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A CLEARER VIEW:

ASU NO. 2016-14

New FASB Standards for Not-for-Profits

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INTRODUCTION & BACKGROUND

As a not-for-profit organization, the ability to present your financial "story" clearly and concisely is important to many of your stakeholders, including donors, development officers and the governing board. Your financials need to make sense to those who impact governance, financing, fundraising and long- and short-term decision making.

The Financial Accounting Standards Board (FASB) has issued the first changes to accounting standards for NFPs in more than 20 years. Accounting Standards Update (ASU) No. 2016-14, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities affects nearly every NFP classification including charities, foundations, private colleges and universities, non-governmental healthcare providers, cultural institutions, religious organizations and trade associations.

Although the standards are wide-sweeping, they are designed to ultimately simplify financial reporting. They also present a unique opportunity for your organization to improve efficiencies and facilitate more informed decision making. NFP organizations can leverage the new FASB requirements to their benefit with some advance planning. This guide explains the new standards in detail, and provides guidance on how to leverage them to your organization's benefit.

Why new FASB standards?

In order to fully understand the intention, or goal, of the new ASU it helps to know a little bit about why and how the FASB decided to issue reporting changes after more than two decades of established procedure.

Currently, financial statements for NFPs are prepared according to guidance originally published in 1993 (Statement of Financial Accounting Standards No. 117, Financial Statements of Not- for-Profit Organizations). While the FASB believes that this reporting model remains sound, stakeholders have expressed concerns regarding several areas. These concerns include:

- The complexity of net asset classification and its impact on "understandability"
- Deficiencies in information about an organization's liquidity and the availability of its resources
- Lack of consistency across organizations in the types of information provided about expenses and investment returns
- Misunderstanding about the statement of cash flows

To address these concerns, the FASB issued an Exposure Draft, Presentation of Financial Statements of Not-for-Profit Entities in April 2015. After

receiving an unusual amount of feedback, much of it negative, the FASB decided to split its deliberations into two phases. The issuance of ASU No. 2016-14 represents the conclusion of Phase I. The FASB has not yet announced a timeline for the second phase, which will focus on certain issues considered more challenging.

To help make financial reporting more straightforward for NFP organizations, ASU 2016-14 aims to provide improved classification of net assets and the information presented in the financial statements and footnotes about an organization's liquidity, financial performance and cash flows. As a result, stakeholders (such as donors, grantors and creditors) should find it easier to understand how NFPs manage their funds. Done effectively, these changes could have a positive impact on business development as well as the organization's overall management and governance.

When do the new standards take effect?

The new standards take effect December 15, 2017. If your organization is on a calendar year, then the new standards will apply beginning in 2018. If your organization is on a fiscal year, then the new standards will apply for annual periods ending in 2019.

If your organization adopts the new standards ahead of time, all the better as early adoption provides an opportunity to test new reporting methods and fine-tune supporting operations prior to the official beginning of the regulatory period.

Tell me more. How do the new standards change my current reporting procedures?

Overall, the changes in reporting brought about by ASU 2016-14 impact four major areas including:

1. New net asset classifications
2. Information about liquidity & availability of resources
3. Information about expenses and investment returns
4. Presentation of operating cash flows

To ensure you are getting the maximum benefit out of the opportunity presented by the new standards, you'll want to first understand exactly what the standard prescribes and how it may impact your organization. This resource guide explains these changes to reporting procedures in detail. Read on for a deeper dive into ASU No. 2016-14.

WHAT'S NEW

New Net Asset Classifications

With the growing complexity in the regulatory environment that affects NFPs, simplification of net asset classifications is a breath of fresh air. Previously, organizations were required to present unrestricted, temporarily restricted and permanently restricted net assets for financial reporting purposes. These three categories have caused confusion for users of financial statements as well as accountants. ASU No. 2016-14 simplifies net asset reporting by utilizing only two classifications:

1. Net assets with donor restrictions
2. Net assets without donor restrictions

Simply put, net assets previously disclosed as temporarily restricted and permanently restricted will now be condensed into one category – net assets with donor restrictions. The combination of these two classifications now simplifies the face of financial statements and all related disclosures, including the nature of net asset composition and endowment disclosures. The change also reduces the administrative burden to prepare all of the previously required detail for financial reporting purposes.

Organizations should still separately track contributions received with differing restrictions, whether those contributions are to be maintained in perpetuity or utilized for a specific purpose, or over a period of time as those specified donor restrictions still exist.

The new ASU also updates current standards for endowments, including the need for organizations to "assess the relevant facts and circumstances for their endowment gifts and their relevant laws to determine the classification of endowment funds" within the new reporting model. With that in mind, organizations do still have the option to further "disaggregate net assets with donor restrictions between those expected to be maintained in perpetuity and those expected to be spent over time or for a particular purpose" (previously the temporarily and permanently restricted classifications). The organization is merely required to summarize those disaggregated amounts to the two net asset classifications on the statement of financial position.

