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De-Mystifying Gift Liability Reports

PART I

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Now that the New Year is under way, most planned giving officers are turning their attention to the administrative aspect of their programs: mailing beneficiary tax reports in a timely fashion, providing annual trust performance reports, and, for some, addressing gift annuity reserve reports and the upcoming FASB liability reporting season.

This article addresses liability reporting, both that required in some states to document gift annuity reserves and that required by all charities' accountants in preparing annual financial reports. These requirements can be vexing to planned giving officers — and even to their colleagues in the finance and controllers' offices. The question and answer format that follows attempts to clarify and de-mystify liability reporting.

Q: What is a liability report and why is it used?

A: Planned gifts involve payment streams that must be properly accounted for and may require the creation of reserve accounts. The payer is *liable* for payments, and the *liability* is the estimated amount required to cover all future payments. The two types of liability reports needed when administering planned gifts are FASB (Financial Accounting Standards Board) liability reports, which are provided to auditors, and state gift annuity reserve reports, used in complying with regulated states.

Q: Why do some states require reports for gift annuities, and not for other planned gifts?

A: Gift annuities are contracts between a charity and its donors and are backed by the issuing institution's total assets. In an effort to protect the donors and annuitants from potential default on annuity payments, some states regulate charitable annuities along with commercial insurance contracts through their state insurance commissioners. The level of regulation varies among the states that do not exempt annuities from scrutiny. In addition to requiring annual filings, some states require the charity to maintain a reserve fund sufficient to cover its future annuity payments. Further still, some states regulate how gift annuity reserve funds can be invested and which assets can be accepted to fund gift annuities.

Remainder trusts, lead trusts, and pooled income funds are separate entities from the issuing institution with separate tax identification numbers. Payments from these gifts are supported only by the trust's or pool's assets. If a charity goes bankrupt, the trust or pooled income fund assets are not affected and cannot be accessed by the charity or its creditors.

Q: What is the difference between a gift annuity liability report used in accounting procedures (the "FASB reports") and a gift annuity liability report for state regulators ("reserve reports")?

A: The reports are essentially the same, but the specifics can be different. FASB does not dictate exact mortality tables, interest assumptions and calculation methodologies, whereas state regulators do. FASB liabilities are required for all planned gift types whereas state regulation applies only to gift annuities.

The frame of reference differs as well. FASB is concerned with accurate and consistent accounting practices, which include correct booking of assets and liabilities, valid income assumptions, and appropriate adjustment of the liability over the lifetime of the gift. One goal of FASB 116/117 was to help create consistency among charities' financial statements by defining the appropriate approach while leaving the details and execution in the hands of the accountants.

State regulators are similarly concerned with valid income assumptions but with the goal in mind of protecting donors and beneficiaries from potential default on gift annuity payments by charities. State regulators do not specify gift accounting procedures but do in some cases impose investment restrictions.

Q: How often do I run liability reports and on what date(s)?

A: FASB liability reports are computed once per year, as of the organization's fiscal year end, for the purpose of booking an adjustment to the net asset entries of each planned gift. The organization's auditors will establish reporting dates that correspond with the annual financial reporting cycle. Reserve reports for state regulators are almost always computed as of the calendar year end. In some cases, however, an organization can petition to use a fiscal-year-end valuation date for annuity reserve reporting. Typically, reports are computed shortly after the valuation date; states impose specific deadlines for filing annuity reserve reports.

Q: How is a liability computed? How does a factor relate to a liability?

A: A common misconception is that the liability is based on a "fixed" life expectancy. In fact, a liability is computed by adding together every payment remaining in the payment stream, and discounting each one for interest and mortality. A payment of $500 paid 10 years from now, discounted at 6 percent, and multiplied by a 91.45 percent chance of a beneficiary being alive to receive it, equals \$500 x $(1/1.06)^{10}$ x .9145 = \$255.33. All discounted payments are summed to produce the liability.

For fixed-payment gifts, a factor is a liability based on \$1 paid each year. The factor times the annual payment amount equals the reserve. The more conservative (lower) the interest assumption, the higher the reserve will be. The more conservative (longer lives) the mortality table, the higher the reserve will be.

