2016 Guidance on Nonprofit Financial Statement Presentation Changes

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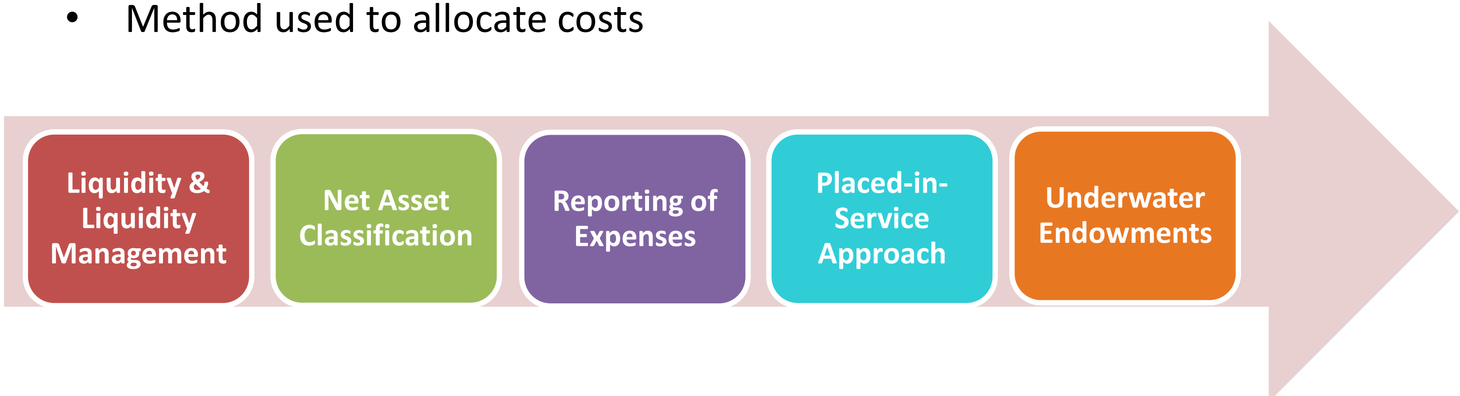
Objectives for this Accounting Standards Update (ASU)

- ✓ Update, not overhaul, the current model
- ✓ Improve net asset classification
- ✓ Improve the information presented in the financial statements, specifically over the following:
  - Liquidity
  - Financial performance
  - Expense classification
  - Cash flows
- ✓ Enable nonprofit organizations to better "tell their financial story" to the users of the financial statements

Main Provisions

- ✓ Liquidity & Liquidity Management (Qualitative & Quantitative)
- ✓ Net asset classification
  - Composition of net assets with donor restrictions and how said restrictions affect the use of resources
- ✓ Reporting Expenses by Natural Function and Classification
  - Method used to allocate costs
- ✓ Placed-in-Service Approach
- ✓ Underwater Endowments
- ✓ Other
  - Statement of cash flows
  - Investment return



Effective Date & Transition

- ✓ Effective for fiscal years **beginning after** December 15, 2017
  - Fiscal year 2019 (7/1/18-6/30/19)
  - Calendar year 2018 (1/1/18-12/31/18)

- ✓ Provisions under this new guidance will be **retroactively applied**, in the year of adoption

- ✓ Emphasis-of-matter paragraph will be included in the auditor's report if the adoption results in a material effect on the financial statements.

Effective Date & Transition

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- ✓ If presenting comparative (dual year) financial statements, the reporting entity has the option to **omit the following** for the year prior to adoption:
  - Reporting expenses by function and classification (if not current required to do so)
  - Disclosure about liquidity and availability of resources

  For example, in FY2019 a nonprofit organization will be required to report their expenses by nature and function and disclose information about their liquidity and availability of financial resources. However, the nonprofit organization will not be required to report their expenses by nature and function or disclose information about liquidity and availability of financial resources for FY2018, even if comparative (dual year) financial statements are presented.

- ✓ Reporting entities will need to disclose the nature of any reclassifications or restatements and their effects, if any, on changes in the nets for the periods presented.