The new approach recognizes changes in the law that now allow organizations to spend from a permanently restricted endowment even if its fair value has fallen below the original endowed gift amount. Such "underwater" endowments will now be classified as net assets with donor restrictions, rather than the current presentation as unrestricted net assets. The guidance also requires expanded disclosures regarding underwater endowments.

In addition, the new standard eliminates the current "over-time" method for handling the expiration of restrictions on gifts used to purchase or build long-lived assets such as buildings. Not-for-profits must use the placed-in-service approach (in the absence of explicit donor stipulations to the contrary.)

In other words, NFPs must reclassify these gifts as net assets without donor restrictions when the asset is placed in service, rather than over the asset's useful life. As a result, organizations won't be able to match the depreciation expense with the release of these restricted net assets unless stipulated by the donor.

What about unrestricted net assets?

Not much has changed for this classification beyond the label "net assets without restrictions." This classification includes revenues received without any restrictions imposed by a donor. When a donor restriction has expired, those net assets are still released and reclassified as net assets without restrictions.

Information About Liquidity & Availability of Resources

While everyone can agree on the importance of information about liquidity and availability of resources, there is much debate about the manner in which the information is provided. ASU No. 2016-14 sets forth new requirements that help users of financial statements to better understand the NFP's available resources. The new standard addresses liquidity risk by requiring:

1. Qualitative information that indicates how the NFP manages its liquid available resources to meet cash needs for general expenses within one year, and
2. Quantitative information that indicates the availability of financial assets on the statement of financial position to meet cash needs for general expenses within one year.

An asset's availability may be affected by its nature, which could be characterized by any of the following:

- External limits imposed by donors, grantors, laws and contracts with others
- Internal limits imposed by board decisions
- Board designations or other internal limits on the use of net assets without donor restrictions

New disclosures aimed at improving financial reporting transparency should enable financial statement users to better understand the organization's liquidity risk, as well as the resources available to help manage these risks. NFP organizations will need to look beyond the classified statement of financial position and provide additional disclosures to show how restrictions imposed by donors, grantors, laws, contracts or board decisions could impact the availability of financial assets. These disclosures could be problematic as they may add additional time and cost to the preparation of GAAP financial statements under audit. In addition, the organization must be able to substantiate the information they provide.

Information About Expenses

To provide a clearer picture of a NFP's spending, ASU No. 2016-14 requires the reporting of expenses by both function (which is already required) and nature – in one location. This presentation shows how the nature of expenses relates to the functions of those expenses. Examples include salaries and wages, employee benefits, supplies and rent as related to program services and supporting activities. These can be presented on a separate statement, on the statement of activities or in the footnotes. In addition, the standard calls for enhanced disclosures regarding specific methods used to allocate costs among program and support functions.

Voluntary health and welfare organizations have been subject to this for a number of years through a requirement to present a Statement of Functional Expenses. To provide more consistency in reporting and to improve the usefulness of the presented information, FASB has broadened this requirement to include all NFP financial statements. In addition, the ASU enhances the disclosure requirements around the methods used to allocate costs among the functional categories to provide more useful information about the effects of these methods.

