

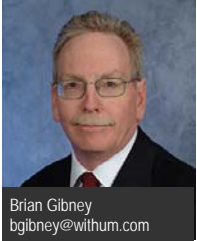
WS+B E-FLASH

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NFP No. 11-12

SO WHAT'S YOUR STORY?

By Brian Gibney, CPA, Partner



FASB to Consider Giving Not-for-Profits the Opportunity to "Tell Their Story" through revised reporting requirements

NOTICE TO NOT-FOR-PROFITS

The Financial Accounting Standards Board (FASB) is interested in hearing more about your organization, and not just the numbers. FASB's Not-for-Profit Advisory Committee (NAC) is currently working on substantial

changes to how NFPs are required to report their accounting and financial data, acknowledging that a one-size-fits-all approach is no longer working. Reporting would include not only metrics, but also more information about their mission, their clients, successes and failures, operations and financial health. For some organizations, this is a terrific opportunity to explain their financial data and differentiate themselves among other NFPs. For others, this may pose more of a challenge.

BASIC NFP REPORTING MODEL HAS REMAINED SUBSTANTIALLY UNCHANGED

It took FASB, which began operations in 1973, more than 20 years to address not-for-profit (NFP) accounting and reporting issues in a meaningful way. It did so in 1993 when it dove headlong into the promulgation of accounting and financial reporting standards related to not for profit organizations with the issuance of FAS 116 – **Accounting for Contributions Received and Contributions Made** and FAS 117 – **Financial Statements of Not-for-Profit Organizations** (now codified in ASC 958). Prior to that time much of the guidance related to NFP accounting and reporting had been published by the American Institute of Certified Public Accountants (with the acquiescence of the FASB).

FAS 116 set out the basic requirement for recognizing contributions received from and given to others and delineated the distinctions between unrestricted, temporarily restricted and permanently restricted net assets. FAS 117 provided guidance on the presentation and

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QUESTIONS OR COMMENTS?

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disclosure requirements for financial statements of NFPs. The requirements of 116 and 117 initially caused a significant amount of disconcert in the NFP community. Many expressed concern over the requirement to record revenues in one year even though the expenses those revenues were to fund might be incurred in subsequent years; there was fear that stakeholders would not understand the process of transferring revenues from temporarily restricted assets to unrestricted assets. While some CFOs in the NFP community still complain about this today, by and large the NFP community has “bought in” on both the classification and the presentation of net assets.

Overtime, the disclosure requirements of NFPs have increased significantly as a consequence of both subjecting NFPs to previously published accounting pronouncements from which they were originally exempt and from the publication of new accounting pronouncements not specifically related to NFP issues. FAS 142 **Goodwill and Other Intangible Assets** – is an example of the former and FAS 157 - **Fair Value Measurements** is an example of the latter. FAS 116 and 117 however, have remained largely unchanged. It has now been more than 18 years since their publication and at least one group believes these venerable pronouncements are due for an overhaul. If the FASB's Not-for-Profit Advisory Committee has its way, substantial changes are on the way.

THE NFP ADVISORY COMMITTEE

The Not-for-Profit Advisory Committee (“NAC” or “Committee”) was established by the FASB in 2009 to serve as a vehicle for the exchange of information and ideas between it and the NFP community. It was primarily established to help the FASB understand the issues and needs of the NFP community and how those needs differ from the needs of business entities. The committee was formed in 2010 with members appointed from a broad spectrum of NFP sectors and individuals of disparate backgrounds. Specifically, the NAC is to provide the FASB with feedback from the NFP community on existing guidance and projects.

The NAC has taken its job seriously; from late 2010 and throughout 2011 it performed outreach to the NFP community to determine if current accounting and reporting requirements meet the needs of the NFP community. The results of that outreach effort identified a number of areas where the NFP community indicated current accounting and reporting requirements fall short of the needs of NFPs.

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In September 2011 NAC recommended significant changes in the way NFPs report and requested that the FASB put the topic on its agenda. In November 2011 the FASB complied by adding to its agenda two projects. The first project, entitled Not-for-Profit Financial Reporting: Financial Statements, is to reexamine existing NFP financial reporting standards with a focus on net asset classification requirements and improving disclosure information related to liquidity, financial performance and cash flows. The second project, entitled Not-for-Profit Financial Reporting: Other Financial Communications, is a research project related to NAC proposals to include a Management's Discussion and Analysis (MD&A) section in the financial statements of NFPs.

WHAT GENERAL ISSUES WERE IDENTIFIED BY NAC?

