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LEARNING SOLUTIONS

NFP Accounting Basics: Functional Expenses, Endowments, Programmatic Investments

June 2, 2025

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Application of accounting and auditing principles is the responsibility of an organization's management and their independent public accountant.

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Learning Objectives

1. Identify the basic financial statements of nonprofit organizations
2. Describe the accounting for contributions
3. Recognize net asset classifications for nonprofit organizations
4. Analyze a transaction to determine if it's a contribution of exchange transaction

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Agenda

- Endowments
- Programmatic Investments
- Functional Expenses

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Endowments

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Definition – Endowment

Endowment

- An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP). The use of the assets of the fund may be with or without donor-imposed restrictions. Endowment funds generally are established by donor-restricted gifts and bequests to provide a source of income in perpetuity or for a specified period. Alternatively, an NFP's governing board may earmark a portion of its net assets as a board-designated endowment fund.

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Endowment Funds

Fund Types:

- True/Permanent
- Quasi
- Term

Endowments

With Donor Restrictions

- Term Endowments
- Permanent Endowments

Without Donor Restrictions

- Quasi / Board Designated

Donor Restrictions

- Each source must be evaluated separately

Original Gift | Gains & Losses | Interest & Dividends

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Uniform Prudent Management of Institutional Funds Act (UPMIFA)

- In 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved UPMIFA
  - UPMIFA is a revision of UMIFA
- Applies to donor-restricted endowment funds
  - Not to board designated funds

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UPMIFA Cont'd

- UPMIFA provides guidance for prudent spending of a donor-restricted endowment fund

"May appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established"

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Spending

- The amount of appropriations from the endowment fund reduces net assets with donor restrictions

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Underwater Endowments

- Deficit would be in with donor restrictions net assets
- Need to disclose policy for spending on underwater endowments

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Programmatic Investments

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What is a Programmatic Investment?

- Properties of a programmatic investment
  - Further the NFPs objectives & mission
  - Not looking for return on the investment
- Three most common types:

Loans	Equity Interests	Guarantees

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Examples

Low-interest or interest-free loans to students with demonstrated financial need	Student loans that will be forgiven upon the completion of a defined amount of community service after graduation	Investments in nonprofit, low-income housing projects
Loans to small for-profit businesses owned by members of economically disadvantaged groups or individuals who are members of those groups, for whom commercial loans are not available or are not available at affordable interest rates	Loans to for-profit companies that are conducting research consistent with the NFP's mission	Loans, typically of small dollar amounts, made to small businesses or individuals who lack access to banking and related services as a way to help the borrower out of poverty (referred to as microfinance)
Investments in businesses in deteriorated urban areas under a plan to improve the economy of the area by providing employment or job training for residents	Investments in NFPs that have a mission of combating community deterioration	Guarantees of an NFP’s debt, which increases the amount of credit

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Criteria

- Its primary purpose is to further the tax-exempt objectives of the NFP
- The production of income or the appreciation of the asset is **not** a significant purpose

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Considerations

- Core considerations for determining the proper accounting for programmatic investments, regardless of their form:
  - An assessment of whether an investment is programmatic or not is made when the initial investment transaction occurs
  - Because one of the goals of making programmatic investments is furthering the mission of the NFP and because, by definition, the production of income or the appreciation of the asset is not a significant consideration in the determination of whether to invest, programmatic investments often have a contribution element
  - Programmatic investments are subject to the same accounting standards as similar financial instruments, except for the contribution element, if any. Thus, loans are within the scope of the standards in ASC 310, Receivables, and **ASC 326, Credit Losses**; ownership interests are subject to the standards for reporting relationships, including consolidation, equity method, and ASC 321, Equity Securities; and guarantees are subject to the standards in ASC 460, Guarantees.
  - The relative significance of the investments to an NFP's operations and financial position and the **quantitative and qualitative risks** arising from them is considered when determining the type of financial statement presentation and the extent of the disclosures. Thus, even though the amount of programmatic investments might quantitatively be considered immaterial, user needs for qualitative information are a consideration in determining the appropriate financial reporting.

