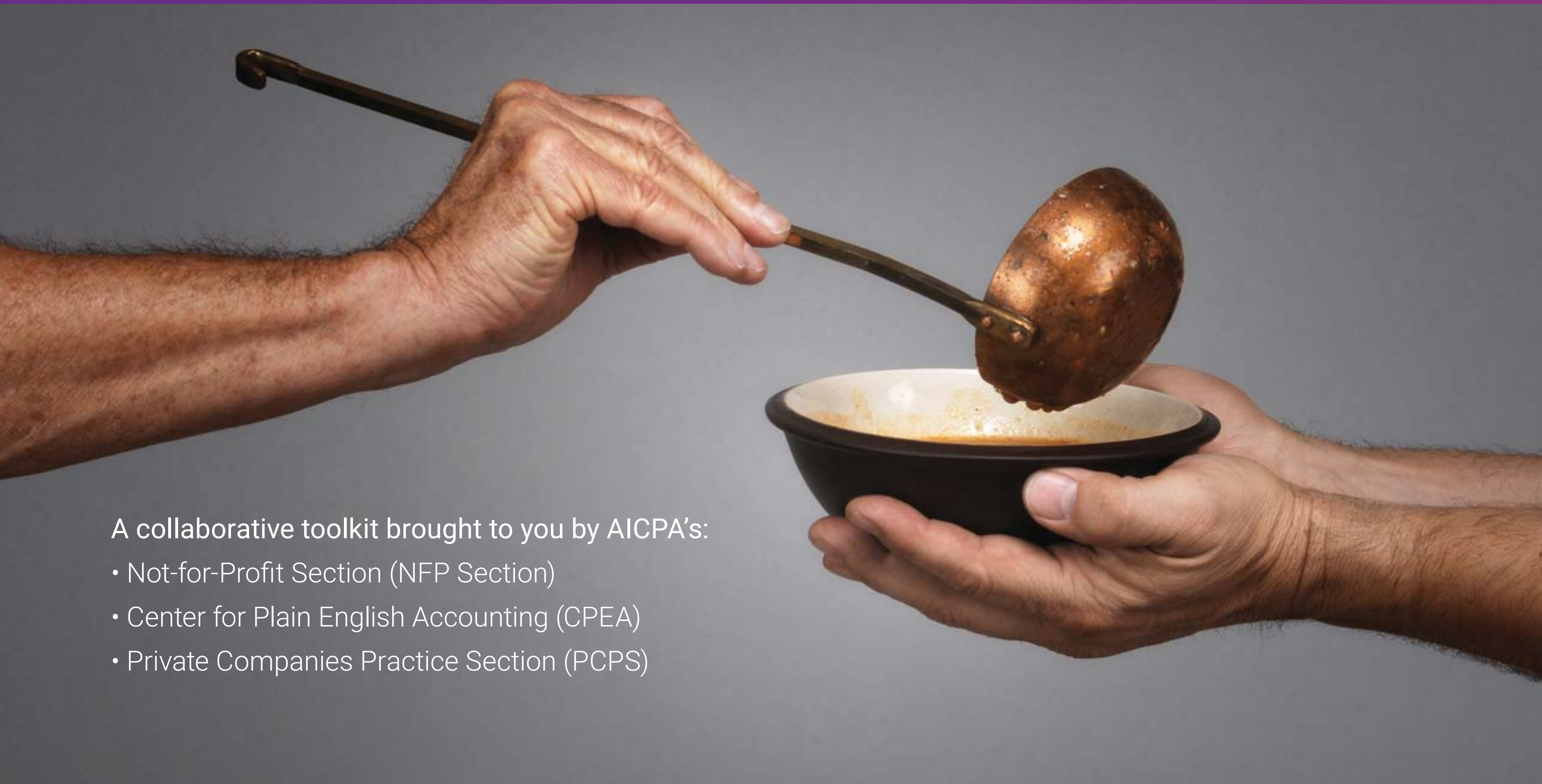
Exploring FASB's Not-for-Profit Financial Reporting Standard: ASU 2016-14

ASU 2016-14: The FASB's New NFP Standard



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ASU 2016-14
The FASB's New NFP Standard