Liquidity & Liquidity Management

- ✓ Quantitative information, either on the face of the balance sheet or in the notes that communicates the availability of an **entity's financial assets** at the balance sheet date to meet **cash flow needs** for operations within **one year from the balance sheet date**.
  - Total amount of financial assets
  - Amounts that are **not available** to meet cash needs within 12 months from the balance sheet date because of: 1) external limits such as donor restrictions and 2) internal actions from the Board of Directors such as Board Designated net assets

- ✓ Qualitative information that discloses how the reporting entity **manages its liquid resources** to meet **cash flow needs** for operating expenses within **one year from the balance sheet date**.
  - Strategy for **addressing risks** that may affect liquidity, including its use of a line of credit
  - Policy for establishing liquidity reserves
  - Basis for determining the **time horizon** used for managing liquidity

Liquidity & Liquidity Management

- ✓ Examples of items to consider in the assessment surrounding liquidity of financial assets include:
  - Nature of the asset- is the asset able to be liquidated quickly and used as working capital?
  - External limits imposed by donors, contracts, laws, etc.
  - Internal limits imposed by Board of Directors

Liquidity & Liquidity Management

Sample Disclosures

<u>Example #1</u> – Liquidity Disclosure

The Agency's financial assets available within one year from the statement of financial position date for general operating expenses are as follows:

Cash and cash equivalents	$ 556,986
Grants, contracts and other receivables	456,985
Prepaid expenses and other	63,895
Liquidity reserve	(420,000)
	$ 657,866

The Agency has a policy to maintain financial assets on hand equal to sixty days of operating expenses, which totaled approximately $525,000 in fiscal year 2016. At times, the Board of Directors designates a portion of any operating surplus to its liquidity reserve, which totaled $420,000 at June 30, 2016. The liquidity reserve may be drawn upon in the event of financial distress or an immediate liquidity need resulting from events outside the Agency's routine course of business. Additionally, the Agency has a line of credit which allows for borrowings up to $1,000,000.

Liquidity & Liquidity Management

Sample Disclosures

Example #2 - Liquidity Disclosure

The Agency has financial assets available for use within one year from the statement of financial position date totaling $657,866, which includes cash and cash equivalents totaling $136,986, grants, contracts and other receivables of $456,985 and prepaid expenses and other totaling $63,895. None of the financial assets available for use are subject to donor or other contractual restrictions that make them unavailable for general expenditure within one year of the statement of financial position date. Certain grants, contracts and other receivables are subject to donor imposed time restrictions that will elapse within one year.

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Net Asset Classification

Statement of financial position and statement of activities shall report net assets into two groups:

1. Net assets without donor restrictions
2. Net assets with donor imposed restrictions

Current Presentation	Unrestricted	Temp. Restricted	Perm. Restricted
New Presentation	**Without Donor Restrictions**	**With Donor Restrictions**	
+			
Disclosures	**Amount, purpose, and type of board designations**	**Nature and amount of donor restrictions**	

Net Asset Classification

- ✓ Amounts and purpose of board designated net assets no longer required (but still allowed) to be disclosed on the face of the financial statements
  - Need to disclose the process relating to the use of board designated net assets (i.e. Board of Directors must vote)
  - If balance reported on the face of the statement of financial position, no need to duplicate in the footnotes
- ✓ Composition of net assets with donor restrictions and how the restrictions affect the use of resources

Reporting of Expenses

- ✓ Report expenses by nature and function in one location in the financial statements
  - Can be presented on the face of the statement of activities, separate statement of functional expenses, or within the notes to the financial statements
- ✓ Include in the footnotes to the financial statements a description of the method used to allocate costs among program and support functions.
  - The level of detail disclosed in the footnotes will depend on the complexity of the agency and its allocation plan – large complex agencies will have a more robust method for allocating costs
  - A disclosure containing a high level overview of the agency's allocation methodology is sufficient
- ✓ Tracking and disclosing expenses between general and administrative (G&A) and fundraising is necessary if fundraising expenses are material or significant.

