CONNECT COLLABORATE Innovate

# Changes in Nonprofit Financial Statements

## CLA National Association Conference

# Session Objective(s)

- Summarize the proposed changes and impact to new accounting standards
- Discuss and understand:
  - NFP Reporting Model ASU Update
  - Impact of Lease Standard
  - Impact of Revenue Recognition Standard
  - Effective and Pending Standards
- Q&A

# Not-for-Profit Reporting Model

# Effective Dates and Transition



- Effective date: fiscal years "beginning" after December 15, 2017
  - 12/31/18 or 6/30/19
- Early application is permitted
- Application on a retrospective basis
- If comparative financial statements are presented option to omit the following for periods presented before the year of adoption:
  - Expenses by functional and natural classification
  - Disclosures about liquidity and availability of resources
- Year of application
  - Disclose nature of any reclassifications or restatements and their effects, if any, on changes in net assets classes for each year presented

# Project Goals

- Update, not overhaul, the current model
- Provide more useful information to donors, grantors, creditors, and others
- Improve the current net asset classification requirements
- Improve the information presented in financial statements and notes about a NFPs liquidity, financial performance, expenses, and cash flows.
- Better enable NFPs to “tell their financial story”

# Changes Intended to Address

- Complexities with the current three classes of net assets
- Inconsistencies in reporting of financial performance measures
- Deficiencies in transparency and utility of information regarding liquidity
- Inconsistencies in reporting of expenses by function and nature
- Misunderstandings in presentation of cash flows information

# Two Phase Project:
# Phase 1 – ASU 2016-14



- Net Assets
  - Classifications
  - Underwater endowments
  - Disclosures of board designations
  - Expirations of capital restrictions
- Investment Returns
  - Netting investment income and expenses and elimination of disclosure on netted expenses
- Expenses
  - Expenses by nature/analysis of functional expenses
  - Enhanced disclosures of cost allocations

