NACUBO

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September 18, 2015

Mr. David Bean
Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: Project No. 3-26E

Dear David:

On behalf of the National Association of College and University Business Officers (NACUBO), I submit the following comments on the exposure draft, "Accounting and Financial Reporting for Irrevocable Split-Interest Agreements." NACUBO's comments on the proposal were developed with input from member institutions and our Accounting Principles Council (APC). The APC is comprised of experienced business officers from both independent and public colleges and universities.

NACUBO is a nonprofit professional organization representing chief business officers at approximately 2,200 public and independent not-for-profit colleges and universities. In its capacity as a professional association, NACUBO develops accounting and reporting guidance for the higher education community and offers professional development for college administrative professionals on a wide array of financial management and reporting topics.

We appreciate the time and effort that the Board and staff have devoted to this project. NACUBO's representative on the Governmental Accounting Standards Advisory Council requested that "funds held in trust by others" be added to the technical agenda close to a decade ago. We were extremely pleased to see that the Governmental Accounting Standards Board (GASB) incorporated "funds held in trust by others" into the "split-interest agreement" project.

<u>Overall Comments:</u>

<u>Revenue reclassification</u>
The proposed guidance will result in a complete change in the financial accounting and reporting for irrevocable split interest agreements, with the most significant change being the timing of revenue recognition. Under the proposed guidance, voluntary non-exchange transaction revenue

is being conceptually redefined as a deferred inflow of a resource. We do not conceptually understand how a resource inflow (revenue) related to a split-interest investment (an asset with present service capacity) is now a deferred inflow of a resource—a concept that has, heretofore, been applied only to previously defined assets and liabilities. While paragraph 9 in the basis for conclusions mentions the Board's evaluation of Concepts Statement 4, we respectfully request that the Board reassess the construct within the context of Statement 33.

Although the exposure draft states that paragraph 5 of Statement 33 is amended, it is not clear what the amendment will be. It appears, however, that the amendment to paragraph 5 will make Statement 33 no longer applicable to irrevocable split-interest agreements. Clarifying the nature of the amendment and the reasoning for drawing conclusions is important because higher education institutions have been following Statement 33 for revenue recognition related to split–interest agreements, as discussed in the following paragraph.

Currently, irrevocable split-interest agreements are considered voluntary non-exchange transactions under Statement 33. Assets received in voluntary non-exchange transactions—and the related revenue—are recognized when eligibility requirements have been met. The time requirement is the most pertinent eligibility requirement for revenue recognition of split-interest agreements. Time requirements are considered met during the period in which the resources are required to be used or when use is first permitted. When a donor enters into a split-interest agreement with a public institution—and the institution is the intermediary—the terms of the agreement contain instructions to invest the transferred assets. The requirement to invest the gift for a certain period of time is a time requirement. That time requirement is met when the institution invests the transferred assets.

NACUBO strongly believes that meeting eligibility requirements is consistent with the explanation of "reporting period applicability" that is discussed in Concepts Statement 4. The act of investing puts an asset to use to generate an economic benefit, and because the public institution honors the gift's time requirements, the asset's related inflow of resources should be applicable to the current period.

<u>Subsequent fair value measurement</u>
Paragraph 11 of the ED provides that fair value adjustments that result from remeasurement of the assets are considered inflows of resources and therefore revenue. We are having difficulty understanding this proposed requirement as it is inconsistent with proposed recognition at the inception of the agreement when the fair value of the asset is recorded as a deferred inflow of a resource. The following paragraphs provide our questions and thoughts.

> First, if initial recognition of the split-interest investment asset (its fair value when received) results in a deferred inflow of a resource, why would subsequent fair value measurements result in revenue recognition? Why does remeasurement create an economic benefit that is applicable to the current reporting period (revenue recognition) while initial measurement does not? The logic and treatment of the resource is inconsistent. We request that the Board provide its reasoning.

> Second, because of the nature of the agreements (trust or trust-like arrangements), required adjustments as a result of remeasurement should reside with the trust (trust-like arrangement) until a specified event triggers termination of the split-interest agreement. Currently, public institutions reflect changes in the fair value of the trust assets within the associated liability. The associated liability is additionally adjusted for changes to the present value of estimated payments to other parties to the agreement with an offset to nonoperating revenue or expense. (The present value of estimated payments can fluctuate as the fair value of the asset increases or decreases.) It is not clear from the exposure draft whether this accounting treatment would continue under the proposed guidance given the lack of specific guidance for remeasurement of the liability.

