

Executive Summary **Financial Reporting Best Practice Papers - Topics 1-19**

The STRENGTH MATTERS™ CFO Working Group

The group of Chief Financial Officers (“CFOs”) and accounting professionals listed below have worked together since 2007 identifying the “best practices” we believe are important in presenting meaningful financial statements to the world. Our group held heated debates on many topics (e.g. developer fees and timing of revenue recognition, how are deferred fees tracked and booked, what is a functional expense). Surprisingly, we discovered that we held strong, even passionate, feelings about how our financial statements should speak. We want our financial statements to reflect the true value of our organizations. We want them to tell the corporate story in a shared, and therefore meaningful language others can understand. We hope that you will share this goal.

You may be reading some of these recommended best practices with a sinking heart. If you are preparing to follow them, in particular the implementation of EITF 04-05 (a.k.a. the “consolidation challenge”), we share your pain. We understand the considerable time and effort involved creating eliminating entries and recasting prior years to find the beginning consolidated retained earnings. As organizations grow, the eliminations and spreadsheet gyrations become more complex and it is easy to question why consolidation is necessary at all. Of course EITF 04-05 is now GAAP and to obtain unqualified audit opinions, we must comply. GAAP aside, we have come to appreciate the value of consolidated statements if presented in conjunction with consolidating schedules, where each of the core parent companies presented can be shown on a stand along basis.

It is through consolidation that the reader sees the scale of the enterprise controlled by the parent. The parent stops thinking of itself as a group of silos, each standing alone and begins to understand the size of the enterprise it sustains. It is in consolidation, as well, that the inter-relatedness of developer fees, management fees, and inter-company loans is captured. The reader can appreciate the value the parent brings to its subsidiaries. This last point is critical if the parent companies of nonprofit real estate developers and owners are to achieve independent status and access to capital at the enterprise level rather than deal-by-deal project-based financing.

Accounting is a language and a powerful tool with which to communicate the value of our enterprises. Accounting standards are never static and change as business practices evolve. We invite financial professionals in the affordable housing industry to embrace these practices and to be part of the dialogue.

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TOPIC 1 - Determination of Parent Organization Fiscal Year-End

It is possible for a parent entity to consider a fiscal year-end that is three months before or after the year-end of its subsidiary entities. Based on GAAP, this would be an acceptable practice, but may create practical issues and challenges, especially with the reconciliation of intercompany accounting. Consolidated financial statements prepared where the fiscal year-end of the parent and its subsidiaries differs by more than three months would not be considered prepared in accordance with GAAP.

We suggest that the industry change to a calendar year-end for their parent and subsidiary entities. Each organization should still evaluate its individual situation to determine the best yearend fit based on their company requirements and other factors such as staffing considerations.

TOPIC 2 – Presentation: Comparative Statements vs. Non-comparative Statements

Based upon industry practice and applicable accounting pronouncements, the presentation of comparative financial statements is preferred. As described above, there may be situations in which the presentation of comparative financial statements is neither meaningful nor practical. In some instances, the presentation of comparative financial statements may involve the restatement of the earliest year presented. Accordingly, the organization should consider the need for comparative information and evaluate the time and resources necessary to present comparative financial statements.

The presentation of supplementary schedules is also encouraged (see Topic 5 for a discussion of supplementary schedules). Supplementary schedules that include consolidating statements of financial position, consolidating statements of activities and consolidating statements of cash flows with summarized prior year information are recommended to facilitate a reader's knowledge of the organization.

TOPIC 3A - Consolidation Issues: Eliminations and Presentation of Minority/Non-controlling Interests

If consolidated financial statements are prepared, GAAP requires all inter-organization transactions and balances to be eliminated. For example, if consolidated financial statements were presented for a nonprofit parent organization and its subsidiary company, an account receivable on the books of the parent would be eliminated if it arose from transactions with the subsidiary company. The related account payable to the parent appearing on the books of the subsidiary company also would be eliminated for consolidated financial statement purposes.

