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FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Q&A NOT-FOR-PROFIT FINANCIAL STATEMENT EXPOSURE DRAFT FREQUENTLY ASKED QUESTIONS

Overall

1 WHY IS THE FASB PROPOSING CHANGES TO FINANCIAL REPORTING BY NOT-FOR-PROFIT ORGANIZATIONS (NFPs)?

The current reporting model of NFPs has held up well for over 20 years but stakeholder comments and the recent financial crisis suggest that a comprehensive update would be beneficial. The FASB agrees that it is time to refresh the model so that NFPs' financial statements might better communicate their financial performance and condition to their donors, grantors, creditors, and other stakeholders.

2 WHAT ARE THE MAJOR IMPROVEMENTS THAT THE FASB HOPES TO ACHIEVE THROUGH ITS PROPOSED CHANGES TO GAAP?

The proposed Accounting Standards Update (ASU) identifies several major improvements that are directed at increasing the understandability, comparability, and usefulness of an NFP's current net asset classification requirements and of information presented in financial statements and notes that is useful in assessing an NFP's liquidity, financial performance, and cash flows.

3 WOULD ALL NFPs BE AFFECTED? IF NOT, WHAT TYPES OF ENTITIES ARE OUTSIDE OF THE SCOPE OF THE PROPOSED ASU?

The proposed ASU would affect substantially all NFPs as defined by the *FASB Accounting Standards Codification®*. Those NFPs typically include charities, foundations, private colleges and universities, nonprofit health care providers, cultural institutions, religious organizations, and trade associations, among others. They generally do not include investor-owned entities or entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

4 HOW WOULD THE PROPOSAL HELP CREDITORS, DONORS, AND OTHER USERS OF FINANCIAL STATEMENTS ASSESS AN NFP'S LIQUIDITY?

Current reporting practices often do not make clear how, if at all, restrictions affect liquidity. Enhanced disclosures about financial assets and the extent to which they are not available in the near term because of limits imposed by donors, laws, and internal governing board actions should help creditors and donors in their assessment of an NFP's liquidity. Qualitative disclosures about how an NFP manages its liquidity would add further clarity and usefulness to existing information.

5 HOW WOULD THE PROPOSAL HELP USERS ASSESS AN NFP'S FINANCIAL PERFORMANCE?

A user's ability to assess financial performance would be improved in several ways. Perhaps foremost is a new requirement to report two intermediate measures reflecting the results of current operations that focuses on the resources available for use in the current period in carrying out the purposes for which an NFP exists. One measure would reflect the operating results before internal transfers (for example, governing

board designations and appropriations). The second measure would reflect the operating results after internal transfers that make resources unavailable or available for use in current operations. Distinguishing and reporting operating activities separate from other activities (such as most investing and financing activities) and the proposed disclosures about the nature of operating expenses also would provide donors, creditors, and other users with information useful in assessing financial performance.

6 HOW WOULD THE PROPOSAL HELP USERS ASSESS AN NFP'S SOURCES AND USES OF CASH?

Presenting all cash flows—operating, investing, and financing—using the direct method should increase the understandability and, thus, the usefulness of information about an NFP's sources and uses of cash, particularly from its operating activities.

7 WOULD MANAGEMENT DISCUSSION/EXPLANATIONS BE ALLOWED TO SUPPLEMENT THE GAAP REQUIREMENTS?

Yes. Most donors, creditors, and other users understand that financial statements have their limits and that an NFP's financial performance, efforts, and accomplishments cannot be measured by any single metric or by financial statements alone. Although the FASB is not addressing management commentary, members of the FASB's Not-for-Profit Advisory Committee (NAC) and others strongly encourage the use of management commentary to help explain an NFP's financial story.

Net Assets

8 WHY IS THE FASB PROPOSING TO COLLAPSE THE TWO DONOR-RESTRICTED CLASSES OF NET ASSETS (TEMPORARY AND PERMANENT) INTO A SINGLE DONOR-RESTRICTED CLASS OF NET ASSETS? WOULD USEFUL INFORMATION BE LOST?

The FASB believes the line between temporary and permanent restrictions became blurred when nearly all states adopted a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). FASB members believe clear disclosures about various types of restrictions provided in notes can be more useful than the highly aggregated temporary and permanent amounts that currently are provided on the face of financial statements and that such disclosure should prevent the loss of useful information. The FASB also believes that the proposed change would help reduce complexity and increase the understandability of information presented on the face of the statement of financial position.

