



Chapter 1

Financial Reporting

Learning objectives

- Identify the two classes of net assets.
 - Identify the basic financial statements prepared by not-for-profits (NFPs).
 - Identify various reporting formats used by NFPs.
 - Identify reporting issues related to investments and endowments.
-

Introduction

This chapter will discuss what basic information NFP entities must report in their financial statements. We will also discuss some of the reporting formats used by NFP entities.

FASB Accounting Standards Update (ASU) No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, was released on August 18, 2016. This ASU changes the way all NFPs classify net assets and prepare financial statements. The standard is effective for annual financial statements issued for fiscal years beginning after December 15, 2017, and for interim periods within fiscal years beginning after December 15, 2018. Early application is permitted.

This chapter will cover the major accounting and financial reporting requirements under ASU No. 2016-14.

Net assets

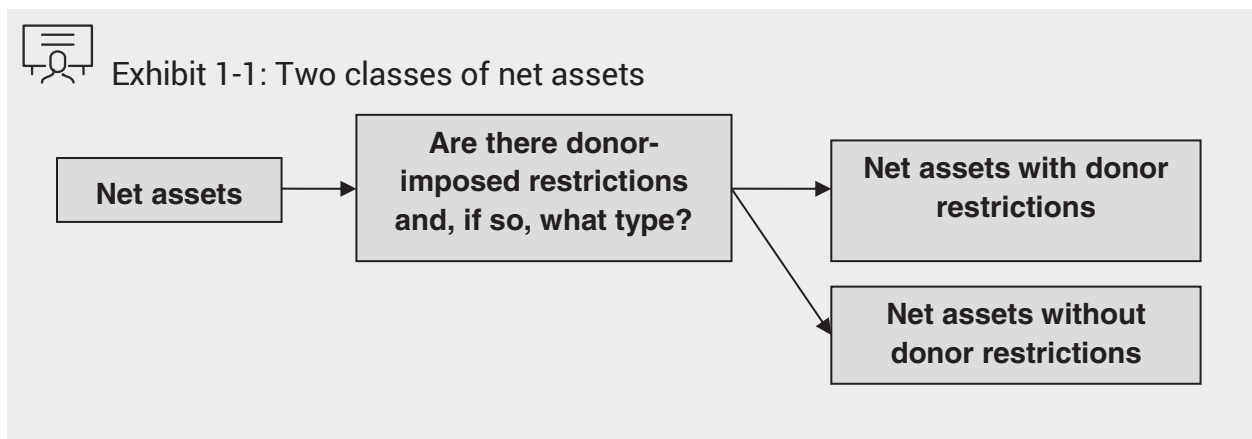
Is there a difference between a class of net assets and a fund? Yes! A fund has a self-balancing set of accounts with assets, liabilities, and fund balance accounts, whereas net assets simply represent the difference between assets and liabilities.

How an entity maintains its internal records is not an issue addressed by FASB. Instead, FASB *Accounting Standards Codification (ASC) 958, Not-for-Profit Entities*, requires that information about each class of net assets be reported in the financial statements.

NFP organizations are unique in that they often receive substantial amounts of contributions. These donations can contain donor-imposed restrictions as to their use. Information about restrictions on net resources is important to financial statement users.

A donor-imposed restriction is defined as a stipulation (donors include other types of contributors, including makers of certain grants) that is more specific than the broad limits resulting from the nature of the organization, the environment in which it operates, and the purpose specified in its articles of incorporation or bylaws.

Net assets can be broken down into two classes¹ based on the existence or absence of donor-imposed restrictions as shown in exhibit 1-1.



The two classes of net assets are described as follows:

- *Net assets with donor restrictions.* The part of the net assets of an NFP that is subject to donor-imposed restrictions. These types of restrictions can be either temporary or perpetual in nature.
- *Net assets without donor restrictions.* The part of the net assets of an NFP that is not subject to donor-imposed restrictions.

¹ Prior to ASU No. 2016-14 there were three net asset classes (unrestricted, temporarily restricted, and permanently restricted). For more information, see the discussion following this section and fasb.org.

Footnote disclosures are required to include the timing and nature of the donor-imposed restrictions, as well as the composition of net assets with donor restrictions at the end of the period. The disclosures will continue to show an analysis by time, purpose, and perpetual restrictions.

At times, an NFP's governing board may make designations or appropriations that result in self-imposed limits on the use of resources without donor restrictions, known as board-designated net assets. FASB added a new requirement to disclose board designations on net assets without donor restrictions. Board-designated net assets can be described in the notes to the financial statements if the nature of the designation (that is, amount and purpose) is not clear from the description on the face of the statement of financial position.



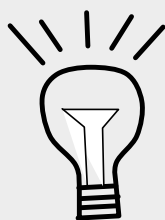
All net assets are classified as net assets without donor restrictions, unless the net assets result from contributions whose use is limited by donor-imposed stipulations.

Knowledge check

1. Which is accurate of net assets?
 - a. Donor stipulations that are temporary or perpetual in nature will be footnote disclosed.
 - b. Board-designated resources are reported as net assets with donor restrictions.
 - c. In the absence of donor-imposed restrictions, net assets must be classified as net assets with donor restrictions.
 - d. Endowment funds are classified as net assets with donor restrictions whose use is limited by donor-imposed stipulations that expire by passage of time.

