Johnson Lambert
cpas + consultants

+

# Trust or Bust

# Accounting and Auditing for Split Interest Agreements

# Introductions

+
**Kristin Hogan, CPA**
Principal
Johnson Lambert

+
**Emily Deming, CPA**
Manager
Johnson Lambert

# Agenda

- **Split Interest Agreements:** Overview & Common Types
- **Split Interest Accounting:** Initial Recognition & Remeasurement under U.S. GAAP
- **Split Interest Accounting:** Disclosures Under U.S. GAAP
- **Auditing Split Interest Agreements:** Audit Objectives & Procedures by Assertion

+

# Split Interest Agreements:

# Overview & Common Types

# Split Interest Agreements (SIAs) - Definitions

- An agreement in which a donor enters into a trust or other arrangement under which a not -for -profit entity (NFP) receives benefits that are shared with other beneficiaries

- Typically, there are two components:
  - Lead interest
  - Remainder interest

# Split Interest Agreements - Common Types

## Charitable lead trust (CLT)

- Distributions made to the NFP over a specified period
- NFP is the lead interest
- Upon termination, assets are paid to the donor or beneficiary

## Charitable remainder trust (CRT)

- Distributions are made to other beneficiaries over a specified period
- Upon termination, assets are paid to the NFP

## Perpetual trust held by a third party

- Assets are held by a third party
- Distributions are made to the NFP into perpetuity
- The NFP will never receive the assets in the trust, only distributions

## Charitable gift annuities

- NFP receives contributed assets from donor
- NFP promises to pay the donor, individuals, or entities designated by the donor based on agreement terms

## Pooled (life) income fund

- Donors contribute to a pooled fund and receive a specified number of units
- Until a donor's death, the donor (or other beneficiary) is paid income
- NFP

# Polling Question #1

ABC NFP receives notice from a donor that they will be included in a trust for their benefit. The trust will pay the donor’s beneficiaries a specified amount each year, and upon the death of the donor any amount remaining in the trust will be given to the NFP.

**For the above example, what type of SIA would this be?**

+ Charitable lead trust
+ Charitable remainder trust
+ Charitable gift annuity
+ Pooled income fund

# Polling Question #1 - Answer

ABC NFP receives notice from a donor that they will be included in a trust for their benefit. The trust will pay the donor's beneficiaries a specified amount each year, <u>and upon the death of the donor any amount remaining in the trust will be given to the NFP</u>.

**For the above example, what type of SIA would this be?**

- Charitable lead trust
- **Charitable remainder trust**
- Charitable gift annuity
- Pooled income fund

+

# Split Interest Accounting:

# Initial Recognition & Remeasurement under U.S. GAAP

# General Considerations for Recognition of SIAs

| | |
|---|---|
| Contribution Revenue Recognition | • Contribution revenue should only be recognized for unconditional promises to give<br>• If assets are received before conditions are met, this is recorded as a refundable advance liability |
| Revocable Agreements | • A donor can change or withdraw the gift if needed; examples include:<br>○ Revocable trust<br>○ A NFP included as a beneficiary in a will<br>• Until the agreement becomes irrevocable, this is conditional |
| Donor-Imposed Restrictions | • In most cases, SIAs are considered to be donor restricted<br>• Certain criteria must be met to be considered without donor restrictions |
| Recognition Timing | • If no donor conditions present, recognition should occur once the SIA is executed by all parties<br>• Enough information is needed by the NFP to make the necessary journal entries |

# Polling Question #2

ABC NFP receives an email from a legal firm, informing them that they have been included in the will of their client in the amount of $250,000.

**In this circumstance, how should the NFP record this transaction?**

- Record a receivable with corresponding contribution revenue
- Record a split interest asset at fair value with a corresponding advance refund liability
- Record a receivable with a corresponding advance refund liability
- Make no entries at this time

# Polling Question #2 - Answer

ABC NFP receives an email from a legal firm, informing them that they have been included in the will of their client in the amount of $250,000.

