Chapter 1

FINANCIAL STATEMENT REQUIREMENTS

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Identify the basic financial statements.
- Determine the basic requirements of the financial statements.

TECHNICAL BACKGROUND INFORMATION

In the list below, the FASB *Accounting Standards Codification* (ASC) 958, *Not-for-Profit Entities*, requires not-for-profit entities (NFPs) to present financial statements showing aggregate information about the entity. The general-purpose financial statements required by FASB ASC 958 also include the accompanying notes to the financial statements.

The general-purpose financial statements required by FASB ASC 958 for not-for-profit entities are:

1. The Statement of Financial Position [May also properly be referred to as a Balance Sheet]
2. The Statement of Activities
3. The Statement of Cash Flows
4. Voluntary health and welfare organizations are also required to present a Statement of Functional Expenses

The Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, was released on August 18, 2016. The newly released ASU will change 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. For more information visit www.fasb.org.

KNOWLEDGE CHECK

1. Which is true of the general-purpose financial statements for not-for-profit entities?

    a. Voluntary health and welfare organizations are required to present a Statement of Functional Expenses.
    b. Not-for-profit entities do not present financial statements showing aggregate information about the entity.
    c. The general-purpose financial statements exclude the accompanying notes to the financial statements.
    d. The general-purpose financial statements for not-for-profit organizations are the same as for businesses.

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 based on the presence of donor-imposed restrictions on their use; for example, cash available for unrestricted current use 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 the FASB ASC 210, *Balance Sheet*.
- Disclosing in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets.

The statement of financial position should focus on the organization as a whole. It does this by reporting total assets, total liabilities, and total net assets for the organization. Three classes of net assets are required to be reported as unrestricted net assets, temporarily restricted net assets, or permanently restricted net assets.

Information about the nature and amounts of different types of permanent restrictions or temporary restrictions on net assets should be reported either on the face of the statement or in the notes to the financial statement. Separate lines in the statement may be used for permanently restricted net assets to distinguish between holdings (such as land or collections) and endowments.

Separate lines in the financial statements can also be used for temporarily restricted net assets to distinguish among the following types of donor restrictions: support of a particular operating activity, investment for a specified term, use in a specified period, or acquisition of a long-lived asset.

Unrestricted net assets can also use separate lines to report self-imposed limits (designations) on net assets. In cases where separate lines are used in any of the three classes of net assets, a total of aggregate net assets, the sum of all separately stated unrestricted, temporarily restricted, and permanently restricted net assets, must also be shown in the net assets section of the statement of financial position. Exhibit 1-1 reports one example of a statement of financial position. 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.

KNOWLEDGE CHECK

2. Which is true of the statement of financial position?

   a. Information about the nature and amounts of different types of permanent restrictions or temporary restrictions on net assets should be either reported on the face of the statement or in the notes to the financial statement.
   b. Unrestricted net assets cannot use separate lines to report self-imposed limits (designations) on net assets.
   c. Assets and liabilities cannot be presented in a number of ways to provide information about liquidity.
   d. Totals are only required to be reported for net assets.

Exhibit 1-1

Not-for-Profit "A"
Statement of Financial Position
June 30, 20X2 and 20X1
(in thousands)

	20X2	20X1
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
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:		
Unrestricted	113,138	103,770
Temporarily restricted	24,242	25,490
Permanently restricted	142,020	137,000
Total net assets	279,400	266,260
Total liabilities and net assets	$290,030	$278,600

The Statement of Activities

In many ways, the statement of activities parallels an income statement for a for profit organization. However, because not-for-profit entities have an operating purpose other than making a profit, for profit financial statement terms, such as income statement and net income, are not used. Instead, the terms "statement of activities" and "change in net assets" are used in the reporting of NFPs.

The statement of activities focuses on the organization as a whole for a specified period of time (the current fiscal year) and requires that the amount of change in net assets for the period be reported. In addition, the amount of change in permanently restricted net assets, temporarily restricted net assets and unrestricted net assets must also be reported.

The statement of activities reports revenues, gains, expenses, and losses for the period. Revenues are reported as increases in unrestricted net assets unless the use of the assets received is limited by donor-imposed restrictions. Expenses are reported as decreases in unrestricted net assets. That may seem somewhat odd at first. However, as organizations use resources to meet donor-restricted purposes, the resources are released from restrictions and the expenses are reported as a decrease in unrestricted net assets. Likewise, gains and losses recognized on investments and other assets (or liabilities) are reported as increases or decreases in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor stipulations or by law.