The NAC identified the following specific areas where NFP organizations indicated improvements were needed:

- The current accounting and disclosure requirements do not allow or enable NFPs to fully "tell their story";
- There is a lack of financial comparability between NFPs both within a given sector (for example colleges and universities) and across different sectors;
- The current net asset classification has become outdated and current accounting and disclosure requirements do not enable stakeholders to determine NFPs' liquidity and financial health.

These issues are not necessarily discrete – there are varying amounts of overlap between and among each of them. Following is a more detailed discussion of the specific changes proposed by NAC.

WHAT RECOMMENDATIONS WERE MADE BY NAC?

Proposal—Augment Management Disclosures

As indicated above, one of the issues raised by many of those canvassed as part of the project is the (perceived) failure of the current reporting framework to allow NFPs to adequately "tell their story". As a result the NAC has made the following specific proposals designed to enable NFPs to get their story out. Those proposals include:

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- Implementation of a framework to enable management of NFPs to better explain trends, the organization's financial health and stability and its liquidity. The Committee proposes NFPs include this information as required supplementary information in a Management's Discussion and Analysis (MD&A) section similar to that required for financial statements of governmental entities. The MD&A would precede the auditor's report and the basic financial statements and footnotes. NAC has recommended a framework for MD&A which includes the following four areas: Introduction and Overview, Financial Health, Operations and Liquidity.
- Larger NFPs should report information by major lines of business. Such reporting would be akin to segment reporting currently required by public entities and would serve to provide a linkage between an entity's sources of revenues and its program costs and the net cost of providing various services.
- Requiring all NFPs to report expenses by both functional and natural classification. The NAC indicated that the possible location for such reporting could be within the MD&A, the basic financial statements, the notes to the financial statements or in supplemental information.
- Increased reporting of non-financial metrics.

WS+B Analysis

Adoption of the MD&A proposal should improve NFP reporting. Of course, many smaller NFPs may find it burdensome – a fact acknowledged by NAC and addressed by allowing reduced analysis. Too, there is the risk that many NFPs will merely mimic information that is readily available in the financial statements without providing any greater insight into the entity's goals, accomplishments and failures. But for those NFPs that choose to utilize this tool (and they do not have to be limited to the large national and international organizations) the MD&A provides a real opportunity to go behind the amounts reported and discuss program success and failures, units of service, financial health, where they have been, where they are going and other matters related to the financial and programmatic success of the organization.

At this point, the utility of the proposal for segment reporting is up in the air. It might prove useful to national and international organizations; its application to smaller organizations is questionable. One issue would be delineating between segments and functional areas.

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"...the MD&A provides a real opportunity to go behind the amounts reported and discuss program success and failures..."



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The proposal to require all NFPs to present expenses by functional areas and natural classification is a good one. When combined with other proposals for revisions to the statement of activities (discussed later) it would both improve comparability between NFPs and give a clearer picture of how NFPs fund their various program activities.

The ability to report non-financial metrics should appeal to most NFPs. For example, food banks might disclose the total number of pounds of food distributed; a methadone clinic might disclose contact visits and/or doses administered. When coupled with other financial and non financial information (perhaps in the MD&A) this information could greatly assist in NFPs “telling their story”.

Proposal—Revise the Statement of Activities

NAC determined that users of NFP financial statements believe the current framework for reporting, particularly in the statement of activities, does not facilitate comparability between different NFPs – including those within the same sector. In addition, there was a consensus that changes to the current net asset classification and related disclosures is warranted. In addition, the Committee believes that financial statement users focus more on changes in unrestricted net assets while the current financial reporting model emphasizes the change in total assets. Finally, the Committee reviewed current note disclosures and considered ways to both streamline current disclosures and make them more meaningful. Some of the recommendations proposed by the Committee include the following:

- Implementation of a single model of reporting to be applied across the broad spectrum of NFPs. Separate reporting models for those that are engaged in business-like activities (healthcare for instance) should be avoided if possible.
- NFPs would have to define and report an operating measure in the statement of activities. For simple NFPs the operating measure may be defined as the change in unrestricted net assets.
- Provide greater synchronization between the operating measure in the statement of activities and operating cash as presented in the statement of cash flows.
- The statement of cash flows would be presented using the direct method.
- Encouraging or requiring a two-statement approach to presenting operations. The first statement would present an operating section and a non-operating section. The non-operating section would contain changes in unrestricted endowments, items of other comprehensive income etc. The sum of the two sections on the first statement would

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combine to form the change in unrestricted net assets. The second statement would begin with the change in unrestricted net assets and work to the change in total net assets.