The receivable is a valid asset from the standpoint of the parent as a separate entity, but is not an asset from the standpoint of the consolidated financial statements because the consolidated economic entity cannot owe itself.

Eliminating entries are also required for income statement items. For instance, when fees are charged between affiliated entities, the subsequent revenue and expense should be eliminated from the income statement of the consolidated entity, even if the fee does not create end-of-period A/R or A/P.

Consolidating or eliminating entries are made on worksheets only for the purpose of preparing consolidated financial statements. They are not recorded on the books of the entities included in the consolidated group.

Developer fees incurred and earned by members of a consolidated group present several unique challenges. Elimination of developer fees in consolidation will be discussed in Topic 4b (not available at this time).

TOPIC 3B – Consolidation Issues – Steps for a Successful Consolidation

The consolidation of nonprofit organizations and operating partnerships can be a daunting task. The CFO group has compiled a list of steps to use as a guide when going through this process. Each organization should review its own facts and circumstances to see how best to achieve a proper consolidation process. Following are several main points to consider when working on the consolidation:

1. Review operating level entity documents to determine control or lack of control.
2. Perform the consolidation through accounting software as opposed to a manual consolidation using spreadsheets.
3. For third-party managed properties, process journal entries monthly from property manager's records.
4. Consider using accounting firm software to perform the consolidation.
5. Consider performing eliminations quarterly.
6. Be mindful of auditor consolidation targets.

TOPIC 4A - Developer Fee Recognition

There is no specific authoritative literature that provides guidance for the recognition of developer fee revenue. Usually, agreements between the developer and the project are based on tax attributes to achieve certain tax benefits. However, the financial reporting process ultimately depends on GAAP application and guidance. The CFO Group organizations generally utilize either of the following two approaches for developer fee recognition:

Recognize developer fee revenue as earned during the development period based on a specified percentage relating to services performed during the predevelopment phase of a project and the remainder of the developer fee recognized during the development period based on the percentage of completion method of accounting.

Or

Recognize developer fee revenue on a basis that corresponds to the earnings benchmarks described in the development services agreement.

Although these two approaches may differ between organizations, the fundamental bases for determining developer fee revenue recognition are similar: 1) developer fee arrangements are evidenced by written, executed agreements that identify the developer fee; 2) organizations apply the percentage of completion method, or an approximation of that method, to determine the extent that services have been rendered; and 3) organizations utilize available data to periodically evaluate developer fee collection or exposure to loss.

While there is no clear consensus of method among the CFO group or guidance from the GAAP literature, a method that corresponds to or approximates the percentage of completion method, as adjusted for continuing exposure to loss when necessary, would be the best practice for the industry. Individual circumstances within various organizations may warrant other practices and would be acceptable if based on sound logic and the basic premises of GAAP revenue recognition principles.

TOPIC 4B - Developer Fee Elimination During Consolidation or Combination

There are two recognized approaches to eliminating developer fee income in financial statements that consolidate or combine the developer earning the fee and a property that capitalizes the fee.

First approach: Elimination of all inter-company profits

Many accountants cite the guidance found in Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, which generally requires all interorganization balances and transactions to be eliminated. This is done so that the resulting financial statements present the financial position and operating results of the reporting organization and all of its controlled entities as if they were a single enterprise.

Second approach: Treat developer fee as a partial real estate sale to the limited partner

Other accountants cite the sections of SOP 92-1 and FAS 66 that describe partial sales of real estate. Such sections illustrate accounting for the transfer of real estate from a partner to a partnership in which it holds a partial interest, as long as certain forms of continuing involvement or control are not maintained.

The CFO group includes proponents of both approaches, although the majority uses the first method (eliminating all intercompany transactions). Each organization should look at its own facts and circumstances to determine which method would be proper for its consolidated financial statements.

TOPIC 5 - Determination and Presentation of Supplemental Information

Based upon the above analysis, very little supplemental information is actually required. Organizations receiving federal awards must provide a schedule of expenditures of federal awards and a schedule of findings and questioned costs. Nonprofit organizations are required to disclose information about functional classification of expenses either on the statement of activities or in

the footnotes. In certain situations, an organization's funding source may require additional information such as a comparison of actual to budgeted revenues and expenses.

