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Impact of FASB ASU 2016-14 on Nonprofit Health Care Organizations

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- More than 4,500 employees
- Offices coast to coast
- Serve more than 6,800 health care clients

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Speaker Introductions

- Cathy Clarke, Chief Assurance Officer
  - More than 20 years of experience.
  - Experience in conducting training sessions for audit and accounting staff within CLA and for the American Institute of CPAs.
  - Current member of FASB's Not-for-Profit Advisory Committee

- Trent Fast, Principal, National Assurance Technical Group
  - More than 20 years of experience
  - Serves health care organizations including
    - Performance of financial audits
    - Audits in accordance with the Uniform Guidance issued by the Comptroller General of the United States
    - Not-for-profit tax compliance
    - Reimbursement reporting and advisory

Learning Objectives

- At the end of this session, you will be able to:
- Discuss how the new and pending changes to the FASB Not-for-Profit Reporting model affect the health care industry
- Describe changes to requirements of disclosures surrounding liquidity and restrictions on resources
- Describe changes to disclosures of expenses by function and nature
- Discuss improvements that will address misunderstandings in presentation of cash flows information

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 HCEs liquidity, financial performance, expenses, and cash flows.
- Better enable HCEs to “tell their financial story”

Changes Intended to Address

- Complexities in the use of the required three classes of net assets,
- Deficiencies in the transparency and utility of information in assessing an organization's liquidity,
- Inconsistencies in the type of information provided about expenses, and
- Misunderstandings about and the limited usefulness of the statement of cash flows, particularly with regards to the reporting of operating cash flows.

Crafting the Final Standard

- Exposure Draft
  - Issued April 2015
  - Comment period and re-deliberation completed
  - THANK YOU to all who commented, your voice was heard!
- Final Standard
  - ASU 2016-14 – Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities
  - Issued August 18, 2016
  - 264 pages
  - Effective date is fiscal years beginning after 12/15/2017
    - ◊ 12/31/18 or 6/30/19 year-ends