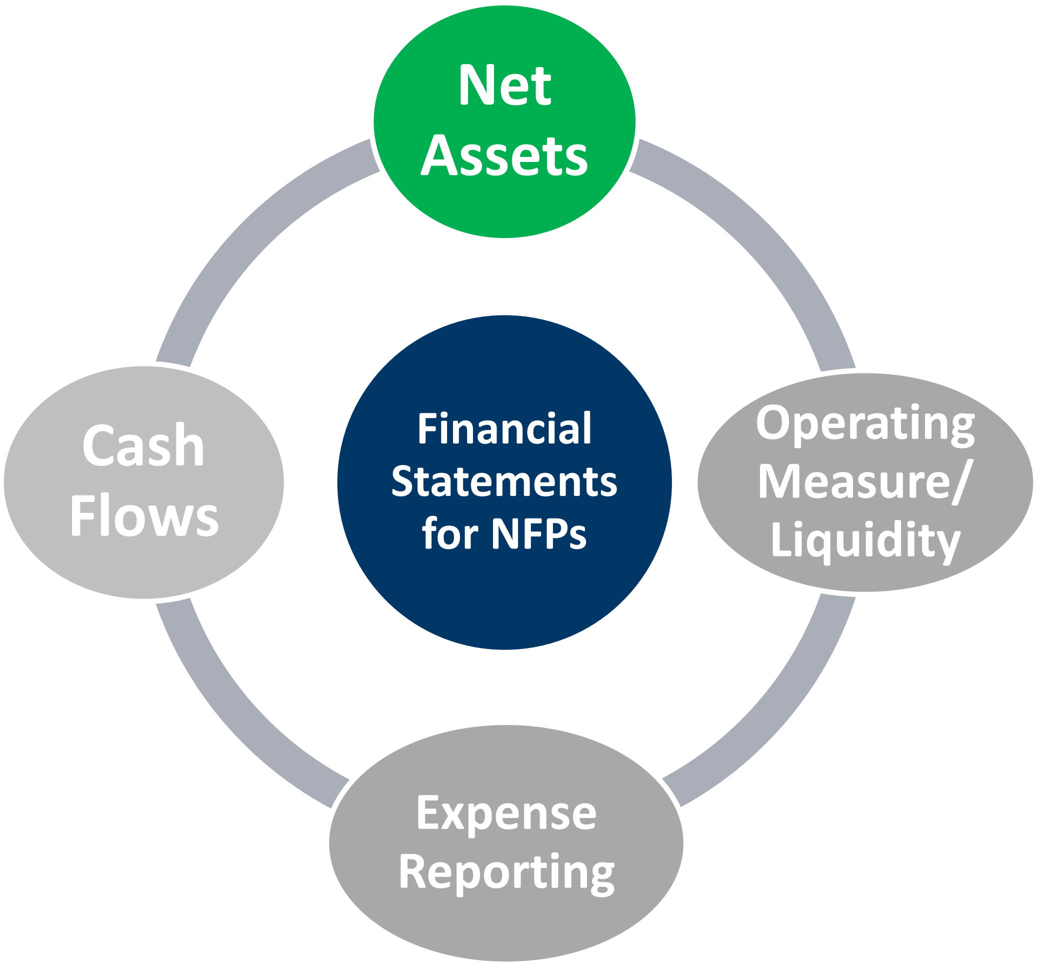
# Phase 1

- Operating measures
  - Modest improvements about disclosures, especially board appropriations, designations and other transfers
- Liquidity/Availability
  - Quantitative disclosures about availability
  - Qualitative disclosures about liquidity
- Statement of Cash Flows
  - Direct or Indirect method allowed; indirect reconciliation no longer required

# Phase 2

- Operating Measures
  - Whether to require intermediate measures
  - Whether and how to define such measures
  - Alternative disaggregation approaches
- Realignment of certain cash flow statement items
- Segment reporting as an alternative to an analysis of expenses by nature and function for business-oriented health care not-for-profits

