

FASB In Focus

Proposed Accounting Standards Update

Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954): Presentation of Financial Statements of Not-for-Profit Entities

On April 22, 2015, the Financial Accounting Standards Board (FASB) issued a proposed Accounting Standards Update (ASU) intended to improve existing standards for financial statement presentation by not-for-profit organizations (NFPs).

Why Is the FASB Improving GAAP for Financial Statement Presentation by NFPs?

The FASB originally initiated a project as part of its ongoing review of GAAP standards to ensure they continue to meet the needs of a changing financial reporting environment. For the most part, the current reporting guidance was established in 1993, when the Board issued FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.

The FASB's Not-for-Profit Advisory Committee (NAC) and other stakeholders told the Board that while existing standards for financial statements of NFPs are sound, they could be improved to provide better information to donors, creditors, and other users of financial statements.

Who Would Be Affected by the Changes in This Proposed ASU?

The proposed ASU would affect substantially all NFPs as well as creditors, donors, grantors, and others that use their financial statements. Those NFPs typically include charities, foundations, private colleges and universities, nongovernmental health care providers, cultural institutions, religious organizations, and trade associations, among others.

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

The proposed ASU focuses on improving the current net asset classification requirements and information presented in financial statements and notes that are useful in assessing an NFP'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.** Currently, GAAP requires NFPs to present on the face of the statement of financial position the amount for each of three classes of net assets based on the absence or presence of donor-imposed restrictions and the nature of those restrictions: unrestricted, temporarily restricted, and permanently restricted. In some cases, these classifications have resulted in confusion about whether and how limits imposed by laws, contracts, and governing boards affect an NFP's classes of net assets, and how those kinds of limits and donor restrictions affect liquidity, financial performance, and cash flows. The term *unrestricted net assets* also has been misunderstood by some stakeholders. Another source of confusion is the way underwater donor-restricted endowment funds

are classified. An endowment fund is an established fund of cash, securities, or other assets to provide income for the maintenance of an NFP. Generally, an underwater endowment fund is one for which the current fair value of the fund is below its original gift amount or other amount that the NFP is required to maintain by the donor or by law. According to existing GAAP, rather than reporting the amounts by which an endowment fund has fallen below its original gift within the permanently restricted class of net assets, that amount must be disaggregated from the fund and presented within unrestricted net assets. This too has created complexity and additional confusion among preparers and users of financial statements.

2. **Inconsistent reporting of intermediate measures of operations in the statement of activities.** Existing GAAP does not define and neither requires nor precludes the reporting of intermediate measures of operations. As a result, practices among NFPs are vastly different. Many do not report such a measure, and those reporting an operating measure define it in different ways. In addition, the definition used for reporting operating activities in a statement of activities is inconsistent with the definition for reporting operating cash flows in the statement of cash flows, which results in difficulties communicating and assessing an NFP's financial performance.

3. **Lack of consistency in the type of information provided about expenses of a period.** For example, some NFPs provide information about operating expenses by both function and nature, but others do not. Some NFPs report investment return net of investment expenses on the statement of activities, while others report investment expenses separately.
4. **Misunderstandings about—and opportunities to enhance—the utility of the statement of cash flows.** This is particularly true in the reporting of operating cash flows.

How Does the Proposed ASU Seek to Improve These Areas of Financial Reporting?

Net Asset Classification

The proposed ASU would:

- Require 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.
- Retain current requirements to provide information about the nature and amounts of different types of donor-imposed restrictions, and also require similar information about governing board designations, highlighting the importance of information about how those restrictions and designations affect the use of resources, including their liquidity.

- Change how the underwater amounts of donor-restricted endowment funds are classified; those amounts would be classified in net assets with donor restrictions. The proposed ASU would 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. The latter could also help in assessing liquidity.

Liquidity Information

The proposed ASU includes some specific requirements directed at improving a financial statement user's ability to assess an NFP's liquidity and how it is being managed by the NFP. Specifically, the proposed ASU would require the disclosure of both quantitative and qualitative information about the liquidity of assets and near-term demands for cash as of the reporting date, including:

- The amount of financial assets at the end of each period and
- The amount that, because of restrictions or limitations on their use, is not available to meet the cash needs in the near term
- The amount of financial liabilities that require cash in the near term, and

- The way an organization manages its liquidity, including the time horizon it uses in the management of liquidity.

Statement of Activities

The proposed ASU would require:

- Presentation on the face of the statement of activities of the amount of the change in each of the two classes of net assets noted above, rather than that of the currently required change for each of three classes. An NFP would continue to report the currently required amount of the change in total net assets for the period.
- Presentation of two measures (subtotals) of operating activities associated with changes in net assets without donor restrictions. Those subtotals would reflect operating activities for the period, which would be distinguished from other activities on the basis of whether the resource inflows and outflows are from or directed at carrying out an NFP's purpose for existence and available for current-period operating activities.
 - a. First subtotal: would include operating revenues, support, expenses, gains and losses that are without donor-imposed restrictions and is before internal transfers
 - b. Second subtotal: would include the effects of internal transfers resulting from governing board designations, appropriations, and

similar actions that place (or remove) self-imposed limits on the use of resources that make them unavailable (or available) for current-period operating activities.

- 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.
- All NFPs to present investment return net of related external and direct internal expenses.