The basic financial statements

FASB ASC 958 requires NFP entities to present financial statements showing aggregate information about the entity. It establishes minimum standards for financial reporting that are generally no more stringent than requirements for a business enterprise. In general, it allows significant flexibility in presenting certain information, allowing financial reporting to evolve to meet the needs of different NFP groups.



The general purpose financial statements required by FASB ASC 958-205-05 for NFP entities are the statement of financial position, the statement of activities, the statement of cash flows, and accompanying notes to the financial statements. NFP entities must also present an analysis of expenses by function and nature in one location. This may be presented in the notes to the financial statements, in the statement of activities or as a separate statement. A fourth statement of functional expenses is no longer required only for certain NFP entities; this information must now be reported by all NFPs.

Other terms can be used for these statements, such as “balance sheet” for the statement of financial position. However, a statement of cash flows should only be titled as such.

Knowledge check

2. What is accurate of FASB ASC 958?
 - a. In general, FASB ASC 958 allows no flexibility in presenting certain information.
 - b. FASB ASC 958 focuses on reporting aggregated information about the entity as a whole.
 - c. The general purpose financial statements required by FASB ASC 958 for NFP entities are the statement of financial position, the statement of activities, the statement of cash flows, the statement of functional expense and accompanying notes to the financial statements.
 - d. FASB ASC 958 changed the requirement to report information about funds.

The statement of financial position

A statement of financial position reports an entity's assets, liabilities, and net assets. Generally, assets and liabilities should be aggregated into reasonably homogeneous groups. Assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use; for example, cash available for current use without donor restrictions need not be reported separately from cash received with donor-imposed restrictions that is also available for current use. However, cash or other assets either (a) designated for long-term purposes or (b) received with donor-imposed restrictions that limit their use to long-term purposes should not be aggregated on a statement of financial position with cash

or other assets that is available for current use. For example, cash that has been received with donor-imposed restrictions limiting its use to the acquisition of long-lived assets should be reported under a separate caption, such as “cash restricted to investment in property and equipment,” and displayed near the section of the statement where property and equipment is displayed. The kind of asset should be described in the notes to the financial statements if its nature is not clear from the description on the face of the statement of financial position.

As illustrated in the following, assets and liabilities can be presented in a number of ways to provide information about liquidity.

Approaches to providing information about liquidity

- Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash.
- Classifying assets and liabilities as current and noncurrent, as defined by FASB ASC 210-10.
- Disclosing in notes to financial statements any additional relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets.

ASU No. 2016-14 includes disclosure requirements aimed at improving a financial statement user’s understanding of an entity’s liquidity and how it is being managed. NFPs are required to disclose the following quantitative and qualitative information about liquidity of assets and short-term demands on those assets:

- Qualitative information on how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date
- Quantitative information that communicates the availability of financial assets at the balance sheet date to meet cash needs for general expenditures within one year of the balance sheet date

The statement of financial position should focus on the entity as a whole. It does this by reporting total assets, total liabilities, and total net assets for the entity. In addition, the amount of each of the two classes of net assets must also be reported.

Information about the nature and amounts of different types of restrictions on net assets with donor restrictions should be either reported on the face of the statement or in the notes to the financial statement. Separate lines in the statement may be used for purpose, time, and perpetual restrictions, such as support of a particular operating activity, investment for a specified term, or use in a specified period.

At times, an NFP’s governing board may make designations or appropriations that result in self-imposed limits on the use of resources without donor restrictions, known as board-designated net assets. Information about the nature and amounts of different types of designation or appropriation on net assets without donor restrictions should be either reported on the face of the statement or in the notes to the financial statement.

In cases where separate lines are used in any of the two classes of net assets, a total must still be reported for each of the two classes of net assets.

Exhibit 1-2 reports one example of a statement of financial position after the implementation of ASU No. 2016-14. Note that this example sequences assets and liabilities based on liquidity and does not display information about the nature of restrictions on the face of the financial statement.



Exhibit 1-2

Not-for-profit "A" Statement of Financial Position December 31, 20X8 and 20X7 (in thousands)		
	20X8	20X7
Assets:		
Cash and cash equivalents	\$ 85	\$ 560
Accounts and interest receivable	1,130	1,680
Inventories and prepaid expenses	710	1,020
Contributions receivable	3,025	2,700
Short-term investments	6,410	5,560
Collections of works of art (Note X)	-	-
Land, buildings, and equipment	60,600	63,580
Long-term investments	218,070	203,500
Total assets	\$290,030	\$278,600



Exhibit 1-2 (continued)




Not-for-profit "A" Statement of Financial Position December 31, 20X8 and 20X7 (in thousands)		
	20X8	20X7
Liabilities and net assets:		
Accounts payable	\$ 2,070	\$ 1,150
Refundable advance	200	450
Grants payable	675	1,500
Notes payable	500	1,040
Long-term debt	7,185	8,200
Total liabilities	10,630	12,340
Net assets:		
Without donor restrictions	113,138	103,770
With donor restrictions	166,262	162,490
Total net assets	279,400	266,260
Total liabilities and net assets	<u>\$290,030</u>	<u>\$278,600</u>

The statement of activities

In many ways, the statement of activities is like an income statement for an NFP entity. However, because NFP entities have an operating purpose other than making a profit, terms like income statement and net income are not used. Instead, the terms "statement of activities" and "change in net assets" are used.