# FASB Presentation of Not-for-Profit Financial Statements



# Two Net Asset Classes

| | | | |
|---|---|---|---|
| **Current Presentation** | Unrestricted | Temporarily Restricted | Permanently Restricted |
| **Proposed Presentation** | Without "Donor" Restrictions | With "Donor" Restrictions | |

# Net asset classification requirement

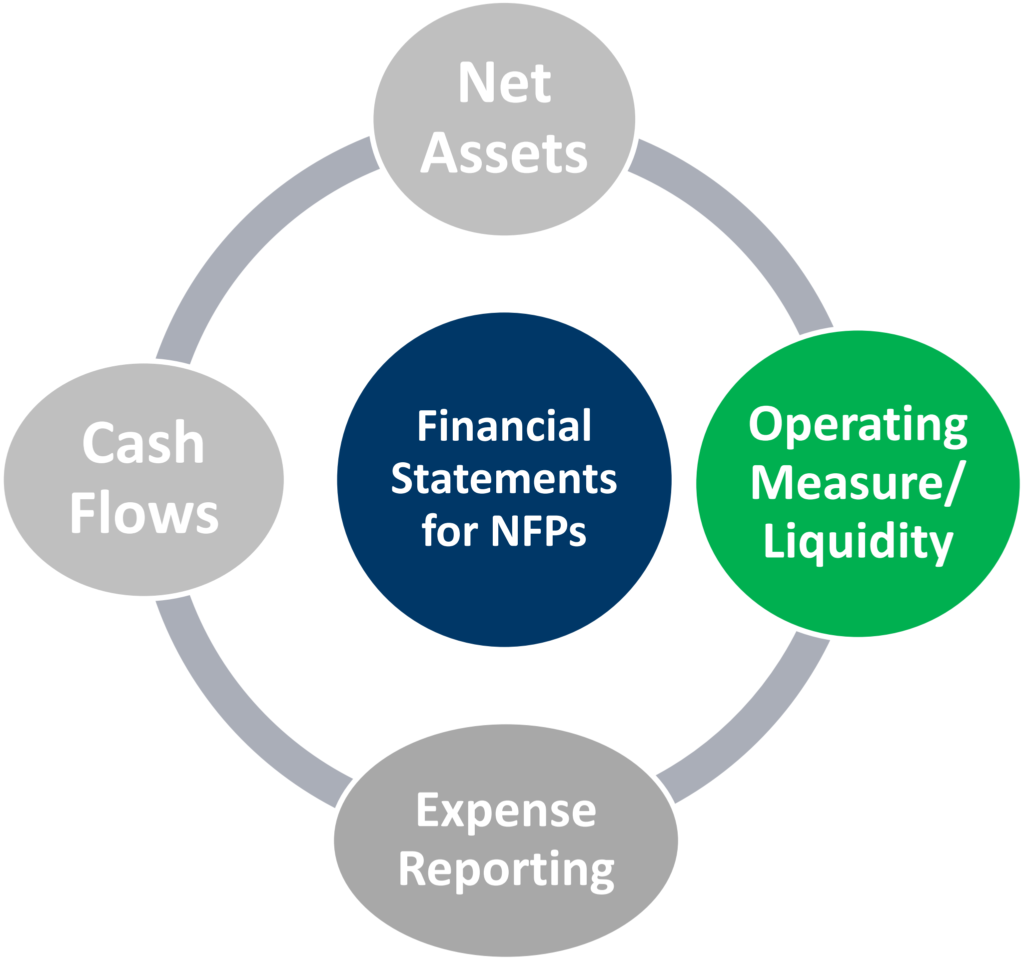
- Two classes
  - Donor/grantor-imposed restrictions
    - Includes perpetual and temporary
  - Without donor/grantor-imposed restrictions
    - Includes board designated
- Disclosure requirement:
  - Composition of net assets with donor/grantor restrictions
  - Emphasis on how/when resources (net assets) can be used.
    - Specified purpose
    - Specified time
    - Perpetual (endowment)
  - Quantitative and qualitative information about board designations.

