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New Developments Summary

FASB amends NFP financial statement presentation

ASU 2016-14 will change the face of NFP financial statements

Overview

On August 18, the FASB released ASU 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, with the goal of improving not-for-profit entity (NFP) financial statements to provide more useful information to donors, grantors, creditors, and other financial statement users. The ASU significantly changes how NFPs present net assets on the face of the financial statements, as well as requires additional disclosures for expenses by nature and function and for the liquidity and availability of resources.

The ASU represents the first major change to NFP financial statement presentation since the mid-1990s, and marks the completion of the first phase of the FASB's project related to NFP financial reporting. The second phase is focused on defining the term "operations" and aligning the presentation of measures of operations in the statement of activities with measures of operations in the statement of cash flows.

The new guidance will be effective for annual financial statements for fiscal years beginning after December 15, 2017 and for interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted.

This bulletin provides a high-level summary of ASU 2016-14, including transition guidance. NFPs should begin evaluating the ASU's impact and planning their transition to the new guidance as soon as possible.

Contents

A. Net asset classifications and disclosures

Net asset classifications

The most significant change resulting from ASU 2016-14 will transform the face of NFP financial statements by requiring entities to present two net asset classes (net assets with donor restrictions and net assets without donor restrictions) rather than three net asset classes (unrestricted, temporarily restricted, and permanently restricted). In part, this change reflects the FASB's view that the distinction between permanent and temporary restrictions has been blurred due to changes in state laws and the widespread adoption of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA). The reduction in the number of asset classes is expected to reduce the complexity and enhance the understandability of NFP financial statements.

Net assets with donor restrictions will be those subject to donor-imposed restrictions, while net assets without donor restrictions will be those not subject to donor-imposed restrictions. This distinction is important, and donor stipulations will be the only factor in determining how net assets are classified. Consistent with current guidance, management, the board, or another governing body will not be able to designate the classification of a gift as donor-restricted. Further, a board-designated endowment will be classified as part of net assets without donor restrictions.

The two required net assets classes will represent the minimum disaggregation if both apply. An NFP may choose to further disaggregate net assets into additional subclasses, such as those expected to be maintained in perpetuity, those spent over time, or those spent for a particular purpose. However, the new standard will require the total for each of the two net asset classes and total net assets to be reported on the statement of financial position.

For the statement of activities, the new guidance will permit flexibility in the presentation of the information, as long as the requirements are met. In other words, the information may be presented in a single column, in multiple columns, or in two separate statements (for example, a summary statement of changes in net assets without donor restrictions followed by a statement of changes in net assets, including net assets with donor restrictions). Each presentation has advantages and disadvantages, and an NFP should choose the presentation considered most useful to its financial statement users.

Disclosures for donor restrictions and board designations

The new two-class net asset classification system will not eliminate the requirement to disclose the various types of donor-imposed restrictions. NFPs will be able to report separate line items within net assets with donor restrictions, or in the notes to the financial statements, to distinguish between the types of donor-imposed restrictions, including those that are perpetual in nature. Types of donor restrictions to be disclosed could include, but are not limited to, the following restrictions:

- Support for a particular operating activity
- Investment for a specified term
- Use in a specified period
- Acquisition of long-lived assets

Additionally, NFPs will be required to disclose information about the nature and amounts of different types of restrictions that impact how and when, if ever, the donor-restricted net assets can be used.

The new standard will also require disclosures about the amounts and purposes of board designations of net assets without donor restrictions. Any governing board actions that result in self-imposed limits on the use of resources will also be disclosed in the notes to the financial statements.

Endowments

ASU 2016-14 includes expanded guidance on the reporting of all endowment funds, in addition to making changes to the presentation of underwater donor-restricted endowments.

In general, endowment funds can be established by either donors or a governing board and must be reported in the statement of financial position based on the existence or absence of donor-imposed restrictions. Under the new guidance, if donors contribute funds with stipulations that the resources be invested either for a long, specified period of time or in perpetuity, these funds will be considered donor-restricted endowment funds and will be reported on the statement of financial position within net assets with donor restrictions. If a governing board designates or earmarks portions of net assets without donor restrictions to be invested for a generally long, but not necessarily specified, period, these funds will be considered board-designated endowment funds and will be reported within net assets without donor restrictions.

Although rare, it is possible for a board-designated endowment fund to also include a portion of net assets with donor restrictions that were not restricted for investment in perpetuity. For example, if an NFP receives a contribution designated for a particular purpose but is unable to spend the contribution in the near term, then the board might decide to designate the funds for long-term investment, despite the absence of a donor restriction to that effect.

