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Implementing the New Standards for NPO Financial Reporting and Revenue Recognition

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Financial Reporting Changes Background

- Financial Accounting Standards Board (FASB) Not-for-Profit Advisory Committee (NAC)
- Studied areas for improving Generally Accepted Accounting Principles (GAAP) for NFPs
- ASU 2016-14 was issued August 18, 2016

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Learning Objectives

- Review the changes for the new not-for-profit financial reporting standard
- Discuss how the changes impact financial statement presentation and your organization
- Highlight changes that are still under discussion
- Review the timing of the changes

Key Objectives of Standard

- Update, not overhaul, of the current model
- Provide better information to donors, grantors, creditors, and other users of the financial statements
- Improve on current net asset classification requirements
- Improve the presentation in the financial statements and disclosures about a NFPs liquidity, financial performance, expenses, and cash flows
- Enable NFPs to “better tell their financial story”

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Problems the Standard Addresses

- Complexities with the current three net asset classes
- Deficiencies in the transparency and ability to assess an organization's liquidity
- Inconsistencies in the information provided about expenses
- Misunderstandings about the limited usefulness of the statement of cash flows

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#1 - Change in Net Asset Classes

- Address complexities with the current three classes of net assets
- Address misunderstandings and confusion around the term “unrestricted net assets”
- Address deficiencies in the information provided on how restrictions imposed by donors, laws, and governing boards affect an NFP’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	

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#1 - Change in Net Asset Classes

- Two classes
  - Without donor imposed restrictions
    - Includes board designated
  - Donor imposed restrictions
    - Includes perpetual and temporary
- Added disclosure requirements
  - Composition of net assets with donor restrictions
  - Emphasis on how/when net assets can be spent
    - Specified purpose
    - Specified time
    - Perpetual (endowment)
  - Quantitative information about board designations

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Statement of Financial Position

Net assets:	
Without donor restrictions	$90,000
With donor restrictions	110,000
Total net assets	$200,000

Minimum presentation required

Alternative disaggregation allowed

Net assets:	
Without donor restrictions -	
Undesignated	$85,000
Designated by the Board for purpose	5,000
	90,000
With donor restrictions -	
Time restricted only, for periods after 2018	5,000
Purpose restricted	50,000
Perpetual in nature	55,000
	110,000
Total net assets	$200,000

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Statement of Activities - Example 1

	Without Donor Restrictions	With Donor Restrictions	Total
Revenue and other support:			
Contributions	$ 8,600	$ 8,400	$ 17,000
Fees	5,200		5,200
Investment return, net	6,600	18,000	24,600
Other	300		300
Net assets released from restrictions	19,000	(19,000)	-
Total revenues and other support	39,700	7,400	47,100
Expenses:			
Program A	13,000		13,000
Program B	14,500		14,500
Management and general	2,000		2,000
Fundraising	2,000		2,000
Total Expenses	31,500	-	31,500
Change in net assets	8,200	7,400	15,600
Net assets at beginning of year	81,800	102,600	184,400
Net assets at end of year	$ 90,000	$ 110,000	$ 200,000

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Statement of Activities - Example 2

	Without Donor Restrictions	With Donor Restrictions: Program Restrictions	With Donor Restrictions: Endowment Funds	With Donor Restrictions: Total	Total
Revenue and other support:					
Contributions	$ 11,989	$ 3,487	$ 12,044	$ 15,531	$ 27,520
Fees	7,083			-	7,083
Investment return, net	113		(3,618)	(3,618)	(3,505)
Net assets released from restrictions	6,913	(1,112)	(5,801)	(6,913)	-
Total revenues and other support	26,098	2,375	2,625	$ 5,000	31,098
Expenses:					
Program A	13,960			-	13,960
Program B	5,497			-	5,497
Management and general	4,609			-	4,609
Fundraising	1,441			-	1,441
Total Expenses	25,507	-		-	25,507
Change in net assets	591	2,375	2625	5,000	5,591
Net assets at beginning of year	124,465	11,474	145794	157,268	281,733
Net assets at end of year	$ 125,056	$ 13,849	$ 148,419	$ 162,268	$ 287,324

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Example of Reclassification of Opening Balances