At a minimum, it is recommended that a comprehensive set of consolidating schedules, as well as parent-only schedules of debt and cash composition and a consolidating schedule of activities for the parent entity - based on multiple lines of business, be included as supplemental information to provide financial statement users with a clear picture of the financial position and activities of the organization. Importantly, organizations are generally not restricted in the supplemental information that may be presented. Accordingly, each organization should work with the principal users of its financial statements to determine any additional supplemental information that might be needed to best communicate their "story" to the readers of those statements.

TOPIC 6 - Preparation of the Statement of Financial Position

As best practice, the CFO group recommends presentation of the statement of financial position on a classified basis. Additionally, SFAS No. 117 requires nonprofit organizations to present a statement of financial position that reports the amounts of its total assets, liabilities, and net assets and focuses on the organization as a whole. The statement of financial position, including the accompanying notes to the financial statements, must provide relevant information about liquidity, financial flexibility, and the interrelationship of the organization's assets and liabilities. While SFAS No. 117 does not require the use of a particular format for the statement of financial position, organizations are encouraged to use a classified format in presenting this statement. Under this format, assets and liabilities are classified as either current or noncurrent. Classifications commonly include current assets, property and equipment, other assets, current liabilities, long-term debt, and net assets.

TOPIC 7 - Net Assets Section of the Statement of Financial Position

GAAP Net assets represent the difference between the organization's assets and liabilities and are classified into three categories--unrestricted net assets, temporarily restricted net assets and permanently restricted net assets--based on the presence or absence and nature of donor-imposed restrictions. SFAS No. 117 Financial Statements of Not-for-Profit Organizations requires the amounts of the three classes of net assets and total net assets be presented on the face of the statement of financial position. SFAS No. 117 also requires the change in permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets be reported on the statement of activities. In addition, further information must be reported for temporarily restricted and permanently restricted net assets including a description and dollar amount of the different types of permanent restrictions and temporary restrictions. This information can be reported either on the face of the statement of financial position as secondary captions of the respective class of net assets or in the notes to the financial statements.

TOPIC 8 - Statement of Functional Expenses: Methodologies and Combining Allocation Methodology

An organization should issue a statement of activities, with totals for each distinct and separate line of business, general and administrative costs not allocated, and fundraising activities. This information would be required in either the statement of activities or in the notes to the financial statements. As a supplementary schedule the organization should consider a detailed matrix of expenses by natural classification that agrees in total to each item of expense in the statement of activities. As a result, the functional expenses schedule is presented as supplementary information (that is, as additional information accompanying financial statements rather than as a basic financial statement, unless the organization qualifies as a voluntary health and welfare organization).

Each organization should evaluate their own situation and determine the best approach to presenting information about the functional classification of its expenses. The matrix of expenses is not a required part of the basic financial statements, however, its inclusion with the financial statements is highly recommended. This will provide readers more detailed information, increase transparency and give investors a way to compare organizations in a meaningful manner. (See Exhibit A for an example of a statement of functional expenses.)

TOPIC 9 - Issuance of Stand-Alone Financial Statements or Parent-Only Financial Statements

It seems that the majority of the annual audited financial statements issued by the CFO group are prepared on a consolidated basis and parent-only financial statements are not issued. Although it is acceptable for an organization to prepare parent-only financial statements in addition to the consolidated financial statements of the organization, disclosures in the notes accompanying the financial statements and references in the auditor's report should be made to inform readers that the financial statements are part of a broader reporting group and are not the general-purpose financial statements of the organization taken as a whole.

In situations where the presentation of parent-only financial information is considered necessary, organizations should consider presenting consolidating financial statements as a supplemental schedule to the basic financial statements issued (see Topic 5 - Determination and Presentation of Supplemental Information) as an alternative to separate parent-only financial statements. This presentation, as recommended in Topic 5, offers readers both the consolidated information required by GAAP and the ability to see the parent-only financial information on a stand-alone basis.

