How the new changes to lease accounting could affect you

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News for Nonprofits

NONPROFIT AGENDAS

AUGUST/SEPTEMBER 2016

How the new changes to lease accounting could affect you

Much-anticipated updated accounting standards are out on how to treat leases. They will affect all organizations that lease assets such as real estate, vehicles and equipment.

Accounting for your leases

Currently, the proper treatment of a lease depends on whether it's a capital lease or an operating lease. Capital leases (for example, a lease of equipment with a $1 purchase option at the end) are reported as assets and liabilities on balance sheets. Operating leases (for instance, a lease of office space for 10 years) don't appear on balance sheets and are recognized on financial statements only as rent expense and a disclosure item.

The Financial Accounting Standards Board (FASB) in February issued an update to the proper treatment of leases in financial statements under U.S. Generally Accepted Accounting Principles (GAAP). The new guidance is called Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*.

ASU 2016-02 requires you to recognize assets and liabilities for *all* leases with terms of more than 12 months. You'll report the right to use the leased asset (for example, a building or piece of equipment) on the balance sheet as an asset and the obligation to pay rent, reduced to its present value, as a liability.

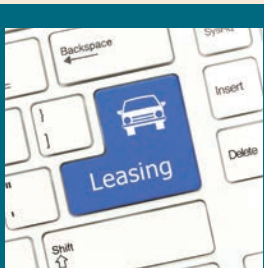
Your recognition, measurement and presentation of expenses and cash flows arising from a lease will continue to depend largely on whether it's a finance lease (similar to a capital lease) or operating lease:

Finance leases. On the statement of activities, you'll recognize the amortization of leased assets separately from interest on the lease liability. On the statement of cash flows, you'll classify repayments of the principal portion of the lease liability within financing activities. Payments of interest on the lease liability and variable lease payments will be classified within operating activities on that statement.

Operating leases. You'll recognize a single total lease cost, computed so that the cost of the lease is allocated over the lease term generally on a straight-line basis. All cash payments will be classified within operating activities on the statement of cash flows.

The new standard also requires organizations to make disclosures to help users of their financial statements better understand the amount, timing and uncertainty of cash flows related to leases. Disclosures will include information about variable lease payments and options to renew and terminate leases.

3 steps to take now



With the effective date of the new accounting rules several years down the road, it might be tempting to delay preparation. That would be a mistake.

The rules will apply to prior-year comparative information that is included in your financial statements when the rules take effect. If you typically include two years of comparative information, you'll need to be able to present the 2018 and 2019 data in a format that complies with the new rules when you include it in your 2020 financial statements.

To get started:

- Perform an inventory of your leases — you can use the inventory to determine which leases require which accounting treatment.
- Determine the effects of additional lease liabilities — you may need to contact lenders and other stakeholders if the changes will affect debt covenants or other metrics they consider.
- Make appropriate changes to accounting and financial reporting processes — adjustments to your tracking of debt covenants and month end procedures might be necessary under the new requirements.

Accounting for combined contracts

Your nonprofit may enter into a contract with both lease and service components (for example, an office space lease that includes maintenance services). ASU 2016-02 dictates that organizations continue to separate the lease components from the nonlease components and provides additional guidance on how to do so.

In particular, the payment an organization makes under the contract is allocated to the lease and nonlease components on a relative standalone price basis. Payment related to nonlease components isn't considered a lease payment, so it's excluded from the measurement of lease assets or liabilities.

Preparing for lease negotiations

The changes to how your organization will account for leases on your financial statements also may change how you approach lease negotiations or prompt you to seek lease modifications. With specific lease terms playing a role in determining your reporting responsibilities, your priorities could change.

> *"ASU 2016-02 requires you to recognize assets and liabilities for all leases with terms of more than 12 months."*

For instance, it might prove wise to request lower fixed rent and higher variable costs through percentage rent or common area maintenance charges. That's because you can exclude most variable lease payments when measuring lease assets and liabilities (other than those that depend on an index or a rate set at the beginning of the lease or are, in substance, fixed payments). You might even consider buying instead of leasing, as you'll end up with similar debt on your balance sheet as you would if you lease.

Be prepared

Most nonprofits will need to comply with the new standards on their financial statements for annual periods beginning after December 15, 2019, and for interim periods beginning a year later. Early adoption is permitted, and early preparation is encouraged. (See "3 steps to take now" at left.)