	Current GAAP	Reclassifications: Implied time restriction	Reclassifications: Underwater portion of endowment	Reclassifications: Other	New GAAP
Assets:					
Cash and Cash Equivalents	$ 16,003				$ 16,003
Receivables and other	23,095				23,095
Investments	145,794				145,794
Property & equipment	120,581				120,581
Total Assets	305,473	-	-	-	305,473
Liabilities:					
Accounts Payable	1,915			-	1,915
Accrued Expenses	8,566			-	8,566
Long-term Debt	7,668			-	7,668
Total Expenses	18,149	-		-	18,149
Net Assets:					
Unrestricted	23,237		1,084	(24,321)	-
Temporarily Unrestricted	119,097	(100,735)		(18,362)	-
Permanently Unrestricted	144,990			(144,990)	-
Without Donor Restrictions		100,735		24,321	125,056
With Donor Restrictions			(1,084)	163,352	162,268
Total Net Assets	287,324	-	-	-	287,324
Total Liabilities and net assets	305,473	-	-	-	305,473

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Footnote Disclosure 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	$	5,500
Research		6,000
Educational seminars and publications		4,000
Program B activities:		
Disaster relief		2,000
Educational seminars and publications		10,000
Program C activities: general		2,000
Buildings and equipment		10,500
Annuity trust agreements for research		10,000
		50,000
Subject to the passage of time:		
For the periods after December 31, 2018		5,000
Subject to NFP's spending policy and appropriation		
Investment in perpetuity including amounts above original gift amount of $40,000 the income from which is expendable to support:		
Program A activities		20,000
Program B activities		12,000
Program C activities		23,000
		55,000
Total Net Assets with Donor Restrictions	**$**	**110,000**

Board Designated Net Assets

- New required disclosure of nature and amounts of board designations of net assets
- New FASB 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 NFPs to have policies and/or practices regarding board designations on net assets

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Disclosures for Board Designations

Undesignated	$ 55,000
Quasi-endowment	30,000
Operating reserve	5,000
Total net assets	$ 90,000

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 $30,000 at December 31, 2018. 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 $5,000 at December 31, 2018.

#2 - "Underwater" Endowments

- Updated FASB definition:
  - Donor-restricted endowment fund for which the fair value of the fund at the reporting date is less than either the original gift amount or the amount required to be maintained by the donor or by law that extends donor restrictions.
- Report entire balance of endowment fund "with donor restrictions" class of net assets.
- Enhanced disclosures related to underwater funds

Example Disclosures

Underwater Endowment Funds with Deficiencies –

Over time, the fair value of assets associated with individual donor restricted endowment funds may fall below the level that the donor or the State Prudent Management of Institutional Funds Act requires NFP to retain as a fund of perpetual duration.

Deficiencies of this nature exist in three donor-restricted endowment funds, which together have an original gift value of $14,500, a current fair value of $13,416, and a deficiency of $1,084 as of December 31, 2017.

These deficiencies resulted from unfavorable market fluctuation 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 Directors.

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#3 - Donations/Contributions Restricted for Purchase of Property & Equipment

- No longer allowed to imply a time restriction, except if 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
- Eliminated the option to release the donor-imposed restriction over the estimated useful life of the asset
- Examples:
  - Donated vehicle
  - Capital campaign to build a new facility

#4 - Liquidity and Availability of Resources Disclosures

- ➢ Qualitative information on how a NFP manages its liquid resources available to meet cash needs for general expenditures within one year (in footnotes)

- ➢ Quantitative information that communicates the availability of the financial assets (cash, accounts receivable, investments) to meet cash needs for general expenditures within one year (on statement of financial position and/or in footnotes)

  - Availability may be affected by –
    - Nature of the assets
    - External limits imposed by donors, laws, and contracts with others
    - Internal limits imposed by board directors

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Quantitative Availability Disclosure

Financial assets, at year end	$ 148,000
Less:	
Contractual or donor-imposed restrictions making financial assets unavailable for general expenditure	(110,000)
Quasi-endowment fund, primarily for long-term investing	(30,000)
Less amounts set aside for liquidity reserve	(5,000)
Financial assets available within one year to meet cash needs for general expenditures within one year	$ 3,000

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Qualitative Liquidity Disclosures

- The Board periodically designates a portion of any operating surplus to its liquidity reserve. As of December 31, 20XX, the liquidity reserve was $5,000. 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, NFP also could draw upon $50,000 of available lines of credit (as further discussed in Note XX) or the quasi-endowment fund of $30,000.

