. – Amendments would be applied only to the portion of revenue or expense that has not yet been recognized at the effective date. – No restatement of prior period results or cumulative effect adjustment at the beginning of the year of adoption would be required under the modified prospective transition basis. — Retrospective application also would be permitted.	
Early adoption	Permitted	
Transition disclosures	In the first interim and annual period of adoption, entities using the modified prospective approach would disclose the: — nature of, and reason for, the change in accounting principle; and — reasons for significant changes in each financial statement line item in the current reporting period resulting from the application of the proposed ASU. Entities following the retrospective approach would provide the disclosures required under US GAAP for this approach.	
* NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the counter market.		

Contributing authors
Lisa C. Hinkson; Amanda E. Nelson

KPMG's Financial Reporting View
kpmg.com/us/frv

kpmg.com/socialmedia