# Underwater Endowments

- Reported within “with donor restrictions” class of net assets.

- Disclose
  - Policy to spend from underwater funds
  - Original gift of underwater funds (in aggregate)
  - Fair value of underwater funds (in aggregate)

# FASB Presentation of Not-for-Profit Financial Statements



# Financial Performance – Intermediate Operating Measure

- Presentation will remain optional.
  - Disclosures required
  - If transfers between operating and non operating exist, required to disclose nature and amount in notes
- Performance Indicator in Health Care Entities – No change
- Phase 2 – define required intermediate operating measures for all NFPs based on mission and availability

# Liquidity



## Qualitative

- Define time horizon used to manage liquidity (30, 60, 90 days)
- Information on HOW manage liquidity (cash reserves, line of credit)

## Quantitative

- Total Financial Assets
- Restrictions on financial assets
- Total financial liabilities
- Annual Only
- Could be covered on statements

# Investment Return

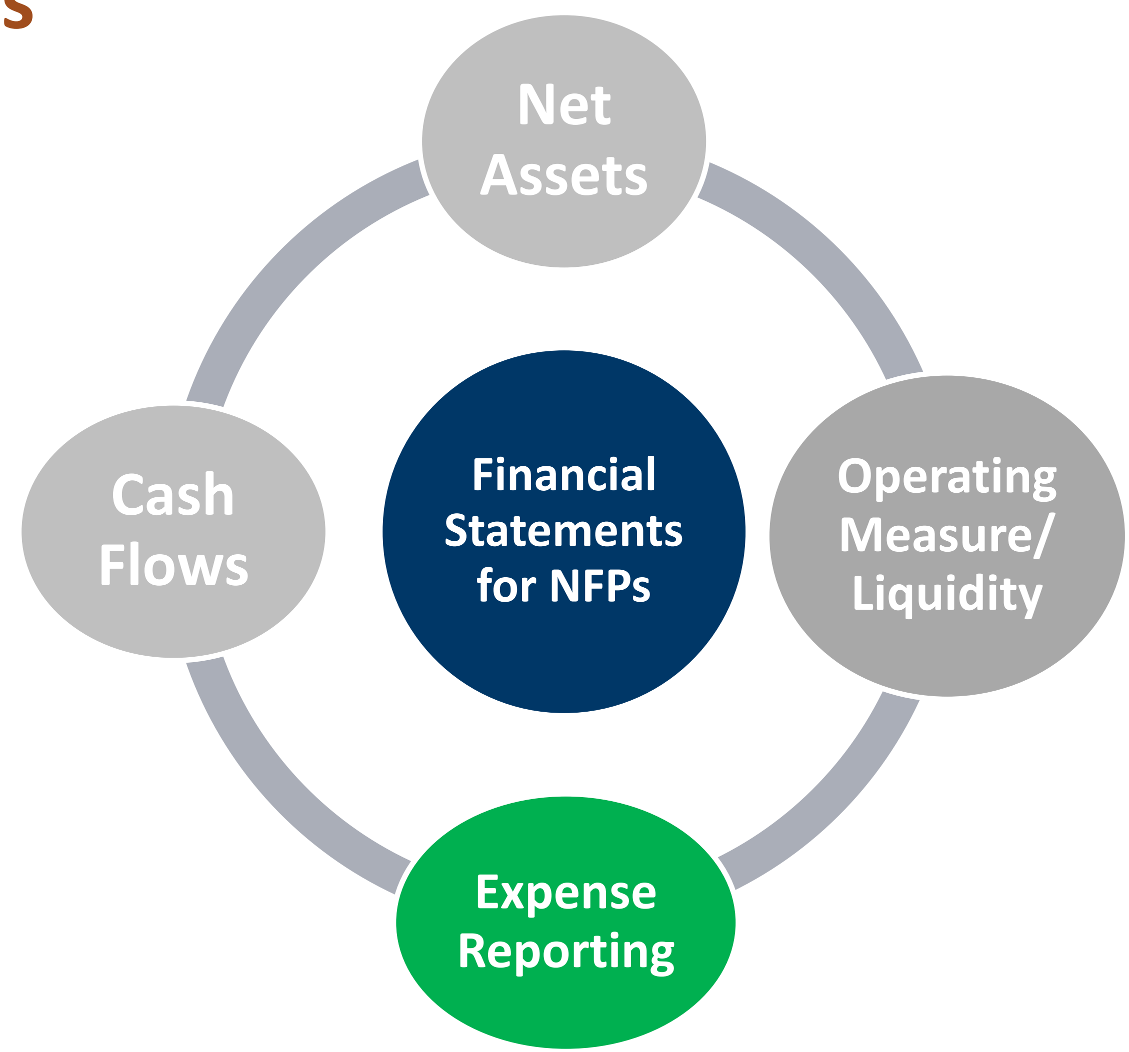
- Net presentation of investment expenses against investment return.
  - Both EXTERNAL and direct INTERNAL expenses
  - Removes requirement to disclose the gross investment income and expense (permitted but no longer required)

# Impact of the Changes

## Changes to the operating measures/liquidity are most likely to impact

- NFPs that present a performance measure
- All NFPs for the liquidity disclosures
  - Greater requirements for those who do not present a classified balance sheet
- NFPs that have large investment portfolios with internal investment expenses

# FASB Presentation of Not-for-Profit Financial Statements



# Expense Analysis

- Present an analysis of expenses by function and nature in one location (in the notes, in the statement of activities, or as a separate statement)
- Include a description of the method used to allocate costs among program and support functions
- Investment expenses netted against investment returns may be excluded
- Voluntary Health and Welfare entities no longer required to present a separate statement of functional expenses
- Still debating “business like” NFP requirement

# Functional Expenses Defined

- Program Services

**Activities that result in good and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists.**

# Functional Expenses Defined

- Supporting Activities

**Supporting activities are all activities of an NFP other than program services.**

**i.e management and general activities, fundraising activities, and membership development activities**

# Supporting Activities

- Oversight
- Business management
- General recordkeeping and payroll
- Budgeting
- Financing, including unallocated interest costs
- Soliciting funds other than contributions and membership dues
- Disseminating information to inform the public of the NFP's stewardship of contributed funds
- Making announcements concerning appts.
- Producing and disseminating the annual report
- Recruiting and employee benefits activities (i.e. human resources)
- Expenses of the governing board
- Advertising