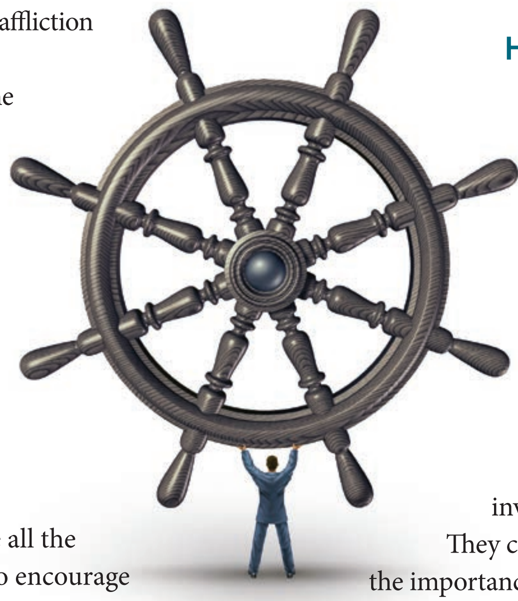
Moving on to your nonprofit's 2nd leader

Do you know of a nonprofit with a founding father who just won't let go of the reins?

Many organizations run into a dilemma in which the original person instrumental in getting the nonprofit off the ground resists delegating key responsibilities to other staff members — or helping the organization transition to a new leader. That nonprofit is likely suffering from an ailment sometimes called "Founder's Syndrome."

Is your organization vulnerable?

Nonprofits suffering from this affliction generally share some common characteristics: For example, the founder wields a disproportionate amount of power. And he or she recruits board members who may act primarily out of their loyalty to this person, rather than to the organization; instead of governing, the board merely rubber-stamps the founder's suggestions.



The founder also might make all the important decisions, failing to encourage input from other sources by mentoring promising subordinates. Perhaps worst of all, the founder impedes, or fails to cooperate with, efforts to form a clear succession plan.

These conditions leave organizations in a vulnerable and risky position. If something should happen to the founder — retirement, death, disability or something else — how would the organization carry on?

It's worth noting that founders' reluctance to loosen their grip isn't necessarily due to a power-hungry need to control. Founders may fear that the organization would falter without their continued connection.

For example, they worry that donations might drop off if they're not reaching out into the community anymore, or that others in the organization lack the background to make savvy decisions. Or founders might have invested so much of themselves and their lives in the organization that they simply can't imagine a different path.

How can you treat the "syndrome"?

The good news is that Founder's Syndrome is treatable. The first step is to address the situation with the founder. This can be uncomfortable, but it's critical. Members of the board or perhaps senior staff should begin by acknowledging the founder's invaluable role over the years. They can then move on to discuss the importance of preserving the founder's legacy when he or she inevitably can no longer lead.

Here are some other advisable actions:

Form a succession plan. A succession plan is a vital ingredient in preserving the organization. If no one in the organization wants to tackle this discussion with the founder, a professional coach or consultant could be retained.

Encourage founders to be active in the transition. Don't just foist a transition onto the founder. One important contribution founders can make is recording their institutional memories. The leader's vast knowledge should be documented so the organization can continue to benefit from it.

Ask the board of directors to step up. The board may need to step up its accountability in the absence of the strong leader to whom they've been accustomed. Board members must seize the reins and educate themselves about the organization in any areas where they're lacking. This may require replacing existing board members. Bringing on new staff may be advisable, too.

The board can form an active fundraising committee so that a single individual isn't responsible for driving donations. An army of zealous volunteers could be deployed as a bulwark against donation decline.

Entering Phase 2

Your organization's founder likely has invested the proverbial blood, sweat and tears into launching your not-for-profit and overseeing its growth. That person, ideally, should become part of the plan as you create a road map for the organization's future. Planning for the second generation of nonprofit leadership is in its own way just as important as creating a start-up nonprofit — be sure to allow your organization the time it needs to ready itself for that next stage. ■

Can you hear them now?

Social listening can boost supporter engagement

Nonprofits are beginning to tune into a relatively new marketing tactic known as social listening. Some of the best known commercial brands have used the tactic for years, but now its low cost and proven effectiveness are gaining the attention of not-for-profits that see the value of tapping into their supporters' passions while they're hot.

Understanding social listening

Social listening refers to more than just monitoring social media such as Facebook, Twitter and Instagram for mentions of your organization and related keywords. It also includes identifying and engaging online with topics that interest your supporters, as well as "influencers" who can extend your message by sharing it with their audiences. Social listening gives you valuable insights on the issues that resonate with your supporters and influencers, allowing you to tailor your communications with them.

When it comes to influencers, you needn't grab the attention of a Taylor Swift, Kim Kardashian or Ellen DeGeneres. Connecting with a group of influencers who each have several hundred followers can expand your reach exponentially. For example, a conservation organization might connect with a popular rock climber or other outdoor enthusiast to reach his or her followers. A tip: Get to know your influencers by following and interacting with them before making a request.