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Interest Rate Considerations

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Programmatic Loans

- Stated interest rates on programmatic investments may
  - Be at market
  - Be below-market when compared to loans to entities of similar credit risk
  - Not bear interest

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Market Rate

- In some cases, a programmatic loan
  - Bears a market interest rate, and
  - The NFP expects at origination to collect all contractual cash flows
- The NFP evaluates the credit worthiness of the borrower and the loan is priced on the basis of a number of factors, with a key factor being that borrower's creditworthiness
- At origination, the loan should be recognized in accordance with ASC 310-10 and the allowance for credit losses should be recognized in accordance with ASC 326-20

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Origination

- Unless the NFP has elected to report programmatic investments at fair value using the "Fair Value Option," programmatic loans are reported at amortized cost

Debit Loan Receivable

Credit Cash

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CECL

- The allowance for credit losses is a valuation account that is deducted from, or added to, the amortized cost basis of the loan to present the net amount expected to be collected on the loan

Debit Credit Loss Expense

Credit Allowance for Credit Loss

CECL Application

- The allowance for credit losses only includes amounts the NFP does not expect to collect due to credit risk
- The amounts not expected to be collected for reasons unrelated to credit loss, such as those associated with an NFP’s employee service or the fulfillment of performance-based conditions, would not be included in the allowance for credit losses

Example

- Forgiveness of a loan to an employee of an NFP is part of the employee's compensation for services rendered
- Forgiveness of a loan to a student if upon graduation the student serves as a teacher in a low-income area is a conditional contribution

Subsequent Measurement

- Interest income is recognized at the stated rate

Below Market (But Collectable)

- Using an interest rate that varies from prevailing interest rates warrants evaluation of whether the face amount and the stated interest rate of a note or obligation provide reliable evidence for properly recording the exchange and subsequent related interest
- If a NFP issues an interest-free or below-market-interest loan to a borrower and the NFP is not compensated for that reduced rate in some manner, FinREC believes the NFP has made an **inherent contribution** to the borrower
- Record the loan at its amortized cost basis, adjusted by a valuation account that is deducted from the amortized cost basis to report the net amount expected to be collected on the financial asset

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Definition

Inherent Contribution

- An inherent contribution is "[a] contribution that results if an entity voluntarily transfers assets (or net assets) or performs services for another entity in exchange for either no assets or for assets of substantially lower value and unstated rights or privileges of a commensurate value are not involved"

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Journal Entry

Debit Loan Receivable (Amount Lent)

Debit Contribution Expense (Cash – FV)

Credit Cash (Amount Lent)

Credit Discount on Loan (Cash – FV)

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CECL Cont'd

- The NFP also determines the initial estimate of the valuation allowance for credit losses based upon its expectation of collection of the contractual payments
- If the NFP has multiple loans, it considers whether the loan has similar risk characteristics to other loans the NFP has made, in which case the NFP determines the allowance for expected credit losses on a collective basis

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Subsequent Measurement Cont'd

- No additional contribution expense is recognized during subsequent measurement of a programmatic loan except:
  - Loans that contain conditional promises to give
  - Loan forgiveness

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Subsequent Measurement Cont'd

- The difference between the periodic interest cost calculated using the interest method and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization
- At each reporting date, should also adjust the allowance for credit losses
  - Compare current estimate of expected credit losses with the estimate of expected credit losses previously recorded

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Loan Accounting

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Factors Impacting Accounting

- Factors
  - Interest Rate compared to market
  - Expectation to collect
  - Terms that include potential forgiveness

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Accounting for Loans

Potential Accounting Treatments

- Recording loan as receivable
- Record loan as a contribution
- Bifurcate between receivable & contribution

Below Market Interest

Impact of Interest Rates

- If the investment bears a market rate and collection is expected
  - Record a loan receivable

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Impact of Interest Rate Cont'd

- If the investment bears no interest or an interest rate below market rates & the loan is expected to be fully repaid
  - Loan interest is imputed
- Contribution expense is recognized
  - Difference between the amount transferred and the NPV of the investment

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Impact of Interest Rate Cont'd

- There are two methods to record the loan receivable when interest is below market
  - Effective interest rate method
  - Inherent contribution method

Effective Interest Rate Method

Initial Measurement

- Db Loan (amount provided)
- Db Contribution Expense (difference between PV of contractual payments and cash provided)
- Cr Discount (equals contribution expense)
- Cr Cash (amount provided)

Subsequent Measurement (annually)

- Db Discount
- Cr Interest Income

Inherent Contribution

Initial Measurement

- Db Loan Receivable (fair value after imputing interest)
- Db Contribution Expense (difference)
- Cr Cash (amount provided)

Subsequent Measurement (annually)