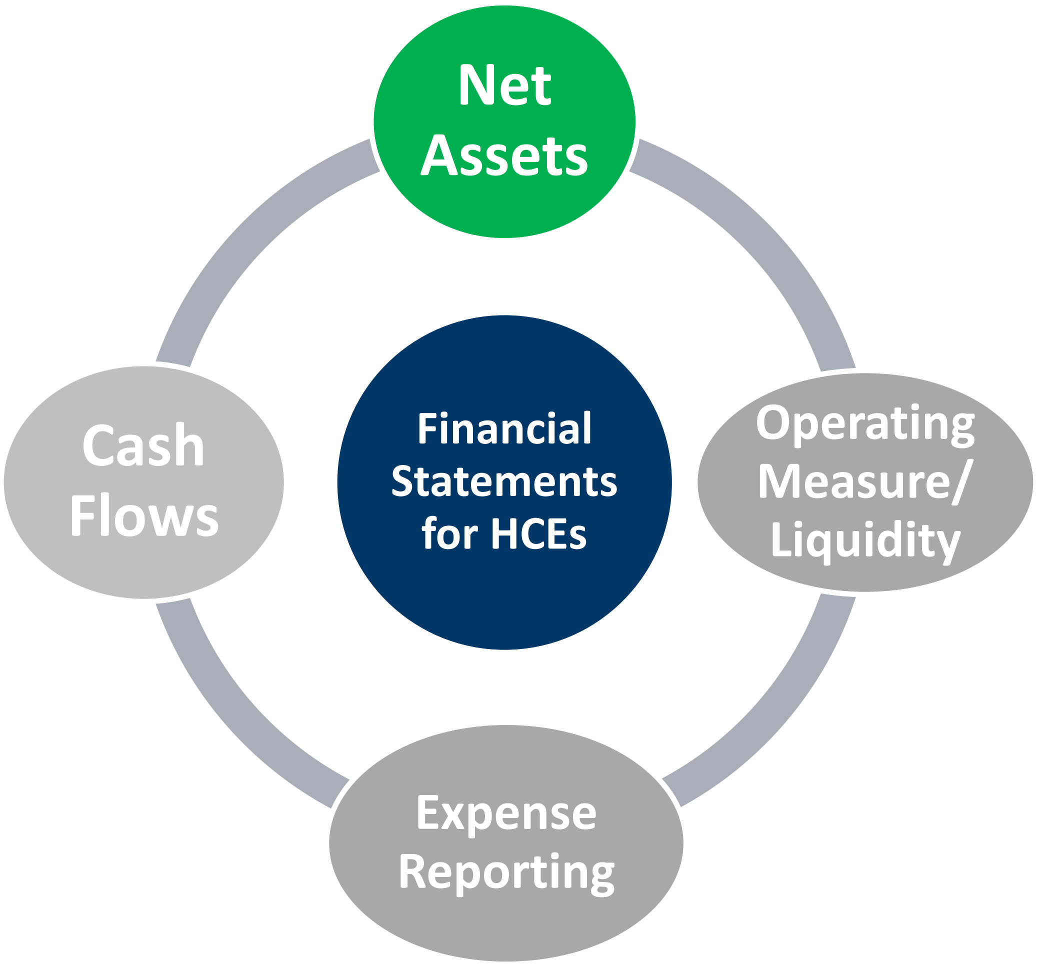
We're Not Done Yet …

- Certain items from the Exposure Draft moved to Phase Two project for further consideration
  - Operating Measures
    - Whether to require immediate operating measure(s)
    - Whether and how to define such measure(s), and what items should or should not be included in the measure(s)
    - Alternative disaggregation approaches suggested by stakeholders
  - Statement of Cash Flows
    - Realignment of certain items
  - Expense Reporting
    - Consideration of segment reporting for health care entities

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

FASB Presentation of HCE Heath Care Financial Statements



Net Assets Objectives

The new standard should address:

- Complexities with the current three classes
- Deficiencies in the transparency of information around restrictions
- Address deficiencies in the utility of information about how restrictions imposed by donors, laws, and governing boards affect an HCE's liquidity and classes of net assets

Two Net Asset Classes

Current Presentation	Unrestricted	Temporarily Restricted	Permanently Restricted
New 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.

Implementation – Balance Sheet

Net assets:	
Without donor restrictions	97,677
With donor restrictions	115,657
Total net assets	213,334

Minimum presentation required

Alternative disaggregation allowed

Net assets:	
Without donor restrictions -	
Undesignated	92,677
Designated by the Board for [purpose]	5,000
	97,677
With donor restrictions -	
Time restricted only, for periods after 20X1	5,250
Purpose restricted	8,250
Perpetual in nature	102,157
	115,657
Total net assets	213,334

Net Asset Disclosures – With Donor Restrictions

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

Subject to expenditure for specified purpose:	
Program A activities:	
Purchase of equipment	$ 1,530
Research	2,128
Educational seminars and publications	760
Program B activities:	
Patient care	1,120
Educational seminars and publications	1,079
Program C activities: general	1,484
Buildings and equipment	1,075
Annuity trust agreements for residents	1,425
	10,601
Subject to the passage of time:	
For periods after June 30, 20X1	3,140
Subject to HCE spending policy and appropriation:	
Investment in perpetuity (including amounts above original gift amount of $22,337),the income from which is expendable to support:	
Program A activities	27,524
Program B activities	13,662
Program C activities	13,662
Any activities of the organization	105,793
	160,641
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	2,210
Paid-up life insurance policy that will provide proceeds upon death of insured foran endowment to support general activities	80
	2,290
Not subject to appropriation or expenditure:	
Land required to be used as a recreation area	3,000
Total net assets with donor restrictions	$ 193,413