Presentation of Operating Cash Flows

The proposed ASU would require two fundamental changes to increase the understandability and usefulness of the statement of cash flows:

- Present on the face of the statement the net amount for operating cash flows using the direct method of reporting rather than the indirect method. (The latter would be permitted but no longer required.)
- Classify certain cash flows differently from current guidance, as follows:
 - Classify as operating cash flows (rather than as investing cash flows) those

cash flows resulting from (1) purchases of long-lived assets, (2) contributions restricted to acquire long-lived assets, and (3) sales of long-lived assets.

- Classify as financing cash flows (rather than as operating cash flows) those cash flows resulting from payments of interest on borrowings, including cash management activities.
- Classify as investing cash flows (rather than as operating cash flows) those cash flows resulting from receipts of interest and dividends on loans and investments other than those made for programmatic purposes.

How Would These Proposed Changes Improve Financial Reporting?

Net Asset Classifications

The Board believes that requiring only two (rather than three) classes of net assets (and changes in them) to be presented on the face of financial statements will reduce complexity in financial reporting and increase the understandability of the information provided. This is especially true because changes in laws now allow 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 would provide information about limits placed on net assets by governing boards and donors.

Statement of Activities

Requiring all NFPs to present more standardized intermediate measures of operations would be helpful in communicating the financial performance of NFPs in ways that are more comparable—and thus more understandable—to creditors, donors, and other external users. The proposed requirement for a subtotal before internal transfers resulting from governing board actions should result in greater comparability across the many diverse types of NFPs and may also be useful to governing boards and managers of NFPs in benchmarking their financial performance to peers within their industries. The reporting of internal transfers after that subtotal and within operations would enable NFPs to better “tell their financial story” by providing important information about how the NFP is managed.

The reporting of expenses by both their function and nature will add information useful to creditors, donors, grantors and others in understanding an NFP’s expenses and in assessing (1) the degree to which they are fixed or discretionary, (2) how the related resources are being allocated, and (c) the costs of the services provided.

The reporting of investment return net of related expenses would provide a more comparable measure of investment return across all NFPs, regardless of whether their investment activities (1) are managed by internal staff, outside investment managers, volunteers, or a combination,

or (2) employ the use of mutual funds, hedge funds, or other vehicles for which management fees are embedded in the investment return of the vehicle.

Cash Flows

Requiring an NFP to present operating cash flows using the direct method would increase the understandability of information about cash flows and its usefulness to an NFP’s creditors, donors, and other users, including members of its governing board. Moreover, no longer requiring those cash flows to be presented using the indirect (reconciliation) method would eliminate the costs to provide and explain information that often is found to be confusing and misunderstood by some users of NFP financial statements.

Reclassifying items reported in a cash flow statement to better align them with this Update’s proposed notion that operating activities reported in the statement of activities—which is based on whether “resource inflows and outflows are from or directed at carrying out an NFP’s purpose for existence”—is expected to increase understandability and also help communicate financial performance.

Enhanced Disclosures

Requiring enhanced disclosures would improve the usefulness of information helpful in assessing a number of areas, among them:

- The effects of limits placed on the use of resources by an NFP’s governing board and by its donors, particularly limits

that impinge on an NFP’s liquidity, financial flexibility, and ability to allocate resources toward needed services

- The methods governing boards and their designees use to manage liquidity to meet near-term demands for cash, and
- The types of resources used (expenses by nature) and how they are allocated (expenses by function) in carrying out operating activities, including about the methods used for allocating expenses.

When Would the Amendments Be Effective?

The effective date, and whether it should be the same for all NFPs, as well as whether early adoption would be permitted, will be determined by the Board after considering stakeholders’ feedback on this proposed Update.

What Kind of Feedback Is the Board Seeking from Stakeholders?

The Board invites individuals and organizations to review and comment on all matters in this proposed ASU—particularly on questions for respondents, including suggesting alternatives that might increase the expected benefits, minimize complexities, and reduce costs. Instructions on how to submit comments are contained in the proposed ASU. All written comments are requested by August 20, 2015.

HIGHLIGHTS OF KEY PROPOSED CHANGES

Area	Current GAAP	Proposed Changes
Net Asset Classifications	<ul style="list-style-type: none"> • Three classifications: unrestricted, temporarily restricted, permanently restricted • Underwater endowment amounts reported in unrestricted net assets. 	<ul style="list-style-type: none"> • Two classifications: Without donor restrictions, with donor restrictions • Underwater endowment amounts reported in net assets with donor restrictions, with enhanced disclosure.
Statement of Activities	<ul style="list-style-type: none"> • Present the amounts of the net change in three classes of net assets and of total net assets. 	<ul style="list-style-type: none"> • Present the amounts of the net change in two classes of net assets and of total net assets • Present two measures of operating activities (before and after internal transfers) both of which are within changes in net assets without donor restrictions • Present information about expense by function, nature, or both with enhanced disclosure in notes if both are not on the face of the statement • Present investment return net of related investment expenses.
Cash Flows	<ul style="list-style-type: none"> • Present the net amount for operating cash flows using the indirect (reconciliation) method of reporting, with additional presentation of the direct method permitted. 	<ul style="list-style-type: none"> • Present the net amount for operating cash flows using the direct method of reporting, with additional presentation of the indirect method permitted but no longer required • Certain items reclassified among cash flow categories to improve alignment with statement of activities.
Liquidity		<ul style="list-style-type: none"> • Enhanced disclosures.

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

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