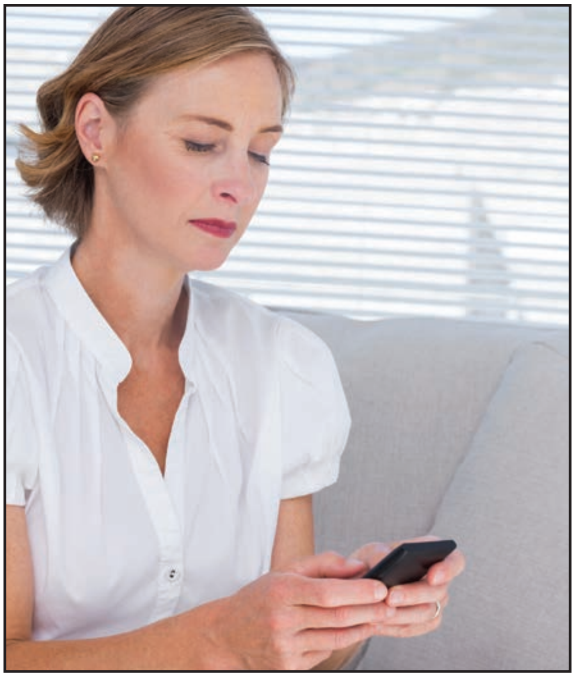
Getting started

To begin, develop a list of key terms related to your organization and its mission, programs and campaigns. You'll want to treat this as a "living document," updating it as you launch new initiatives.

These are the terms you'll "listen" for on social media. A variety of free online tools are available to perform this monitoring, including Google Alerts, Technorati, Addictomatic, Twazzup and Social Mention. When your supporters or influencers use the terms, you can send them a targeted email with a call to action, such as a petition, a donation solicitation or an event announcement. Your call to action could be as simple as asking them to share your content.

> *"You can use trending hashtags (a keyword or phrase that is popular at the moment on social media, such as #GameofThrones) to keep your engagement relevant and leverage current events on a real-time basis."*

For example, American Rivers — a nonprofit dedicated to river conservation — used social listening to mobilize their members when the Colorado River in the Grand Canyon was threatened by two development proposals. The organization found that many of its supporters were talking about the Grand Canyon on Facebook and Twitter and sent those supporters targeted automated emails within 24 hours of the mention, asking them to sign or, if they'd already signed, share a petition. The organization gained 2,500 new signatures as a result, with a 24% petition conversion rate.



You also can use trending hashtags (a keyword or phrase that is popular at the moment on social media, such as #GameofThrones) to keep your engagement relevant and leverage current events on a real-time basis. You might be able to find creative ways to join the conversation while promoting your organization or campaign.

For example, Habitat for Humanity jumped on the #Oscars hashtag during the 2014 Academy Awards and used the show's tribute to the 75th anniversary of "The Wizard of Oz" to highlight a "There's No Place Like Home" campaign. By including the hashtag in its posts, the organization had the potential to reach a massive worldwide audience.

Time to tune in

Social media is no fad, and savvy nonprofits know they need to embrace and make the most out of it. By pursuing social listening, you can cost-effectively improve your engagement efforts and propel your campaigns.

NEWS FOR NONPROFITS

Private colleges fail on financial health

As many as 159 degree-granting private colleges that provide federal money for financial aid have failed to satisfy the U.S. Department of Education's (DOE's) financial responsibility standards for the 2013–14 academic year (the latest figures available), according to an analysis by the *Chronicle of Higher Education*. Ninety-three of the failing institutions were nonprofits.

The DOE calculates a composite of three ratios from an institution's financial statements — the primary reserve, the equity ratio and the net income ratio — ranging from -1.0 to 3.0. A score equal to or greater than 1.5 indicates a financially responsible institution. Scores of less than 1.5 but more than or equal to 1.0 indicate a school that requires additional oversight. Those with lower scores are typically subject to cash monitoring requirements and may be required to post a letter of credit. ■

More states embrace social impact bonds

Connecticut and South Carolina will experiment with social impact bonds, it was recently reported, or have already begun using them. Private companies and nonprofits provide funding upfront to combat difficult social problems, and, if the nonprofit recipients can satisfy measurable goals, the states will pay them back with interest.

The South Carolina program, for example, will send registered nurses into the homes of low-income pregnant women to teach parenting skills and how to keep their kids healthy. It will be funded by organizations including the Duke Endowment, and researchers will determine whether the program meets goals such as fewer preterm births, fewer hospitalizations and longer intervals between births. ■

FASB project on financial statements rolls on

The Financial Accounting Standards Board (FASB) continues to develop a set of accounting standards expected to dramatically alter how nonprofits prepare their financial statements. Since comments on the Exposure Draft of proposed Accounting Standards Update (ASU) No. 2015-230, *Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954): Presentation of Financial Statements of Not-for Profit Entities*, were received in August 2015, the FASB has continued to focus on net asset classification, presentation of expenses, information useful in assessing an organization's liquidity and methods of presenting operating cash flows.

The FASB has recently made some notable amendments to the proposed standard. Among these, nonprofits wouldn't need to disclose internal salaries and benefits that are netted against investment return. And they wouldn't be required to present their operating cash flows using the direct method but could continue to use either the direct or indirect method.

The final ASU is expected in the third quarter of 2016. It will first apply to financial statements for calendar year 2018, with early adoption allowed. ■

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