The statement of activities focuses on the entity as a whole and requires that the amount of change in net assets for the period be reported. In addition, the amount of change in net assets without donor restrictions and net assets with donor restrictions must also be reported.

The statement of activities reports revenues, gains, expenses, and losses for the period. Revenues are reported as increases in net assets without donor restrictions unless the use of the assets received is limited by donor-imposed restrictions. Likewise, gains and losses recognized on investments and other assets (or liabilities) are reported as increases or decreases in net assets without donor restrictions unless their use is restricted by explicit donor stipulations or by law.

In the statement of activities...	
	All expenses are reported as decreases in net assets without donor restrictions. That may seem somewhat odd at first. However, as entities use resources to meet donor-restricted purposes, the resources are released from restrictions and the expenses are reported as a decrease in net assets without donor restrictions.
	An entity must report information about the nature and functional classification of expenses, such as major classes of program services and supporting activities. This information can be done on the face of the statement of activities, as a separate statement, or in the notes to the financial statements. Therefore, entities can display expenses either by natural or functional classification in the statement of activities as long as the functional information is presented.
	Events that simultaneously increase one class of net assets and decrease another class of net assets (reclassifications) are reported as separate items in the statement of activities. For example, using resources to meet a donor-stipulated purpose restriction would simultaneously decrease net assets with donor restrictions and increase net assets without donor restrictions.

NFP entities have a great deal of flexibility in how items are sequenced in the statement of activities. Revenues, gains, expenses, losses, and reclassifications can be arranged in a variety of orders. In addition, an entity may choose to report some intermediate measure of operations, such as operating revenues over expenses.

Exhibit 1-2 reports one example of a statement of activities after implementation of ASU No. 2016-14. Note that this example uses three columns to display information: two for the classes of net assets and one total column. Also, note that change in total net assets as well as changes in the two classes of net assets is reported. Reclassifications (net assets released from restrictions) are reported separately.

**Exhibit 1-2**

Not-for-profit "B"
Statement of Activities
Year ended December 31, 20X8
(in thousands)

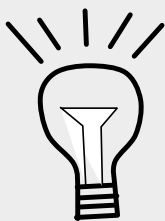
	Net Assets without Donor Restrictions	Net Assets with Donor Restrictions	Total
Revenues, gains, and other support:			
Contributions	\$ 8,790	\$ 9,480	\$ 18,270
Fees	5,600		5,600
Income on long-term investments (Note F)	5,200	1,710	6,910
Other investment income (Note F)	650		650
Net unrealized and realized gains on long-term investments (Note F)	8,628	7,472	16,100
Net assets released from restrictions (Note E):			
Satisfaction of program restrictions	13,490	(13,490)	
Expiration of time restrictions	1,250	(1,250)	
Total revenues, gains, and other support	43,608	3,922	47,530
Expenses:			
Program 1	12,380		12,380
Program 2	9,340		9,340
Program 3	2,720		2,720
Management and general	5,460		5,460
Fund-raising	4,150		4,150
Total expenses (Note G)	34,050		34,050
Change in net assets	9,558	3,922	13,480
Net assets at beginning of year	120,675	183,470	304,145
Net assets at end of year	\$130,233	\$187,392	\$ 317,625

Knowledge check

3. Which is accurate regarding the statement of activities?
- a. In many ways, the statement of activities is like an income statement for an NFP entity.
 - b. Because NFP entities have an operating purpose other than making a profit, terms like income statement and net income are used.
 - c. The statement of activities focuses on segments of the entity.
 - d. An entity must report some intermediate measure of operations, such as operating revenues over expenses.
4. Which is accurate regarding the statement of activities?
- a. The statement of activities reports revenues, gains, expenses, and losses for the period.
 - b. Revenues are reported as increases in net assets with donor restrictions unless the use of the assets received is limited by donor-imposed restrictions.
 - c. All expenses are reported as decreases in net assets with donor restrictions.
 - d. NFP entities have little flexibility in how items are sequenced in the statement of activities.

The statement of cash flows

FASB ASC 958-205-05-5 requires NFP entities to report a statement of cash flows. Entities should follow the provisions of FASB ASC 230-10-45.



The listing of financing activities in FASB ASC 230-10-45-14 includes cash receipts that are donor-restricted for long-term purposes. Some examples would be contributions for capital assets and additions to an endowment. However, because cash restricted for long-term purposes is normally excluded from cash available for current use, a cash contribution for a long-term purpose would normally be reported as both a cash inflow from financing activities and a cash outflow from investing activities.

Entities may report cash flows from operating activities using either the direct or indirect method. If the direct method is used, ASU No. 2016-14 removes the requirement to present the indirect method reconciliation.

For business enterprises, net income is used as the starting point in the indirect method and the reconciliation required under the direct method. For NFP entities, change in total net assets should be used. In addition, cash flow from operating activities would include, if applicable, agency transactions. Exhibit 1-3 presents an example statement of cash flows using the indirect method.