- For NFPs that generate significant revenues from program activities or functional areas, revenues would be linked to the related expenses to enable the reader to determine how a program's revenues compare to its costs.
- The three current net asset classes used for reporting (unrestricted, temporarily restricted and permanently restricted) would be reduced to two – donor-restricted and other net assets. Types of donor restrictions would be disclosed either on the face of the financial statements or in the notes. The term "unrestricted net assets" would be replaced with "other net assets" as currently, unrestricted net assets often contains assets with other legal restrictions on them.
- Require the disclosure of total contributions somewhere in the financial statements or notes.
- Provide more information regarding donor restrictions and the satisfaction of those restrictions.

WS+B Analysis

Who could be against improving comparability among non-profits? Is this not akin to motherhood and apple pie? If this can be done without forcing all NFPs into a "one-size fits all" financial statement presentation, then try it. The proposal for requiring the statement of cash flows be presented using the direct method will most likely draw opposition. On the other hand, enabling stakeholders to see the revenues funding specific program activities is a significant improvement over current reporting – a win for everyone. The two statement approach may prove to be cumbersome.

In general, the proposals related to the net asset classes seem solid. Changing the nomenclature from unrestricted net assets to something more descriptive is overdue. There are many NFPs with significant "unrestricted" assets that have outside (legal) restrictions on their use (for example trust funds or cash set aside to secure a loan). Condensing the temporarily and permanently restricted net asset classes into one class for purposes of presentation on the statement of financial position would not significantly impair analysis – particularly when the specific restrictions are delineated in the notes.

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The goal of requiring all NFPs to report an operating measure, - to improve comparability - is laudable but may prove elusive. Many single purpose NFPs may not find it a useful tool. For other NFPs that currently do report an operating measure, the current GAAP requirement to define the operating measure in the notes to the financial statements is sufficient to allow reporting flexibility and enable users to compare results between organizations.

One caveat - revision of the statement of activities may be impacted by the current joint FASB/IASB project on Financial Statement Presentation. The FASB/IASB discussion paper issued in June 2008 proposes that an entity's financial statements (statement of financial position and statements of activities) classify transactions and account balances into operating, financing and investing activities. And while the initial discussion paper specifically excludes NFPs from its provisions, it does indicate that future research and analysis would be conducted before making a final decision as to its applicability to NFPs.

Proposal—Improve Reporting of Liquidity

The Committee determined that liquidity is a key indicator of an NFP's financial health and consequently, is of interest to many stakeholders. Furthermore, current net asset information does not provide a direct measure of liquidity. Moreover, the current financial reporting by NFPs does not provide sufficient information to enable users of the financial statements to adequately determine an entity's liquidity. One reason for this is the failure of NFPs (and, by extension, their auditors) to fully comply with existing GAAP guidance.

The Committee determined that users need better access to information regarding donor restrictions, board restrictions and the timing of when assets will convert to cash. The Committee also noted that many users require more information about restrictions on "unrestricted" net assets and on temporarily restricted net assets with respect to when cash is available for either operations or to pay debt service. In order to provide users with better information related to an entity's liquidity NAC proposed the following disclosures (to be made either on the face of the financial statements or in the notes):

- The amount of net assets available for immediate liquidation without penalty.
- The amount of net assets converting to (consuming) cash during a specified time frame following the date of the statement of financial position.
- The amount of net assets required to be retained to satisfy statutory and other external requirements.
- The amount of net assets designated by the Board.

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- The amount of net assets invested in long-term assets not readily available to conversion to cash.
- Amount of donor restricted assets that can be spent either based on a Board appropriation or the passage of a short amount of time.
- Amount of donor restricted assets by type of restriction.
- Unrestricted and restricted net assets disaggregated on the face of the financial statements by the following three categories: spendable, designated and non-spendable.

WS+B Analysis

The proposal to delineate net assets classes further into a spendable, designated and non spendable categories might prove useful; however, this information would be substantially determinable if current GAAP reporting and disclosure requirements were more rigidly adhered to. In addition, there may be difficulty with both defining each category and in assigning assets to each of the categories, which could diminish the comparability of the information between various NFPs. Many of the other proposals appear to amount to a re-affirmation of current reporting requirements or recommended reporting practices.

CONCLUSION

It is not possible to predict the end result of the NAC project as this issue has just been placed on the FASB's agenda. Nothing is imminent. However, some of the NAC proposals are extensive and would require significant changes in the NFP reporting model and specific disclosures, if enacted. Many of the proposals would improve financial reporting by NFPs and deserve serious consideration by the NFP community. Not-for-profit entities (and their auditors) are urged to be cognizant of the FASB's activities and participate in those activities to the extent possible.

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