# Analysis of Expenses



The table below presents operating expenses by both their nature and function for fiscal year 20X1.

| | Program Activities | | | | Supporting Activities | | | |
|---|---|---|---|---|---|---|---|---|
| | A | B | C | Programs | Management and General | Fund-Raising | Supporting | 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 | 865 | 1,000 | 490 | 2,355 | 240 | 560 | 800 | 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 | 196 | 109 | 77 | 382 | | | | 382 |
| Total expenses | $13,296 | $8,649 | $ 5,837 | $ 27,782 | $ 2,038 | $2,150 | $ 4,188 | $ 31,970 |

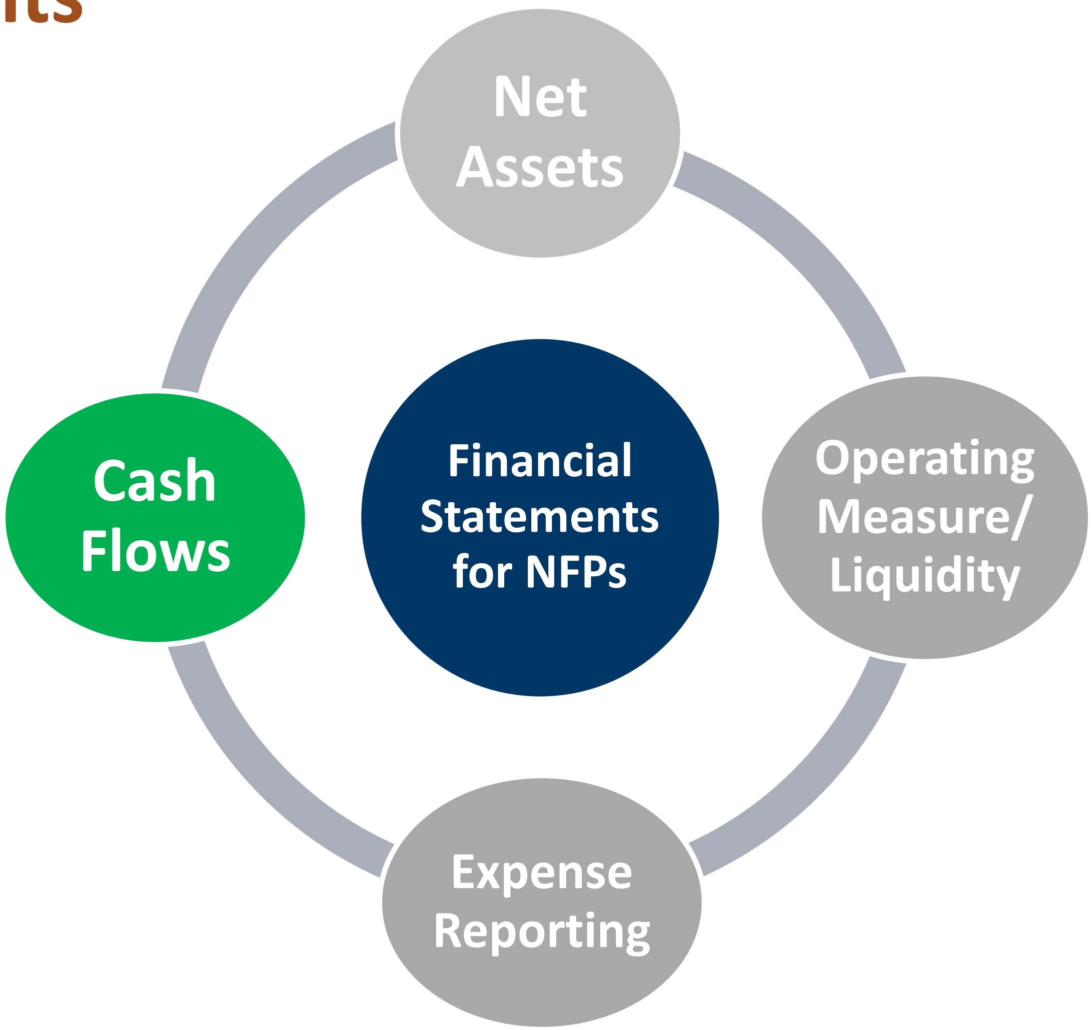
The financial statements report certain categories of expenses that are attributable to more than one program or supporting function. Therefore, these expenses require allocation on a reasonable basis that is consistently applied. The expenses that are allocated include depreciation, interest, and office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