Net Asset Disclosures – Without Donor Restrictions

The governing board of Health Care Entity A has several standing board policies that affect the presentation of board designations, appropriations, and other similar transfers on the statement of activities. Bequests without donor restrictions are designated for long-term investment (quasi-endowment); however, no bequests were received during 20X1. Occasionally the governing board designates a portion of its net assets without donor restrictions for its liquidity reserve; however, no amounts were added to the liquidity reserve during 20X1. Annually, the governing board appropriates portions of the quasi-endowment and donor-restricted endowments for current-period operations. During 20X1, a total of $9,500 was appropriated and used, consisting of $2,000 from the quasi-endowment and $7,500 from donor-restricted endowments. Not-for-Profit Entity A placed $1,640 of equipment into service during the year, which was funded with $1,500 of donor-restricted funds that is shown as a release from restrictions, as well as $140 of donated equipment. Both of these amounts are included in board designations, appropriations, and similar transfers on the statement of activities.

Health Care Entity A's governing board has designated net assets without donor restrictions for the following purposes as of June 30, 20X1.

Quasi-endowment	**$ 34,628**
Liquidity reserve	**1,300**
Total	**$ 35,928**

Board-Designated Net Assets

- New required disclosure of nature and amounts of board-designations of net assets
- New FASB ASC Master Glossary definition:
  - Net assets without donor restrictions subject to self-imposed limits by action of the governing board.
  - Board-designated net assets may be earmarked for future programs, investment, contingencies, purchase or construction of fixed assets, or other uses.
  - Some governing boards may delegate designation decisions to internal management. Such designations are considered to be included in board-designated net assets.
- Definition indicates a need for HCEs to have policies and/or practices regarding board-designations on net assets; even if no designations

Example Disclosures – Board-Designations

Net assets without donor restrictions:	
Undesignated	56,377
Quasi-endowment	35,000
Operating reserve	1,300
Total net assets	92,677

Tabular disclosure or on face of balance sheet

Text disclosure in notes

Note 13 - Net Assets Without Donor Restrictions

The Board of Directors of XYZ Organization has several standing board policies that affect the presentation of board designations on net assets. Bequests without donor restrictions are designated for long-term investment (quasi-endowment). The quasi-endowment fund balance totaled $35,000 at December 31, 20XX. Additionally, the Board of Directors has established an operating reserve with the objective of setting funds aside to be drawn upon in the event of financial distress or an immediate liquidity need. The operating reserve balance totaled $1,300 at December 31, 20XX.

Expiration of Capital Restrictions

- Absent explicit donor stipulations
- Placed-in-service approach
  - Reporting expirations of restrictions on gifts of cash or other assets to be used to acquire or construct a long-lived asset
  - Reclassify amounts from net assets *with donor restrictions* to *without donor restrictions* for long-lived assets placed in service as of the beginning of the period of adoption
- Eliminates the option to release the donor-imposed restriction over the estimated useful life of the asset

Underwater Endowments

- Currently reported within unrestricted net assets.
- New reporting will be within "with donor restrictions" class of net assets.

- Disclose
  - Policy to reduce expenditures from underwater funds
  - Original gift of underwater funds (in aggregate)
  - Fair value of underwater funds (in aggregate)
  - Amount by which funds are underwater (in aggregate)

Underwater Endowments Disclosures

Underwater Endowment Funds

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 SPMIFA requires HCE A to retain as a fund of perpetual duration. HCE A 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.