Given the nature of trust arrangements established for the term of the split interest gift, we ask the Board to help us understand its conclusion about subsequent valuation adjustments within the context of Concepts Statement 4 and Statement 72.

<u>Impact of redefining initial revenue recognition and subsequent fair value adjustments</u>
Under the proposed guidance, the majority of revenue related to split-interest arrangements will not be recognized until termination of the agreement. In the current model, a significant portion is recognized at inception and, a remaining portion (which could be significant depending on the actual vs. expected term of the agreement), is recognized at termination. This change will result in institutions having to derecognize revenue when the standard becomes effective and recognize it, instead, in the future. As a result, even though the institution will book a cumulative effect adjustment in the year of implementation, a user looking at prior years and future years might think that the institution has earned more revenue over time than they really have.

<u>Implementation concerns</u>
The exposure draft is extremely difficult to understand. The varieties of irrevocable split interest agreements can be confusing and current financial accounting and reporting practice is complex. The proposal introduces new concepts to an already conceptually challenging area without adequate examples. We strongly recommend illustrative scenarios for each major type of irrevocable split interest agreement with accompanying journal entries. Without illustrations, we are afraid the proposal will be nearly impossible to implement. For example, paragraph 14 of the ED states “If the amount recognized for the liability has been discounted, a portion of the disbursement should be allocated to the liability (thereby reducing the liability), and the remainder portion of the disbursement should be reported as interest expense/expenditure in resource flows statements.” There is no discussion or explanation, however, of how to determine the portion by which the liability should be reduced or for which interest expense should be recognized.

The illustration below is provided to highlight differences between current and proposed accounting and reporting practice and illustrate the complexity of the necessary entries. Results of the transaction entries also demonstrate issues with the timing of revenue recognition. (Entries that impact revenue are intentionally contrasted with color.)

Illustration: Charitable Remainder Trust – Government Is the Intermediary
Assume a donor creates a charitable remainder annuity trust by transferring $1,000,000 to an institution as the intermediary. The trust agreement provides that $50,000 be transferred annually to a beneficiary (the donor's spouse) as long as the beneficiary lives, which is estimated to be 10 years. Assume the funds are invested and that the discount rate commensurate with the risk involved is 6 percent. At the end of the beneficiary's life, the remaining assets are to be transferred to the institution as restricted assets (and the institution invests the assets as an endowment).

The fair value of the liability is measured as the present value of an annuity of $50,000 for 10 years ($50,000 x 7.36, or $368,000). Assume the $1,000,000 is immediately invested, therefore the time requirement is met. Since the terms of the agreement stipulate that the remaining assets be transferred to the institution as a permanent endowment, these resources are maintained in Restricted Net Assets-Nonexpendable. The following table shows the entries that would be made at the inception of the agreement under current GAAP and under the proposed guidance.

Current Entries			**Proposed Entries**		
Agreement acquisition			Agreement acquisition		
Dr. Invested trust assets	1,000,000		Dr. Invested trust assets	1,000,000	
Cr. Liability to beneficiary		368,000	Cr. Liability to beneficiary		368,000
Cr. Gift revenue - nonoperating		632,000	Cr. Deferred Inflows		632,000

Year 1
Assume no change in the actuarial assumptions in the first year other than the passage of time. Also, assume that the fair value of the trust increased by $65,000. The first $50,000 was transferred to the beneficiary.

At the end of the first year, the present value of 9 payments of $50,000 (at a 6 percent discount) to the beneficiary would be $340,100.

The following table shows the entries that would be made at the end of the first year under current GAAP and the proposed guidance. Note that the amount by which the liability is adjusted under the proposed guidance represents the amount required to reduce the liability to the present value of the remaining payments to the beneficiary. This amount takes into account the increase in the value of the assets as well as the amortization of the discount. Although we believe that this would be the required entry, there is a lack of guidance in the ED to support this assumption. The ED says only that the liability would be reduced by a portion of the payment to the beneficiary, but not how that portion would be determined.