**In this circumstance, how should the NFP record this transaction?**

+ Record a receivable with corresponding contribution revenue
+ Record a split interest asset at fair value with a corresponding advance refund liability
+ Record a receivable with a corresponding advance refund liability
+ **Make no entries at this time**

**Why?**

A will is revocable until death, and is therefore a conditional contribution. As the contribution is conditional and no funds have been received, there are no entries to record.

# Fair Value - Initial Measurement - Remainder & Lead Interest Agreements

- Fair value can be calculated using the present value of expected cash flows

- Inputs that will be used include:
  - Expected lifespan of donor
  - Expected cash flows
  - Expected payments to other beneficiaries (for remainder agreements)
  - Expected rate of return on assets (discount rate)

# Fair Value - Initial Measurement - Perpetual Trust Held by a Third Party

- Fair value can be calculated using the fair value of assets contributed
- Annual distributions are reported as investment income
  - Can be either with or without donor restrictions, depending on the agreement

# Fair Value - Initial Measurement - Charitable Gift Annuity

- Fair value can be calculated using the fair value of assets contributed
- Annuity payment liability should also be recognized at fair value

- Multiple approaches available to determine fair value of the liability:
  - Market approach
  - Income approach

# Fair Value - Initial Measurement - Pooled (Life) Income Fund

- Assets contributed should be measured at fair value

- Contribution revenue recognized can be calculated using present value
  - Discounted based on estimated remaining lifespan of donors
  - Difference between assets contributed and contribution revenue is reported as deferred revenue

- Income from the fund should be recorded as an increase in deferred revenue

- Payments to the donors should be recorded as a decrease in deferred revenue

- Amortization of the discount should be recorded as a decrease in deferred revenue and change in value of split -interest agreements

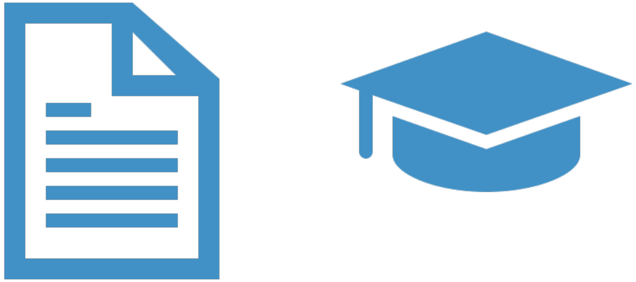
# Fair Value - Remeasurement

- Remeasurement should occur at least annually
  - In conjunction with the date of the NFP’s financial statements
- Remeasurement should use the same techniques as the original valuation
- Gains or losses recognized should be classified appropriately
  - With or without donor restrictions depending on the agreement

# Example - Perpetual Trust Held by a Third Party - Initial Measurement

- **ABC Foundation is included in an irrevocable perpetual trust**
  - The trust agreement was executed on 2/1/23.
  - The trust distributes investment earnings to the trust beneficiaries on an annual basis based on the % interest in the trust.

- **The investment earnings can only be used for scholarships**
  - More narrow purpose than ABC Foundation’s overall exempt purpose



# Example - Perpetual Trust Held by a Third Party - Initial Measurement (Continued)

- ABC Foundation is to receive 25% of the investment earnings of the trust each year into perpetuity
- ABC Foundation's controller was provided with a statement of the trust assets as of the most recent valuation date, 1/31/23,
  - Total assets of the trust are $430,000

<u>The journal entry recorded by the NFP as of 2/1/23 to record the investment:</u>

Debit to split interest investment for $107,500 ($430k x 25%)
Credit to contribution revenue (with donor restriction) for $107,500

# Example - Perpetual Trust Held by a Third Party - Remeasurement

- ABC Foundation's year-end is 12/31/23
- The Foundation received a distribution of $30,000 from the trust before the end of the year.
- The Foundation received a 12/31/23 trust statement
  - The total value of the trust is $470,000
  - ABC Foundation should have 25%, or $117,500 recorded
  - This is $10,000 higher than the amount currently recorded