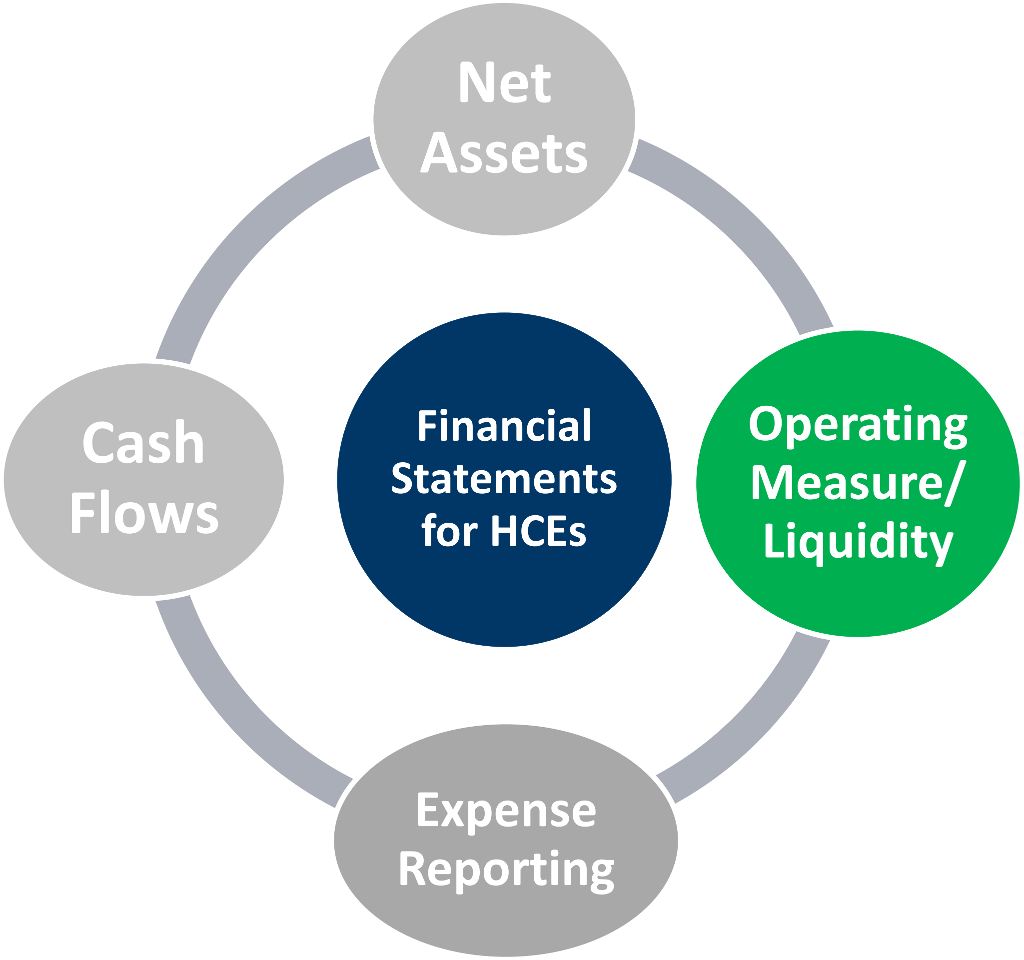
As of June 30, 20X1, three donor-restricted endowment funds had aggregated original values totaling $3,500, current fair values totaling $3,300, and deficiencies totaling $200. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after the investment of new contributions for donor-restricted endowment funds and continued appropriation for certain programs that was deemed prudent by the Board of Trustees.

Impact of the Changes

Changes due to net assets classifications and disclosures are most likely to impact

- HCEs with endowments that are
  - Large
  - Relatively new
  - Have a significant number of underwater funds
- HCEs with large quasi-endowment and other board-designated funds
- HCs that have significant capital assets

FASB Presentation of HCE Heath Care Financial Statements



Operating Measure/ Liquidity Objectives

- Provide transparency and utility of information provided to donors, grantors, creditors, and others in assessing an entity's liquidity
- Address inconsistencies in reporting of an intermediate measure of operations
- Improve comparability across all HCEs

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 HCEs based on mission and availability

Measure of Operations Disclosures

Measure of Operations

NFP A's operating revenues in excess of expenses and transfers includes all operating revenues and expenses that are an integral part of its programs and supporting activities, net assets released from donor restrictions to support operating expenditures, and transfers from Board-designated and other non-operating funds to support current operating activities. The measure of operations includes support for operating activities from both donor-restricted net assets and net assets without donor restrictions designated for long-term investment (the donor-restricted and quasi-endowment) according to NFP A's spending policy, which is detailed in Note X. The measure of operations excludes endowment support for non-operating activities, investment return in excess (less than) amounts made available for current support, gains and losses on extinguishment of debt, and changes in fair value of the interest rate swap. Included in the line item *transfer of funds, net* is investment return appropriated from quasi-endowment to operations of $1,025, contributions designated by the Board of Trustees for capital projects from operations of $3,000, and contributions and bequests designated by the Board of Trustees for quasi-endowment from operations of $5,000.