Exhibit 1-3

Not-for-Profit "C"
Statement of Cash Flows
Year Ended December 31, 20X8
(in thousands)

Cash flows from operating activities:	
Change in net assets	\$ 15,500
Adjustments to reconcile change in net assets to net cash used by operating activities:	
Depreciation	4,000
Increase in accounts and interest receivable	(640)
Decrease in inventories and prepaid expenses	290
Increase in contributions receivable	(425)
Increase in accounts payable	2,520
Decrease in refundable advance	(450)
Decrease in grants payable	(400)
Contributions restricted for long-term investment	(3,540)
Interest and dividends restricted for long-term investment	(400)
Net unrealized and realized gains on long-term investments	(16,800)
Net cash used by operating activities	(345)
Cash flows from investing activities:	
Purchase of equipment	(1,500)
Proceeds from sale of investments	70,000
Purchase of investments	(78,200)
Net cash used by investing activities	(9,700)
Cash flows from financing activities:	
Proceeds from contributions restricted for:	
Investment in endowment	300



Exhibit 1-3 (continued)

Not-for-Profit "C" Statement of Cash Flows Year Ended December 31, 20X4 (in thousands)	
Investment in term endowment	50
Investment in plant	1,300
	1,650
Other financing activities:	
Interest and dividends restricted for reinvestment	55
Payments on notes payable	(1,040)
Payments on long-term debt	(1,100)
	(2,085)
Net cash used by financing activities	(435)
Net decrease in cash and cash equivalents	(10,480)
Cash and cash equivalents at beginning of year	10,530
Cash and cash equivalents at end of year	\$ 50
Supplemental data:	
Noncash investing and financing activities:	
Gifts of equipment	\$ 240
Gift of paid-up life insurance, cash surrender value	50
Interest paid	521

Reporting expenses by function and nature in one location

All NFPs are required to present expenses by function and nature in one location after implementing ASU No. 2016-14. This information can be presented in the notes, in the statement of activities, or as a separate statement. Prior to ASU No. 2016-14, voluntary health and welfare entities were required to present a statement of functional expenses. They may now choose from one of the three options to report this information.

Exhibit 1-4 is an example of a separate statement used to present expenses by function and nature in one location titled a statement of functional expenses. This matrix format makes it easy to determine the extent to which resources are used for such things as salaries, travel, and supplies within a program area.



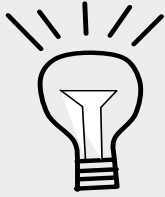
Exhibit 1-4

Not-for-Profit "D" Statement of Functional Expenses Year Ended December 31, 20X8 (in thousands)				
	Supporting Services			
	Program	Management and General	Fund- Raising	Total
Awards and grants	\$50,632	\$ —	\$ —	\$ 50,632
Salaries	2,720	9,471	12,076	24,267
Employee benefits	365	1,717	8,466	10,548
Payroll taxes	145	2,132	1,680	3,957
Professional fees	142	1,096	1,338	2,576
Supplies	72	628	1,618	2,318
Telephone	191	562	1,206	1,959
Postage and shipping	44	416	2,929	3,389
Occupancy	287	1,695	2,591	4,573
Information processing	656	562	1,549	2,767
Printing and publications	135	612	4,885	5,632
Meetings and conferences	719	1,085	2,167	3,971
Other travel	191	788	1,192	2,171
Other expenses	159	919	502	1,580
Depreciation	634	913	1,534	3,081
Total expenses	<u>\$ 57,092</u>	<u>\$ 22,596</u>	<u>\$ 43,733</u>	<u>\$123,421</u>

Relationships within the financial statements

Within the basic financial statements there are many relationships that exist. For example, the cash and cash equivalents number from the statement of financial position will also appear in the statement of cash flows.

Comparative financial information



NFP entities often use columns in their financial statements. Such an approach makes it difficult to include comparative financial information for each column, unless a complete set of statements is included for the prior year.

Sometimes, an entity will include only a total column from the prior year to provide comparative information. If the information provided does not constitute a comparative presentation in conformity with generally accepted accounting principles (GAAP), such information should be reported with an appropriate title such as “with summarized financial information for the year ended June 30, 20X1.” A note disclosure would also be required.

Reporting formats

NFP entities have a lot of flexibility in presenting information in their financial statements. One aspect of this flexibility is to report disaggregated information by using columns in the financial statements.

Entities may use several columns to present information as long as the certain totals for the entity are reported. For example, the statement of financial position must report total assets, total liabilities, and total net assets, as well as totals for the two classes of net assets.

Entities may report columns in the financial statements to convey a variety of information. Some of the approaches used are as follows:

- *Net asset class.* Advantages of reporting the statement of activities in this format is that total contributions for the entity are shown, and the reclassifications between classes of net assets are easy to see. Exhibit 1-2 (shown earlier) is an example of a statement of activities with columns for each class of net assets. Some NFPs also use this format for the statement of financial position.
- *Operating based formats.* Some entities find it useful to break out operating activities from other activities. For example, exhibit 1-5 helps users understand the degree to which operations are dependent upon contributions. Other operating type formats could include the following:
 - *Operating and plant.* Some entities find it useful to show activities and balances related to land, building, and equipment separate from their operating activities.
 - *Operating and investments.* Some entities have substantial amounts in endowment and similar types of investments and find it helpful to report this information separately.
- *Fund information.* Exhibit 1-6 is an example of a balance sheet with columns for each fund. For some entities, fund information remains important for external financial reporting.

Entities also have the flexibility of different columns among the financial statements. For example, an entity may only have one column in the statement of financial position and use three columns in the statement of activities to report information by net asset class.

