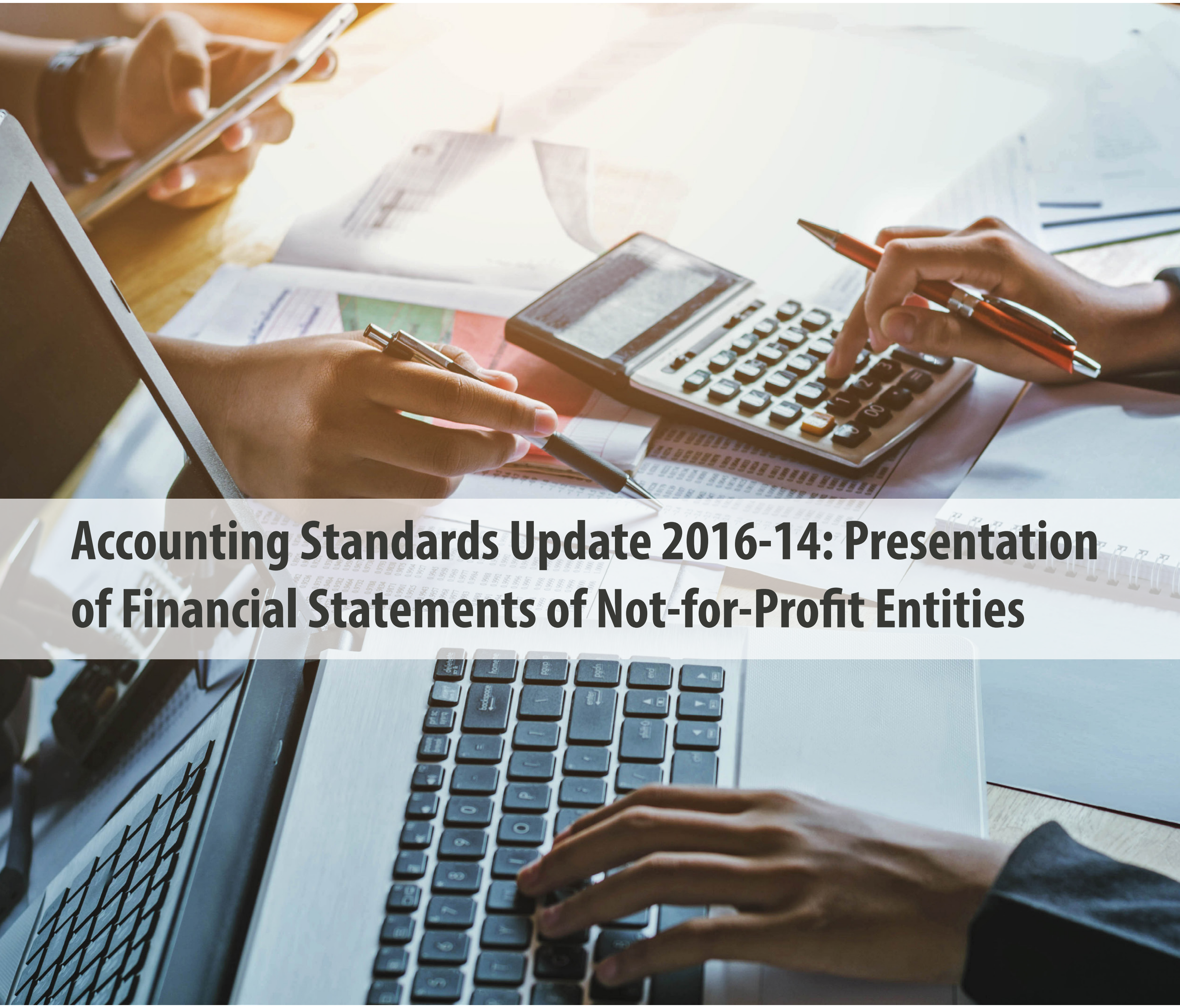
James Moore
Certified Public Accountants and Consultants



Accounting Standards Update 2016-14: Presentation of Financial Statements of Not-for-Profit Entities

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The Financial Accounting Standards Board (FASB) issued an update in August of 2016 that will require all nonprofit entities to change their financial statement presentation. While change is often met with reluctance and hesitancy, this standard is an opportunity for organizations to improve their financial reporting and make it more informative and useful to board members, grantors, and potential donors.

The new standard includes changes to both the statements themselves (statement of financial position, statement of activities, statement of cash flows, and statement of functional expenses) as well as the notes to the financial statements. The effective date for implementation is for fiscal years beginning after December 15, 2017; in other words, depending on your organization's year end, the year of implementation will be the year ended December 31, 2018, June 30, 2019, or September 30, 2019.