By: Russ Madray

On August 18, 2016, the FASB issued Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.* The amendments in this ASU are intended to improve financial statement presentation by not-for-profit (NFP) organizations—a model that has existed for more than 20 years. The new guidance will affect substantially all NFPs, including charities, foundations, private colleges and universities, nongovernmental health care providers, cultural institutions, religious organizations, and trade associations, among others, and requires NFPs to improve their presentation and disclosures to provide more relevant information about their resources (and the changes in those resources) to their donors, grantors, creditors, and other users. There are qualitative and quantitative requirements in a number of areas, including net asset classes, investment return, expenses, liquidity and availability of resources, and presentation of operating cash flows. Practitioners and their NFP clients will need to be especially mindful of the enhanced and additional disclosures required by this ASU. Accordingly, our report will focus on these new disclosure requirements.

Net Asset Classification

In order to simplify the net asset classification scheme, the new guidance requires NFPs to present, on the face of the statement of financial position, the amount for each of two classes of net assets—*net assets with donor restrictions* and *net assets without donor restrictions*—as opposed to three. However, the guidance does retain current requirements to provide information about the nature and amounts of different types of donor-imposed restrictions, and also requires similar information about governing board designations. The disclosures are intended to highlight the importance of information about how those restrictions and designations affect the use of resources, including their liquidity. See the illustrative note disclosures at the end of this report for examples of these requirements.

As part of the change to net asset classification, the amendments change how endowments that have a current fair value less than the original gift amount (or amount required to be retained by donor or by law), known as “underwater” endowments, are classified; rather than reducing unrestricted net assets for amounts by which endowment funds are underwater, those amounts will be reported within net assets with donor restrictions. The amendments also require disclosure of the aggregate amount by which the funds are underwater, the original gift amount (or amount required to be maintained by the donor or law), and any governing board policy or decisions to spend, or not spend, from such funds. See the illustrative note disclosures at the end of this report for an example of this requirement.

CPEA Observation: NFPs also now will 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; the option to imply a time restriction and release the restriction over an asset’s useful life (the “over-time” approach) will no longer be permitted. This change is intended to improve comparability and better reflect the economics of such transactions.

Information about Liquidity

In order to provide more transparency, the new guidance includes requirements aimed at improving the ability of financial statement users to assess an NFP’s available financial resources and liquidity. Specifically, the amendments require disclosure of both quantitative and qualitative information about the *availability of* and *how* the NFP manages its liquid available resources to meet cash needs for general expenditures within one year of the balance sheet date. See the illustrative note disclosures at the end of this report for examples of these requirements.

CPEA Observation: While note disclosures will still be needed, presenting a classified balance sheet may be an effective way for organizations to comply with many of the new liquidity disclosure requirements.

Expense Presentation

In order to make information about expenses more comparable and useful, the new guidance requires all NFPs (not just voluntary health and welfare organizations) to provide information about their operating expenses by both nature and function—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. See the illustrative note disclosures at the end of this report for an example of this requirement.

Practice Note: While a separate statement of functional expenses is not required, it may be the most effective presentation option for NFPs with more than one program.

CPEA Observation: A net presentation of investment expenses against investment return will be required on the face of the statement of activities; external and direct internal investment expenses will be netted against the investment return. A disclosure of the components of investment expense will no longer be required.

<u>Statement of Cash Flows</u>

In a departure from the FASB's original exposure draft, which would have required the direct method, the new guidance allows NFPs to continue to present either the direct or indirect method of reporting operating cash flows. However, the presentation or disclosure of the indirect method reconciliation is no longer required if the NFP uses the direct method. The FASB hopes that the removal of the reconciliation requirement will encourage more NFPs to use the direct method.

<u>Effective Date and Transition</u>

The amendments 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 is permitted. The amendments should be initially adopted only for an annual fiscal period or for the first interim period within the fiscal year of adoption.

NFPs will apply the ASU's guidance retrospectively. If presenting comparative financial statements, an NFP can elect to omit the following information for any periods presented before the period of adoption:

- Analysis of expenses by both natural classification and functional classification (the separate presentation of expenses by functional classification and expenses by natural classification is still required). NFPs that previously were required to present a statement of functional expenses do not have the option to omit this analysis; however, they may present the comparative period information in any of the formats permitted in this ASU, consistent with the presentation in the period of adoption.
- Disclosures about liquidity and availability of resources.