Financial Statements – Liquidity Disclosures

- Qualitative Information
  - Financial assets available to meet near-term demands for cash, including demands resulting from near-term financial liabilities
- Quantitative Information
  - Face of Balance Sheet or Notes
- Availability of a financial asset may be affected by:
  - Its nature
  - External imposed limits
  - Internal imposed limits

Qualitative Liquidity Disclosures

HCE A utilizes a 60-day time horizon to assess its immediate liquidity needs. This period of time was established based on management's review of the typical life cycle of converting its financial assets to cash and typical payments of its trade payables. The entity 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. As of June 30, 20X1, the liquidity reserve was $1,300. This is a governing board-designated fund with the objective of setting funds aside to 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, HCE A also could draw upon $10,000 of available lines of credit (as further discussed in Note XX) or the quasi-endowment fund.

Quantitative Liquidity Disclosures

Financial assets, at year end	$ 229,200
Less:	
Contractual or donor-imposed restrictions making financial assets unavailable for general expenditure	(192,413)
Quasi-endowment fund, primarily for long-term investing	(34,628)
Less amounts set aside for liquidity reserve:	(1,300)
Financial assets available within one year to meet cash needs for general expenditures within one year	$ 859

Additional Example Disclosures

- The following quantitative and qualitative disclosures may supplement an unclassified balance sheet presentation.

958-210-55-7 NFP A has $395,000 of financial assets available within one year of the balance sheet date consisting of cash of $75,000, contributions receivable of $20,000, and short-term investments of $300,000. None of the financial assets are subject to donor or other contractual restrictions that make them unavailable for general expenditure within one year of the balance sheet date. The contributions receivable are subject to time restrictions, but will be collected within one year. NFP A has a goal to maintain financial assets, which consist of cash and short-term investments, on hand to meet 60 days of normal operating expenses, which are, on average, approximately $275,000. As part of its liquidity management, NFP A invests cash in excess of daily requirements in various short-term investments including certificate of deposits and short term treasury instruments. As more fully described in Note xx, NFP A also has committed lines of credit in the amount of $20,000, which it could draw upon in the event of an unanticipated liquidity need.

Additional Example Disclosures

- The following qualitative disclosures may supplement a classified balance sheet presentation.

Note T

As part of NFP A's liquidity management, it invests cash in excess of daily requirements in short-term investments. To help manage unanticipated liquidity needs, NFP A has committed lines of credit in the amount of $20 million which it could draw upon. Additionally, NFP A has a quasi-endowment of $33 million. Although NFP A 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, amounts from its quasi-endowment could be made available if necessary. However, both the quasi-endowment and donor endowment contain lock-up provisions that would reduce the total investments that could be made available.

NFP A's financial assets due 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		1,650
	$	11,580

NFP A's endowment funds consist of donor endowment and quasi-endowment. Income from donor endowment is restricted for specific purposes and, therefore, is not available for general expenditure. 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.

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)

Defining Internal Investment Expenses

Involve the direct conduct or direct supervision of the strategic and tactical activities involved in **generating investment return**.