The examples we have discussed are just some of the ways an entity may display information in the financial statements. Again, entities have a significant amount of flexibility in financial statement formats. However, in all cases, entities must report the basic information that focuses on the entity as a whole.

**Exhibit 1-5**

Not-for-Profit "E"
Statement of Activities
Year Ended December 31, 20X8
(in thousands)

	Net assets without donor restrictions	Net assets with donor restrictions	Total
Operating revenues			
Symphony activities			
Box office and tour	\$70,500		\$70,500
Media and other revenues	10,502		10,502
Theatrical presentations	5,025		5,025
Interest and dividends	3,030		3,030
Other income	1,208		1,208
Total operating revenues	90,265		90,265
Operating expenses			
Program expenses			
Symphony activities			
Performances	110,150		110,150
New productions	5,203		5,203
Other expenses	1,414		1,414
Theatrical presentations	8,222		8,222
	124,989		124,989
Supporting services			
Symphony Hall	7,556		7,556
General management	9,652		9,652
	17,208		17,208
Total operating expenses	142,197		142,197
Loss from operations	(51,932)		(51,932)



Exhibit 1-5 (continued)

Not-for-Profit "E"
Statement of Activities
Year Ended December 31, 20X8
(in thousands)

	Net assets without donor restrictions	Net assets with donor restrictions	Total
Contributions	52,017	\$10,435	62,452
Net assets released from restrictions			
Satisfaction of program restrictions	1,515	(1,515)	
Expiration of time restrictions	5,968	(5,968)	
	59,500	2,952	62,452
Fund-raising expenses	(15,005)		(15,005)
	44,495	2,952	47,447
Change in net assets	(7,437)	2,952	(4,485)
Net assets			
Beginning of year	52,817	65,092	117,909
End of year	45,380	68,044	113,424

**Exhibit 1-6**

Not-for-Profit "F" Balance Sheet December 31, 20X8 (in thousands)			
	A Fund	B Fund	Total
Assets:			
Cash	\$12,432	695	\$ 13,127
Contributions receivable	8,712	14,246	22,958
Investments	8,315		8,315
Inventories	3,670		3,670
Prepaid expenses	5,357		5,357
Land, buildings, and equipment	5,450		5,450
Total assets	\$43,936	14,941	\$58,877
Liabilities and net assets:			
Accounts payable	\$ 9,752		\$ 9,752
Accrued expenses	505		505
Deferred member dues	15,045		15,045
Notes payable	8,399		8,399
Total liabilities	33,701		33,701
Net assets:			
Without donor restrictions	8,233	7,419	15,652
With donor restrictions	2,002	7,522	2,002
Total net assets	10,235	14,941	25,176
Total liabilities and net assets	\$43,936	\$14,941	\$58,877

Notes to the financial statements

NFP entities are subject to many of the same notes to the financial statements as any business enterprise. However, FASB ASC's incremental industry-specific guidance for not-for-profits also contains requirements specifically for NFPs. For example:

- FASB ASC 958-205-50 requires that if an NFP discloses in its financial statements a ratio of fund-raising expenses to amounts raised, it also shall disclose how it computes that ratio.
- FASB ASC 958-360-50 requires that an NFP that does not recognize and capitalize its collections or that capitalizes collections prospectively shall describe its collections, including their relative significance, and its stewardship policies for collections. If collection items not capitalized are de-accessed during the period, it also shall describe the items given away, damaged, destroyed, lost, or otherwise de-accessed during the period or disclose their fair value.
- FASB ASC 958-605-50 requires that an entity that receives contributed services shall describe the programs or activities for which those services were used, including the nature and extent of contributed services received for the period and the amount recognized as revenues for the period. Entities are encouraged to disclose the fair value of contributed services received but not recognized as revenues if that is practicable. The nature and extent of contributed services received can be described by nonmonetary information, such as the number and trends of donated hours received or service outputs provided by volunteer efforts, or other monetary information, such as the dollar amount of contributions raised by volunteers. Disclosure of contributed services is required regardless of whether the services received are recognized as revenue in the financial statements.
- The pending content in FASB ASC 958-210-50-1A requires an NFP to disclose both qualitative and quantitative information about how it manages its liquid resources.

In FASB ASC topics, section 50 (XXX-YY-50) contains specific disclosure requirements for a subtopic. It does not include general disclosure requirements that may reside in the *Notes to Financial Statements* topic of FASB ASC and other general presentation topics. This section may include references to general disclosure requirements that encompass the items addressed by the subtopic.

Investments and investment income

Investments commonly held by NFPs

NFP entities acquire various kinds of investments by contribution or purchase. These investments can be divided into the following four broad categories:

1	Investments in equity securities with readily determinable fair values (other than consolidated subsidiaries and equity securities reported under the equity method) and all investments in debt securities, which are investments that are subject to the requirements of FASB ASC 958-320
2	Investments that are accounted for under the equity method
3	Investments in derivative instruments that are subject to the requirements of FASB ASC 815 (If an investment would otherwise be in the scope of FASB ASC 958-320 and it has within it an embedded derivative that is subject to FASB ASC 815, the host contract [as described in FASB ASC 815-15-05-1] remains within the scope of FASB ASC 958-320.)
4	Other investments, which are those included in the scope of FASB ASC 958-325 (For example, certain investments in real estate, mortgage notes that are not debt securities, venture capital funds, certain partnership interests, oil and gas interests, and certain equity securities that do not have a readily determinable fair value. Other investments do not include investments described in the preceding three items or investments in consolidated subsidiaries.)