- Db loan receivable
- Cr Interest Income

Below Market Loan

- When loan is repaid
  - Debit Cash
  - Credit Loan Receivable

Collectability

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Collectability

- Future collectability is uncertain
  - No future repayment is anticipated
    - Record contribution expense
  - Partial repayment is expected
    - Recognize loan receivable at PV of Future Cash Flows
    - Difference between principal and PV FCF is contribution
- No provision for loan allowance should be recorded

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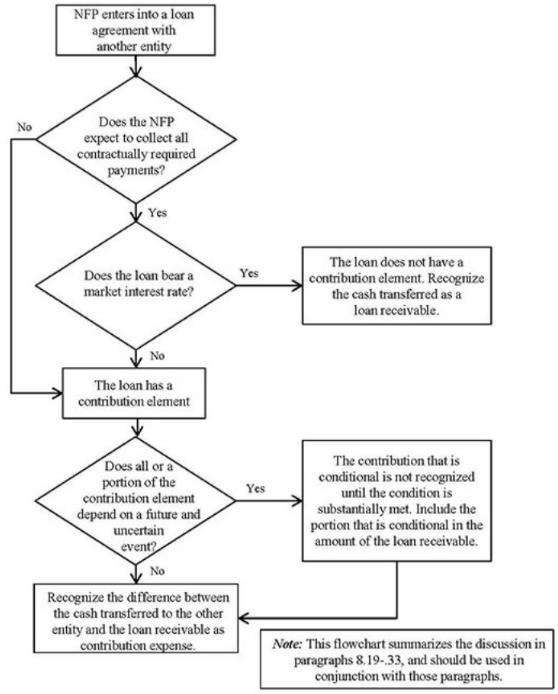
Contribution vs. Loan



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Forgiveness

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Forgiveness Considerations

- To encourage the borrower to take a specific action that achieves programmatic objectives, the loan document may include terms upon which all or a portion of the loan principal will be forgiven
- Those loan documents contain conditional promises to give
  - Represent a barrier that must be overcome as well as a right of release from obligation
  - Should be recognized when the condition(s) on which they depend are substantially met

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Recognition

- Recognized at the amount of cash (or other assets) transferred to the borrower
  - Unless there are other off-market terms, such as a below-market interest rate stated in the loan

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Forgiveness

- Forgiveness of some or all of the principal amount in accordance with the loan's contractual forgiveness provisions would be recognized as a contribution made by
  - Reducing the loan's carrying amount and
  - Recognizing contribution expense

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The Crazy

- Generally, a contractual feature that can result in variability in the cash flows due on a loan would be evaluated for bifurcation as a separate derivative contract under ASC 815
- Subsequent to initial recognition, the bifurcated derivative would be recorded at fair value, with changes in fair value recognized in the statement of changes in net assets

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Some Sanity

- Due to the conflict in guidance for recognition of not-for-profit contributions and derivatives, FinREC believes the NFP may elect to apply the recognition guidance in FASB ASC 720 and FASB ASC 958
- Under this accounting policy election, the conditional contribution feature would not be bifurcated under FASB ASC 815
- FinREC believes that the accounting policy elected should be applied on a consistent basis and the **NFP should consider whether it is a significant accounting policy that should be disclosed in the notes to the financial statements**

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Proposal

Derivatives Scope Refinements and Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract

- Issued: July 23, 2024

- Background:
  - Stakeholders' concerns about the application of derivative accounting to contracts with features based on the operations or activities of one of the parties to the contract and the diversity in accounting for a share-based payment from a customer that is consideration for the transfer of goods or services

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Proposal Cont'd

- Would exclude from derivative accounting contracts with underlyings that are based on **operations or activities** specific to one of the parties to the contract
- The scope exception would include **variables based on financial statement metrics** of one of the parties to the contract, as well as the **occurrence or nonoccurrence of an event** related to the operations or activities specific to one of the parties to the contract

Exclusion

- Contracts with a single underlying based on either a market rate, market price, or market index or the price or performance of a financial asset or financial liability of one of the parties to the contract would not qualify for the proposed scope exception

Proposal Cont'd

- Contracts with multiple underlyings for which some are excluded from derivative accounting and some are not would be evaluated on the basis of the **predominant characteristics** of the contract to determine whether the entire contract (or embedded feature) is subject to the requirements of Topic 815
  - Would change the predominant characteristics assessment to require that an entity assess which underlying is expected to have the **largest expected effect** on changes in the fair value of the contract (or embedded feature)