# Example - Perpetual Trust Held by a Third Party - Remeasurement (Continued)

The following entry will be recorded for the investment income earned:

Debit cash for $30,000
Credit investment income with donor restrictions for $30,000 (income can only be used for scholarships)

To update the fair value as of 12/31/23, the NFP would record the following journal entry:

Debit the split interest asset for $10,000
Credit the change in value of split interest (with donor restriction) for $10,000

# Polling Question #3

A NFP executes an irrevocable remainder trust with a donor. The NFP will hold and invest the assets and is required to make payments to the donor's beneficiary each year until the donor's death. Upon the donor's death, the NFP may use the funds for any purpose.

The initial trust amount contributed by the donor was $750,000.

**How should the NFP initially measure the split interest asset?**

+ The fair value of amount contributed, less future cash flows
+ The fair value of amount contributed and liability for future payments
+ The fair value of amount contributed

# Polling Question #3 - Answer

**How should the NFP initially measure the split interest asset?**

- The fair value of amount contributed, less future cash flows
- **The fair value of amount contributed and liability for future payments**
- The fair value of amount contributed

**Why?**

Because the NFP is holding the assets (acts as the trustee) and will be the party remitting payment to the beneficiaries, a corresponding liability is needed. In addition, the asset should be measured at fair value, which in this case was estimated using the present value of future cash flows.

# Split Interest Accounting:

# Disclosures under U.S. GAAP

# Split Interest Agreements - Disclosures under U.S. GAAP

## General Information

General terms of existing SIAs

## Assets and Liabilities

Assets and liabilities recognized under SIAs, if not reported separately in the statement of financial position

## Inputs Used

Basis used for recognizing assets and liabilities, and discount rate or other assumptions used

## Statement of Activities Impact

Contribution revenue recognized under SIAs and change in value of SIA assets

## Fair Value Disclosures

For assets and liabilities measured at fair value, disclosure requirements include:

- FV level (1, 2, or 3)
- Level 3 disclosures, if applicable
- Embedded derivatives, if applicable

# Example Disclosures

| | September 30, 2022 | September 30, 2021 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | $ | $ |
| Certificate of deposit | | |
| Accounts and contributions receivable, net | | |
| Investments | | |
| Planned giving investments | | |
| Beneficial interest in assets held by others | | |
| Long-term receivables, net | | |
| Prepaid expenses and other assets | | |
| Fixed assets, net | | |
| Total assets | | |
| **Liabilities and net assets** | | |
| Liabilities: | | |
| Accounts payable and accrued expenses | $ | $ |
| Deferred revenue | | |
| Deferred rent and lease incentive obligation | | |
| Deposits | | |
| Planned giving liabilities | | |
| Total liabilities | | |

# Example Disclosures (Continued)

Investments, at fair value, within the fair value hierarchy at September 30, 2022 are as follows:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Investments: | | | | |
| Cash and cash equivalents * | $ | $ | $ | $ |
| Mutual funds | | | | |
| Equities | | | | |
| Fixed income | | | | |
| Total investments | | | | |
| Planned giving assets: | | | | |
| Cash and cash equivalents * | | | | |
| Mutual funds | | | | |
| Common stock | | | | |
| Fixed income | | | | |
| Total planned giving assets | | | | |
| Beneficial interest in assets held by others | | | | |
| Total | | | | |

+

# Auditing Split Interest Agreements:

# Audit Objectives & Procedures by Assertion

# Audit Objectives for Split Interest Agreements

# Audit Objectives & Procedures by Assertion - Existence

**Audit Objectives:**

- Assets and liabilities recognized for split-interest agreements represent valid revenues, assets, and liabilities.