Initial recognition

Pursuant to FASB ASC 958-320-30-1, debt and equity securities are initially measured at their acquisition cost (excluding brokerage and other transaction fees) if they are purchased, and at fair value if they are received as a contribution or through an agency transaction. Pursuant to FASB ASC 958-325-30-1, other investments are initially measured at their acquisition cost (including brokerage and other transaction fees) if they are purchased, and at fair value if they are received as a contribution or through an agency transaction. Pursuant to FASB ASC 815-10-30, all derivative instruments are measured initially at fair value. Investments that are accounted for under the equity method are generally measured initially at cost pursuant to FASB ASC 323-10-30, although FASB ASC 970-323-30 provides more specific guidance for real estate ventures, and FASB ASC 323-10-30-2 requires initial measurement at fair value for the following:

1. A retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with paragraphs 810-10-40-3A through 40-5

2. An investment in the common stock of an investee (including a joint venture) recognized upon the derecognition of a distinct nonfinancial asset or distinct in substance nonfinancial asset in accordance with FASB ASC 610-20
-

Knowledge check

5. Which is accurate of the initial measurement of investments?
- Debt and equity securities are initially measured at their acquisition cost if they are purchased.
 - Investments that are contributed are measured at donor's cost.
 - Derivative instruments are not measured at fair value.
 - All investments are initially recorded at cost.
-

Investment income

Investment revenue is reported on the statement of activities. It includes dividends, interest, rents, royalties, and similar payments on assets held as investments.

Per FASB ASC 958-320-45-1, dividend, interest, and other investment income should be reported in the period earned as increases or decreases in net assets without donor restrictions unless the use of the assets received is limited by donor-imposed restrictions. Donor-restricted investment income should be reported as an increase in net assets with donor restrictions, depending on the type of restriction.

All NFPs report investment return net of external and direct internal investment expenses. Requiring an NFP to report its investment return net of external and direct internal investment expenses provides a more comparable measure of investment returns across all NFPs, regardless of whether their investment activities (1) are managed by internal staff, outside investment managers, volunteers, or a combination, or (2) employ the use of mutual funds, hedge funds, or other vehicles for which management fees are embedded in the investment return of the vehicle. After the implementation of ASU No. 2016-14, there is no longer a requirement to disclose netted expenses. Removing this disclosure will help eliminate the difficulties and related costs in identifying embedded fees, and the resultant inconsistencies in the reported amounts of investment expenses.

Knowledge check

6. Which is accurate of investment income?
- Investment income excludes dividends.
 - If there are no donor-imposed restrictions on the use of the income, it should be reported as an increase in net assets with donor restrictions.
 - Investment income includes interest.
 - Investment income excludes gains.
-

Unrealized and realized gains and losses

Unrealized gains and losses arise from changes in the fair value of investments, exclusive of dividend and interest income recognized but not yet received and exclusive of any write-down of the carrying amount of investments for impairment. Unrealized gains and losses are recognized in some circumstances (for example, when the investments are carried at fair value), but not in others (for example, when the investments are carried at cost). However, there are circumstances (for example, impairment) in which unrealized losses on investments carried at cost should be recognized.

Realized gains and losses arise from selling or otherwise disposing of investments. If realized gains and losses arise from selling or otherwise disposing of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amounts reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should exclude the amount that has previously been recognized in the statement of activities. However, the components of that gain or loss may be reported as the realized amount (the difference between amortized cost and the sales proceeds) and the unrealized amount recognized in prior reporting periods. Exhibit 1-7 illustrates this reporting.



Exhibit 1-7: Reporting gains and losses

Facts

1. In 20X1, an NFP entity with a December 31 year-end purchases an equity security with a readily determinable fair value for \$5,000.
2. At December 31, 20X1, the fair value of the security is \$7,000.
3. During 20X2, the security is sold for \$11,000.

Reporting gains and losses

20X1	Recognize a \$2,000 unrealized gain and adjust the carrying value to \$7,000. (The reported unrealized gain equals \$7,000 fair value less \$5,000 carrying value.)
20X2	Recognize a \$4,000 realized gain and adjust the carrying value to zero. (The realized gain may be reported as the net of \$11,000 selling price less the \$7,000 carrying value at the time the security was sold.)

To the extent that investment gains and losses are recognized, they should be reported in the statement of activities as increases or decreases in net assets without donor restrictions, unless their use is by explicit donor stipulations or by law. In such cases, they should be reported in the statement of activities as increases or decreases in net assets with donor restrictions.

Knowledge check

7. Which is accurate of realized gains and losses?
- a. Realized gains and losses arise from selling or otherwise disposing of investments.
 - b. If realized gains and losses arise from selling or otherwise disposing of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amounts reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should include the amount that has previously been recognized in the statement of activities.
 - c. Realized gains and losses should not be reported in the statement of activities.
 - d. Unrealized gains and losses should be reported in the statement of financial position as a separate line item.

Valuation subsequent to acquisition

As illustrated in the following table, the valuation of investments subsequent to acquisition depends in part on the type of investment.