Investment returns on donor-restricted endowment funds generally are considered free of donor restrictions, unless their use is limited by a donor-imposed restriction or by law. In the United States, most donor-restricted endowment fund earnings are subject to UPMIFA, which extends the donor's restriction to the investment return until the funds are appropriated for expenditure by the governing board. As a result, under the new guidance these returns will be reported within net assets with donor restrictions until appropriated for expenditure. Upon appropriation, the restriction expires as long as all time and purpose restrictions have been met.

An "underwater endowment fund" is a donor-restricted fund whose value has fallen below either the original gift amount or the amount required to be maintained by the donor or by law. Current guidance requires accumulated losses to be reflected as a reduction of unrestricted net assets and to present the endowment fund at the amount required to be maintained by the donor or by law. The new standard, however, will change this presentation and require the accumulated losses to be included together with the related fund in net assets with donor restrictions. This change is intended to enhance the understandability and helpfulness of disclosures for underwater endowment funds.

In addition to the new presentation of underwater endowment funds, the new standard will require enhanced disclosures, including

- The governing board's interpretation of the relevant state UPMIFA law as to its ability to spend from underwater endowment funds
- The NFP's policy, and any actions taken during the period, concerning the appropriation of underwater endowment funds

- The aggregate amounts of the following items:
  a. Fair value of underwater endowment funds
  b. Original endowment gifts or levels required to be maintained by donor stipulation or law
  c. Amount of funds' deficiencies (that is, bullet a less b)

Placed-in-service approach

Current guidance provides an option for reporting the expiration of donor-restrictions on gifts restricted for the acquisition or construction of long-lived assets using the useful life approach, which allows NFPs to release donor-imposed restrictions over the estimated life of the assets. The new guidance will eliminate this option and, in the absence of explicit donor stipulations, NFPs will be required to use the placed-in-service approach. This approach will require that the full gift amount be reclassified from net assets with donor restrictions to net assets without donor restrictions when the acquired or constructed asset is placed in service. This guidance will apply to both purpose-restricted contributions of long-lived assets for which the donor did not stipulate how long the assets must be used, as well as the contribution of cash or similar liquid assets restricted for the acquisition or construction of long-lived assets.

The new guidance includes an exception to the placed-in-service requirement if a donor restriction extends beyond the point when the asset is placed in service. For example, if a donor specifies that the acquired property, plant, or equipment must be used for a specified period of time, the restriction would expire over the period of time that the asset is used.

B. Reporting of expenses

Functional expenses

Under existing guidance, the analysis of expenses by both natural classification and functional classification is required only for voluntary health and welfare organizations. In ASU 2016-14, however, the FASB expanded this requirement to apply to all NFPs.

The new standard will require an analysis of expenses by function and nature to be presented in one location in the financial statements, whether in the notes or in a separate financial statement. Expenses will be disaggregated by functional expense category, for example, major classes of program services and supporting activities. Within each functional class, expenses will be further disaggregated by their natural expense classifications, such as salaries, rent, supplies, and depreciation. Investment expenses, gains and losses, or other items that for-profit entities typically report in other comprehensive income will not be included in this expense analysis.

Furthermore, a qualitative description of the method(s) used to allocate expenses among programs and support functions will be included in the notes to the financial statements.

Example: Analysis of functional expenses

The table below serves as an illustration of how expenses might be presented by both nature and function in the financial statements.

	Program activities				Supporting activities			
	A	B	C	Programs subtotal	MG&A	Fund-raising	Support subtotal	Total expenses
Salaries/benefits	$ X	$ X	$ X	$X	$ X	$ X	$X	$X
Rent/utilities	X	X	X	X	X	X	X	X
Professional fees	X	X	X	X	X	X	X	X
Supplies	X	X	X	X	X	X	X	X
Depreciation	X	X	X	X	X	X	X	X
Interest	X	X	X	X	X	X	X	X
Total expenses	$ X	$ X	$ X	$X	$ X	$ X	$X	$X

Investment returns

The new ASU will require NFPs to report investment returns net of related investment expenses, including both external and direct internal investment expenses. The purpose of the new guidance is to provide a more comparable measure of investment returns across all NFPs, regardless of whether their investment activities are managed by internal staff or outside investment managers. The amendments will also eliminate the current difficulties and related costs of identifying and separately accounting for embedded fees often included in investment vehicles such as mutual funds and hedge funds. The net presentation of investment returns means that expenses will be included in the net asset categories in which investment returns are reported, that is, net assets with or without donor restrictions.