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Example of Combined Disclosure

Note X – Liquidity and Availability of Financial Assets

The theater's working capital and cash flows have seasonal variations during the year attributable to the annual cash receipts for subscriptions and a concentration of contributions received near calendar year end. To manage liquidity the Theater maintains a line of credit of $3 million with a bank that is drawn upon as needed during the year to manage cash flow and then repaid in full by the end of the fiscal year

The following reflects the theater's financial assets as of the balance sheet date, reduced by amounts not available for general use within one year because of donor-imposed restrictions. Amounts available include the Board-approved appropriation from the endowment fund for the following year as well as donor-restricted amounts that are available for general expenditure in the following year.

	2017	2016
Current assets, excluding non-financial assets	$ 3,183,318	$ 2,710,890
Add: endowment fund appropriation for following year	547,700	591,554
Subtract: cash restricted by lessor to specific uses	(942,941)	(823,430)
Subtract: donor restrications for specific purposes	(250,000)	
Subtract: board-designated operation reserves and other	(225,129)	(299,011)
Financial assets available to meet cash needs for general expenditures within one year	2,312,948	2,180,003

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Example – NFP with Deficiency in the Composition of Assets to Comply with Donor-Imposed Restrictions

	Option 1		Option 2	
Cash	$	1,050		1,050
Receivables		3,210		3,210
Total financial assets		4,260		4,260
Receivables scheduled to be collected in more than one year		(2,200)		(2,200)
Contractual or donor-imposed restrictions:				
Donor contributions restricted to specific purposes		(3,750)		(1,910) *
Funds restricted by lender		(150)		(150)
Financial assets available to meet cash needs for general expenditures within one year	$	(1,840)	$	-

* Donations restricted for purposes are more than general expenditures total is $3,750

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#5 - Expense Reporting

- Present an analysis of expenses by function <u>and</u> nature in one location
  - May be presented in 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 and general expenses

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Analysis of Expenses

- Presentation in the notes or in a separate statement

	Program A	Program B	Program Subtotal	Management & General	Fund-Raising	Supporting Subtotal	Total Expenses
Salaries, benefits, and taxes	$ 7,400	$ 4,900	$ 12,300	$ 1,130	$ 900	$ 2,030	$ 14,330
Grants to other organization	2,070	2,700	4,770				4,770
Supplies and travel	600	1,500	2,100	200	500	700	2,800
Services and professional fees	160	3,000	3,160	200	340	540	3,700
Office and occupancy	1,160	1,000	2,160	200	100	300	2,460
Depreciation	1,440	1,300	2,740	250	140	390	3,130
Interest	170	100	270	20	20	40	310
Total Expenses	$ 13,000	$ 14,500	$ 27,500	$ 2,000	$ 2,000	$ 4,000	$ 31,500

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Analysis of Expenses

- Presentation on the face of the Statement of Activities

Expenses:		
Grant activities -		
	Grants	4,770
	Salaries, benefits, and taxe	12,300
	Occupancy costs	2,160
	Depreciation	2,740
	Supplies	2,100
	Other	3,430
		27,500
Management and general -		
	Salares, benefits and taxes	1,130
	Occupancy costs	200
	Depreciation	250
	Other	420
		2,000
Fundraising		
	Salares, benefits and taxes	900
	Other	1,100
		2,000
Total Expenses		31,500

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Disclosures of Allocation Methods

Note 5 - Methods Used for Allocation of Expenses Among Program and Supporting Services

The financial statements report certain categories of expenses that are attributable to one or more program or supporting services of the Organization. Those expenses include depreciation, the Executive Director's office, communications department, and information technology department. Depreciation is allocated based on a square footage basis, the Executive Director's office is allocated based on a time and cost study of where efforts are made, certain costs of the communications department are allocated based on a cost study of where efforts are allocated based on the benefit received, and the information technology department is allocated based on a cost study of specific technology utilized.

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Functional Expenses Defined

- Program Services
  - Activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists.
- Supporting Activities
  - Supporting activities are all activities of an NFP other than program services. Generally, they include the following:
    - Management and general activities
    - Fundraising activities
    - Membership development activities

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Management and General Expenses

- Oversight
- Business management
- General recordkeeping and payroll
- Budgeting
- Financing, including unallocated interest costs
- Soliciting funds other than contributions and membership dues
- Administering government, foundation, and similar customer-sponsored contracts, including billing and collecting fees and grant and contract financial reporting.
- Disseminating information to inform the public of NFPs stewardship of contributed funds
- Making announcements concerning appointments
- Producing and disseminating the annual report
- Employee benefits management and oversight (human resources)
- All other management and administration except for the direct conduct of program services, fundraising activities, or membership development activities.