# Analysis of Expenses

- The analysis by nature and function could also be shown as an SOA breakout

| | | |
|---|---|---|
| **Grant Activities:** | | |
| Salaries and benefits | $ | 1,808 |
| Occupancy costs | | 970 |
| Depreciation | | 845 |
| Supplies | | 1,255 |
| Other | | 56 |
| | | 4,934 |
| **Management and General:** | | |
| Salaries and benefits | | 452 |
| Occupancy costs | | 243 |
| Depreciation | | 211 |
| Supplies | | 314 |
| Other | | 14 |
| | | 1,234 |
| **Total Expenses** | $ | 6,168 |

# FASB Presentation of Not-for-Profit Financial Statements



# Statement of Cash Flow Objectives

- Improve the utility of the statement of cash flows
- Better align operating cash flows with operating measures in the statement of activities

# Cash Flow Statement



- Can continue to use either direct or indirect method
- If use direct, no longer required to show indirect reconciliation
- Other proposed changes deferred to Phase 2
  – Reclassifications between type of activity (i.e. operating, investing and financing)
  – Alignment of Statement of Cash Flows with the Statement of Activities

# Leases

# Lease Accounting

ASU 2016-02 issued February 25, 2016

– Right-of-use model

– Scope:

- Lease contracts in the scope of Topic 842 involve:
  - An identified asset
    - That is explicitly or implicitly specified
    - Supplier has no practical ability to substitute and would not economically benefit from substituting the asset
  - The right to control the use of that asset during the lease term
    - Decision-making authority over the use of the asset
    - The ability to obtain substantially all economic benefits from the use of the asset

# Lessee Accounting Model

| | Balance Sheet | Income Statement | Cash Flow Statement |
|---|---|---|---|
| Finance | Right-of-use asset<br>Lease liability | Amortization expense<br>Interest expense | Cash paid for principal and interest payment |
| Operating | Right-of-use asset<br>Lease liability | Single lease expense on a straight-line basis | Cash paid for lease payment |

Classification criteria substantially similar to that in previous lease guidance

Private companies may use risk-free rates when measuring present value of lease liabilities

Effect of leases on the statements of income and cash flows largely unchanged

# Lease Classification



- Financing lease if ANY of the following 5 conditions are met:
  - Transfer of ownership
  - Option to purchase is reasonably certain
  - Lease term is a major part of the economic life
  - Present value of lease payments is substantially all of the fair value of the underlying asset
  - The underlying asset is of a specialized nature
- If none of the above are met, the lease is operating

# Lessor Accounting Model



| | Balance Sheet | Income Statement | Cash Flow Statement |
|---|---|---|---|
| Sales-type & Direct Financing | Net investment in the lease | Interest income and any selling profit on lease | Cash received for lease payments |
| Operating | Continue to recognize the underlying asset | Lease income | Cash received for lease payments |

Lessor accounting is largely unchanged

Classification criteria substantially similar to that in previous lease guidance

# Lease Accounting



- Short-term leases – lessee may make an accounting policy election by class of underlying asset not to recognize lease assets and liabilities when the lease term is 12 months or less
- Optional periods – recognize only if reasonably certain to exercise the option (same for purchase options)
- Leveraged leases – those commencing before the effective date are grandfathered

# Lease Accounting



- Effective Date:
  - Public entities (including NFP with conduit debt)– 12/31/19 or 6/30/20
  - Nonpublic entities – 12/31/20 or 6/30/21
  - Early adoption permitted for all entities
  - Transition – recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach
    - A number of practical expedients are available

# Revenue Recognition

# Revenue Recognition – Effective Date



## ASU 2015-14 extended the effective date

- One year extension for public and private entities
- ASU making the extension official is expected to be issued soon