In this article, we will not only help you understand how these changes will impact your organization's financial reporting, but also provide tips, recommendations, and examples related to implementation. If done correctly, implementation of this ASU can create better informed board members, a better understanding between program and finance departments, and a platform to attract grantors and donors with your organization's message.

Key Changes

There are six key areas of changes outlined by the standard, each with its own unique challenges and opportunities. Each area has been summarized below, including recommendations related to implementation and references to example exhibits.

1. *Reporting of Expenses*

ASU 2016-14 requires disclosure and analysis of expenses by both natural and functional classifications, as well as required disclosure related to the method of allocation for functional categories. Voluntary health and welfare organizations will already be familiar with this reporting, which is typically done on the statement of functional expenses. This reporting model is now expanding to all nonprofit organizations, so let's discuss what it means.

Natural classification tells people *how* you spent your money, for example, on salaries and benefits, office supplies, travel, advertising, grants to subrecipients, etc. *Functional* classification tells people *why* you spent your money, namely, for program services, management and general expenditures (overhead), or fundraising. Both classifications provide valuable information for different reasons. Management and the governing board need to be informed on natural classifications in order to create an effective budget and to pinpoint areas of potential savings. Grantors and donors rely on functional classification to judge how efficiently the organization is running—in other words, what percentage of total expenses is going toward program services. With increasing pressure on organizations to maintain high program expense ratios, cost allocation has become a hot topic that is outside the scope of this article. If you have questions on your cost allocation plan or indirect cost rate, please contact us for more information.

As you can see, both natural and functional classifications provide value to the organization, which is why they are now being required for all nonprofit organizations. This change in reporting is a good opportunity for management of nonprofit organizations to evaluate their current allocation methodologies and class codes to ensure functional expense information is being recorded correctly in the accounting software. See Exhibit 1 for an example of a statement of functional expenses.

2. *Net Asset Classification*

Under old FASB guidance there are three categories of net assets: unrestricted, temporarily restricted, and permanently restricted. The definition of and distinction between these three categories was sometimes blurry, and note disclosures were lacking. Under ASU 2016-14, there are only two net asset classes: net assets without donor restrictions, and net assets with donor restrictions. You can probably gather from the names that the new definitions are more straightforward:

Use these classifications correctly, or you could unintentionally walk your organization into a donor restriction.

Net assets without donor restrictions are funds that are received as general revenues that can be used for any purpose. For example, if you have a fundraiser or a contribution drive to raise general funds for the organization, these are net assets without donor restrictions. In some cases, you may hold a fundraiser for general purposes and then the board will decide to designate a portion for a specific program or purpose (e.g., to purchase a new vehicle or pay down debt). These board-designated funds are considered net assets without donor restrictions, but under new guidance these designated amounts must be tracked and disclosed in the notes to the financial statements. These board designations can be lifted at any time through action of the board. This new disclosure requirement provides an opportunity for organizations to examine their current board designations and evaluate whether they are appropriate or should be removed.

Net assets with donor restrictions are any funds you receive from a donor or grantor that are for a specific purpose or are to be used within a specific time frame. For example, if a donor writes you a check with a memo saying it is to be used to purchase school supplies for children attending the program, that donation is classified as net assets with donor restrictions until it is spent for that specified purpose. The standard also requires that the nature and amount of restrictions must be disclosed. This can be done either on the face of the financial statements on the statement of activities or in a note to the financial statements. See Exhibit 2 for example financial statement presentation of net assets under the new guidance.

It is important to note that it is possible for the organization to unintentionally walk itself into a donor restriction. For example, let's say the organization holds a fundraiser and notes on the flyer that "all donations will go directly to providing meals for the homeless!" In this instance, the people paying for the fundraiser are doing so with the understanding that their donation is restricted for the advertised purpose. This is something to keep in mind when holding fundraisers. While we know donors like to know their money is going to a good cause, it is easy to get trapped in a situation where you have an abundance of funds for programs but little to no net assets without donor restrictions to pay salaries and other overhead expenses. Maintaining a sufficient reserve in net assets without donor restrictions is critical to a nonprofit organization's financial health.

3.

Liquidity

The new standard does more than just change net asset classifications; it also requires enhanced disclosures related to the organizations liquidity (i.e., the cash you actually have available for emergencies). Organizations must now disclose both quantitative and qualitative information related to the financial assets available to meet cash needs for general expenditures within one year. To do this, you start with the current assets on the statement of financial position, and then subtract:

- Amounts subject to donor restrictions
- Amounts subject to board designations
- Amounts limited by the nature of the asset (e.g., the amount of beneficial interests or endowments not realizable within one year)

These disclosures are useful to both internal and external parties, as they provide valuable information on the financial health of the organization and its ability to meet unforeseen cash needs. Analysis of these disclosures may cause the board to consider creating a cash reserve, or it may inform management of the need to appeal for more unrestricted grants and donations. See Exhibit 3 for an example of liquidity disclosure.

