In Brief

The nonprofit landscape has changed significantly over the past 26 years, expanding in size and scope while facing new challenges and keeping up with the overall pace of change in society. FASB's new standard on financial reporting for not-for-profit entities, Accounting Standards Update (ASU) 2016-14, has effectively updated the reporting model to better align it with the current state of the nonprofit sector. The author describes the major changes in ASU 2016-14 and how nonprofits can utilize it to provide a clearer presentation of their financial results.

The Reporting Impact of ASU 2016-14

Painting the Picture from a Nonprofit's Financial Perspective

By David M. Rottkamp

In June 1993, FASB issued Statement of Financial Accounting Standards (SFAS) 116 and 117. As a result, the accounting and reporting of financial information in a nonprofit's financial statement were vastly changed. FASB encouraged nonprofits to apply these standards immediately, but many nonprofits chose to wait until the mandatory effective date, which was two to three years out, depending on the size of the organization. The lengthy implementation period was due to the significance of the changes incorporated into the standards. Terminology changed, methodologies changed, and the presentation of financial statements changed; it was a new world in terms of how nonprofits reported their financial information. Some flexibility, however, was allowed in how financial information was reported. This flexibility led to differences in how nonprofits were permitted to report similar information within their financial statements, which created some confusion among nonprofit stakeholders.

A Changing Environment

Over the last two decades, the nonprofit sector has continued to grow, with many more nonprofits in existence today than in the early 1990s. They have become larger, more sophisticated, and more expansive, as well as expanded their program services and the range of people they serve. The impact of the sector on local and national economies has also grown. At the same time, nonprofits have faced significant financial and programmatic challenges, such as reduced revenue streams, increased service delivery, fraud, declining cash flow, and challenges attracting qualified employees. Many nonprofits have had to merge with others, reduce or close programs, or even close their doors.

Nonprofit financial statements are used by many third-party stakeholders, including donors, governments, foundations, and service recipients, for a variety of reasons, including funding, support, volunteerism, and program usage. Over time, nonprofit financial reporting has become more diverse, even among similar types of nonprofit organizations. In addition, there have been challenges in assessing a nonprofit's sustainability based on the current reporting model. This diversity has led to stakeholder confusion.

Reflecting these changes, FASB in 2016 issued Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.* Although this ASU was not drafted to address the economic and other challenges faced by modern nonprofits, FASB has nevertheless created a reporting model that provides for enhanced transparency, clarity, and consistency within the sector. The standard is not considered an overhaul, although it has created vast opinions, thoughts, challenges, and discussions. As with SFAS 116 and 117, FASB gave nonprofits up to two years to implement the changes addressed in ASU 2016-14 and develop systems, processes, and policies to address the standard. Most nonprofits have taken this time to create a new financial statement, one that "paints the picture" of who and what they are from a financial perspective. The five most significant changes in the new standard are the classification of net assets, investment return, expenses, liquidity and availability of resources, and the statement of cash flows.

Net Asset Classification

Under the SFAS 117 reporting model, a nonprofit reports its net assets in one of three classes: unrestricted, temporarily restricted, or permanently restricted. Among stakeholders, there was confusion as to whether unrestricted net assets were truly available for the nonprofit to utilize as it deemed prudent and necessary. Many times, a nonprofit did not have "free" use of unrestricted net assets; for example, a financial institution's requirement to maintain various escrow fund accounts as part of a debt obligation. Although this is reported as part of unrestricted net assets, the escrow fund accounts are not truly available for the nonprofit's operations. As such, they were limited as to use.

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Another example of confusion was the reporting of endowment funds. The original endowment corpus and its subsequent earnings are required to use both permanent and temporarily restricted net asset classifications. In recent years, many states have enacted laws that allow nonprofits to spend the original corpus of endowments. Under SFAS 117, however, the original corpus is considered permanently restricted; a disconnect was therefore created as a result of GAAP requirements and interpreted law.

Under ASU 2016-14, unrestricted net assets will be reported as "net assets without donor restrictions," and temporarily and permanently restricted net assets will be reported as "net assets with donor restrictions." This clarification allows stakeholders to better understand which net assets may be donor restricted and which are available for nonprofits to utilize. While the change in terminology is not difficult to understand and implement, nonprofits must decide if they want to further disaggregate the two classes of net assets into more discrete classes for stakeholders to see. Flexibility in presentation is still present; examples are shown in the *Exhibit.*

In addition, there will be expanded note disclosures in the areas of underwater endowments and board-designated net assets. The expanded disclosures should enhance stakeholders' understanding of financial balances.

As part of the implementation process, nonprofits should consider the following as it relates to net asset classification and the reporting format in the statements of financial position and activities:

- Aggregation or disaggregation of net assets: whether to present on face of the statement or in the notes, and how much detail in each
- Without donor restrictions: specific board designation, plant, or other designations
- With donor restrictions: time and purpose restrictions, endowments, and split interest agreements
- Statement of activities: columnar format or layer format
- Expenses: how to report by nature and function
- Operating measures: whether to report (board designations and appropriations must now be disclosed on the face of the statements or in the notes and disaggre-

Exhibit
Sample Methods of Presenting Net Assets in Nonprofit Financial Statements

Minimum presentation

Net assets:	
Without donor restrictions	$125,056
With donor restrictions	$162,268
Total net assets	$287,324

Alternative disaggregation allowed

Net assets:	
Without donor restrictions	
Undesignated	$24,931
Operating reserve	$25,000
Designated by the board for capital projects	$75,125
	$125,056
With donor restrictions	
Time restricted for future periods	$2,783
Purpose restricted	$11,066
Endowment fund	$148,419
	$162,268
Total net assets	$287,324

gated and described by type).