## Effective for reporting periods beginning on or after:

- December 15, 2017 for public companies (incl conduit debt)
  - December 31, 2018/June 30, 2019
- December 15, 2018 for private companies and not-for-profit organizations
  - December 31, 2019/June 30, 2020
- Early implementation permitted for annual periods beginning after December 15, 2016 (the original public company effective date)

# Revenue Recognition (Topic 606)

**Objective:** To develop a single, principle-based revenue standard for US GAAP and IFRS

- The revenue standard aims to improve accounting for contracts with customers by:
  - Providing a robust framework for addressing revenue issues as they arise
  - Increasing comparability across industries and capital markets

***Substantially converged with IFRS on major provisions***

# Final U.S. GAAP Model – Scope

- All contracts with customers, <u>except</u>
  - ✘ Lease contracts
  - ✘ Insurance contracts
  - ✘ Financial instruments
  - ✘ Guarantees
  - ✘ Non-monetary exchanges in the same line of business to facilitate sales to customers
- Certain contracts not with customers are <u>excluded</u>:
  - – Contributions
  - – Collaborative arrangements

# Final U.S. GAAP Model – Recognition

Recognize revenue to depict the transfer of goods or services in an amount that reflects the consideration to which the entity expects to be entitled

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

# Major Changes in Comparison to Current Guidance



- Focus is on the contract rather than on transactions of certain types or by certain industries
- Constraint on revenue
- Licenses
- Recognition and measurement guidance applies to transfers/sales of nonfinancial assets to non-customers
- Guidance on accounting for costs to obtain and fulfill a contract with a customer (if not addressed in other topics)
- Disclosures

# Final U.S. GAAP Model – Disclosure



**Disaggregation of revenue**

- Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors

**Information about contract balances**

- Opening and closing balances
- Amount of revenue recognized from contract liabilities
- Explanation of significant changes in contract balances

**Remaining performance obligations**

- Transaction price allocated to remaining performance obligations
- Quantitative or qualitative explanation of when amounts will be recognized as revenue

**Interim requirements**

- All quantitative disclosures in annual and interim *(public entities only)*

# Membership Dues (Illustrative Example)



Under 605: ABC amortizes membership dues monthly over the life of the membership

Applying 606: ABC sells a one-year membership (**Step 1: Identify Contract**)

Per the membership, ABC must discount travel, provide a magazine subscription, and provide advocacy in Washington (should promised goods or services be combined as one performance obligation or kept separate) (**Step 2: Identify Performance Obligations**)

Memberships are $16 (**Step 3: Determine Transaction Price**)

(Does any portion of the membership represent a contribution?)

Transaction price attributed to one performance obligation (If more than one performance obligation, would need to allocate transaction price on standalone selling price basis) (**Step 4: Allocate Transaction Price**)

Since customer simultaneously receives and consumes benefit through the year, revenue will be recognized over time—that is, monthly over the life of the membership (**Step 5: Recognize Revenue**)

# Practical Steps for Implementing ASC 606



Compile a list of all organizational revenues, e.g.

- Membership Dues
- Patient Fees
- Entrance fees
- Royalties
- Advertising Revenue
- Sponsorship Revenue
- Federal, State, or Private Grants
- Investment Income
- Contributions
- Retail Sales
- Educational Service Fees
- Pass-Through Funds
- Tuition
- Fee for Service
- Refunds
- Miscellaneous
- For-Profit Affiliate Revenues

# Practical Steps for Implementing ASC 606



- Develop and document a position paper on each revenue stream
  - Read the standard
  - Document your current process (if applicable)
  - Identify the relevant sections, being as specific as possible when options are presented
  - Support your position with facts, including facts as to why a specific section may not be applicable
  - Document your conclusion on how to recognize revenue
  - Review with your external auditor
  - Finalize and approve new recognition policy
- Consider discussing issues with similar organizations within your industry
- If a change is required, is it material?
  - If no, document, discuss impact with auditors (annual passed adjustment?) and continue with prior recognition methodology