Comments Due

- Comments were due: October 21, 2024

Forgiveness Not in T&C

- The terms of a programmatic loan do not include forgiveness, but the NFP investor decides to forgive all or a portion of the loan amount
- Determining whether a loan is forgiven and accounted for as a contribution, or is uncollectible is a matter of judgment, and sometimes challenging as both a decrease in collectability and a decision to forgive may occur within a short period of time

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Forgiveness Not in T&C Cont'd

- If all or a portion of a loan is to be forgiven, to determine whether that forgiveness is a contribution or written off against the allowance for credit losses, FinREC believes the fair value of the loan (or the fair value of the portion being forgiven) should be measured at the time of forgiveness to determine the contribution made, as FASB ASC 720-25-30-1 requires contributions made to be measured at the fair value of the liability cancelled

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Example 1

- NFP provides a programmatic loan to a borrower for $150,000. The terms of the loan were at market and the loan is a fixed rate loan.
- The NFP determines that the loan is fully uncollectible and forgives the full amount of the loan
  - Since the fair value of the loan is zero, there is no contribution made to be recognized
  - Loan is written off to the allowance for credit losses

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Example 2

- NFP provides a programmatic loan to a borrower for $150,000. The terms of the loan were at market and the loan is a fixed rate loan
- During the term of the loan, the NFP had estimated and recorded an expected credit loss of $30,000 based on the credit risk of the borrower
- The NFP informs the borrower that they will not be required to repay any of the loan **due to action by the borrower that is consistent with the goals of the NFP**
- At the time of forgiveness of the loan, the NFP has determined that a portion of the loan is uncollectible as a result of the borrower's inability to pay

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Example 2 Cont'd

- At the time of forgiveness, the fair value of the loan is $125,000 (reflects the credit risk of the borrower and changes in interest rates since the origination of the loan)

Debit: Contribution expense	**$125,000**
Debit: Allowance for credit losses	**$30,000**
Credit: Loan	**$150,000**
Credit: Credit loss expense	**$5,000**

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Partial Forgiveness

- If a loan is not forgiven in full and if the debtor is experiencing financial difficulty, the NFP accounts for the changes in terms by applying the guidance in FASB ASC 310 which requires a determination of whether the refinancing or restructuring is a new loan or a continuation of the existing loan and, thus, determine the loan's discount rate and the accounting for unamortized net fees and costs, if any

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No Repayment Expected

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No Repayment Expected

- Entirely a contribution

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Accounting for Potential Forgiveness

- Conditions for forgiveness
  - Creates a barrier that must be overcome by the borrower (conditional contributions)
- Recognized at the amount transferred to the borrower
  - Debit Loan Receivable
  - Credit Cash

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Accounting for Forgiveness

- Recognized as a contribution made by reducing the loan's carrying amount and recognizing contribution expense when the condition(s) for forgiveness are substantially met
  - Db Contribution Expense
  - Cr Loan Receivable

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Loan Forgiveness vs. Impairment

- Impairment vs. forgiveness
  - Professional judgment

- General Rule: Loan impairment
  - Change in probability of collection

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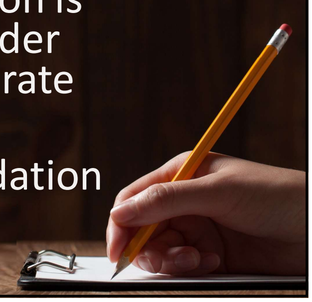
Example – Programmatic Loan

- A community foundation makes a $100,000 programmatic loan to an arts organization. The note is noninterest bearing, is unsecured, and a balloon payment due at the end of the five-year term. The community foundation determines that a market rate for a loan with the same terms and a borrower of equal credit worthiness as the arts organization is 5%. The PV of the contractual payments due under the loan discounted at the imputed 5% interest rate is $78,350.
- What journal entry would the community foundation recognize for this programmatic loan?



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Functional Expenses

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Natural Classification Defined

- A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses

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Functional Classification Defined

- The method of grouping expenses according to the **purpose** for which the costs are incurred
- The primary functional classifications are program services and supporting activities

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Program vs. Supporting Activities

Program Services

- The activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the **purposes or mission** for which the NFP exists

Supporting Services

- All activities of a NFP other than program services

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Number of Programs

- The number of functional reporting classifications for program services varies according to the nature of the NFP and the services it renders
- Most NFPs incur costs and provide services for several separate and identifiable programs, and the expenses for those programs should be disaggregated

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FinREC

- Program information in the financial statements is most meaningful when it correlates with descriptions of the NFP's mission and the NFP's programs that are used by the NFP in its fund-raising materials, its programmatic promotional materials, website descriptions, tax filings, annual reports, and other public information

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Common Question

Can an NFP have only one program?

