HOW TO READ NONPROFIT FINANCIAL STATEMENTS

A PRACTICAL GUIDE

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Andrew S. Lang, CPA | William D. Eisig, CPA
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PREFACE

If you are familiar with the earlier versions of this publication, you know how valuable a resource this book is to readers of nonprofit financial statements. This updated edition of the publication has been expanded and incorporates even more information that will make this a must-have resource.

This edition has been updated to reflect the new requirements of the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities,* which will be effective for most nonprofits for fiscal years beginning after December 15, 2017. The provisions of the ASU can be adopted early if a nonprofit chooses to do so.

The illustrations in this book are designed to provide readers with both the format of nonprofit financial statements before the adoption of ASU 2016-14 as well as the format once a nonprofit adopts the provisions of ASU 2016-14. The illustrations highlight best practices as well as the required changes outlined in the ASU. These illustrations provide a great resource for those trying to read and interpret nonprofit financial statements as well as for those who are responsible for designing and preparing nonprofit financial statements.

A new chapter has been provided that discusses reserves. This is a challenging topic and one that many organizations struggle with, and unfortunately there isn't a single, definitive answer. There are certain considerations and other factors, however, that an organization should analyze in making an assessment regarding appropriate reserves.

This edition provides a new section discussing general financial analysis that provides greater insight into what readers of nonprofit financial statements should be looking for to enable them to satisfy their fiduciary responsibility whether they are a board member, audit committee member, advisor, or internal CEO or CFO. The section also provides some of the more common ratios that can be used to obtain information about the financial condition of a nonprofit organization. This information should be used by all readers and preparers of nonprofit financial statements to ensure the financial statements are designed to provide an accurate depiction of the nonprofit organization's financial position, activities, and results.

This edition also includes a new chapter on benchmarking to assist nonprofits in making comparisons to other nonprofit organizations.

A glossary is included that will assist readers in identifying the meaning of specific terms used in nonprofit accounting and financial statements that can be referred to time and time again.

INTRODUCTION

This book is designed to help you understand the financial statements of nonprofit organizations. If you are a nonprofit executive or volunteer leader who is not familiar with the formats and language of financial reports, or if you simply wish to brush up on your skills, you will find that this book has been prepared especially for you.

Understanding financial information is vital to managing a successful nonprofit organization. As a nonprofit executive, you know this to be true. If you are a volunteer leader and wish to fulfill your fiduciary responsibility to guide your organization, it is equally important. The best leaders do not lead without this knowledge.

The text is intended to provide you with knowledge that you can apply in carrying out your roles and responsibilities in your organization. To that end, you are encouraged to work through the exercises presented to gain insight into the principal concepts surrounding nonprofit financial statements. The exercises reinforce the concepts presented.

The requirements of nonprofit financial reporting in general have grown increasingly complex over the years. The purpose of financial reporting is to provide the financial story of the organization. With the issuance of the Financial Accounting Standards Board (FASB) Accounting Standards Update 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities,* the requirements for how information is presented in nonprofit financial statements have been significantly updated. This edition has been updated to reflect these new requirements and provides explanations and illustrations of many of the new financial statement presentation requirements.

Also, many nonprofit organizations have activities, such as significant federal funding, that require unique reports. These reports and the requirements have also changed as a result of the Office of Management and Budget issuing Title 2 Code of Federal Regulations (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). As a result, special materials have been added near the end of the text to provide those interested with the most important information pertaining to these activities and the updated reporting.

A glossary is included at the end of the text to familiarize you with both the common terms associated with nonprofit financial statements and to provide you with a resource for the future. Understanding the language of nonprofit organizations is essential to understanding your organization's financial statements.

By beginning to read this text, you have taken an important first step in increasing your capabilities. When you have finished the text, you will have accomplished something truly worthwhile.