9 NOTWITHSTANDING THE PREVIOUS ANSWER, CAN AN NFP PROVIDE ADDITIONAL INFORMATION ABOUT THE NATURE OF DONOR RESTRICTIONS ON THE FACE OF THE STATEMENT OF FINANCIAL POSITION?

Yes. Financial reporting standards generally establish minimum requirements and most NFPs strive for best practices that help them communicate with their stakeholders. While the FASB would no longer require net asset classes for temporary and permanent restrictions, and would discourage the use of such labels, an NFP may find it useful to disaggregate along the lines of certain broad groupings of restrictions—for example, donor-restricted endowments—on the face of the statement of financial position, while presenting additional detail in the notes as necessary.

10 WHY IS THE FASB PROPOSING TO ALSO REQUIRE DISCLOSURES ABOUT VARIOUS TYPES OF BOARD DESIGNATIONS THAT PLACE INTERNAL LIMITS ON THE USE OF NET ASSETS THAT ARE WITHOUT DONOR RESTRICTIONS?

The FASB believes such disclosures would help an NFP show how its resources are being managed, and that, in turn, would help an NFP tell its financial story. An NFP could choose to provide that information on the face of the statement of financial position or in notes to its financial statements.

11 WHY IS THE FASB CHANGING THE TERM *UNRESTRICTED NET ASSETS* TO THE MORE CUMBERSOME TERM *NET ASSETS WITHOUT DONOR RESTRICTIONS?*

The FASB was told that the term *unrestricted net assets* is sometimes misunderstood to mean without any restrictions. Although the proposed change in terminology is not a change in substance, the FASB believes that refining the terminology would help better communicate that net assets that are not subject

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to donor-imposed restrictions nonetheless could be subject to other restrictions resulting from laws, regulations, and the terms and conditions of bond agreements and other contracts.

12 WHY IS THE FASB PROPOSING TO RECLASSIFY THE AMOUNT BY WHICH A DONOR-RESTRICTED ENDOWMENT FUND IS *UNDERWATER* FROM NET ASSETS WITHOUT DONOR RESTRICTIONS TO NET ASSETS WITH DONOR RESTRICTIONS?

Under laws predating UPMIFA, spending from an underwater endowment fund was precluded until such fund was restored to its historic dollar value (HDV). To help convey that the amount to be maintained permanently continued to be the HDV of the fund, the standards developed at that time required that the underwater amount of the fund be classified as a reduction in unrestricted net assets, rather than permanently restricted net assets. Enacted versions of UPMIFA now allow spending, within the bounds of prudence, from an underwater endowment fund. The FASB believes that classifying the entire amount of an endowment fund as donor restricted, whether underwater or not, is consistent with current laws, and not bifurcating an endowment fund into two separately classified amounts would reduce the complexity and increase the understandability of information and, thus, increase its usefulness to creditors, donors, and other stakeholders.

13 IF UPMIFA HAS ELIMINATED THE CONCEPT OF HDV IN ORDER TO PERMIT CONTINUED PRUDENT SPENDING IN SUCH SITUATIONS, WHY IS THE FASB PROPOSING TO RETAIN A NOTION OF UNDERWATER ENDOWMENTS IN FINANCIAL REPORTING AND ENHANCE THE DISCLOSURE REQUIREMENTS IN THIS AREA?

Notwithstanding the elimination of HDV from the law, the FASB understands that NFPs still commonly use any shortfalls in the value of endowment funds versus their original gift amounts (or other level required by the donor or law) as important data points in determining their policies for spending from their endowment funds. The NFP community still commonly uses the term *underwater* to refer to such situations. Thus, the Board believes that disclosures surrounding an NFP's policies about spending from underwater endowment funds can provide its creditors and other users with useful insights about (a) how the entity is managing resources and (b) potential constraints on its liquidity and financial flexibility.

Statement of Activities

14 WHICH REVENUES AND EXPENSES QUALIFY AS OPERATING ACTIVITIES OF THE PERIOD? WHICH DO NOT?

All revenues that are from carrying out an NFP's purpose for existence (its mission) *and* are available for current-period activities would qualify as operating revenues. Similarly, all expenses incurred in carrying out those activities would qualify as operating expenses. Donor-restricted contributions to support specified operating activities would not qualify as current-period operating revenues; however such restricted support would qualify as operating support in the period the restriction expires or is met—that is, when the resources became available to support a current-period operating activity. Lastly, revenues and expenses from or for investing and financing activities generally are not from or directed at carrying out an NFP's purpose for existence and thus would not qualify as operating revenues or expenses.