In addition, nonprofits must consider several potential GAAP modifications to conform to the new standard. These include—

- the reporting of an underwater endowment,
- the reporting of gifts for fixed assets or cash restricted for acquisition or construction of fixed assets, and
- board designations made by internal management.

Investment Return

ASU 2016-14 updates the manner in which a nonprofit will report investment income and related investment expenses (external and direct internal). Nonprofits must report investment return net of any external or identified direct internal investment expenses, which may not be reported as part of their overall expenses in the financial statements. This requirement is a welcome change, as many nonprofits believe that the reporting of investment fees as part of administrative expense unfairly increases their administrative spending percentage. In order to properly implement this section of the standard, nonprofits will need to determine if they have incurred any direct internal investment expenses. While unlikely for smaller nonprofits, larger nonprofits may have staff functions that develop and execute strategies and direction of their investment portfolios. If so, the nonprofit will be allowed to calculate the cost of this internal work and net the result against investment income. Finally, nonprofits are no longer required to disclose the components of investment income or investment expense. Nonprofits should consider the following with this area:

- Is there an amount to carve out of expenses, and consequently improve various expense reporting metrics?
- If direct internal amounts are allocated, are they supported by audit evidence?
- Are the amounts identified reasonable?
- Do the identified amounts relate to the development and execution of investment strategy and direction, and not basic accounting or endowment management?

Expenses

There has been vast diversity in practice related to the reporting of expenses in nonprofit financial statements. Under SFAS 117, all nonprofits were required to report expenses by function in their financial statements. As such, they were required to report total expenses by various major program activities and by their support functions, which may include administration and fundraising. Certain types of nonprofits (previously considered voluntary health and welfare organizations) were also required to report these functions by natural classification (i.e., salaries, occupancy, supplies, contracted services), thereby creating a statement of functional expenses.

The new standard requires *all* nonprofits to report an analysis of expenses by function and by natural classification. This analysis can be presented on the face of the statement of activities, in a separate statement of expenses, or in a note. The style of presentation is not mandated, thereby still allowing for flexibility. The new standard also requires nonprofits to provide qualitative disclosure about the methods used to allocate expenses among program and support functions, utilizing the new enhanced guidance regarding direct conduct or direct supervision. Similar to the other changes, nonprofits should consider the following:

- Where to report the analysis of expenses by function and nature: on the face of the statement of activities, separate statement of expenses, or in a note?
- Where is it easier understood by stakeholders?
- Whether to include expenses included in other lines within the statement of activities (i.e., salaries included in COGS)
- Whether to exclude certain expenses from the analysis (i.e., external or direct internal investment expenses)
- Cost allocations: does the current accounting policy comply with the new concepts of direct conduct or direct supervision?
- How to determine the significant expense allocation methods used and where to disclose them in the financial statements.

Liquidity and Availability of Resources

This new note disclosure captures available financial assets as of the balance sheet date to meet the cash needs for general expenditures within one year of the balance sheet date. It is a brand new disclosure and will help stakeholders understand the intersection of assets and net assets. While liquidity and availability of resources is not a new concept for nonprofits, this new disclosure requires that significant consideration be given to formal policy creation, definitions, and the inclusion or exclusion of certain financial assets. There are two key aspects to the new disclosure: a quantitative chart presenting available financial assets, and a qualitative presentation of how a nonprofit manages its liquid resources and its liquidity risk.

Managing liquid resources and liquidity risk is a practice most nonprofits address on a consistent basis. How a nonprofit translates this practice into words in its financial statements is something different. Does the organization we have a line of credit? Does it have an operating reserve? Does it have investments? How does seasonality affect cash receipts and liquidity? These questions must be addressed in order to develop a written description and policy regarding how the organization manages its risk and liquid resources. No two nonprofits are alike, and thus this consideration is very specific to each organization. Many nonprofits are specifically addressing the concept of an operating reserve so they can include it in their financial statements as part of their new liquidity policy.

The availability of financial assets as of the balance sheet date to meet the cash needs for general expenditures is contingent on several factors, including the availability of the financial asset itself, taking into account any limitations that may exist on such financial asset by an internal party (e.g., a board of directors) or an external party (e.g., donors, law, contract). These limitations reduce an asset's availability for future use. Another challenging concept is defining a "general expenditure." This will vary among nonprofits and should be clarified so stakeholders better understand the nonprofit's perspective. General expenditures may mean all expenses of the nonprofit, or only those expenses that are not paid for with restricted funds or endowment funds, and may or may not include capital-like transactions. Again, significant flexibility is afforded to nonprofits. Transparency is paramount to assist stakeholders in understanding this new disclosure.

This note provides stakeholders the ability to understand if the nonprofit has positive or negative available financial assets for future use. The need to put this into perspective within the financial statement will depend on each nonprofit and will require planning and interpretation.

Statement of Cash Flows

Nonprofits may present the statement of cash flows using the direct or indirect method. This has not changed from past GAAP; however, nonprofits that present the statement of cash flow using the direct method are no longer required to also present the indirect reconciliation as part of the statement. This reduces its length and allows for greater clarity.

Providing a Clearer Picture

Modern nonprofit stakeholders are financially sophisticated and understand the interplay between operations and fiscal management. They desire a clearer presentation of financial statements. Financial reporting that is transparent, clear, and consistent allows nonprofit stakeholders to review financial activity and determine how involved they desire to be. ASU 2016-14 enables nonprofits to tell their financial stories through their financial statements in a way that was not as evident under prior GAAP. ❑

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