Valuation subsequent to acquisition	
Equity securities with readily determinable fair value (other than consolidated subsidiaries and equity securities reported under the equity method) and all debt securities	Investments that are accounted for under the equity method or a fair value election
FASB ASC 958-320-35-1 requires that investments in equity securities with readily determinable fair value and all investments in debt securities be measured at fair value in the statement of financial position.	Various investments can fall into this category and the guidance regarding valuation subsequent to acquisition is difficult to summarize.
Derivative instruments	Other investments
FASB ASC 815-10-25-1 and FASB ASC 815-10-35-1 require that investments in derivative instruments be reported as either assets or liabilities depending on the rights or obligations under the contracts and should be subsequently re-measured at fair value. Similarly, an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to FASB ASC 815-10 if and only if all of the criteria in FASB ASC 815-15-25-1 are met.	Guidance concerning the carrying amounts of other investments subsequent to acquisition differs depending upon the type of NFP.

Investment pools

An NFP may pool part or all of its investments (including investments arising from contributions with different kinds of restrictions) for portfolio management purposes. The number and the nature of the pools may vary from entity to entity.

When a pool is established, ownership interests are initially assigned (typically through unitization) to the various pool categories (sometimes referred to as *participants*) based on the market value of the cash and securities placed in the pool by each participant. Current market value is used to determine the number of units allocated to additional assets placed in the pool and to value withdrawals from the pool. Investment income and realized gains and losses (and any recognized unrealized gains and losses) are allocated equitably based on the number of units assigned to each participant.

Net assets of an endowment fund

As discussed in FASB ASC 958-205-45, an NFP shall report the net assets of an endowment fund in a statement of financial position within the two classes of net assets based on the existence or absence of donor-imposed restrictions. Some examples of endowment funds are the following:

Net assets with donor restrictions (perpetual)	Net assets with donor restrictions (time)	Net assets without donor restrictions
For example, the portion of a perpetual endowment that must be maintained in perpetuity — not used up, expended, or otherwise exhausted — is classified as net assets with donor restrictions that are perpetual.	For example, the portion of a term endowment that must be maintained for a specified term is classified as net assets with donor restrictions due to time restrictions.	For example, a board-designated endowment, which results from an internal designation on net assets without donor restrictions, is not donor-restricted and is classified as net assets without donor restrictions.

Donor-restricted endowment funds

Classification of donor-restricted endowment funds subject to UPMIFA

When classifying a donor-restricted endowment fund, consideration shall be given to both the donor’s explicit stipulations and the applicable laws that extend donor restrictions. Investment return generally is considered free of donor restrictions unless its use is limited by a donor-imposed restriction or by law. In the United States, most donor-restricted endowment funds are subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA) that extends a donor’s restriction to use of the funds, including the investment return, until the funds are appropriated for

expenditure by the governing board. Thus, if a donor or law imposes a restriction on the investment return, those returns shall be reported within net assets with donor restrictions until appropriated for expenditure. Conversely, for an endowment fund that is created by a governing board (board-designated endowment fund), assuming no other purpose-type restrictions exist on the use of those funds, that original fund and all investment returns are free of donor restrictions and shall be reported in net assets without donor restrictions.

In the absence of interpretation of the phrase *appropriated for expenditure* in subsection 4(a) of UPMIFA by legal or regulatory authorities, for purposes of the guidance related to presentation of financial statements, appropriation for expenditure is deemed to occur upon approval for expenditure, unless approval is for a future period, in which case appropriation is deemed to occur when that period is reached. Approval for expenditure may occur through different means within and across NFPs. Upon appropriation for expenditure, the time restriction expires to the extent of the amount appropriated and, in the absence of any purpose restrictions, results in a reclassification of that amount to net assets without donor restrictions. If the fund is also subject to a purpose restriction, the reclassification of the appropriated amount to net assets without donor restrictions shall not occur until that purpose restriction also has been met.

An underwater endowment is a donor-restricted endowment fund for which the fair value of the fund 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. In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce net assets with donor restrictions.

In initially applying the guidance related to presentation of financial statements to a donor-restricted endowment fund in existence when an enacted version of the UPMIFA is first effective practitioners should consult FASB ASC 958-205-45.

Financial statement presentation

Gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in net assets without donor restrictions if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the entity has a similar policy for reporting contributions received, reports consistently from period to period, and discloses its accounting policy in the notes to the financial statements.

Realized and unrealized losses on investments may be netted against realized and unrealized gains on a statement of activities.

Some NFP entities, in managing their endowment funds, use a spending rate or total return policy. Those policies consider total investment return — investment income (interest, dividends, rents, and so forth) plus net realized and unrealized gains (or minus net losses). Typically, spending rate or total return policies emphasize the use of prudence and a rational and systematic formula to determine the portion of cumulative investment return that can be used to support operations of the current period and the

protection of endowment gifts from a loss of purchasing power as a consideration in determining the formula to be used.

An NFP shall disclose information to enable users of financial statements to understand the net asset classification, net asset composition, changes in net asset composition, spending policies, and related investment policies. At a minimum, an NFP shall disclose all of the following information for each period for which it presents financial statements:

- a. A description of the governing board's interpretation of the law or laws that underlie the NFP's net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from underwater endowment funds.
- b. A description of the NFP's policy or policies for the appropriation of endowment assets for expenditure (its endowment spending policy or policies), including its policy, and any actions taken during the period, concerning appropriation from underwater endowment funds.
- c. A description of the NFP's endowment investment policies, including all of the following:
 - i. Return objectives and risk parameters
 - ii. How return objectives relate to the NFP's endowment spending policy or policies
 - iii. The strategies employed for achieving return objectives
- d. The composition of the NFP's endowment by net asset class at the end of the period, in total and by type of endowment fund, showing donor-restricted endowment funds separately from board-designated endowment funds.
- e. A reconciliation of the beginning and ending balance of the NFP's endowment, in total and by net asset class, including, at a minimum, all of the following line items that apply:
 - i. Investment return, net
 - ii. Contributions
 - iii. Amounts appropriated for expenditure that contain no purpose restrictions
 - iv. Other changes.