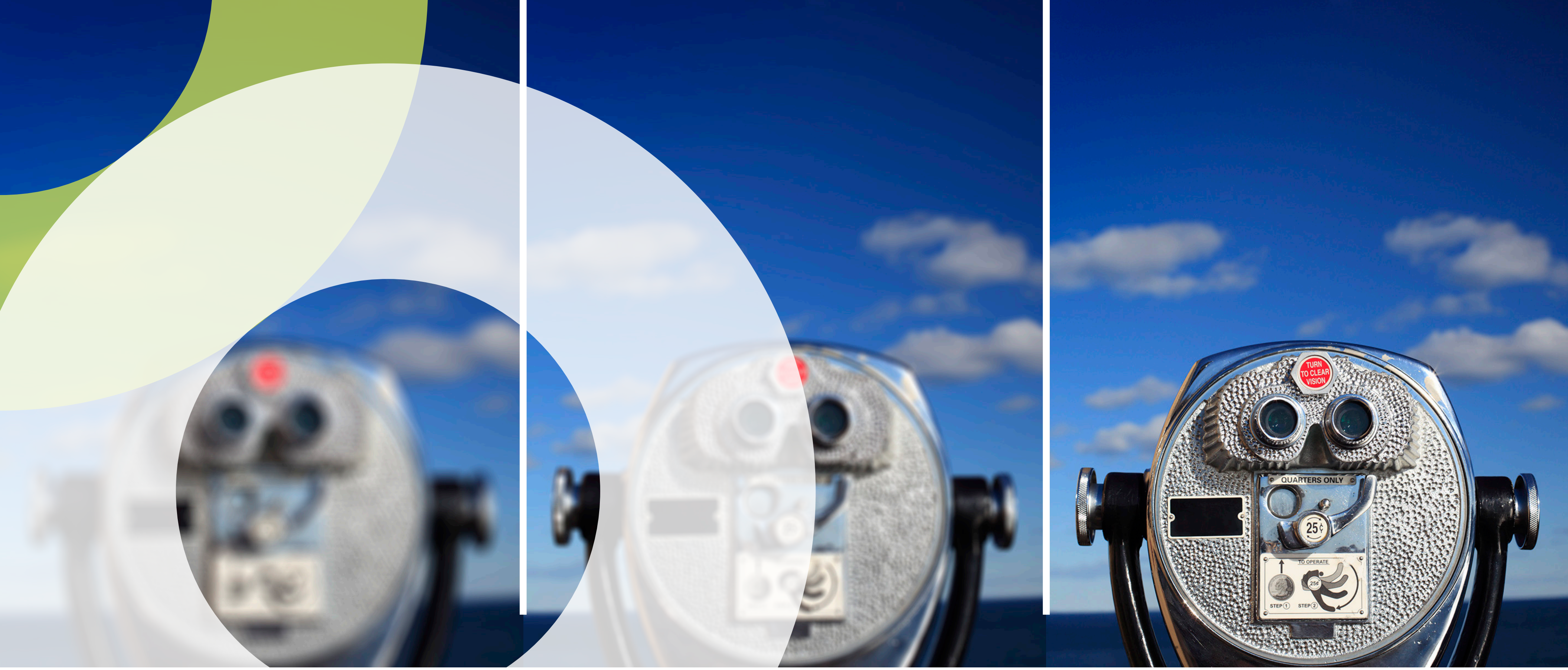
What does this mean for your organization?

Upon implementation, an organization's financial statements will need to present a matrix, which shows all expenses incurred by both functional and natural categories in one location. These can be reported on the face of the Statement of Activities, a separate Statement of Functional Expenses or a footnote to the presentation requirements. This information will help financial statement users assess the degree to which expenses are fixed or discretionary, how the related resources are allocated and the costs of services provided.

Second, you will be required to disclose the methodology used to allocate costs among program and support functions as a footnote to the analysis of functional expenses by natural categories. In particular, the ASU requires disclosure of the specific base used to allocate costs for each natural category.

FASB has acknowledged that the new requirements will increase the burden on NFP organizations that present financial statements as they ensure that the allocation methods are consistently applied across periods. While the amount of documentation required will increase, the ASU actually reduces other reporting requirements.

The analysis of functional expenses by natural categories must be presented for each year covered by the financial statements, which may complicate application of the new requirement. While early implementation is allowed, the best timing may vary based on your organization's situation.



Information About Investment Returns

Prior to the issuance of ASU 2016-14, lack of consistency across the NFP industry in reporting investment returns presented some problems for financial statement users. The new standard seeks to remedy that. Going forward, all investment expenses, both direct internal and external, are required to be netted with investment returns on the face of the financial statements. This change eliminates the previously required disclosure that breaks out the components of the investment returns. There will be no effect to the bottom line of the financial statements.

This new presentation will provide consistency and easier comparability among NFPs, regardless of whether they are using internal investment managers or have hired external investment groups. Additionally, this change provides a cost savings to the NFP, as it eliminates the added resources needed to determine embedded fees with investments held by external managers. It also eliminates the additional disclosure requirement for netted investment expenses.

Presentation of Cash Flow

One of the more controversial components of the FASB's Exposure Draft of 2015 was its requirement that organizations use the "direct method," not the "indirect method" to present net cash from operations on the statement of cash flows. While the two methods produce the same results, the direct method provides more understandable information to financial statement users.

ASU 2016-14 allows NFPs to use either method. However, if an organization opts to use the direct method, it will no longer need to include an indirect method reconciliation or incur the added costs that result. This change allows for greater flexibility in determining which method provides the clearest picture of the NFPs operating cash flows. The goal of this change is to provide flexibility, but also to encourage more NFPs to use the direct method.

WHAT SHOULD MY ORGANIZATION DO NOW TO PREPARE?

It's not too early to begin implementing ASU 2016-14. In fact, the earlier you start to transition, the better. Make the most of the interim time before the effective date for your organization by establishing a "trial phase" to work out any kinks before the official reporting period begins. Your CSH advisor can help you leverage maximum value from standard implementation. If you have questions about how the new standard will affect your not-for-profit, please contact us.

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