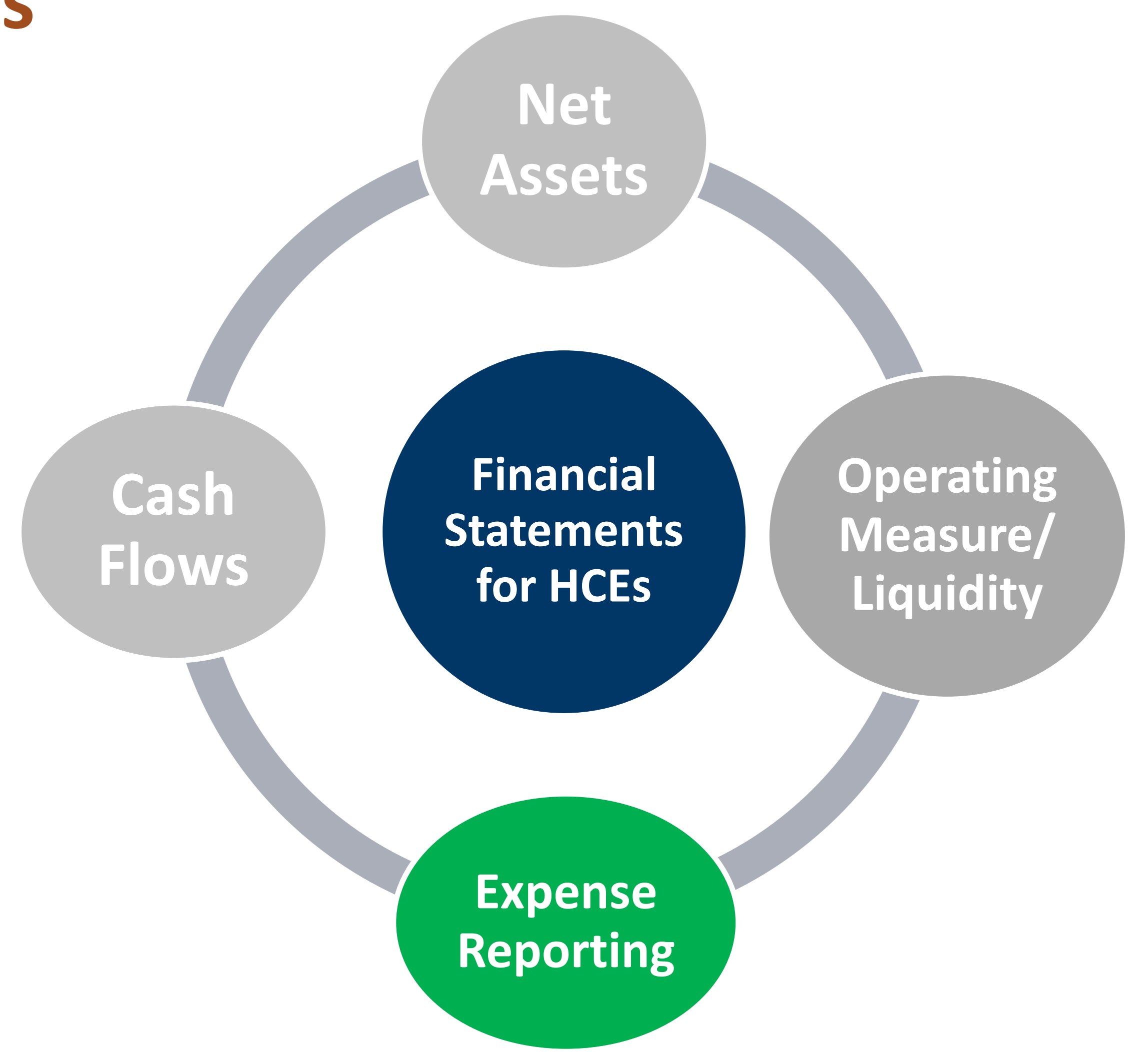
- Salaries, benefits, travel, and other costs associated with staff responsible for development and execution of investment strategy
- Allocable costs associated with internal investment management and supervising, selecting, and monitoring of external investment management firms
- DO NOT include items that are not associated with generating investment return such as costs associated with unitization and other such aspects of endowment management.