Direct internal investment expenses are those involved in the direct conduct or supervision of strategic and tactical activities that generate investment returns. These activities may include salaries, benefits, travel, or other personnel costs incurred by individuals responsible for the development and execution of the investment strategy, as well as costs associated with investment management or with the supervision, selection, and monitoring of external investment management firms. Direct internal investment expenses do not include items that do not directly contribute to generating investment returns, such as costs associated with unitization or other similar aspects of endowment management.

Practical insight: Allocating internal costs

NFPs are advised to exercise caution when allocating costs to investment expenses under the new guidance. Direct internal investment expenses are intended to fall under a relatively narrow definition and should include only those that directly contribute to generating investment returns.

For example, such costs would not include allocated general and administrative costs, such as bookkeeping or accounting functions.

An NFP will be permitted to report investment returns on separate line items by portfolio if each line item relates to a portfolio that is either managed differently or derived from different sources. For example, net returns on invested operating cash may be presented separately from net returns on endowments. Additionally, amounts of net investment returns appropriated for spending may be separately presented from returns in excess of amounts appropriated for spending.

C. Liquidity and availability of resources

In order to enhance the usefulness of the financial statements, the new standard will require new disclosures of qualitative and quantitative information about the liquidity and availability of resources.

Qualitative disclosures

NFPs will be required to qualitatively describe in the notes to the financial statements information that is useful in assessing the liquidity of resources or the maturity of assets and liabilities, as well as how they manage liquid resources available to meet cash needs for general expenditures within a year of the date of the statement of financial position.

Quantitative disclosures

The new ASU will also require NFPs to disclose the availability of financial assets as of the date of the statement of financial position to meet cash needs for general expenditures within one year. This information may be disclosed either in the notes or on the face of the statement of financial position (for example, classifying assets and liabilities as current and noncurrent, or sequencing assets and liabilities based on nearness of conversion to cash or reaching maturity), with additional qualitative information included in the notes, as necessary. The additional disclosures will include information about the availability of financial assets due to their nature; external limits imposed by donors, laws, and contracts; and internal limitations.

D. Statement of cash flows

After much deliberation, the FASB decided to continue to allow NFPs to choose either the direct or indirect method of reporting cash flows. The Board amended the guidance, however, to remove the requirement to provide a reconciliation to the indirect method when the direct method is used.

Practical insight: Statement of cash flows

Although ASU 2016-14 will not require NFPs to use the direct method in reporting cash flows, the Board is considering a project to improve overall guidance for the cash flows statement (including classification) across all industries. This means that there could be changes in this guidance at a future date.

E. FASB's Phase 2: NFP operations and operating measures

The initial proposal for this ASU included requiring NFPs to present two intermediate measures of operations associated with changes in net assets without donor restrictions: operating results before transfers and an operating excess (deficit) after transfers. After receiving significant feedback on this proposal, the Board chose to address these proposed changes separately in a second phase of its NFP financial reporting project to allow for a timely release of ASU 2016-14. Although there are no required changes at this time, if an NFP elects to present measures of operations, ASU 2016-14 provides examples that illustrate

- An intermediate measure of operating revenues and support in excess of operating expenses
- Contributions designated by the board for capital projects or endowment as a transfer from operating to nonoperating on the statement of activities
- Investment returns appropriated for operations as a transfer from nonoperating to operating activities

Phase two of the NFP project is ongoing and is expected to

- Address whether and how to define the term *operations*
- Align measures of operations in the statement of activities with measures of operations in the statement of cash flows
- Consider additional or alternative disaggregation or classification approaches (compared to the current operating and nonoperating classification scheme)
- Consider requiring business-oriented health care NFPs to disaggregate by segment, instead of reporting expenses in the current analysis by natural and functional classification

NFPs may benefit from monitoring the Board's ongoing deliberations of potential changes to how operating results are presented in the financial statements.

F. Effective date and transition

The amendments will be effective for fiscal years beginning after December 15, 2017 and for interim periods, if applicable, within fiscal years beginning after December 15, 2018. Initial adoption should be for an annual period or the first interim period within the year of adoption. Early adoption is permitted.

NFPs will be required to apply a retrospective transition approach in the year the new guidance is first applied. This means that NFPs will apply amendments in this ASU to each period presented in the financial statements. However, an NFP presenting comparative financial statements will have the option to omit two of the amendments for periods presented before the period of adoption:

- The analysis of expenses by both natural and functional classifications will not be required for the prior period. This exception applies only to those NFPs that were not previously required to present the statement of functional expenses. Health and welfare organizations therefore do not have the option to omit this analysis.
- Disclosures about liquidity and availability of resources will not need to be included for the period prior to adoption.