Yes

Program Activities

- Program objectives
- Nature of services
- Constituents served
- Magnitude of the program to the NFP's overall activities
- Budgetary categories
- Oversight, regulatory, grant, or other compliance requirements
- Other factors that may be relevant to financial statement users

Supporting Activities

- Management & General
- Fundraising
- Membership Development

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Management & General

- Management and general activities are not identifiable with a program, fund-raising activity, or membership-development activity but are indispensable to the organization

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Industry

- Some industries have functional categories of supporting activities that are prevalent in that industry
  - i.e. colleges and universities typically have institutional support and institutional development activities

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Number of Classifications

- A single functional reporting classification is ordinarily adequate to portray each kind of supporting service
  - May present more detailed disaggregated information for each kind of supporting service

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Fundraising

- Fundraising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets or time
- Financial statements should disclose total fundraising expense

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Membership Development

- Membership development activities include soliciting for prospective members and membership dues, membership relations, and similar activities
  - However, if there are no significant benefits or duties connected with membership, the substance of membership development activities may, in fact, be fundraising

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Example Disclosure / Statement

	Program Activities				Supporting Activities			
	A	B	C	Programs Subtotal	Management and General	Fund-Raising	Supporting Subtotal	Total Expenses
Salaries and benefits	$ 7,400	$3,900	$ 1,725	$ 13,025	$ 1,130	$ 960	$ 2,090	$ 15,115
Grants to other organizations	2,075	750	1,925	4,750				4,750
Supplies and travel	890	1,013	499	2,402	213	540	753	3,155
Services and professional fees	160	1,490	600	2,250	2u0	390	590	2,840
Office and occupancy	1,160	600	450	2,210	218	100	318	2,528
Depreciation	1,440	800	570	2,810	250	140	390	3,200
Interest	171	96	68	335	27	20	47	382
Total expenses	$13,296	$8,649	$ 5,837	$ 27,782	$ 2,038	$2,150	$ 4,188	$ 31,970

Direct Identification vs. Allocation

- Some expenses are directly related to and can be assigned to a single major program or service or a single supporting activity
- Other expenses relate to a combination or programs or supporting activities

Assignment

- Direct identification of specific expenses is the preferred method for charging expenses to various functions
  - If an expense can be specifically identified with a program or supporting service, it should be assigned to that function

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Allocation

- If direct identification is impossible or impracticable, an allocation is appropriate
- A reasonable allocation of expenses among an NFP's functions may be made on a variety of bases
- Objective methods of allocating expenses are preferable to subjective methods
  - The allocation may be based on related financial or nonfinancial data

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Joint Activities

- Activities That Combine Fundraising Activities With Activities That Have Elements of Another Function
  - **General Rule**: 100% charged to fundraising
  - **Exception:** Must meet **ALL** 3 Criteria
    1) Purpose
    2) Audience
    3) Content

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Keep Up to Date

- An NFP should evaluate its expense allocation methods periodically
  - Review time records or activity reports of key personnel, the use of space, and the consumption of supplies and postage
- Reviewed by management and revised when necessary to reflect significant changes in the nature or level of the NFP's current activities

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Common Deficiencies

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Common Issues in Functional Reporting in FS

- Use of more than one method to allocate expenses during a reporting period
- Lack of support for allocations
- Use of a fixed percentage to allocate costs rather than a basis more accurately representing true cost allocations

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Substantiating Allocations

- Organization should maintain documentation supporting:
  a. Allocation methodology
  b. Calculations used to do the actual allocation and to support disclosures
  c. Basis of calculations

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Substantiating Allocations Cont'd

  d. Reasonableness of the allocations
  e. Support for the original transactions
  f. Use of consistent methodology during the period and from year to year
  g. Internal controls surrounding expense allocation process

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Case Study

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Case Study – Summer Library Foundation

- You have been provided with a Statement of Functional Expenses and a set of journal entries from the Summer Library Foundation.
- Your task is to determine how each expense should be categorized on the Statement of Functional Expenses.

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3, 2, 1 Method of Applying New Knowledge

3 things I learned

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2 actions to apply what I learned

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1 way I will share my learning

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What Questions Do You Have?

Jaclyn Veno, CPA
Learning & Development Specialist
Jaclyn@galassolearningsolutions.com
https://galassolearningsolutions.com

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