**Audit Procedures May Include:**

- For agreements where the NFP is the trustee (holds the assets), confirm with the custodian the existence of the assets
- In other cases where a third party is the trustee, confirm the existence of the assets with the trustee

# Audit Objectives & Procedures by Assertion - Completeness

## Audit Objectives:

- All assets, liabilities, and revenues for split-interest agreements are recorded

## Audit Procedures May Include:

- Obtain a listing of all irrevocable split interest assets and liabilities
- Discuss with management of the NFP their procedures for identifying new irrevocable split interest agreements
- Review minutes from board of directors or other committee meetings for mention of any planned giving assets or other trust contributions

# Audit Objectives & Procedures by Assertion - Valuation

**Audit Objectives:**

+ Assets and liabilities are measured using appropriate measurement methods.

**Audit Procedures May Include:**

+ Reviewing agreement terms and the NFP's calculation to ensure the calculations are reasonable and in accordance with GAAP
+ Ensuring that the value of the trust used to calculate the fair value of the asset (if applicable) is materially consistent with the amount confirmed by the custodian or trustee of the assets.

# Audit Objectives & Procedures by Assertion - Rights & Obligations

## Audit Objectives:

+ The NFP has a valid right to split interest assets recorded
+ The NFP has appropriately identified any liabilities arising from split interest agreements

## Audit Procedures May Include:

+ Reviewing the terms of the agreement to understand the rights entitled to the NFP and any liabilities assumed by the NFP
+ Ensuring that the trust is irrevocable
+ If terms are ambiguous, an attorney assessment may be necessary

# Audit Objectives & Procedures by Assertion - Presentation & Disclosure

## Audit Objectives:

- Related disclosures of assets, liabilities, and net assets are included.
- Net assets arising from split-interest agreements have been reported in the appropriate net asset class.

## Audit Procedures May Include:

- Agreements are reviewed to understand any donor imposed restrictions
- Review financial statement presentation & disclosures to ensure consistency with agreements and that all required disclosures under GAAP are made

# Polling Question #4

**Audit procedures performed over split interest assets may include all of the following, except:**

- Reviewing the executed split interest agreements
- Confirming the assets with the controller of the NFP
- Testing the NFP’s calculation of the split interest assets
- Reviewing board minutes for any new trust agreements

# Polling Question #4 - Answer

**Audit procedures performed over split interest assets may include all of the following, except:**

+ Reviewing the executed split interest agreements
+ **Confirming the assets with the controller of the NFP**
+ Testing the NFP’s calculation of the split interest assets
+ Reviewing board minutes for any new trust agreements

**Why?**

Per AU-C 505, audit evidence is more reliable when it is obtained from independent sources outside the entity. Confirming the assets with the controller would not be an independent source.

# Questions

# Connect With Us!

JohnsonLambert.com

@Johnson_Lambert and @JL_Careers

Facebook.com/JohnsonLambertCPA/

LinkedIn.com/company/Johnson -Lambert -LLP

# Disclaimer

+ This presentation is provided solely for educational purposes to Johnson Lambert LLP's intended audience. It is intended to provide general information and may reference information from reputable sources.
+ Although our firm has made every reasonable effort to ensure that the information provided is accurate, we make no warranties, expressed or implied, on the information provided. The information is updated as of the date of the presentation. It may change as situations may continue to evolve and/or new and additional guidance are issued.
+ The content contained herein should not be relied upon as accounting or tax advice because it does not take into account any specific organization's facts and circumstances.
+ The views expressed by the presenters are not necessarily those of Johnson Lambert LLP
+ 

Johnson Lambert LLP is a CPA and consulting firm focused on serving distinct industry niches. For 35+ years, we have focused on providing audit, tax, and advisory services to a national and selectively international client base including insurance entities, nonprofit organizations, and ERISA -qualified benefit plans. Johnson Lambert is also an independent member of DFK International/USA, a worldwide association of independent accounting and management consulting firms. For more information about Johnson Lambert LLP, please visit JohnsonLambert.com.