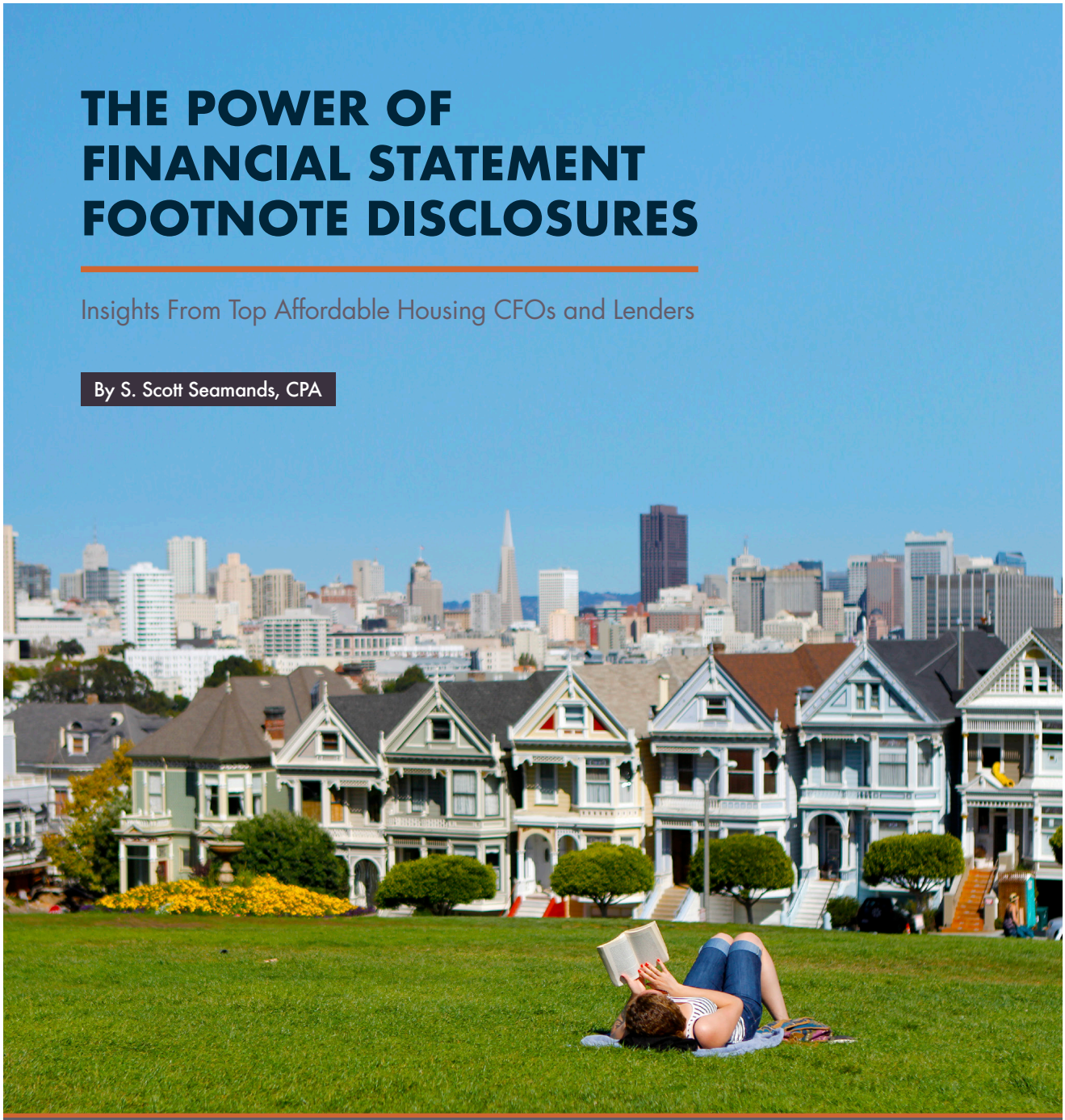
# THE POWER OF FINANCIAL STATEMENT FOOTNOTE DISCLOSURES

Insights From Top Affordable Housing CFOs and Lenders

By S. Scott Seamands, CPA



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Five years ago, Lindquist, von Husen & Joyce was selected to lead a working group of lenders and CFOs connected to many of the largest, nonprofit affordable housing developers in the country. Our main task was to create a series of twelve best practice papers, each of which focused on one specific footnote disclosure commonly seen in the consolidated financial statements of affordable housing developers.