Enhanced Guidance on M&G Allocation

- Activities that represent direct conduct or direct supervision of program or other supporting activities require allocation from management & general activities

- Examples added:
  - IT – benefits various functions and generally would be allocated to program, fundraising, M&G
  - CEO – could be allocated to program, fundraising, M&G
  - CFO – could be allocated to M&G and investment expense
  - HR – generally would assign all to M&G
  - Grant Accounting and Reporting – program reports would be program (grant-related) but financial reports and related accounting would be M&G

#6 - Investment Return

- Present investment expenses net against investment return.
  - Both EXTERNAL and direct INTERNAL expenses
  - **Removes** requirement to disclose the gross investment income and expense (permitted but not required)

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Defining Internal Investment Expenses

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

- Salaries, benefits, 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
- DOES NOT include items that are not associated with generating investment return such as costs associated with unitization and other such aspects of endowment management

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Reporting of Investment Return – Examples

- Direct internal investment expenses involve the *direct conduct* or *direct supervision* of the strategic and tactical activities involved in generating investment return. The following are some examples:
  - CIO's Compensation: potentially all of expense
  - CFO's Compensation: Potentially a partial allocation of expense
  - Investment Accountant's Compensation: Potentially a partial allocation of expense
  - CIO's Travel Expenses to Visit Fund Managers: Potentially all of expense
  - Accountant Performing Endowment Allocations: None

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#7 - 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

Operating Cash Flows - Which Presentation is More Informative?

Cash received from contributors	10,700
Cash received from service recipients	5,000
Interest and dividends received	8,600
Miscellaneous receipts	100
Cash paid to employees	(13,500)
Cash paid to suppliers	(5,700)
Interest paid	(400)
Grants paid	(5,700)
Net cash used by operating activities	(900)

Direct Method

Indirect Method

Cash flows from operating activities:	
Change in net assets	$ 16,600
Adjustments to reconcile change in net assets to net cash	
Depreciation	3,000
Net gains on investments	(15,800)
Net gain on sale of equipment	(120)
Net change in operating assets and liabilities -	
Contributions receivable	(880)
Prepaid expenses and other assets	(460)
Accounts payable and accrued expenses	390
Grants payable	870
Contributions restricted for long-term investments	(4,500)
	(17,500)
Net cash used by operating activities	(900)

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Effective Dates and Transition

- Effective Date:
  - Fiscal years beginning after 12/15/2017 (e.g. CY 2018 and FY 2018/2019)
  - Interim financials the following year
- Transition:
  - In year of adoption apply all provisions of the new ASU
- 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

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Revenue Recognition

- **ASU 2014-09 - Revenue From Contracts with Customers**
- Final standard issued in May of 2014.
- Why?
  - Convergence of U.S. and International Standards.
  - Create consistency between different industries for similar economic transactions.
- Effective: for annual reporting periods (and interim for public companies) beginning after Dec 15, 2017, (**2018**) and interim reporting periods for nonpublic companies in years beginning after Dec 15, 2018 (**2019**).
- Early adoption: permitted.

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Revenue Recognition

<u>Core Principle</u> -

- An entity shall recognize revenue to depict the **<u>transfer</u>** of goods or services to the customer in an amount that reflects the consideration the entity receives, or expects to receive, in exchange for those goods or services provided.

Revenue Recognition

Five steps to apply the core principle:

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 satisfied a performance obligation.

Revenue Recognition

<u>Step 1: Identify the Contract</u> –

- May be written, oral or implied.

- Contract must have commercial substance.

- Parties to the contract have approved the contract and are committed to satisfying their respective obligations.

- Each party must have **<u>enforceable</u>** rights regarding the goods or services being transferred. If both parties can cancel, then it is not a contract.

- The entity can identify the terms and manner of payment for those goods or services.

- **Collectability must be probable, or no revenue recognition.**

Revenue Recognition

Step 2: Performance Obligations – (ASC 606-10-25-16 through 25-18)

- A promise in a contract to transfer a good or service to a customer.
- At contract inception, an entity should assess the goods or services promised in a contract that is distinct or as a series that are substantially the same.

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Revenue Recognition

Step 3: Transaction Price – (ASC 606-10-32-2)

-Definition: Amount that vendor ***expects*** to be entitled to for transferring goods or services.

-Probability-weighted amount of consideration that an entity expects to receive from the customer in exchange for the goods or services, or "the most likely amount".