While the indirect method of cash flow statements will still be allowed, the direct method is preferred.

4.

Cash Flow Statement

You may already be familiar with the two methods of cash flow statement preparation: direct and indirect. Under previous guidance, the organization would have to present a reconciliation of indirect cash flow when presenting under the direct method. However, this requirement is eliminated under the new standard in an effort to encourage direct method presentation. It is widely believed that the direct method is easier for financial statement users to understand and provides a better snapshot of how the organization spends its cash. While the indirect method will still be allowed under the new standard, direct method is preferred. See Exhibit 4 for examples of the direct method under new guidance. Additionally, another new standard (ASU 2016-18, Restricted Cash) requires that cash restricted by donors and grantors be combined with unrestricted cash in the statement of cash flows rather than as a separate reconciling item.

5. *Underwater Endowments*

An underwater endowment fund is endowment fund where the fair value of the corpus of the endowment has fallen below the original donation amount. Many endowments received in the mid-2000s were quickly underwater due to the recession in 2008, and while some may have recovered since then it is still possible that some organizations are dealing with underwater endowments. Under the old guidance, these endowments were shown as a reduction to unrestricted net assets (now net assets without donor restrictions). Under the new guidance, underwater endowments will instead be shown as a reduction in net assets with donor restrictions, which is more appropriate given the substance of the endowment. Additionally, the new standard requires disclosure of the current fair value of the underwater fund, the original gift amount, and the difference between the two (the amount of the fund deficiency). See Exhibit 5 for an example disclosure.

6. *Investment Return*

Current guidance provides two options for presenting investment expenses on the statement of activities. An organization can either net investment expenses against investment income and present as net return on investment as a component of revenues, or they can present investment expense completely separate from investment income as a component of expenses. Under the new guidance, net presentation as one line item in the "Revenue and Other Support" section of the statement of activities is required. This change also eliminates the requirement to disclose the composition of investment return and the amount of investment expense. This change encourages more comparable presentation of investment return across nonprofit organizations.

Closing Notes

The changes we've discussed, while extensive, all serve to make the financial statements of a nonprofit organization more understandable and useful to the users of those statements. However, the IRS has not yet updated the Form 990 to reflect the changes of ASU 2016-14. So while early implementation is permitted, it will save your organization some headaches to hold off on implementation until the tax forms are in line with the new financial statement requirements. While implementation may be time consuming on the front end, the result should be higher quality financial reporting, increased understanding by the board and management of the organization's financial position, and enhanced ability to inform donors and grantors on the organization's financial health.

exhibit one

	Program Services						
	Advisory	Training	Total	Management & General	Fundraising & Development	Costs of Goods Sold	Total
Grants & other assistance	$ 294,261	$ -	$ 294,261	$ -	$ -	$ -	$ 294,261
Salaries & wages	6,769,754	1,061,585	7,831,339	370,234	254,176	-	8,455,749
Employee benefits	1,398,503	310,865	1,709,368	99,963	26,222	-	1,835,553
Payroll taxes	541,580	84,927	626,507	29,619	19,823	-	675,949
Professional services	1,306,807	87,197	1,394,004	12,780	1,704	-	1,408,488
Accounting fees	-	-	-	40,073	-	-	40,073
Legal fees	-	7,939	7,939	-	-	-	7,939
Advertising & promotion	33,085	21,006	54,091	79,261	132,478	-	265,830
Office expenses	87,071	56,654	143,725	9,867	22,794	-	176,386
Information technology	37,858	606,535	644,393	12,399	14,653	-	671,445
Occupancy	446,601	29,799	476,400	14,918	55,427	-	546,745
Travel	170,957	18,283	189,240	149,292	-	-	338,532
Conferences, conventions, & meetings	32,516	66,287	98,803	11,505	-	-	110,308
Interest	387,428	-	387,428	-	9,457	-	396,885
Insurance	198,174	12,556	210,730	5,443	1,022	-	217,195
Training & development	457,617	20,659	478,276	9,113	33,669	-	521,058
Gift shop costs of goods sold	59,621	-	59,621	-	-	-	59,621
Cost of direct benefits to donors	-	-	-	-	-	12,601	12,601
Depreciation & amortization	1,147,186	74,425	1,221,611	20,112	13,960	-	1,255,683
Bad debt expense	-	-	-	16,892	-	-	16,892
Other	31,569	5,977	37,546	2,122	7,474	-	47,142
Total expenses by function	13,400,588	2,464,694	15,865,282	883,593	592,859	12,601	17,354,335
Less expenses included with revenues on the statement							
Gift shop cost of goods sold	(59,621)	-	(59,621)	-	-	-	(59,621)
Cost of direct benefits to donors	-	-	-	-	-	(12,601)	(12,601)
Total expenses included in the expense section on the statement of activities	$ 13,340,967	$ 2,464,694	$ 15,805,661	$ 883,593	$ 592,859	$ -	$ 17,282,113

exhibit two

Net Assets **[The level of detail presented here is not required, however if the information presented on the face is not sufficiently detailed, it must be included in notes.]**