15 WOULD REVENUES AND EXPENSES INCURRED IN CONNECTION WITH PROGRAMMATIC INVESTING ACTIVITIES THAT ARE DIRECTED AT CARRYING OUT AN NFP'S PURPOSES FOR EXISTENCE (RATHER THAN DIRECTED AT GENERATED TOTAL RETURN) QUALIFY AS OPERATING REVENUES AND EXPENSES?

Yes, unless a donor restriction makes some or all of the revenues unavailable for current-period activities.

16 WHY IS THE FASB PROPOSING TO REQUIRE THAT GOVERNING BOARD APPROPRIATIONS AND DESIGNATIONS OF RESOURCES (INTERNAL TRANSFERS) BE SHOWN PROMINENTLY ON THE FACE OF THE ACTIVITY STATEMENT AND AFFECT AN OPERATING MEASURE?

FASB believes that NFPs and their directors or trustees would be better able to communicate how their resources are being managed by clearly and transparently presenting the effect of governing board actions that make resources available or unavailable for current-period operations. Today, NFPs that voluntarily present operating measures include or

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exclude the effects of such actions in differing ways that often are not transparent or well understood by external users of financial statements. Thus, although some stakeholders have expressed concerns about including internal transfers on the face of the statement of activities, Board members believe that presenting internal transfers in ways that are transparent would improve understandability as well as help communicate how resources are being managed. The FASB's proposal that would require NFPs to report two intermediate measures of operations—an operating excess (deficit) before transfers and an operating excess (deficit) after transfers—helps to provide the desired transparency.

17 WHICH OF THE TWO INTERMEDIATE MEASURES OF OPERATIONS IS VIEWED BY THE FASB AS THE OPERATING MEASURE?

The Board is not proposing a single intermediate measure of operations. Rather, FASB members believe that both measures are necessary to clearly communicate the resources made available to and used by an NFP to carry out its current-period operating activities *and* how its resources are being managed. The latter includes communicating the extent to which an NFP's governing board chooses to set resources aside for future periods and make previously set-aside resources available for carrying out current-period operating activities.

18 WHY IS THE FASB PROPOSING TO REQUIRE THAT CONTRIBUTIONS OF LAND, BUILDINGS, AND SIMILAR LONG-LIVED ASSETS THAT ARE WITHOUT DONOR RESTRICTIONS BE CLASSIFIED AS OPERATING REVENUES/SUPPORT?

All contributions of cash, securities, land, buildings, and other assets, whether with or without donor restrictions, are viewed as resulting from carrying out an NFP's purpose for existence. Thus, absent a donor restriction that makes the gifted asset unavailable for current-period activities, those gifts are classified within operations. If instead of selling a gifted asset—to convert it to cash—an NFP decides to use gifted land, buildings, and similar long-lived assets to carry out activities over several periods, its decision would be treated as a governing board action that makes those long-lived assets not fully available for current-period activities. Accordingly, the NFP would report the gift as current-period operating revenue that increases the measure of operations before transfers, and a transfer from operations that would reduce the measure of operations after transfers.

19 HOW WOULD PRIOR YEAR CASH GIFTS RESTRICTED FOR THE ACQUISITION OF SUCH ASSETS BE REPORTED?

A restricted gift would be classified as donor-restricted revenue (rather than current-period operating revenue) in the year received because the unmet restriction made the resources unavailable for carrying out the NFP's purpose for existence in that period. In the subsequent period in which the restriction is met—generally when cash is used to acquire the long-lived asset and it is placed in service—operating support would be recognized, which would increase the measure of operations before transfers. An equal amount would be reported as a decrease to the donor restricted class of net asset to reflect the expiration of the donor restriction. In addition, when a long-lived asset is placed in service, that action makes those assets not fully available for current-period activities. Accordingly, the NFP also would report a transfer from operations that would reduce the measure of operations after transfers. This would yield results on the before-transfer and after-transfer operating measures that are similar to that noted for a current-period gift of a long-lived asset placed in service.

20 CAN A BUSINESS-ORIENTED HEALTH CARE ENTITY STILL CHOOSE TO REPORT A PERFORMANCE INDICATOR?

Yes, but it may be cumbersome to report that additional intermediate measure on the face of the statement of activities. If desired, reporting that measure in notes or in management's discussion and analysis might be more practical.

21 WHY IS THE FASB PROPOSING TO REQUIRE THAT ALL NFPs (RATHER THAN JUST VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS) PROVIDE IN ONE LOCATION INFORMATION ABOUT BOTH THE FUNCTION AND NATURE OF OPERATING EXPENSES?