-Collections on behalf of third parties are not part of price, but amounts charged to customer to reimburse seller costs are (Sales tax)

-If the transaction price cannot be reasonably estimated, an entity shall not recognize revenue from satisfying a performance obligation.

-Consider the effects of:

- Variable amounts (incentives and penalties)
- Non-cash consideration
- Consideration payable to the customer
- Financing component

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Revenue Recognition

<u>**Step 4: Allocation of Transaction Price to Performance Obligations –** (ASC 606-10-32-31 through 34)</u>

- Allocation is based on relative standalone selling price.
- <u>**Defined term:**</u> The price at which an entity would sell a promised good or service separately to a customer.
- Use observable transactions if exist; Otherwise, whatever is best:
  - Expected cost plus margin; market assessment; valuation
  - Residual approach ok (if highly variable or uncertain)
- Applies to all industries, including software.

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Revenue Recognition

<u>Step 5: Recognize Revenue as Performance Obligations are Satisfied – Based on "Transfer of Control</u>"

- Obligation is satisfied when control over good or service is transferred to customer.

- Control is the ability to direct use of the asset and obtain substantially all benefits from it.

- Control may pass **<u>at a point in time or over time</u>.**
  - "Over time" generally earlier recognition for goods and service, as delivery or completion.
  - "Point in time" generally earlier for IP licenses, as it would happen at start of license, rather than over time.

- Focus on control, rather than risks and rewards.

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Revenue Recognition

<u>Presentation</u> (ASC 606-10-45)

- If vendor performs (i.e., recognizes revenue) ahead of payment, recognize a "contract asset".
- If customer pays ahead of performance.
  - "Contract liability" for amounts probable of being kept
  - "Refund liability" for other amounts
  - Does not trigger revenue (ASC 606-10-55-51)
- Recognize receivable if right to payment conditional only upon passage of time.
  - If receivable is recognized without revenue, adjust contract asset/liability

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Revenue Recognition

Disclosures(ASC 606-10-50)

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The disclosure requirements found in the new revenue recognition guidance are significantly in excess of what is currently required under U.S. GAAP.

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Transition

- Methods:

  1. Full Retrospectively to all periods (Restate all prior periods)

  2. Retrospectively to all periods but with permitted practical expedients.
     - Example: Use transaction price at completion rather than estimating variable consideration in comparative periods.

  3. Cumulative effect at date of initial application to reflect effect of new standard on contracts not completed at adoption, plus disclosures.

- No alternative transition method for private companies.

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Proposed Accounting Standard Update – Contributions Received and Made

- The FASB is issuing this proposed update to clarify and improve the scope and the accounting guidance for contributions received and contributions made.

- The amendments will assist entities in:

  - Evaluating whether transactions should be accounted for as contributions within the scope of Topic 958 or as ;

  - Exchange transactions subject to Topic 606 – Revenue from Contracts with Customers.

  - Further to distinguish between conditional contributions and unconditional contributions.

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Proposed Accounting Standard Update – Contributions Received and Made

- In determining whether a transfer of assets is an exchange transaction in which a resource provider receives commensurate value, an entity must evaluate the terms of the agreement and consider the following:

  - The resource provider is not synonymous with the general public;
  - Execution of the resource provider's mission or the positive sentiment from acting as a donor;
  - Expressed intent asserted by the recipient and the resource provider;
  - Resource provider has full discretion in determining the amount of the transferred assets;
  - Potential amount of penalties that could be assessed.

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Proposed Accounting Standard Update – Contributions Received and Made

- If the transaction is deemed to be a contribution then the following needs to be considered:

  - Donor Imposed Condition – new definition
    a. A barrier exists <u>and</u>
    b. Right of return to the promisor for assets transferred or a right of release of the promisor from its obligations to transfer assets.

  - Barrier
    a. Measurable performance related - specified level of service; identified number of units of output; a specific outcome
    b. Limited discretion by the recipient – qualifying expenses
    c. Stipulations related to the purpose of the agreement
    d. Additional actions, endeavors or goals.

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Proposed Accounting Standard Update – Contributions Received and Made

- Transitional Requirements
  - Applied on a modified prospective basis in the first set of financial statements following the effective date to the agreements that are either:
    - a. Not completed as of the effective date
    - b. Entered into after the effective date

- The effective date of the amendments in this proposed update would be the same as the effective date of the amendments in Update 2014-09.

Questions?

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