# Practical Steps for Implementing ASC 606



- If a change in recognition is required, consider impact on the following:
  - Are changes in verbiage needed for new related contracts?
  - Recognition processes within the accounting system
  - Technical changes within the accounting or supporting systems
  - Monthly/annual financial close process
  - Internal financial reporting
  - Audited financial statements
  - Forecast and budget processes
  - Dashboard goals
- Communicate changes to CFO, Board, audit/finance committee, senior staff, key programmatic stakeholders, auditors, internal auditors, contract signers, banks, bondholders, etc.
- Determine requirements to retrospectively adopt the new standard or prepare comparative financial statements (prior year restatement?)
- Develop a plan for staff training

# New Requirements Issued by FASB

Effective Date Pending

Updated through 8/15/2016

# ASU 2016-07 Investments – Equity Method and Joint Ventures

- Eliminates requirement to retroactively adjust accounting treatment for investment
- Equity method on date qualifies for equity method
  - Change in ownership
  - Change in level of influence
- Effective 12/31/17, early application is permitted

# ASU 2016-01 Financial Instruments

- Eliminates distinction between trading and AFS
  - Equity investments at FV w/changes to income
  - Impact on HC Performance Indicator presentation
- Remove disclosure requirement for FV of financial instruments measured at amortized cost (i.e. FV debt) *can early adopt this provision now
- Effective 12/31/19 or 6/30/20
  - Early adoption as of 12/31/18

# ASU 2015-16 Business Combination



- Provisional amounts
  - Accounting incomplete at end of the reporting period in which the combination occurs
- Measurement period adjust provisional amounts
- Recognize adjustments that are identified during the measurement period in the reporting period in which the adjustment amounts are determined
- Effective 12/31/17 or 6/30/18
  - Early adoption is allowed
  - Prospective adoption

# ASU 2015-11 Inventory

- Current: Inventory = Lower of Cost or Market
  - Market = Replacement Cost, Net Realizable Value or NRV less normal profit margin
- New: Inventory = Lower of Cost or NRV
  - NRV = Estimated selling price, less reasonably predictable costs of completion, disposal, and transportation
- Effective 12/31/18 or 6/30/19
- Early adoption is allowed
  - Prospective adoption

# ASU 2015-07 Fair Value Measurement

## Disclosures for Investments…that calculate NAV



- NAV investments excluded from FV hierarchy
- Disclose still required
  - Redemption restrictions
  - Unfunded commitments
- Effective 12/31/17 or 6/30/18
  - Early adoption is allowed

# ASU 2015-05 Accounting for Cloud Computing Costs

- If agreement contains software license:
  - Accounting is consistent with acquisition of software
  - Contractual right to take possession of the software at any time during the hosting period without significant penalty
  - Feasible to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software
- If agreement does NOT contain software license
  - Accounting is consistent with service contract
- Effective: Fiscal years beginning after December 15, 2015 (early adoption permitted)

# ASU 2015-03 Simplifying Debt Issue Costs

- Simplifying the Presentation of Debt Issuance Costs
    - Requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability
    - Requires amortization using effective interest method with expense classified as interest expense (vs. amortization expense)
  - Effective for fiscal years beginning after December 15, 2015. (December 31, 2016/June 30, 2017).
  - Early adoption is allowed.
  - ASU 2015-15 issued to address LOC treatment

# ASU 2015-02  Consolidation – Impact on NFP



- Limited Partnerships now VIE's
- VIE accounting is not applicable to NFP's
- FASB re-deliberated impact on NFP's
  - Consolidation still required for GP
- Effective date:
  - 12/31/2017 (2015-02)
  - Early implementation was allowed
- If adopted, 2015-02 will need to adopt updated standard when issued

# ASU 2014- 15 Going Concern

- Moves guidance from Audit to Accounting
- Management evaluates
- Significant focus on disclosure
- Requires substantial doubt consideration and disclosure
- Effective date:
  - Periods ending after December 15, 2016
  - Early adoption is permitted

# Questions?


## Cathy Clarke

**cathy.clarke@CLAconnect.com**


**To receive future webinar invitations, subscribe at CLAconnect.com/Nonprofit/**