Discussion Issue 1: Grants to Nonprofit Sponsors for Real Estate Development

Issue 1A – Accounting for Grants Received by Nonprofit Sponsors on behalf of Related Party Real Estate Development Projects

Discussion

In order to fill the gaps of funding needed for a LIHTC project, many nonprofit parent organizations (who generally own the general partner/managing member of a LIHTC limited partnership/LLC) receive grants from city or state funders or other organizations. The nonprofit sponsor then loans these funds to the entity that owns the development project at a stated interest rate. These loans are generally lower in priority and are paid only from surplus cash. Often, there are only minimal, or no annual payments made on the loan. Additionally, there may not even be an expectation by the nonprofit sponsor that the loan will be repaid during the life of the project or upon refinancing or sale. However, the development project will always carry the full face value of the debt on its books.

The treatment on the books of the PARENT is at issue (e.g., the standalone entity, not in consolidation since the intercompany items would be eliminated in consolidation). First, is the grant income recognized as current or deferred revenue at the time of receipt? Second, is the loan (Note Receivable) shown on the balance sheet as a receivable in its entirety OR should it have an allowance against it to the extent its collectability is in question? What analysis up-front and annually is appropriate to analyze these loans?

The same analysis is also appropriate for the interest that has accrued on these notes. Some organizations keep all notes on the books but set up an allowance for the accrued but unpaid interest.

Sample Fact Pattern:

Grant Revenue from 3rd Party	$10,000
Deferred Grant Revenue from 3rd Party	$10,000
Note Receivable from Parent to project	$10,000
Valuation Allowance on note receivable	$ 3,000
Valuation allowance expense	$ 3,000
Recoveries of Valuation Reserves	$ 1,000

The treatment on the books of the NONPROFIT SPONSOR is at issue (e.g., the standalone entity, not in consolidation since the intercompany items would be eliminated in consolidation). First, is the grant income recognized as current or deferred revenue at the time of receipt?

Currently, two approaches are known to be taken.

1. The Grant received by the nonprofit sponsor is considered Current Revenue, though some have recorded this revenue above the line as operating revenue, while others present it below the line as other income, below income from operations. Generally, the revenue runs through unrestricted net assets as the funds are expected to be provided to the project for which the funds would be unrestricted.

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2. The Grant received by the nonprofit sponsor is deferred. The revenue is only recognized as payments are received on the note. This revenue would also run through unrestricted net assets.

GAAP Analysis

FASB ASC 958-605-55 provides guidance to distinguish contributions from exchange transactions. Each individual grant agreement should be reviewed and evaluated in order to determine if the agreement meets the definition of a contribution or exchange transaction.

The AICPA's Not-for-Profit Entities A&A Guide provides additional guidance. To determine the accounting for transactions in which an entity voluntarily transfers assets to a NFP, it is first necessary to assess the extent of discretion the NFP has over the use of the assets that are received. If it has little or no discretion, the transaction is an agency transaction. If it has discretion over the assets' use, the transaction is a contribution, an exchange, or a combination of the two.

It's important to note that the AICPA has a NFP Revenue Recognition Industry Task Force that is currently working on implementation of the new Rev Rec ASU. One of the topics noted that they are examining is how the Rev Rec ASU may or may not apply to government grants. The conclusions they reach (particularly any conclusion about whether gov't grants are contracts with customers or contributions) should impact the analysis in this section.

Chapter 5 also includes a flowchart for determining whether a transfer includes a contribution:

[chart shown on following page]

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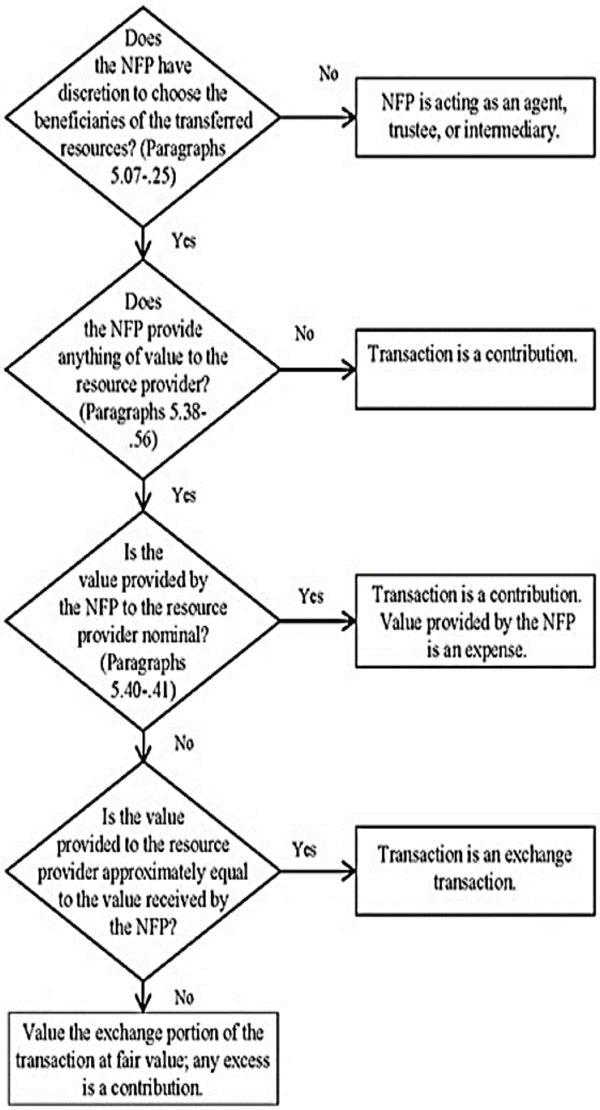
Determining Whether a Transfer to a Not-For-Profit Entity Includes a Contribution