Summary

The general purpose financial statements required by FASB ASC for an NFP entity are as follows: the statement of financial position, the statement of activities, the statement of cash flows, and accompanying notes to the financial statements. NFP entities must also present an analysis of expenses by function and nature in one location. This may be presented in the notes, in the statement of activities, or as a separate statement.

NFP entities have significant flexibility in presenting information in the financial statements. They can use separate columns to display information as long as certain totals for the entity are reported. There are also unique notes to the financial statements for NFP entities.

Many NFP entities hold endowment funds. The NFP reports the net assets of an endowment fund in a statement of financial position within the two classes of net assets based on the existence or absence of donor-imposed restrictions.

Practice questions

1. Which is a class of net assets for NFP entities?
 - a. Net assets unrestricted.
 - b. Net assets designated.
 - c. Net assets with donor restrictions.
 - d. Net assets permanently restricted.

2. The governing board decides to set up a board-designated endowment to be used for a specific operating purpose. In the statement of net assets, the board-designated endowment should be reported as
 - a. Unrestricted net assets.
 - b. Endowment net assets.
 - c. Net assets without donor restrictions.
 - d. Net assets with donor restrictions.

3. The statement of activities is required to report which item?
 - a. Change in net assets without donor restrictions.
 - b. Change in net assets.
 - c. Change in net assets with donor restrictions.
 - d. All of the above.

4. The statement of cash flows would report a cash contribution restricted in use for the future construction of a new building as cash inflow from
 - a. Operating activities.
 - b. Investing activities.
 - c. Financing activities.
 - d. A noncash disclosure.

5. If an entity uses the indirect method in their statement of cash flows to explain cash flows from operating activities, it must begin with which amount?
 - a. Change in net assets.
 - b. Operating income.
 - c. Change in net assets without donor restrictions.
 - d. Net income.

6. Which not-for-profit entity must report an analysis of expenses by function and nature in one location?
 - a. College.
 - b. Labor union.
 - c. Voluntary health and welfare entity.
 - d. All NFPs.

7. Which item is required to be reported in the statement of financial position?

- a. Total net assets.
- b. Total assets.
- c. Net assets with donor restrictions.
- d. All of the above.



Case study: Seaside Performing Arts, Inc.

Case Study: Background information

Seaside Performing Arts, Inc. (SPA) is a private NFP located in the eastern shore of Virginia. The entity owns a local theater that is an historic landmark. It can hold 400 people. The entity supports the area's symphony and several theatrical performances a year. Ticket prices for both the symphony and theatrical performances do not cover the costs of these productions. SPA depends on private contributions to cover approximately one-third of the costs of operations.

Recently, SPA hired Bob Singleton as their accountant. Bob is a business graduate of the local community college and has five years of accounting experience with the town of Accomac. He is familiar with fund accounting used by local governments, but is new to the reporting requirements of NFPs. With the help of his accounting textbook from college, Bob has prepared the statement of operations for the year just ended.

His textbook is not updated for the reporting requirements of ASU No. 2016-14. He has elected to report the functional classification of expenses on the face of the statement.



Case study: Seaside Performing Arts, Inc. (continued)

The following is the statement of operations prepared by Bob.

Seaside Performing Arts, Inc. Statement of Operations Year ended December 31, 201X (in thousands)			
	Unrestricted	Temporarily restricted	Permanently restricted
Operating revenues			
Symphony activities			
Box office and tour	\$70,000		
Media and other revenues	10,500		
Theatrical presentations	5,000		
Interest and dividends	3,000		
Other income	1,200		
Total operating revenues	89,700		
Operating expenditures			
Program expenditures			
Symphony activities			
Performances	110,000	2,400	
New productions	5,200	3,500	
Other expenditures	1,400		
Theatrical presentations	8,000	1,500	
	124,600	7,400	
Supporting services			
Symphony Hall	7,500		
General management	9,600		
	17,100	—	
Total operating expenditures	141,700	7,400	
Loss from operations	(52,000)	(7,400)	



Case study: Seaside Performing Arts, Inc. (continued)

Seaside Performing Arts, Inc.
Statement of Operations
Year ended December 31, 201X
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted
Contributions	\$82,400		
Less:			
Transfers of restricted gifts	(10,400)	9,000	1,400
Depreciation	(12,500)		
Fund-raising expenditures	(15,000)		
Other support and expenditures	44,500	9,000	1,400
Change in net assets	(7,500)	1,600	1,400
Net assets			
Beginning of year	52,800	15,000	50,000
End of year	<u>\$ 45,300</u>	<u>\$ 16,600</u>	<u>\$ 51,400</u>

Case study exercise

Review the statement prepared by Bob. Describe any deficiencies you observe in the statement.

List any changes to this statement from the implementation of FASB ASU No. 2016-14.