Impact of the Changes

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

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

FASB Presentation of HCE Heath Care Financial Statements



New Requirements for Expenses

- Present an analysis of expenses by function and nature in one location
  - May be presented in the notes, in the statement of activities, or as a separate statement
  - Disaggregation of functional expense classifications by their natural expense classifications
  - Voluntary Health and Welfare entities no longer required to present a separate statement of functional expenses
- Include a description of the method used to allocate costs among program and support functions
- Improved guidance about management & general expenses

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 HCE exists.

Functional Expenses Defined

- Supporting Activities

Supporting activities are all activities of an HCE 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 HCE's stewardship of contributed funds
- Making announcements concerning appointments
- 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

Example Disclosure

<u>Note X. Methods Used for Allocation of Expenses from Management and General Activities</u>

<u>The financial statements report certain categories of expenses that are attributable to one or more program or supporting functions of the Organization. Those expenses include depreciation and amortization, the president's office, communications department, and information technology department. Depreciation is allocated based on a square footage basis, the president's office is allocated based on estimates of time and effort, certain costs of the communications department are allocated based on the benefit received, and the information technology department is allocated based on estimates of time and costs of specific technology utilized.</u>

Impact of the Changes

- Changes to expense reporting are most likely to impact
  - HCEs that are not currently including a functional expense statement within their financial statements
  - HCEs that do not have a formal policy surrounding allocation of expenses between program and management & general

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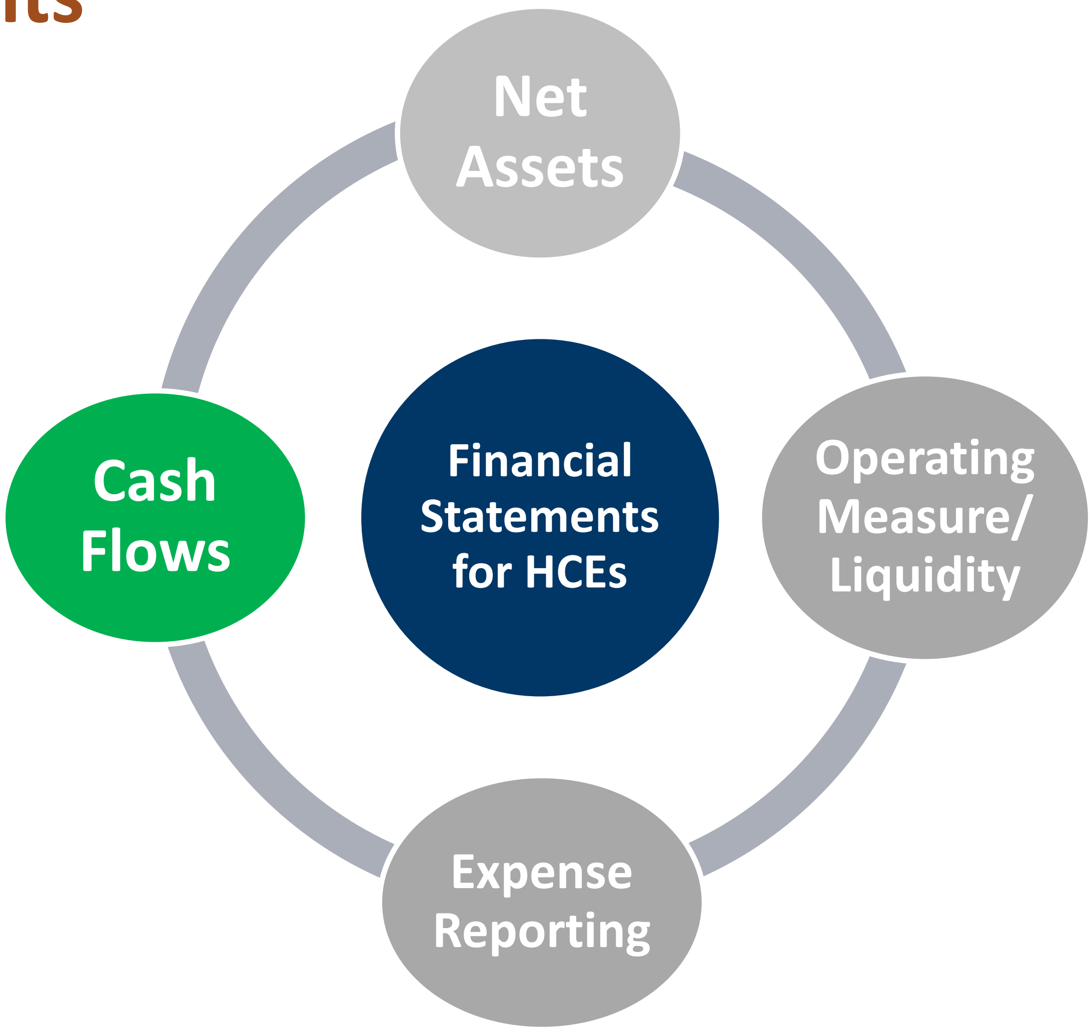