Q: Since FASB provides only general guidelines for reporting, how do I determine interest and mortality assumptions for FASB-compliant liability reports?

A: Liability calculations must take into account the nature of the payment obligation, the estimated return on the investments, and a discount rate commensurate with the risk involved. Statement 116, Paragraph 178 provides an example of accounting for an annuity trust for which the charity donee (remainderman) is trustee. However, the guidelines do not give specific direction regarding the choice of discount rate or calculation methodology.

There are two general policy questions to be addressed: which calculation methodology and mortality assumptions to use and which discount rate(s) to employ.

Using a commonly understood method for calculating the liabilities, such as the IRS deduction methodology, should be acceptable to auditors. This approach is referenced by the American Institute of Certified Public Accountants (AICPA) in its Audit Guide as one acceptable method. Again, there is no specific guidance on mortality tables and any commonly used table should be acceptable to auditors.

The AICPA Audit Guide states that the discount rate selected should not be revised subsequent to the initial booking. Three basic options exist, two recommended and one not:

1. Use the gift's original IRS discount rate for initial booking and for all subsequent revaluations (recommended).

Three factors support this approach: a) if using the IRS methodology, choosing the prevailing discount rate means that the original deduction calculation yields the liability for initial booking; b) this conforms to the stipulation of holding the interest rate fixed for the lifetime of the gift; c) to the extent that the AFR is a measurement of the investment climate at the time of gift creation, it may well serve as a reasonable proxy for that gift's lifetime risk-free return experience.

A detracting factor is the possibility that the AFR does not reflect the organization's approach for investing its charitable gift assets. However, the AFR or a similar discounting rate is likely tied into the charity's long-term return scenario.

2. Select a fixed rate for all planned gifts, or one for each planned gift type, both for initial booking and for all subsequent revaluations (recommended).

This approach mitigates the potential criticism of the AFR approach in that the rate selected can be more closely tied to the institution's investment approach. Its downside is that it requires two calculations at the time the gift is created — the charitable deduction calculation and the FASB-compliant liability calculation. It is possible to book the gift initially using the valuation based on the original AFR and perform subsequent revaluations at the chosen fixed interest rate. This modified approach is simpler but produces an unwarranted jump in liability between the initial booking and the following annual revaluation.

3. Use the gift's original IRS discount rate for initial booking and then the prevailing IRS discount rate at each annual revaluation (NOT recommended).

This method is problematic. Because the rate in force will change every year, liability values jump around for reasons unrelated to the investment approach for gift assets or the mortality experience of beneficiaries. This method also violates the stipulation that the rate applied to each gift should remain unchanged for subsequent periods.

Q: Do all of my annuity reserve reports filed with the states need an actuary's signature?

A: No. Some states require an actuary's signature (e.g. Wisconsin); some do not require an actuary's signature (e.g. New York); and some specify that an actuary's signature is not required if certain conditions are met (e.g. New Jersey).

For comprehensive information on state annuity regulation, try visiting the following Web sites: www.plannedgivingservices.com/giftannuities; www.pgresources.com.

Q: If I need to file with more than one state, can I use the same annuity reserve report for all states?

A: There are two considerations. First, which gifts must be included in the report? California, for example, requires that out-of-state charities include only those gift annuities deemed "California annuities" in their report, although most states require that all gifts in the pool be included in the report.

Second, what is the maximum allowable interest rate and most conservative mortality table required for each gift? A single report can be used to satisfy multiple states when those states require the same group of gifts to be reported on and when each liability is computed based on the lowest allowable interest assumption and most conservative mortality assumption mandated by those states for the gift. An interest rate below the maximum allowable may be used but this will produce an unnecessarily high reserve.

Q: How do I create or obtain a liability report?

A: Because liability computations are mathematically complex, they should be performed by specialized software or by an actuary. Actuaries are usually more costly than using software. Another advantage of using software is that the existing data carries over from year to year.

Note: Part II of this article will cover compliance with regulated states, the affect of minimizing your reserve account, liabilities for deferred annuities, and more.

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