Reporting of Expenses

- ✓ More specific guidance over **support functions** (general and management expenses), examples include:
  - Human resource related functions (recruiting and employee benefit related activities)
  - Financing, including unallocated interest costs
  - Budgeting
  - Oversight and business management
  - General recordkeeping, including payroll
  - Advertising
  - Expenses of the governing body (Board of Directors' retreat)

- ✓ The changes relating to reporting of expenses are most significantly going to impact:
  - Nonprofit organizations that do not currently include a statement of functional expenses, or other means of reporting expenses by nature and function, within their financial statements
  - Nonprofit organizations that do not have a policy over the allocation of expenses between program and supporting (general and management) functions – i.e. organization may need to implement a time study to properly allocate salary costs, which will take time and resources to implement.

Placed-in-Service Approach

- ✓ Client no longer able to release restricted contributions of property and equipment (PP&E) or cash for purchase of PP&E over the useful life of said asset.
- ✓ When considering the classification of donations of capitalized property, PP&E, or contributions of cash for the purchase or construction of PP&E, the placed in service approach should be used.
- ✓ For clients that have donor contributions classified as restricted at the time this new guidance is adopted, said amounts shall be re-classified as unrestricted if the PP&E was placed in service as of the beginning of the reporting period of adoption.
- ✓ The FASB was asked to consider releasing donations for long-lived assets earlier when restriction is for funds to be used on construction related expenditures. The FASB denied such a request as they stated it is the donors intention to subsidize the acquisition and rehabilitation of long-lived assets for expansion of the entity’s operations. The FASB stated that, unless otherwise stated by the donor, the restriction has not yet been met unless the long-lived asset has been purchased and placed into service.

Underwater Endowments

- ✓ Revised net asset classification
  - To be reflected in net assets with donor restrictions rather than in net assets without donor restriction
- ✓ Disclosure in the footnotes to the financial statements with the following information is required:
  - Aggregate amount of original gift
  - Aggregate fair value of such funds at year end
  - Aggregate amount by which funds are underwater, which are to be classified as part of net assets with donor restrictions
  - The reporting entity's policy and any actions taken concerning appropriation from underwater endowment funds

"Underwater" portion of the endowment are to be reflected in net assets with donor restrictions rather than in net assets without donor restriction.

Underwater Endowments (Continued)

Sample Disclosure

Underwater Endowment Funds

From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor requires the Agency to retain as a fund of perpetual duration. Deficiencies of this nature exist in certain donor-restricted endowment funds, which together have an original gift value of $500,000, a current fair value of $300,000, and a deficiency of $200,000 as of June 30, 2016.

The deficiency resulted from unfavorable market fluctuations that occurred shortly after the investment of new contributions for donor-restricted endowment funds and continued appropriation for certain programs that was deemed prudent by the Board of Directors.

Other - Statement of Cash Flows

- ✓ A nonprofit organization may choose to report its statement of cash flows using **either** the **direct or indirect** method.

- ✓ If the **direct method** is used, a **reconciliation** to the indirect method is **not required** (though allowed, if the reporting entity desires to show said reconciliation).

Indirect
- Reconciles from net income to cash provided by operating activities

Direct
- Reports all cash receipts and disbursements from operating activities

- ✓ If you feel the direct method is most useful to the users of the financial statements and you currently use the indirect method, you certainly can make the change to the direct method.

Other – Investment Return

- ✓ Intended to improve comparability between entities that manage their own investments (internally) and those that hire external managers

- ✓ Can still report investment return net of investment fees

- ✓ No longer need to disclose the following information in the footnotes to the financial statements:
  - The **external** and/or **direct internal** expenses netted against investment earnings
  - The **components** of investment returns

- ✓ Direct **internal investment expenses** include the following:
  - Costs such as salaries, benefits, and other costs associated with staff who are responsible for the execution of a nonprofit organization's investment strategy, monitoring the nonprofit's investment position or any other activities that assist in generating **investment return**.
  - Do not include costs incurred that are not directly related to investment income generating activities, such as **management of an endowment**.