Changes to Statement of Cash Flows

- 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

Operating Cash Flows – Which Presentation is More Informative?

Cash flows from operating activities:	
Cash received from contributors	10,645
Cash received from service receipients	5,020
Interest and dividends received	8,570
Miscellaneous receipts	150
Cash paid to employees	(13,400)
Cash paid to suppliers	(5,658)
Interest paid	(382)
Grants paid	(5,175)
Net cash used by operating activities	(230)

Direct Method

Indirect Method

Cash flows from operating activities:	
Change in net assets	15,450
Adjustments to reconcile change in net assets to net cash	
Depreciation	3,200
Net gains on investments	(15,800)
Net gain on sale of equipment	(90)
Net change in operating assets and liabilities -	
Contributions receivable	(325)
Accounts receivable	(460)
Prepaid expenses and other assets	390
Accounts payable and accrued expenses	870
Grants payable	(425)
Contributions restricted for long-term investments	(3,040)
Net cash used by operating activities	(230)

Impact of the Changes

- NFPs that are currently using the direct method of reporting operating cash flows in the Statement of Cash Flows

Transition Guidance

Effective Dates and Transition

- Effective date:
  - Fiscal years <u>beginning</u> after 12/15/2017 (e.g. CY 2018 and FY 2018/2019)
  - Interim financials the following year
- Transition:
  - In year of adoption apply <u>all</u> provisions of the new ASU
  - For comparative years presented; apply all provisions, except can choose not to present –
    - Analysis of expenses by nature and function *(except for Voluntary Health and Welfare Entities that are required under current GAAP to present Statement of Functional Expenses), and/or*
    - Disclosures around liquidity and availability of resources
  - In year of adoption, disclose the nature of any reclassifications or restatements and their effects, if any, on changes in the net asset classes for each period presented.

Disclosures and Auditor's Reports

- Required disclosures:
  - In year of adoption, disclose the nature of any reclassifications or restatements and their effects, if any, on changes in the net asset classes for each period presented.
- Auditor's reports:
  - In year of adoption, include an emphasis-of-matter paragraph in the auditor's report if the adoption results in changes that have a material effect on the financial statements (AU-C 708.07)

Early Adoption

- Early adoption permitted, but must apply the regular transition provisions
- Example of early adoption:
  - HCE chooses to early adopt in CY 2016
  - HCE must apply all provisions to CY 2016 financials
  - HCE presents comparative financials for CY 2015; must apply all provisions to the CY 2015 financials, except HCE can choose not to present –
    - Analysis of expenses by nature and function, and/or
    - Disclosures around liquidity and availability of resources

Practical Guidance

- HCEs are already permitted to make many of the changes in the ASU
- The only changes that cannot be made without formally adopting the ASU are:
  - Presenting one class of restricted net assets (i.e., consolidating temporarily and permanently restricted net assets into net assets with donor restrictions)
  - Underwater endowment accounting
  - Eliminating disclosures of investment return components and netted expenses
  - Eliminating requirement to provide indirect reconciliation if using the direct method for operating cash flows

Questions?

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