During each of the four years from 2013 through 2016, I personally worked with a team of three lenders and three CFOs. On average, we wrote three papers each year, covering all of these footnote disclosures:

- Organization and nature of activities (including a list of all consolidated entities)
- Accounts receivable (including contributions receivable)
- Investments
- Notes receivable
- Property and equipment
- Deferred revenue
- Notes payable
- Net assets (temporarily and permanently restricted)
- Commitments and contingencies
- Related party transactions
- Subsequent events
- Special transactions

Before embarking on this project, we studied the financial statement disclosures of each of the affordable housing developers that make up our StrengthMatters® CFO Working Group. We began by identifying what information was required to be disclosed and then asking ourselves what additional information would be useful to disclose. The resulting sample disclosures were generally viewed as more helpful for increasing transparency in financial reporting – one of the main objectives of the StrengthMatters initiative.

Now that this library of sample footnote disclosures is complete, we hope that many organizations will follow these formats to the extent practical, given that not every organization has the same types of activities to disclose.

**Why would these formats improve your current reporting?** In reviewing the financial statements of most nonprofit affordable housing developers, we saw that although FASB's minimum requirements for disclosure were generally being met, organizations were missing an opportunity to 'tell their story' and provide information that was easier for outside readers to understand (e.g. lenders, investors, state and federal agencies).

All 12 papers are available at StrengthMatters® (www.strengthmatters.net), the host organization. StrengthMatters was created 10 years ago to increase nonprofit affordable housing developers' access to capital through increased transparency and consistency in financial reporting.

Here are some of the insights that we gained from this project, specifically relating to each of the papers listed above. We hope they can help your organization improve transparency and, therefore, access to capital.

## ORGANIZATION AND NATURE OF ACTIVITIES (INCLUDING A LIST OF ALL CONSOLIDATED ENTITIES)

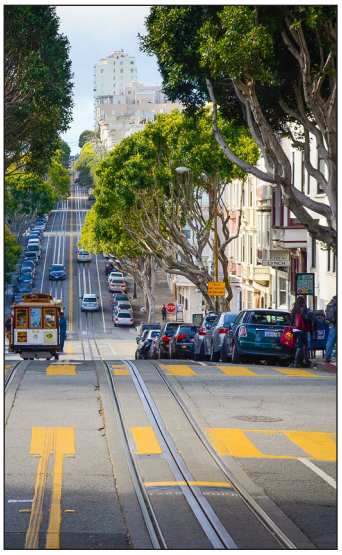
This note is generally the first footnote for a nonprofit affordable housing developer. Although it is necessary to identify each entity included in the consolidated financial statements, the list can be very long (sometimes more than 100 entities are listed) and not very informative.

Our suggested format first identifies the main parent and significant corporate entity names that identify the major lines, such as the development company, the property management company, resident services company, etc. Then a table of all real properties included in the consolidated financial statement follows. This table discloses the entity names as required by GAAP, but more significantly it also identifies each property's location (city), year placed in service, size (in units) and type (multi-family, senior, etc.).

This suggested format is much more interesting to readers and really conveys the size of the portfolio of properties included in the consolidated financial statements.