As noted in Strength Matters Topic 21, a contribution is an unconditional transfer of cash or other assets to an entity or cancellation of its liabilities in a voluntary nonreciprocal transfer. The primary characteristic of contributions is that they are nonreciprocal – that is one entity gives without directly receiving a commensurate value in exchange. Contributions received should be recognized as revenue, with a corresponding increase in assets or decrease in liabilities, in the period unconditionally communicated. FASB ASC 958 further requires contributions to be stated at gross. An example of a contribution would be funding received by the not for profit sponsor from a donor to be used to further the not for profit's affordable housing mission with no specific accountability terms.

The FASB ASC definition of Exchange Transaction is: a reciprocal transfer between two entities that

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results in one of the entities acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations. As noted in the summary of issue, the grants mentioned are generally received from city or state funders or other organizations. Indicators of an exchange transaction include the not-for-profit having to solicit for the grant; the resource provider transferring assets or services in exchange for benefits; nonperformance by the not-for-profit being able to reach beyond return of unspent funds; and the ability by the provider to determine delivery requirements, disallow grant expenses and other restrictions as to the use of the grant funds. The revenue associated with an exchange transaction is recognized in the period the amount is realized and earned (spent). An example of an exchange transaction is rental subsidies received through a Section 8 contract. In this example the NFP is receiving revenue in exchange for providing housing to specific individuals.

CPA Recommendations

If the grant is considered a contribution, it should be recorded as revenue when unconditionally communicated or promised to the recipient with a corresponding increase in assets (cash or receivables). As noted in Topic 21, the netting of contributions against costs funded by the contribution is not in accordance with FASB ASC 958.

Conversely, if the grant is considered an exchange transaction it is subject to the earning process. In this case the transaction should be recognized as revenue when the NFP's obligation(s) to the resource provider has been fulfilled (i.e. loaned to the entity).

CFO Response: Revenue Recognition

The CFO Committee favors treating the revenue recognition of the grant income and the recording of the note receivable with attendant valuation issues as two separate accounting transactions. Although the source of the loan to the limited partnership is grant revenue the actual loan and its value need to be considered separately from the timing of revenue recognition.

We support following the GAAP analysis that distinguishes between grants and contributions, but in both cases we are in agreement that the revenue is recorded in the current period (when unconditionally communicated or loaned to the entity) and not deferred.

We believe a best practice is to separate capital grants from operations on the income statement, as these grant funds can be quite large in a single year.

Issue 1B – Accounting for Notes Receivable by a Nonprofit Sponsor Recorded when Grant Funds are Loaned to a Related Party Real Estate Development Project

Discussion

Currently there are a few approaches known to exist:

1. At the point of making the loan to the development project, collectability of the note receivable is analyzed from two vantage points.

    a. *Collectability from the property's net cash flow*:
    The non-profit sponsor reviews the project's operating pro forma and determines if the

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projected cash flows will be sufficient to make payments on its note payable to the non-profit sponsor. If cash flow is restricted by long-term rent limits, it is often determined that the loan cannot be fully repaid. The initial analysis remains until a subsequent refinancing or sale.

b. *Collectability from a refinancing or sale of the property*.
A simultaneous evaluation of the property is also performed looking at the financial proceeds that could be realized upon a future refinancing or sale of the property, which could be used to repay the debt. In many cases, the fair market value of the property is (and is projected to be in the future) less than the total amount of the outstanding debt, and therefore collectability is not foreseen. An analysis is performed annually as to collectability outlined in Option #2 below.

Based on both analyses, an allowance is set up for all or some portion of the Note Receivable and there would be an offsetting expense to bad debt or loan loss by the same amount at the same time.