LEARNING OBJECTIVES

Every educational effort should have a specific focus. This text has been designed so that once you have completed it, you will be able to:

- Name and understand the primary purpose of a nonprofit's basic financial statements.
- Recognize best practices in the presentation of financial information in nonprofit financial statements.
- Understand the significance of the independent auditor's report and be able to recognize an unmodified (clean) opinion and other types of audit opinions.
- Understand the role of the footnotes in financial statements and the purpose they serve.
- Extract and interpret certain financial information from each of the basic financial statements.
- Understand the basic accounting rules that apply specifically to nonprofit organizations.
- Understand the new financial statement presentation changes required by ASU 2016-14.
- Understand the method of assessing the need for reserves.
- Familiarize yourself with common financial ratios that are useful in assessing the financial health of a nonprofit organization.
- Identify benchmarking techniques.
- Recognize the future complexities related to nonprofit financial reporting.

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CONTENTS

CHAPTER 1

Why You Need to Understand the Update to the Nonprofit Reporting Model

Anyone who is responsible in some way for the welfare of a nonprofit organization, whether as a leader, member, donor, manager, or staff, needs to be well aware of recent changes in rules affecting all nonprofit financial reporting. The Accounting Standards Update (ASU) 2016-14 will change the way nonprofits classify net assets and prepare their financial statements. While the changes do not substantially alter a nonprofit's financial statements, they are of sufficient significance that they must be understood by those with a fiduciary responsibility or simply an interest in the well-being of the entity.

This book has been prepared for any and all readers. It provides definitions of common accounting jargon and provides numerous examples of financial statements reflecting both the old standards and the new ones. We applaud you for investing your time to understand what is new in our nonprofit world.

CHAPTER 2

Why Update the Nonprofit Reporting Model?

The current reporting model for nonprofit organizations has been in existence for more than 20 years. Many stakeholders raised the question as to whether a refreshed model would be more useful to users of nonprofit financial statements. The Financial Accounting Standards Board (FASB) analyzed the situation based on input from the nonprofit industry and concluded that improvements were in order. They then added the project Financial Statements of Not-for-Profit Entities to its agenda, which ultimately led to the issuance of Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities.*

The goals of ASU 2016-14 are to improve the overall understandability, comparability, and usefulness of nonprofit financial statements. The ASU is not an overhaul but an update of existing standards for nonprofit organizations. The update to the current presentation of the net asset classification requirements is one major component of the project. Another aspect of the project was to work to improve the information provided by nonprofits to allow readers to be able to assess the liquidity, financial performance, and cash flows of nonprofit organizations.

Thus, the ASU is aimed at revising current reporting practices so that they are clarified to allow for clearer reporting on how restrictions on a nonprofit's resources affect liquidity. The ASU requires 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. These expanded disclosures should assist users of nonprofit financial statements in assessing an entity's liquidity.

ASU 2016-14 affects substantially all nonprofit entities as defined in the FASB Accounting Standards Codification (ASC). Based on the ASC, nonprofit entities are defined as "an entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business entities." While the first or second characteristic may or may not apply to your organization, the third most certainly should cover the industry as a whole.

CHAPTER 3

Highlights of the Major Changes to the Nonprofit Reporting Model

Net Asset–Related Changes

Update to Net Asset Presentation

The ASU requires a change in the presentation of temporarily and permanently restricted net assets to a single classification of net assets with donor restrictions. This change is designed to reduce complexity and increase understandability of this information. The ASU also requires enhanced disclosures that show the detail of net assets with donor restrictions at the end of the reporting period as well as how the restrictions affect the use of the resources. This additional information must be presented in either the face of the statement of financial position or in the footnotes to the financial statements. The FASB believes that the expanded presentation about various types of restrictions would provide more information than the current aggregated summaries of the total temporarily and permanently restricted net assets presentation and disclosures currently provided to readers of the financial statements.

The previously categorized unrestricted net assets will now be referred to as net assets without donor restrictions. The terminology change is seen as a refinement since the use of the term *unrestricted net assets* implies that the assets are not subject to any restrictions. However this category of net assets is oftentimes subject to restrictions resulting from laws, regulations, and other terms and conditions of bond agreements and other contracts. This change in terminology will more clearly show that these net assets are not subject to any donor restrictions but can in fact be subject to restriction by these other arrangements or parties.

The presentation of net assets with donor restrictions will encompass both the categories previously titled temporarily and permanently restricted net assets with the goal of streamlining this presentation to show all assets with donor restrictions. This category includes funds received with restrictions from both donors and grantors. There has been a lot of confusion in the past surrounding the classification between temporarily and permanently restricted net assets, and this change aims to eliminate this confusion. The use of the term *with donor restrictions* is a heading, and an entity can maintain subcategories under this heading, as they feel necessary to clearly portray their net assets. The disclosures for net assets with donor restrictions should clearly state the nature, purpose, and amount of the donor restrictions so that a reader can fully understand the nature of the restrictions.