Another insight from the paper is how to condense the required disclosure of the percentage of ownership (i.e. control) that the parent and its affiliated nonprofits have over each subsidiary limited partnership. Rather than a long list of negligible percentages owned by each general partner (.01% or .001%) we suggest including this sentence near the table of real properties' ownership entity names: *One or more of ABC's affiliates owns the managing or other general partner interest ranging between .01% and 1% of each limited partnership.*

The final item in the sample disclosure is a list of all other entities included in the consolidated statements. Having previously listed the main lines of business and all properties owned, the remaining entities to be identified are of lesser interest.



## ACCOUNTS RECEIVABLE (INCLUDING CONTRIBUTIONS RECEIVABLE)

GAAP doesn't specify very much required disclosure in this area other than separating the major types of receivables between contributions, contracts, related party items, etc. Our sample disclosure conveys more than the minimal required amount of information.

For contributions, we suggested a table that identifies the types of contributions (unrestricted and temporarily restricted by type of time or purpose restriction). We did not suggest identifying the names of the contributors or grantors since that information is not as useful as the type of contribution.

Similarly, for contract-type grants receivable, we suggest a table that displays totals by type of program (e.g. after-school programs, resident healthcare programs, job training programs, etc.) rather than identifying the names of various government agencies that owe grants or fees to the organization.

These tables identify the parent company's receivables in a separate column from other affiliates' balances, since there is more emphasis on disclosing the parent's liquidity for lenders and donors who are evaluating the parent organization for a possible loan or donation.

For rent receivable, our suggested format discloses residential rent due from tenants, from rent subsidy providers, commercial rent and the allowance for doubtful accounts. Why be more granular about disclosures that aren't required at all? In the case of rent receivable, since rents are normally due on the first day of each month, rents receivable as of a month-end balance sheet date would appear to be at least one month overdue. Thus the increased detail as to the types of rents receivable — as well as the amount reserved by management as potentially uncollectible — helps readers see some of the issues associated with the unique tenant population of the entity's portfolio.

We also included a sample table showing the activity within the allowance for doubtful accounts receivable which reconciles the beginning and ending balances (the required disclosure) by showing the receivable write-offs, recoveries and bad debt expense recognized.

## INVESTMENTS

Disclosures of investments can be quite complex and confusing to readers. Our suggested format attempts to convey the required information in three sections:

- Investments stated at fair value
- Equity-method investments
- Cost-method investments

The first section includes all required information about the marketable securities portfolio, including cost, fair value, Level 1-3 inputs used in determining fair values, etc.

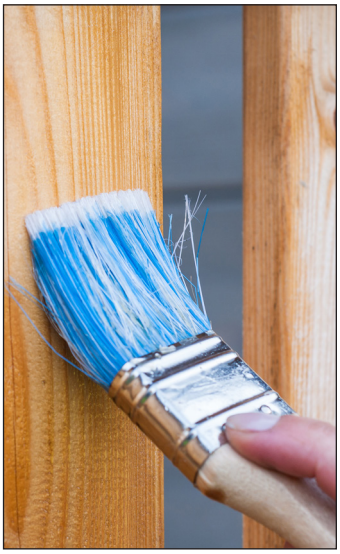
The second section includes required information about equity-method investments including a list of the entities, the ownership or control percentages and summarized financial information for such entities.

The third section identifies the non-marketable security investments maintained at cost and why the organization is not deemed to exercise significant influence over those entities (e.g. it owns less than 20% of voting stock).

## NOTES RECEIVABLE

This disclosure is an opportunity to provide aggregated information for the parent's notes receivable (before inter-company elimination entries and after). It isn't necessary to list every note separately if they can be grouped together with other notes having similar characteristics, such as all secured loans bearing a range of interest rates and maturity dates requiring annual payments based on the underlying properties' net cash flow.

Another insight was to show (parenthetically) how many notes are included in the aggregated totals of each type. This is another way to 'tell your story' when your organization makes homebuyer loans. Even if the dollar amounts are similar, an organization that mentions 150 loans appears to be more active than one that mentions 10 loans.