Practice Note: Advise your NFP clients to discuss the new guidance with their board. Boards count on financial statements and should be a part of the process for managing implementation.

<u>What's Next?</u>

A future Phase 2 of the FASB's NFP project is slated to address additional issues, including:

- Operating measure:
  - Whether to require intermediate measure(s) in the financial statements
  - Whether and how to define such measure(s) and what items should be included
- Alignment of measures of operations in the statement of activities with measures of operations in the statement of cash flows

There is currently no expected timeframe for the completion of the second phase.

Illustrative Note Disclosures

These illustrative note disclosures, adapted from ASU 2016-14, provide examples of the following requirements from the ASU:

Note	ASU 2016-14 Requirement
Note A	Composition of net assets with donor restrictions at the end of the period and how the restrictions affect the use of resources.
Note B	Amounts and purposes of governing board designations, appropriations, and similar actions that result in self-imposed limits on the use of resources without donor-imposed restrictions as of the end of the period.
Note C	Underwater endowment funds, which include required disclosures of (1) an NFP's policy, and any actions taken during the period, concerning appropriation from underwater endowment funds, (2) the aggregate fair value of such funds, (3) the aggregate of the original gift amounts (or level required by donor or law) to be maintained, and (4) the aggregate amount by which funds are underwater (deficiencies), which are to be classified as part of net assets with donor restrictions.
Notes D & E	Quantitative information, either on the face of the balance sheet or in the notes, and additional qualitative information in the notes as necessary, that communicates the availability of an NFP's financial assets at the balance sheet date to meet cash needs for general expenditures within one year of the balance sheet date.
Notes D & E	Qualitative information that communicates how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date.

Note F	Amounts of expenses by both their natural classification and their functional classification and the method(s) used to allocate costs among program and support functions.

Note A – Net Assets with Donor Restrictions

Net assets with donor restrictions are restricted for the following purposes or periods.

<u>Subject to expenditure for specified purpose:</u>	
Program A activities:	
Purchase of equipment	$ 3,060
Research	950
Educational seminars and publications	240
Program B activities:	
Disaster relief	745
Educational seminars and publications	280
Program C activities: general	210
Buildings and equipment	2,150
Annuity trust agreements for research	2,815
	10,450
<u>Subject to the passage of time:</u>	
For periods after June 30, 2019	3,140
<u>Subject to organization spending policy and appropriation:</u>	
Investment in perpetuity (including amounts above original gift amount of $122,337), which, once appropriated, is expendable to support:	
Program A activities	33,300
Program B activities	15,820
Program C activities	16,480
Any activities of the organization	109,100
	174,700

Subject to appropriation and expenditure when a specified event occurs:	
Endowment requiring income to be added to original gift until fund's value is $2,500	2,120
Paid-up life insurance policy that will provide proceeds upon death of insured for an endowment to support general activities	80
	2,200
Not subject to appropriation or expenditure:	
Land required to be used as a recreation area	3,000
Total net assets with donor restrictions	$ 193,490

Note B – Governing Board Designations

Metropolis Community Foundation's governing board has designated, from net assets without donor restrictions of $92,600, net assets for the following purposes as of June 30, 2017.

Quasi-endowment	$ 36,600
Liquidity reserve	1,300
Total	$ 37,900

Note C – Underwater Endowments

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 the Uniform Prudent Management of Institutional Funds Act (UPMIFA) requires Metropolis Hospital to retain as a fund of perpetual duration. Deficiencies of this nature exist in 3 donor-restricted endowment funds, which 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, 2017. 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.

Metropolis Hospital has a policy that permits spending from underwater endowment funds depending on the degree to which the fund is underwater, unless otherwise precluded by donor intent or relevant laws and regulations. The governing board appropriated for expenditure $75 from underwater endowment funds during the year, which represents 3 percent of the 12-quarter moving average, not the 5 percent it generally draws from its endowment.