Current Entries			Proposed Entries		
Increase in value of trust assets			Increase in value of trust assets		
Dr. Invested trust assets	65,000		Dr. Invested trust assets	65,000	
Cr. Trust agreement liability		65,000	Cr. Revenue – nonoperating		65,000
Payment to beneficiary			Payment to beneficiary		
Dr. Liability to beneficiary	50,000		Dr. Liability to beneficiary	27,900	
Cr. Invested trust assets		50,000	Dr. Interest expense - nonoperating	22,100	
			Cr. Invested trust assets		50,000
Adjust liability to PV of 9 payments at $50,000					
Dr. Liability to beneficiary	42,900				
Cr. Change in value of split-interest agreements – Nonoperating revenue		42,900			

Year 2

Assume no change in the actuarial assumptions in the second year other than the passage of time. Also, assume that the trust earned a total of $85,000 in dividends, interest, and realized and unrealized gains. The second $50,000 was transferred to the beneficiary.

At the end of the second year, the present value of 8 payments of $50,000 (at a 6 percent discount) to the beneficiary would be $310,500. The entries in the following table represent those that would be required under both current GAAP and the proposed guidance. Again, note that the adjustment to the liability represents the amount required to reduce the liability to the present value of the remaining payments to the beneficiary. As noted previously, this amount takes into account the increase in the value of the assets as well as the amortization of the discount.

Current Entries			Proposed Entries		
Increase in value of trust assets			Increase in value of trust assets		
Dr. Invested trust assets	85,000		Dr. Invested trust assets	85,000	
Cr. Trust agreement liability		85,000	Cr. Revenue – nonoperating		85,000
Payment to beneficiary			Payment to beneficiary		
Dr. Liability to beneficiary	50,000		Dr. Liability to beneficiary	29,600	
Cr. Invested trust assets		50,000	Dr. Interest expense - nonoperating	20,400	
			Cr. Invested trust assets		50,000
Adjust liability to PV of 9 payments at $50,000					
Dr. Liability to beneficiary	64,600				
Cr. Change in value of split-interest agreements – Nonoperating revenue		64,600			

Year 3

Assume the beneficiary dies at the beginning of the third year and that, at the time of death, the market value of the assets in the trust is $1,050,000. Also assume that the liability account shows a balance of $310,500 (representing eight payments of $50,000 discounted at 6 percent). The following table shows the entries that would be made to terminate the trust and create the endowment per the agreement under both current GAAP and the proposed guidance.

Current Entries			**Proposed Entries**		
Termination of trust:			Termination of trust:		
Eliminate liability			Eliminate liability		
Dr. Liability to beneficiary	310,500		Dr. Liability to beneficiary	310,500	
Cr. Change in value of split-interest agreements – Nonoperating revenue		310,500	Cr. Gain – nonoperating		310,500
			Recognize resource inflow		
			Dr. Deferred inflows	632,000	
			Cr. Revenue - nonoperating		632,000
Creation of endowment			Creation of endowment		
Dr. Endowment investments	1,050,000		Dr. Endowment investments	1,050,000	
Cr. Invested trust assets		1,050,000	Cr. Invested trust assets		1,050,000

NACUBO has an excel spreadsheet that provides “ledger” information for the illustrative transactions, documents the discount calculation, and offers additional journal / ledger entries that explain current period non-operating revenue amounts for fair value adjustments. We will make our work available to GASB staff upon request. We hope that our illustration highlights complexities as well as the differences between current and proposed requirements.

Public institutions—rather than general purpose governments—will be most affected by these future requirements. The requirements create additional differences between higher education institutions that follow FASB and those that follow GASB. The requirements will also create different results between public institutions and their affiliated foundations (FASB entities) for the same gift agreements. Again, we ask the Board to revisit proposed financial statement element classification and revenue recognition. If the Board’s proposed decisions prevail, we ask for implementation guidance related to the timing of previously recognized revenue and existing liabilities.

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We wish to express our appreciation for the opportunity to comment. We look forward to answering any questions the Board or the staff may have. Please contact me at 202-861-2542 or smenditto@nacubo.org.

Sincerely,
Susan M. Menditto
Director, Accounting Policy