We also used the 5-year maturities table to convey more information about liquidity than you will usually find in a notes receivable disclosure. The table is similar to the one described below in the notes payable section.

## PROPERTY AND EQUIPMENT

The table summarizing significant categories of property and equipment is commonly seen. Our suggestion is to add a table for the development in progress, which is less commonly seen. Our suggested format allows your organization to summarize what is in the pipeline and let your readers know how many housing units each project undergoing development activities will create, which year the construction is expected to be completed, and any other relevant information that can be squeezed into a table such as location, ownership entity name, new construction versus acquisition/rehabilitation, etc.

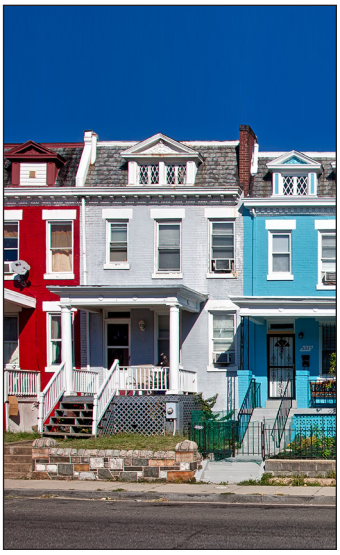
## DEFERRED REVENUE

Deferred revenue arises from different types of transactions but GAAP doesn't require very much disclosure about the balance in this account, other than disclosure of accounting policies regarding revenue recognition.

The most common types of deferred revenue among nonprofit affordable housing developers are unearned grant (or fee) income, unearned rent income and deferred developer fees. We suggested a table format that identifies the amount in each of these categories, the amount eliminated in consolidation and a net that ties to the balance sheet amount.

Below the table, we suggested a paragraph describing each of the three categories to explain the following:

- The amount of grant proceeds received and being deferred
- The period of time that the deferral will last
- The organization's method for recognizing the revenue over that time period
- The period of time that unearned rents will be recognized (e.g. all in the subsequent year or some over a longer lease term)
- The organization's policy for deferring developer fees and for eliminating these inter-company fees



## NOTES PAYABLE

Many organizations have already adopted our suggested format for streamlining their note payable disclosures. Organizations went from listing each note separately, spanning many pages of details, to now summarizing the similar notes in aggregated totals. For example, all permanent mortgage loans payable requiring monthly payments with interest ranging from 3% to 6% per annum, maturing between 2040 and 2070 could all be included in one aggregated total.

Parent notes payable are identified in a separate section than affiliated organization notes payable, for the same reason that was previously mentioned: readers are most interested in the parent's liquidity.

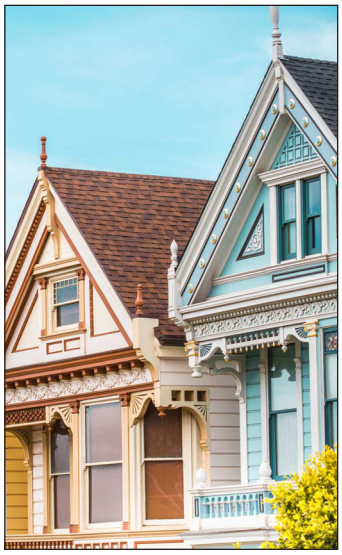
The five-year debt maturity table is suggested to include a separate line for each aggregated total note type, displaying the maturities for each type over each of the next five years. Only the grand total by year is normally disclosed but our suggestion is to provide the expanded table format to convey more information about the types of loans that require principal payments each year.

For permanent restrictions, a paragraph describing the arrangement would be helpful. Please keep in mind that the distinction between temporary and permanent restrictions will soon vanish from the nonprofit financial statement format once the new reporting model for nonprofit organizations becomes effective in 2018.

## NET ASSETS (TEMPORARILY AND PERMANENTLY RESTRICTED)

When we reviewed the formats that are most frequently used for the required disclosure of the make-up of temporarily restricted net assets, we saw many examples that didn't convey very much information about the nature of the restrictions. For example, we saw some donor names but we couldn't tell what their contributions were restricted for.

