FASB In Focus

Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities

On August 18, 2016, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) that improves existing standards for financial statement presentation by not-for-profit organizations.

The FASB's NAC and other stakeholders told the Board that while existing standards for financial statements of not-for-profits are sound, they could be improved to provide better information to donors, grantors, creditors, and other users of financial statements.

Why Is the FASB Improving GAAP for Financial Statement Presentation by Not-for-Profits?

The FASB originally initiated this project on the basis of the recommendations made by the Not-for-Profit Advisory Committee (NAC) in 2011. This was also part of the FASB's ongoing review of Generally Accepted Accounting Principles (GAAP) standards to ensure they continue to meet the evolving needs of a dynamic financial reporting environment.

This guidance will be the first major set of changes to not-for-profit financial statement presentation standards since the issuance of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* in 1993, which established the current reporting guidance.

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Who Would Be Affected by the Changes in This ASU?

The ASU affects substantially all not-for-profits as well as donors, grantors, creditors, and others that use their financial statements.

Those not-for-profits typically include charities, foundations, private colleges and universities, nongovernmental health care providers, cultural institutions, religious organizations, and trade associations, among others.

What Kind of Outreach Did the FASB Undertake When Developing the ASU?

When developing the ASU, the FASB participated in extensive outreach activities and received significant input from a wide variety of stakeholders. Outreach activities are summarized below:

What Areas of Not-for-Profit Financial Statement Presentation Does the ASU Seek To Improve?

The ASU focuses on improving the current net asset classification requirements and information presented in financial statements and notes that is useful in assessing a not-for-profit's liquidity, financial performance, and cash flows.

More specifically, it addresses the following issues raised by stakeholders:

1. Complexity and understandability of net asset classifications
2. Deficiencies in information about liquidity and availability of resources
3. Lack of consistency in the type of information provided about expenses and investment return
4. Misunderstandings about and opportunities to enhance the utility of the statement of cash flows.

What Major Changes Does This ASU Make to These Areas of Financial Reporting?

Net Asset Classification

The ASU accomplishes the following:

- Replaces the existing three classes of net assets (unrestricted, temporarily restricted, and permanently restricted) with two new classes of net assets—*net assets with donor restrictions* and *net assets without donor restrictions*
- Retains current requirements to provide information about the nature and amounts of different types of donor-imposed restrictions, highlighting how those restrictions affect the use of resources, including their liquidity
- Changes the net asset classification of the underwater amounts of donor-restricted endowment funds and requires additional disclosures for underwater endowment funds
- Eliminates the over-time approach for the expiration of restrictions on capital gifts in favor of the placed-in-service approach, in the absence of explicit donor stipulations.

Information about Liquidity and Availability of Resources

The ASU includes some specific requirements directed at improving a financial statement user's ability to assess a not-for-profit's available financial resources and its management of liquidity and liquidity risk. Specifically, the ASU requires the following:

- Qualitative information that communicates how a not-for-profit manages its liquid available resources to meet cash needs for general expenditures within one year of the balance sheet date
- Quantitative information that communicates the availability of a not-for-profit's financial assets at the balance sheet date to meet cash needs for general expenditures within one year of the balance sheet date. Availability of a financial asset may be affected by:
  1. Its nature
  2. External limits imposed by donors, grantors, laws, and contracts with others, and
  3. Internal limits imposed by governing board decisions.

Information about Expenses and Investment Return

The ASU requires:

- All not-for-profits to provide expenses by nature and function, as well as an analysis of expenses by both nature and function. This analysis can be presented on the face of the statement of activities, as a separate statement, or in the notes to the financial statements—supplemented with enhanced disclosures about the methods used to allocate costs among functions.
- All organizations to present investment return net of all related external and direct internal expenses and eliminates the currently required disclosure of those netted expenses.

Presentation of Operating Cash Flows

The ASU allows not-for-profits to continue to present the net amount of operating cash flows using either the direct or indirect method of reporting, while no longer requiring the presentation or disclosure of the indirect method reconciliation if using the direct method.

How Will These Changes Improve Financial Reporting?

Net Asset Classification

Requiring only two (rather than three) classes of net assets to be presented on the face of financial statements will reduce complexity in financial reporting and increase the understandability of the information

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provided. This is responsive to changes in laws now allowing organizations, within the bounds of prudence, to spend from a permanently restricted endowment even though the fair value of the fund may have fallen below the endowed gift amount. Additionally, enhanced disclosures will provide information about limits placed on net assets by governing boards and donors.

Not-for-profits will now be required to use the placed-in-service approach (without specific donor restrictions stating otherwise) to report expirations of restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset. This will improve comparability and better reflects the economics of such transactions.

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Information about Liquidity and Availability of Resources

The new disclosures will provide more transparent information that will enable financial statement users to have a better understanding of how a not-for-profit manages its liquid available resources and its liquidity risks. Furthermore, the additional transparency about the nature and extent of internal and external limits on available resources will provide a foundation of information for users to help begin their assessment of a not-for-profit's liquidity and financial flexibility.

Information about Expenses and Investment Return

The reporting of expenses by both their function (required in current GAAP) and nature will add information useful to donors, grantors, creditors, and others in understanding a not-for-profit's expenses and in assessing:

1. The degree to which they are fixed or discretionary
2. How the related resources are being allocated, and
3. The costs of the services provided.

The reporting of investment return net of related expenses provides a more comparable measure of investment return across all not-for-profits, regardless of whether their investment activities:

- Are managed by internal staff, outside investment managers, volunteers, or a combination of those, or
- Employ the use of mutual funds, hedge funds, or other vehicles for which management fees are embedded in the investment return of the vehicle.

No longer requiring the disclosure of those netted expenses also eliminates the difficulties and related costs in identifying embedded fees and the resulting inconsistencies in the reported amounts of investment expenses.

Presentation of Operating Cash Flows

Continuing to allow not-for-profits to present operating cash flows using either the direct method or the indirect method retains the current flexibility and freedom in financial reporting.

Allowing the presentation of the direct method without requiring the indirect reconciliation provides an opportunity for some not-for-profits to reduce costs and to present information about cash flows in a way that may increase the understandability and its usefulness to particular types of financial statement users.

When Will the Amendments Be Effective?

The amendments in this Update are effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Application to interim financial statements is permitted but not required in the initial year of application. Early application of the amendments in this Update is permitted.

For more information about the project, please visit the FASB's website at www.fasb.org.

The views expressed in this document do not necessarily reflect the views of the FASB. Official positions of the FASB are arrived at only after extensive due process and deliberation.

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