Note D – Availability of Financial Assets

The following reflects Metropolis Museum's financial assets as of the balance sheet date, reduced by amounts not available for general use because of contractual or donor-imposed restrictions within one year of the balance sheet date. Amounts not available include amounts set aside for long-term investing in the quasi-endowment that could be drawn upon if the governing board approves that action. However, amounts already appropriated from either the donor-restricted endowment or quasi-endowment for general expenditure within one year of the balance sheet date have not been subtracted as unavailable.

Financial assets, at year-end	$ 234,410
Less those unavailable for general expenditures within one year, due to:	
Contractual or donor-imposed restrictions:	
Restricted by donor with time or purpose restrictions	(11,940)
Subject to appropriation and satisfaction of donor restrictions	(174,700)
Investments held in annuity trust	(4,500)
Board designations:	
Quasi-endowment fund, primarily for long-term investing	(36,600)
Amounts set aside for liquidity reserve	(1,300)
Financial assets available to meet cash needs for general expenditures within one year	$ 5,370

Metropolis Museum is substantially supported by restricted contributions. Because a donor's restriction requires resources to be used in a particular manner or in a future period, Metropolis Museum must maintain sufficient resources to meet those responsibilities to its donors. Thus, financial assets may not be available for general expenditure within one year. As part of Metropolis Museum's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, Metropolis Museum invests cash in excess of daily requirements in short-term investments. Occasionally, the board designates a portion of any operating surplus to its liquidity reserve, which was $1,300 as of June 30, 2017. There is a fund established by the governing board that may be drawn upon in the event of financial distress or an immediate liquidity need resulting from events outside the typical life cycle of converting financial assets to cash or settling financial liabilities. In the event of an unanticipated liquidity need, Metropolis Museum also could draw upon $10,000 of available lines of credit (as further discussed in Note X) or its quasi-endowment fund.

Note E – Availability of Financial Assets

Metropolis Foundation financial assets available within one year of the balance sheet date for general expenditure are as follows.

Cash and cash equivalents	$ 4,575
Accounts and interest receivable	2,130
Contributions receivable	1,825
Short-term investments	1,400
Other investments appropriated for current use	10,804
	$ 20,734

Metropolis Foundation's endowment funds consist of donor-restricted endowments and a quasi-endowment. Income from donor-restricted endowments is restricted for specific purposes and, therefore, is not available for general expenditure. As described in Note Y, the quasi-endowment has a spending rate of 5 percent. $1.65 million of appropriations from the quasi-endowment will be available within the next 12 months.

As part of Metropolis Foundation's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, Metropolis Foundation invests cash in excess of daily requirements in short-term investments. To help manage unanticipated liquidity needs, Metropolis Foundation has committed lines of credit in the amount of $20 million, which it could draw upon. Additionally, Metropolis Foundation has a quasi-endowment of $33 million. Although Metropolis Foundation does not intend to spend from its quasi-endowment other than amounts appropriated for general expenditure as part of its annual budget approval and appropriation process, amounts from its quasi-endowment could be made available if necessary. However, both the quasi-endowment and donor-restricted endowments contain investments with lock-up provisions that would reduce the total investments that could be made available (see Note X for disclosures about investments).

Note F – Expenses by Nature and Function

The table below presents expenses by both their nature and their function for fiscal year 2017.

	Program Activities				Supporting Activities			
	A	B	C	Programs Subtotal	Management and General	Fund-Raising	Supporting Subtotal	Total Expenses
Salaries and benefits	$ 7,400	$3,900	$ 1,725	$ 13,025	$ 1,130	$ 960	$ 2,090	$ 15,115
Grants to other organizations	2,075	750	1,925	4,750				4,750
Supplies and travel	890	1,013	499	2,402	213	540	753	3,155
Services and professional fees	160	1,490	600	2,250	200	390	590	2,840
Office and occupancy	1,160	600	450	2,210	218	100	318	2,528
Depreciation	1,440	800	570	2,810	250	140	390	3,200
Interest	171	96	68	335	27	20	47	382
Total expenses	$13,296	$8,649	$ 5,837	$ 27,782	$ 2,038	$2,150	$ 4,188	$ 31,970

The financial statements report certain categories of expenses that are attributable to more than one program or supporting function. Therefore, these expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include depreciation, interest, and office and occupancy, which are allocated on a square-footage basis, as well as salaries and benefits, which are allocated on the basis of estimates of time and effort.

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