Phase II

- **Overall**
  - ✓ The following items have been deferred for further consideration to a second phase of the FASB's project.
  - ✓ Timing of the FASB's second phase of this project is to be determined (TBD)
- **Statement of Cash Flows**
  - ✓ Potential re-categorization within the statement of cash flows
    - Reclassifications between type of activity – operations, investing and financing
    - Better align the statement of cash flows with the statement of activities
- **Health Care Nonprofit Organizations - Expense Reporting**
  - ✓ Segment reporting for nonprofit health care organizations
    - Versus the current required analysis of expenses by their natural and functional classification.

Phase II

Operating Measure

- ✓ Whether to require a measure of operations
- ✓ How to define a measure of operations

Defined **required** intermediate operating measures for all NFPs—based on two dimensions:	**Mission (Business & Charitable Activity):** based on whether resources are from or directed at carrying out a NFP's purpose for existence (vs. investing and financing)
	Availability: based on whether resources are available for current period activities and reflecting limits imposed by: -external donors -internal actions of a NFP's governing board

Implementation - Expenses

✓ Method of reporting expenses by nature and classification

- A nonprofit organization should choose their method of reporting expenses as required under this new guidance based on the structure of their current information system (general ledger program) and how it captures data.
- As a reminder, nonprofit organizations are able to report expenses by their nature and classification on a separate statement of functional expenses, within the statement of activities or in the footnotes to the financial statements.

✓ Develop and implement a cost allocation policy sooner than later

- Assess the resources needed to implement such a policy and begin the process sooner than later.
- When developing a cost allocation policy, be sure to consider the key concepts of general and management expenses; direct conduct, direct supervision.

Implementation – Liquidity

- ✓ If not already done, develop a policy for managing your organization’s liquidity needs. This policy will be disclosed in the footnotes to the financial statements (qualitative requirement).

- ✓ Begin to consider entity-wide risks that may affect liquidity and a strategy that addresses those risks
  - Entity-wide risks may include external factors such as political climate, condition of financial markets, and economic trends.
  - Strategy for addressing entity-wide risks should assess the nonprofit organization’s current access to liquid resources, how the risks will adversely affect the availability of those resources and what tools have been or can be implemented to ensure access to liquid resources if needed (i.e. line of credit or rainy day fund).

- ✓ Begin to consider how donor-imposed restrictions affect the nonprofit organization’s use of resources
  - Consider these restrictions when developing the budget and making decisions as to how the nonprofit organization is going to utilize and allocate its resources.
  - Assess any necessary programmatic changes that may need to be made due to said restrictions.

Implementation – Net Assets

- ✓ Determine if the change in reporting restricted net assets results in a need to adjust/update the tracking mechanism currently utilized to accommodate the requirements of the change in reporting.

- ✓ Determine the level of detail and disaggregation you wish to report on the face of the statement of financial position, versus what you wish to report in the notes to the financial statements. Examples include board designated net assets, net assets with purpose restriction or net assets to be held in perpetuity.

Implementation - Other

- ✓ Underwater endowments
  - If not yet done, develop and implement a policy regarding appropriating funds from an endowment that is underwater.
  - Begin to assess information regarding the original amount of the permanently restricted gift, the fair value of endowment funds, and the aggregate amount by which the endowment is underwater, as this new guidance requires the aforementioned information to be disclosed in the footnotes to the financial statements.
- ✓ Gifts of PP&E or cash for purchase of PP&E
  - Beginning immediately, consider following the placed-in-service approach as it is allowed under current standards.
  - Doing so will reduce the impact to the financial statements in the year this guidance is required to be adopted.
- ✓ Consider the number of changes that apply to your organization
  - Look prospectively at the level of effort and resources needed to implement the necessary changes.

Other Considerations

- ✓ Can be early adopted, in whole or in pieces- the provisions that **can be early adopted** are:
  - •Reporting expenses by function and classification
  - •Placed-in-service approach
  - •Qualitative and Quantitative

- ✓ The only **changes** noted within this ASU that **cannot be made** without formally adopting the ASU are:
  - Presenting one class of restricted net assets
  - Eliminating requirement to provide reconciliation of operating activities if using direct method of reporting cash flows
  - Underwater endowment reporting
  - Eliminating disclosures of investment return components and netted expenses

Questions & Comments

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