TOPIC 10 - Allowances for Receivables

Generally accepted accounting principles and CFO Group practice dictate the use of the allowance method to value accounts receivable. Organizations should consider a variety of factors including historical experience, risk tolerance and economic conditions in order to develop a sound valuation policy and they should apply that policy on a consistent basis.

One practical solution to consider with regard to preserving the collectability of past due accounts is to memorialize significantly delinquent receivables with a written promissory note. This improves the organization's ability to eventually collect the outstanding receivable. The odds of prevailing in legal proceedings resulting from nonpayment of a promissory note are generally greater than from nonpayment of a trade receivable. The note may also be secured by assets, which would position the organization in front of unsecured creditors in the event the debtor experiences financial difficulties. In addition, if the debtor entity is eventually sold, a written promissory note may have preference over other trade payables or unsecured obligations of the entity as sales proceeds are disbursed at closing.

TOPIC 11 – Capitalization of Fixed Assets (Policy)

A not-for-profit organization should establish and adopt a formal written capitalization and depreciation policy. The policy should cover at a minimum the dollar threshold at which expenditures are capitalized along with other items mentioned above. Also to note, certain federal programs and funding may require a capitalization policy and adherence to that policy. In addition, tax regulation allows the expensing of some items and should agree to the policy adopted.

TOPIC 12 – Statement of Activities

Although SFAS No. 117 does not provide requirements on the level of aggregation or disaggregation of revenues, as a best practice, the CFO Group recommends disaggregating revenue into classes such as contributions, rental revenue, developer fees, interest income, management fees, debt forgiveness, and gain on the sale of an asset. The CFO Group believes that when determining the items that should be listed separately on the statement of activities, nonprofit organizations should take into consideration the significance of an item to the organization's financial statements in order to provide a clearer picture of the activities of the organization. For example, if items such as government grants, service fee revenue, or management fee revenue are significant to the nonprofit organization, the nonprofit organization should list them as separate line items on the statement of activities.

SFAS No. 117 provides nonprofit organizations considerable leeway in formatting the statement of activities, this allows the organizations to “tell their story” within the guidelines of GAAP. The CFO Group encourages nonprofit organizations to use this flexibility to attempt to be transparent. At a minimum, not-for-profits must show the change in overall net assets as well as the change in permanently restricted, temporarily restricted, and unrestricted net assets in the statement of activities. Organizations may then decide on the appropriate level of aggregation or disaggregation of revenues, expenses, gains, and losses that will provide the most relevant and meaningful information for financial statement users.

TOPIC 13 – Statement of Cash Flows

While SFAS No. 95 encourages use of the direct method of reporting cash flow, most organizations use the indirect method. One advantage of the indirect method is that it focuses on differences between the change in net assets and net cash flow from operating activities. That is, it provides a useful link between the statement of cash flows and the statement of activities and statement of financial position. The CFO group feels that as they become more sophisticated as an industry and compete in the market place for additional capital, investors and lenders will compare their financial statements to those of public companies, the majority of which also use the indirect cash flow method for financial reporting purposes. Because this method is so widely used in practice, most lenders are familiar with the indirect method.

TOPIC 14 – Segment Reporting

Public companies are required by FAS 131 to present certain information about reportable operating segments. Nonprofit organizations are encouraged, but not required, to present information about reportable segments as well. While not-for-profits are not mandated to present reportable segment information, FAS 117 requires non-for-profit organizations to present information about expenses reported by their functional classifications, such as major classes of program services and supporting activities, either on the face of the financials or in the notes (for more information on functional expense disclosure requirements, see Topic 8 Statement of Functional Expenses). The FASB acknowledged in FAS 117 that the requirement for information about a not-for-profit's expenses by function is similar to standards that require information about a business enterprise's industry segments.

While FAS 131 requires certain segment information be reported, the guidance allows for flexibility in the presentation of this information. For segment profit and loss information, the CFO Group encourages nonprofit organizations to consider reporting this information in a summarized income statement format or in a format that best depicts how the organization operates.