The reporting of operating expenses by both their function and nature, in one place, would add information useful to creditors, donors, grantors, and others in assessing (1) the degree to which operating expenses are fixed or discretionary, (2) how resources are allocated toward achieving an NFP's programs, and (3) the costs of the services an NFP provides. The reporting of operating expenses with other expenses in one location could be done on the face of the statement of activities, in a separate statement, or in notes to the financial statements.

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22 WHY IS THE FASB PROPOSING TO REQUIRE THAT NONPROGRAMMATIC INVESTMENT RETURN BE REPORTED NET OF EXPENSES ON THE FACE OF THE STATEMENT OF ACTIVITIES?

Constituents told the Board that requiring the reporting of all investment expenses is not practical for the many NFPs that commonly invest in mutual funds, hedge funds, and other investment vehicles that have imbedded management fees for which the expenses incurred often are not readily determinable. The Board also has been told that users are primarily interested in the net total return of the investment portfolios, regardless of whether they are internally or externally managed. The Board believes that requiring the disclosure of the net investment return will provide a comparable measure of return across all entities regardless of the types of investments an NFP utilizes.

Statement of Cash Flows

23 WHY IS THE BOARD PROPOSING TO REQUIRE THE DIRECT METHOD OF REPORTING OPERATING CASH FLOWS FOR NFPs AND NO LONGER REQUIRE THE INDIRECT METHOD, WHEN BOARD MEMBERS HAVE PUBLICLY ACKNOWLEDGED THAT THEY ARE NOT LIKELY TO TAKE UP SUCH CHANGES FOR BUSINESS ENTITIES?

The Board learned through members of the NAC and other stakeholders that cash flow information can be useful in assessing performance and sometimes crucial in assessing cash flow trends that affect liquidity. However, it also learned that statements of cash flows are underutilized, in part because the indirect method of presenting operating cash flows is complex, not well understood, and not especially relevant to many users of NFP financial statements. The Board noted that governmental colleges, universities, hospitals, and other healthcare providers that follow GASB standards have been required to apply the direct method of reporting operating cash flows and that the cost of implementing that method—from mapping to existing systems and staff training—is justified in light of the increased understandability and, thus, usefulness of the information.

24 CAN AN NFP CHOOSE TO PRESENT OPERATING CASH FLOWS USING THE INDIRECT METHOD?

Yes, if an NFP wishes to, it can voluntarily provide that information in addition to the information provided using the direct method.

25 WHY IS THE FASB PROPOSING TO RECLASSIFY CERTAIN CASH FLOWS FOR REPORTING BY NFPs RATHER THAN WAITING UNTIL IT CONSIDERS WHETHER AND HOW TO DEFINE OPERATING ACTIVITIES FOR REPORTING BY BUSINESS ENTITIES?

A majority of Board members found no compelling reasons to delay improvements that would benefit creditors, donors, and other users of NFP financial statements to await further research and study of financial reporting issues for business enterprises. They noted that classifying cash flows in ways that are better aligned with the notion of operating activities proposed for the statement of activities will increase understandability as well as comparability across NFPs. Those Board members also noted, however, that they expect that comments on this proposed ASU will help inform the Board's research and study of financial reporting matters for business entities and they are committed to considering the interaction of the proposed ASU with its research projects for business entities.

Other

26 DOES THE PROPOSAL INCLUDE ANY ACCOMMODATIONS FOR SMALL NFPs?

No; however, the FASB is seeking comments from stakeholders on all matters in the proposed Update. That includes suggested alternatives for increasing the expected benefits, minimizing complexities, or reducing costs. In addition, the proposal also asks whether there are reasons for any particular size or type of NFP to need a longer time frame to implement any of its proposed requirements. Comments are requested by August 20, 2015.

27 HOW DOES ONE OBTAIN THE PROPOSAL AND FURTHER DISCUSSION ABOUT THE FASB'S REASONS AND EXPECTED BENEFITS FOR CREDITORS, DONORS, GRANTORS, AND OTHER STAKEHOLDERS?

The proposal can be downloaded here. It includes a summary of the major provisions and questions for which the FASB is seeking feedback. An appendix provides the basis for the tentative conclusions that the Board has reached. The Board will redeliberate the issues raised after receiving written comments as well as additional feedback through the outreach activities being conducted before and following the August 20, 2015 comment deadline. In addition, on May 12, 2015, over 1,400 stakeholders attended a live webcast that discussed the proposal and questions raised by many of the stakeholders that participated. An archived version of the webcast is available here. The FASB staff also plans to update this list of questions and answers as additional questions are received.

The views expressed in this document do not necessarily reflect the views of the FASB. Official positions of the FASB are arrived at only after extensive due process and deliberation.

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