Disclosures of Board-Designated Net Assets

The ASU requires additional information to be disclosed either on the face of the statement of financial position or in the notes to the financial statements regarding the various types of board-designated net assets. These are net assets without donor restrictions that the nonprofit's board imposes limits on for specified purposes. This change will assist nonprofit entities in showing how they are managing their resources. The purpose of the board-designated net assets is now required to be disclosed in the footnotes. The FASB also believes this will help nonprofit entities clarify their financial condition and results.

Update to Presentation of Underwater Endowments

Under the ASU, the amount that a donor-restricted endowment fund is underwater will now be presented as part of net assets with donor restrictions. The term *underwater endowments* refers to the situation in which the fair value of the assets to be maintained in perpetuity measured at the financial statement date is less than the original gift or the level required to be maintained by the donor stipulation or law. The premise for the change in showing the underwater amounts as part of net assets with donor restrictions instead of as net assets without donor restrictions is due to changes in the enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) that allows spending, within the guidelines of prudence, from an underwater endowment fund. The FASB believes that the presentation of the entire amount of an endowment fund as donor restricted, whether underwater or not, is consistent with current laws. FASB also believes that keeping the full endowment in one place reduces the complexity of this information and thereby makes the information on endowment funds easier to understand.

The disclosures related to underwater endowments will continue to include the aggregate amounts by which funds are underwater as in current accounting principles generally accepted in the United States of America (U.S. GAAP). The disclosures, however, will also include the aggregate of the original gift amounts for such funds, fair value, and any governing board policy or decision to reduce or not spend from these funds.

Expirations of Capital Restrictions

The ASU will require that nonprofits use the placed-in-service approach to recognize gifts of cash restricted for acquisition or construction of property, plant, and equipment in the absence of a specific donor stipulation to the contrary. This change will assist in reducing the diversity in practice currently seen in nonprofit financial statements. Before the ASU, a nonprofit could recognize a gift over the implied time restriction related to the gift and recognize revenue as they depreciated the asset if this was their policy. Upon adoption of ASU 2016-14, this option has been eliminated unless the donor specifically states a period of time that the contributed asset must be used. This is the only provision in the ASU that changes the accounting (recognition and measurement). All other provisions in the ASU are presentation changes only.

Expense Reporting–Related Changes

Nonprofits will be required to provide an analysis of expenses that shows expenses detailed by nature and by function. Nonprofits have the option to present this information in the statement of activities, a separate statement, or in the footnotes. If the entity chooses to present the analysis in a separate statement, it must be presented as part of the basic financial statements and cannot be presented as a supplemental schedule to the financial statements. The analysis component requires that expenses be shown disaggregated by function and nature. Most nonprofits are currently required to show expenses by function either on the face of the statement of activities or in the footnotes. Currently under U.S. GAAP, only voluntary health and welfare organizations are required to include a separate statement of functional expenses that shows expenses by function and natural classification. Under the ASU all nonprofit entities will be required to provide this analysis of expenses.

Organizations may want to take this opportunity to revisit how they have defined their programs (functions) and assess whether any activities should be combined. If an entity has a large number of programs, the analysis of expenses may become overwhelming to the readers of the financial statements.

Nonprofits will also be required to provide disclosures about the methods they use to allocate costs among the program and supporting services. None of the changes in the ASU with regard to the allocation of expenses changes U.S. GAAP related to the accounting for and disclosure of joint cost activities.

Investment Return–Related Changes

To address issues with diversity in practice with the comparability of the investment return presentation, the ASU will now require nonprofits to present only the net investment return on the face of the statement of activities. The investment expenses that should be netted against investment return are limited to external investment expenses incurred and direct internal investment expenses. External investment expenses are those that are reported to the nonprofit by their external money managers and other external investment management firms related to the management of the investment portfolio. *Direct internal investment expenses* are defined in the ASU as those that "involve the direct conduct or supervision of the strategic and tactical activities involved in