TOPIC 15 – Cash Presentation

Generally, amounts that will be realized in cash, consumed, or sold within an operating period are classified as current assets, while cash restricted for long-term purposes should be segregated from cash available for current use.

Members of the CFO Group generally encounter the following types of cash restrictions: property reserves such as operating and replacement reserves required by partnership and other lenders' regulatory agreements; agency restricted cash; board designated cash restrictions; donor-imposed cash restrictions; and other restrictions from outside parties or agreements at the parent level. The CFO Group recommends nonprofit organizations separate the corporate cash (donor restricted vs. unrestricted) from the property level cash (contractually restricted vs. unrestricted) either on the face of the statement of financial position, notes to financial statements, or in a supplemental schedule.

TOPIC 16 – Footnote Disclosures

Notes are an integral part of the financial statements. They should be used to present material disclosures required by GAAP that are not otherwise presented on the face of the financial statements or in supplemental schedules. Notes for comparative financial statements generally should cover all periods presented to the extent they remain relevant.

Notes generally are accumulated and presented as a separate page or pages after the basic financial statements. Also, the notes should be arranged in the same order as the amounts in the statements to which they relate, and each note should bear a descriptive caption, which corresponds to a financial statement caption. Information about specific footnote requirements is detailed in the following paragraphs.

TOPIC 17 – Contingent Liabilities

An estimated loss from a loss contingency should be accrued through a charge to operations and disclosed if it is probable that a loss has been incurred at the financial statement date and the amount of the loss can be reasonably estimated. Loss contingencies that do not meet those conditions should be disclosed if there is a reasonable possibility that a loss may have been incurred. Guarantees must also be disclosed, even if the likelihood of loss is remote.

The CFO Group recommends showing the detail of all guarantees unless impractical. Smaller entities may find it easier to use such a detailed breakout, while larger entities that have several guarantees may want to use a summarized guarantee disclosure.

TOPIC 18 – Asset Valuation Guidance

Asset valuation guidance applies primarily to those entities who are either electing the fair value option for eligible assets or liabilities, or who have potential impairment in loans or long-lived assets that may require the entity to measure fair value for impairment purposes. Generally, the industry does not sell or trade assets and does not consider the fair value of their assets when evaluating their statements of financial position. Most industry participants believe that the potential benefits of electing the fair value option, Statement of Financial Accounting Standard (“SFAS”) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FASB ASC 825) may not outweigh the effort and cost of implementing the changes necessary to do so.

Much of the information discussed in Topic 18 is for informational purposes and covers SFAS No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB ASC 310) (“FAS 114”) and SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FASB ASC 360) (“FAS 144”). Each organization should perform its own diligence and research to determine how fair value may be applied and implemented in various situations.

TOPIC 19 – Free Cash Flow

Free cash flow (FCF) may be used by lenders and investors as a performance metric used to evaluate the organization's real estate portfolio and its corporate operations. By measuring the cash available to be distributed, after adjusting for capital expenditure requirements, required distributions and working capital, lenders and investors can assess the health of a particular asset, group of assets, or operating entity. By using this metric consistently across the affordable housing industry, lenders and investors will be better able compare portfolio and management operating strength and evaluate debt service capacity on a consistent basis. It is possible that trends in FCF may indicate strengths or weaknesses in various types' of properties, geographic locations, or corporate operations. Additionally, trends in the calculation can indicate improving or deteriorating asset value and may indicate a need to review specific assets for issues such as occupancy, rental increases or required capital expenditures. The capacity of an organization (or a property) to repay its debt obligations and provide a return to investors is important information for industry participants, lenders and investors.

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DISCLAIMER

This paper contains certain recommended financial reporting best practices for nonprofit affordable housing organizations that develop and own affordable housing in the United States. These papers were 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, as well as representatives of socially responsible lenders, working in conjunction with representatives from Novogradac and Company LLP, The Reznick Group, and Lindquist, von Husen & Joyce LLP, three independent public accounting firms. This publication should not be construed as accounting or other advice on any specific facts or circumstances. The contents of these papers 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.

For further information, contact info@STRENGTHMATTERS.net.

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