Our suggestion is to aggregate the table of activity in temporarily restricted net assets by type of restriction. For example identify the total restricted amounts arising from capital improvement contribution grants, resident service programs, multi-year pledges or grants, etc.



## COMMITMENTS AND CONTINGENCIES

Our suggestion is to more clearly label commitments and contingencies in two sections of this note rather than combining them. This way readers will be able to differentiate between things that will happen (commitments) and things that may happen (contingencies) Within each of these two sections, a separate paragraph describing the various commitments and contingencies is presented.

The contingency disclosure of guarantees is often viewed as a frightening part of the disclosures, given that guarantees often total hundreds of millions of dollars. Our suggestion to make the guaranty disclosure more helpful is to add this sentence to each of the guaranty descriptions, where applicable:

> *A payment under such a guarantee would result in the transfer of cash resources from the guarantor to a consolidated affiliate, resulting in an obligation to repay the advance, usually from future operating cash flow. To date, ABC has not experienced any calls on this guaranty.*

This is helpful to the reader since they might view such a contingency differently from a loss contingency, for example.

## RELATED PARTY TRANSACTIONS

Our suggested disclosure separates parent and affiliate transactions, discloses amounts prior to and after elimination entries and provides disclosure of the timing for future collections or payments.

## SUBSEQUENT EVENTS

Most subsequent event disclosures focus on items that consume resources, such as litigation settled subsequent to year-end or other similar losses, purchases of property and new financing arrangements.

We illustrated those disclosures in our sample but we also included some positive events which wouldn't require disclosure. Our suggestion is to include these items to balance out the financial report rather than solely focusing on negative events.

For example, we disclosed a grant awarded to the organization as well as the reimbursement of certain long-standing advances receivable from an affiliate.

## SPECIAL TRANSACTIONS

In this paper, we identified certain types of transactions that occur somewhat frequently in the affordable housing industry, yet can be hard for readers to understand. Specifically, we included examples of the following types of events:

- Real property acquisition
- Deconsolidation
- Transfers of property between affiliates

For real property acquisitions, no disclosure is required within the footnotes. But in most cases, there is a significant amount of activity reflected within the financial statements. The goal of a footnote disclosure is to highlight the categories of property acquired during the year, along with the debt incurred and cash paid for the acquired assets.

Deconsolidations occur when the reporting entity's control over a previously-consolidated subsidiary declines below the 50% threshold, meaning that the subsidiary is no longer a controlled entity. This could happen when an unrelated co-general partner is admitted to a partnership, for example. The impact of this deconsolidation can be significant and our sample footnote summarizes the account balances before and after the deconsolidation is recognized so that the reader can see what changed as a result of the decline in control.

Transfers between affiliates become complicated when real property is involved, since such transfers must be recorded at the net book value of the transferor's property. This is to prevent the seller from recognizing a gain on a property sale to an affiliated organization. (The tax structure of such sales is based on appraised values typically.) The sample footnote shows what was transferred by asset and liability line item along with the net impact of the obligations transferred in excess of the seller's carrying value of the assets transferred.

## A FINAL 'FOOTNOTE'

As the formats suggested in these papers gain more acceptance within the affordable housing industry, we have heard that lenders and other stakeholders appreciate the increased transparency that results from them. We encourage each developer to review the sample disclosures, consider the advantages described above and adapt the samples to fit your specific situation. We think that doing so will reduce the amount of verbal explanations needed and result in increased access to capital — fulfilling the original mission of StrengthMatters and our working group.

For any questions about adapting the disclosure samples and formats to fit your organization, contact Lindquist, von Husen & Joyce LLP, a national provider of audit and tax planning services to affordable housing developers and related nonprofits. We are also available to provide training for your staff on a variety of topics.

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