Without donor restrictions		
Undesignated	3,057,607	1,370,401
Designated by the Board for operating reserve	300,000	250,00
Designated by the Board for endowment	15,511,186	14,912,222
Invested in property and equipment, net of related debt	21,150,885	20,193,878
	40,019,678	36,726,501
With donor restrictions		
Perpetual in nature	22,864,750	22,450,146
Purpose restrictions	14,228,316	10,351,233
Time-restricted for future periods	1,391,825	1,279,636
Underwater endowments	-	(42,677)
	38,484,891	34,038,338
Total net assets	78,504,569	70,764,839
Total liabilities and net assets	$ 94,314,447	$ 86,137,541

exhibit three

Note 2 - Liquidity & Availability

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of the balance sheet date, comprise the following:

Cash & cash equivalents	$ 4,851,231
Accounts receivable	312,216
Operating investments	723,006
Promises to give	985,846
Distributions from assets held under split-interest agreements	145,000
Distributions from beneficial interests in assets held by others	180,110
Endowment spending-rate distributions and appropriations	1,115,664
	$ 8,313,073

Our endowment funds consist of donor-restricted endowments and funds designated by the board as endowments. Income from donor-restricted endowments is restricted for specific purposes, with the exception of the amounts available for general use. Donor-restricted endowment funds are not available for general expenditure.

Our board-designated endowment of $15,511,186 is subject to an annual spending rate of 4.5 percent as described in Note 9. Although we do not intend to spend from this board-designated endowment (other than amounts appropriated for general expenditures as part of our Board's annual budget approval appropriation), these amounts could be made available if necessary.

As part of our liquidity management plan, we invest cash in excess of daily requirements in short-term investments, CDs, and money market funds. Occasionally, the Board designates a portion of any operating surplus to its operating reserve, which was $300,000 as of December 31, 201X.

exhibit four

	20X1	20X0
Cash Flows from Operating Activities		
Program service payments received	$ 13,410,429	$ 12,458,235
Membership receipts	373,781	355,044
Gift shop sales receipts	112,364	107,677
Receipts from federal & state contracts and grants	256,663	285,129
Contributions received, net of amounts restricted for long term purposes	4,264,113	2,647,976
Receipts from beneficial interests & assets held by others	114,989	272,402
Distributions from beneficial interests and assets held by others	182,521	155,717
Other cash receipts	101,275	82,710
Grants paid	(294,261)	(288,376)
Payments for salaries, benefits & payroll taxes	(10,964,676)	(10,734,090)
Payments to vendors	(3,935,150)	(4,086,056)
Interest paid	(441,514)	(493,767)
Net Cash from Operating Activities	3,180,534	762,601
Cash Flows from Investing Activities		
Purchase of operating investments	(275,000)	(150,000)
Proceeds from sales of operating investments	173,520	109,761
Purchases of property and equipment	(1,407,916)	(875,456)
Proceeds from sales of property and equipment	-	5,390
(Addition to) cash restricted to building project	(500,00)	-
(Addition to) withdrawal from assets held under split-interest agreements	88,476	(6,859)
(Addition to) withdrawal from endowment	541,671	(342,531)
Net Cash used for Investing Activities	(1,379,249)	(1,259,695)
Cash Flows from Financing Activities		
Collections of contributions restricted to building project	500,000	-
Collections of contributions restricted to endowment	365,963	1,891,105
Payments to beneficiaries of split-interest agreements	(76,588)	(87,219)
Proceeds from establishment of split-interest agreements	-	107,899
Net borrowings (repayments) under line of credit	(50,00)	275,000
Proceeds from insurance of bonds and notes	-	125,000
Principal payments on bonds, notes and capital leases	(205,236)	(423,568)
Net Cash used for Financing Activities	534,139	1,888,217
Net Change in Cash and Cash Equivalents	2,335,424	1,391,123
Cash and Cash Equivalents, Beginning of Year	3,485,916	2,094,793
Cash and Cash Equivalents, End of Year	$ 5,821,340	3,485,916

exhibit five

Underwater Endowment Funds with Deficiencies: From time to time, the fair value of assets associated with individual donor-restricted endowment funds may fall below the level that the donor or 82 SPMIFA requires NFP B to retain as a fund of perpetual duration. Deficiencies of this nature exist in three donor-restricted endowment funds that together have an original gift value of $3,500, a current fair value of $3,300, and a deficiency of $200 as of June 30, 20XX. These deficiencies 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 Trustees.