2. When the loan is made, it is assumed that the loan will be collectible. However, an annual collectability analysis is performed to determine whether any facts or circumstances have changed the collectability of the note receivable. These facts are used to determine whether a valuation allowance should be set up, increased or decreased. If an allowance is established, an expense is recognized and any restriction on net assets, if appropriate, is released in an equal amount. If in any year it is determined that the value of the note is higher than carried on the balance sheet, there would be a DECREASE to the allowance and revenue would be recognized in a separate revenue account (e.g., recoveries on valuation allowances").

GAAP Analysis

Chapter 8 of the AICPA NFP Entities A&A manual and FASB ASC 310 discusses receivables: As noted in Strength Matters Topic 10, the conditions under which receivables exist usually involve some degree of uncertainty about their collectability. Organizations should record accruals of losses from uncollectible receivables if the following two conditions are met:

1) Information prior to issuance of the financial statement indicates that it is probable that the receivable has been impaired at the date of the financial statement (i.e. nonpayment during the year, underperformance of the underlying property, etc.)

2) The amount of the loss can be reasonably estimated

If both conditions are met, the loss accrual must be made. GAAP requires the use of the allowance method of accounting for bad debts for financial statement purposes, which would apply to all receivable balances existing at year-end (in the initial year as well as annually). If it was determined in year 1 that an amount was uncollectible, and therefore fully allowed, an analysis of the allowance would not be required on a zero balance. Any payments received in future years would be considered bad debt recovery revenue. If it was determined in year 1 that the amount is collectible, or partially collectible, an analysis of the allowance would be required as long as there is a balance existing at year end. The different methods used for calculating allowances include the aging method and the weighted average method. In addition, financing receivables have additional disclosure requirements. Based on the nature

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of the receivables discussed in this memo, the receivables would fall under the definition of a financing receivable. For example, if the not for profit sponsor made a loan to an affordable housing entity with no repayment terms or payments due only as a result of surplus cash and the historical data provides that the property does not typically have surplus cash the not for profit sponsor could conclude that repayment is unlikely and the entire amount should be allowed for in the initial year. In this treatment, the grant revenue recorded would be offset by the bad debt expense in the initial year (reported at gross but with an impact of $0 to net income/loss. Any payment received after this would be treated as revenue through bad debt recoveries.

Discounting receivables – As discussed in Topic 10, receivables for which discounting is not required include trade receivables due within one year and receivables involving transactions between a parent and a subsidiary or between subsidiaries of a common parent. In addition, the codification states that when a note is received solely for cash and no other right or privilege is exchanged, it is presumed to have a present value at issuance measured by the cash proceeds exchanged. [APB 21, paragraph 11, Technical Practice Aid 5220.07 and Current Text I69.104]

CPA Recommendations

The receivable should be recorded in its entirety when the loan is made and will be subject to valuation analysis in the initial year (and subsequent years if the receivable is not fully reserved for in the initial year). If the receivable is fully reserved in the initial year, payments received after this period would be accounted for as revenue through bad debt recoveries.

CFO Response - Recording of Note and Valuation Issues

Most CFO's perform a valuation analysis at the time the note is initially recorded and concur with the CPA's recommendations above. Facts, circumstances and approaches to valuation may differ:

In many cases these notes are cash flow only notes, low in the partnerships' cash flow distribution waterfall. A number of CFO's take a full allowance when the note is initially recorded, and do not record any accrued interest that is not paid on a current basis. If the notes start collecting cash interest or principal reduction are recorded in the period the cash is received.

Others look to the exit or sale and refinancing prospects of the underlying property. If the note is deemed collectible in the long term value of the real estate, no allowance is taken at initial recording. Interest income is typically not recognized unless cash flow is present. The latter group is reluctant to have an underlying limited partnership liability for the note differ from the books of the parent. They are comfortable with the asset on the parent's books and site that the note is disclosed as a related party note (from the parent to the limited partnership), and it is classified as a long term asset with its terms disclosed. This type of disclosure would lead the reader of the financial statements to assign a limited weight to the asset in evaluating the financial strength of the parent.

The CFO group believes that the carrying value of the notes should be evaluated each year, in light of the underlying property's operating history and market analysis. In deteriorating circumstances a valuation allowance may need to be recorded if the note was originally recorded at full value.

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This paper contains certain recommended financial reporting best practices for nonprofit affordable housing organizations that develop and own affordable housing in the United States. This paper was developed by a working group comprised of chief financial officers from certain leading nonprofit affordable housing organizations active in the networks of NeighborWorks® America, Housing Partnership Network and Stewards of Affordable Housing for the Future, working in conjunction with representatives from the independent public accounting firms listed above. This publication should not be construed as accounting or other advice on any specific facts or circumstances. The contents of this paper are intended for general informational purposes only, and you are urged to consult your accountants and other professional advisors concerning your specific situation and any financial reporting or accounting questions you may have.

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