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CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

New Year, New Changes for Not-For-Profit Entities

Karen Costa kcosta@dopkins.com January 2018

Many accounting, reporting and tax changes lie ahead for Not-for-Profit entities, including those that provide healthcare services. Following, listed in order of the dates they become effective, are the changes we believe will be most significant to many of the agencies providing services in Western New York.

1. Tax Cuts and Jobs Act (Tax Reform Bill) – If you think Not-for-Profit entities will escape from the Tax Reform Bill unscathed, think again! The new tax overhaul - the most significant revision to the tax code in over thirty years – will most likely have some impact to many Not-for-Profit entities. Following are highlights of the key provisions in the Tax Reform Bill, which is effective starting January 1, 2018, that could impact tax-exempt organizations:

   a. Compensation and fringe benefits. Tax exempt organizations will pay unrelated business income tax on certain fringe benefits, such as transportation, parking or the use of on-site gyms or athletic facilities provided to employees. Additionally the Tax Reform Bill poses a 21% excise tax for certain tax-exempt organizations on salaries paid to executive employees in excess of $1,000,000. Charities should consider how potential excise taxes on executive compensation may apply to income deferral programs and lump sum retirement benefits.
   b. Separating unrelated business activities. Currently, tax-exempt entities can combine different unrelated business activities for the purpose of reporting unrelated business income subject to tax. Under the new Tax Reform Bill, each activity will need to be accounted for, and taxed, separately.
   c. Charitable contributions. Under the current tax law, a taxpayer can claim a deduction of up to 50% of adjusted gross income (AGI) for certain payments made to charitable organizations. The Tax Reform Bill increases the AGI limit from 50% to 60%.
   d. Standard deduction. Under current tax law, an individual can claim a deduction either by itemizing deductions (including contributions) or claiming a standard deduction. Although the Tax Reform Bill retains the ability to deduct charitable contributions, the increase in the standard deduction amount will reduce the number of taxpayers who itemize their deductions, which could have a significant impact on charitable giving.
   e. Education-focused not-for-profits may be impacted by the ability to use 529 plans for private elementary and high schools – a potential opportunity for those schools, but also a risk for colleges and universities who are no longer the sole beneficiaries of these savings vehicles.

2. ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities,* is effective for entities with calendar year-end December 31, 2018 and fiscal years beginning in 2018. This ASU is intended to improve the current financial reporting model making financial reporting for Not-for-Profit entities more informative to donors, grantors, creditors, and other users. This ASU better enables Not-for-Profit entities to tell their financial story. The new guidance will affect

substantially all Not-for-Profit entities, including charities, foundations, private colleges and universities, nongovernmental health care providers, cultural institutions, religious organizations, and trade associations and requires Not-for-Profit entities to improve their presentation and disclosures to provide more relevant information about their resources. Key provisions include disclosures, both quantitative and qualitative, about an entity's liquidity and the availability of cash; a requirement to report expenses by function (already required) and by natural classification and; clearer and less complex reporting of net asset classifications and of underwater investments.

3. ASU 2014-09, *Revenue Recognition*, is effective for non-public entities with calendar year-end December 31, 2019 and fiscal years beginning in 2019. The core principle of ASU 2014-09 is that revenue should be recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In the healthcare industry, entities receive revenue from governmental agencies (Medicaid/Medicare) under arrangements that allow for the billing of services using interim rates, subject to retrospective adjustments in future years. As a result of these retrospective adjustments, a healthcare agency may receive additional payments, or may be required to refund amounts received, in excess of the interim rate for services provided in a previous period. These potential retrospective adjustments require the entity to estimate the amount of revenue and cash flow ultimately expected from the provision of services.

   The application of ASU 2014-09 is to occur through a five-step process including:

   1. *Identifying the contract*. In healthcare service transactions, in addition to the patient and the healthcare provider, a third party payor is often involved in a transaction. While the contract that exists is between the patient and the healthcare provider, separate contractual arrangements between the healthcare provider and third-party payors need to be considered in revenue recognition.
   2. *Identifying the separate performance obligations within the contract* such as entrance fees or multiple services provided for one bundled rate.
   3. *Determining the contract's transaction price*. An entity should estimate the amount of any variable consideration (such as the retrospective adjustments discussed above) by using either the expected value method or the most likely amount method (further defined in the issued ASU), whichever method can better predict the ultimate amount of the consideration to be received.
   4. Allocating the transaction price to each of the performance obligations
   5. Recognize revenue as or when each performance obligation is satisfied

   ASU 2014-09 also includes substantial disclosure requirements, both quantitative and qualitative, regarding the disaggregation of revenue, information about contract balances, and remaining performance obligations.

4. ASU 2016-02, *Leases*, is effective for non-public entities with calendar year-end December 31, 2020 and fiscal years beginning in 2020. A lease is a contract that conveys the right to use an asset for a period of time in exchange for consideration. ASU 2016-02 requires Agencies with leases greater than 12 months to capitalize these leases and the related assets in a manner similar

to Topic 840, Leases. When deciding how to treat different leasing arrangements, an entity must first determine if a lease involves the identification of an asset that is explicitly or implicitly specified in the lease agreement, or the right to control the use of an asset during the lease term. For both financing and operating leases an entity will recognize a Right of Use (ROU) asset and related lease liability, and will amortize the leases over the lease term.

5. Proposed ASU - *Revenue Recognition of Grants and Contracts by Not-for-Profit Entities.* This proposed guidance, expected to be finalized to coincide with the effective date of ASU 2014-09, *Revenue Recognition,* is intended to clarify the scope and accounting guidance for contributions received and contributions made. Because of the vagueness of existing guidance, there is diversity and difficulty in practice among not-for-profit agencies with the following two issues:

   Issue #1: Characterizing grants and other contracts with governmental agencies as either reciprocal transfers (exchanges) or nonreciprocal transfers (contributions). The proposed ASU would clarify existing guidance by adding explanatory language and providing illustrative examples. Basically, if a resource provider, including a governmental agency, receives value <u>indirectly</u> by providing a societal benefit, this transaction would be considered nonreciprocal and accounted for as a contribution. This is contrary to current practice which relies on the premise that "governmental agencies do not make contributions."

   Issue #2: Distinguishing between conditional and unconditional contributions. Under the proposed ASU, for a contribution to be characterized as conditional, there must be a right of return of any funds received and not spent, or the agreement between the resource provider and the Not-for-Profit entity must include a barrier that allows for the return of funds if certain conditions are not met. When determining if a barrier exists, the Not-for-Profit entity would consider any measureable performance indicators or stipulations contained in the contract. Significant judgement on the part of the Not-for-Profit entity is necessary in determining at what point the resource provider intended for the recipient to retain the funds.

   If a contribution is classified as unconditional, it is then evaluated as to restriction – either unconditional without restriction (unrestricted) or unconditional with restriction (restricted).

For more information, please contact:

Karen D. Costa, CPA
Director
kcosta@dopkins.com ▪ 716.634.8800

Karen has lengthy experience with both for-profit and not-for-profit healthcare organizations specializing in auditing, revenue cycle consulting and certification of their Medicaid cost reports and specialized compliance audits.

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