An organization must report information about the 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 or in the notes to the financial statements. Therefore, organizations 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 temporary donor-stipulated restriction would simultaneously decrease temporarily restricted net assets and increase unrestricted net assets.

NFPs 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 organization may choose to report some intermediate measure of operations, such as operating revenues over operating expenses, to show margin.

Exhibit 1-2 reports one example of a statement of activities. Note that this example uses three columns to display information about the three classes of net assets. Also, note that change in net assets, as well as changes in the three classes of net assets, is reported. Reclassifications (net assets released from restrictions) are reported separately.

KNOWLEDGE CHECK

3. Which is true of the statement of activities?

    a. The amount of change in permanently restricted net assets cannot be reported.
    b. The amount of change in temporarily restricted net assets cannot be reported.
    c. The amount of change in unrestricted net assets must be reported.
    d. The amount of change net assets cannot be reported.

4. Which is true of the statement of activities?

    a. 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.
    b. Revenues, gains, expenses, losses, and reclassifications cannot be arranged in a variety of orders.
    c. Revenue can only be reported as increases in unrestricted net assets.
    d. Expenses must be displayed by natural classification in the statement of activities.

Exhibit 1-2 Not-for-Profit "B" Statement of Activities Year Ended June 30, 20X3 (in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Revenues, gains, and other support:				
Contributions	$ 8,790	$ 9,100	$ 380	$ 18,270
Fees	5,600			5,600
Income on long-term investments (Note F)	5,200	1,590	120	6,910
Other investment income (Note F)	650			650
Net unrealized and realized gains on long-term investments (Note F)	8,628	2,952	4,520	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	(1,098)	5,020	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	(1,098)	5,020	13,480
Net assets at beginning of year	120,675	28,470	155,000	304,145
Net assets at end of year	$130,233	$27,372	$160,020	$317,625

The Statement of Cash Flows

FASB ASC 958-205-05-5 requires NFPs to report a statement of cash flows. Organizations should follow the provisions of the FASB ASC 230-10-45, *Statement of Cash Flows*.

The listing of financing activities in FASB ASC 230-10-45-14 includes cash receipts that are donor-restricted for long-term purposes. Examples include 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.

Organizations may report cash flows from operating activities using either the direct or indirect method. Whereas, for business enterprises, cash flow activity is reconciled to net income (the starting point of the reconciliation) in the statement of cash flows, under the indirect method (as required by GAAP), NFPs reconcile cash flow activities to the change in total net assets (the starting point of the reconciliation) In addition, cash flow from operating activities would include, if applicable, agency transactions. Exhibit 1-3 presents an example statement of cash flows.

KNOWLEDGE CHECK

5. Which is true of the statement of cash flows?

   a. Cash flow from operating activities would always exclude agency transactions.
   b. 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.
   c. Cash flow for operating activities must be reported using the direct method.
   d. Using the direct method, NFP must reconcile cash flow activities to change in unrestricted net assets.

Exhibit 1-3 Not-for-Profit "C" Statement of Cash Flows Year Ended June 30, 20X4 (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
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

The Statement of Functional Expenses

FASB ASC 958-205-05-5 requires voluntary health and welfare organizations to report a fourth financial statement, a statement of functional expenses. Because these types of organizations depend primarily on contributions from the general public, the statement of functional expenses provides additional information on how resources are used. The statement of functional expenses uses a matrix format to report expenses by both functional and natural classification. Exhibit 1-4 is an example of 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.

KNOWLEDGE CHECK

6. Which is true of voluntary health and welfare organizations?

   a. Voluntary health and welfare organizations are not allowed to report a statement of functional expenses.
   b. Voluntary health and welfare organizations depend primarily on contributions from the general public.
   c. The statement of functional expenses does not provide any information on how resources are used.
   d. The statement of functional expenses does not provide information on functional and natural classification of expenses.

Exhibit 1-4 Not-for-Profit "D" Statement of Functional Expenses Year Ended June 30, 20X5 (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	$57,092	$22,596	$43,733	$123,421

Use of Columns

It should be clear that NFPs 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. Organizations may use several columns to present information as long as 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 three classes of net assets.

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

- *Net asset class* – An advantage of reporting the statement of activities in this format is that total contributions for the organization 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 organizations find it useful to break out operating activities from other activities. For example:
    - *Operating and plant* – Some organizations find it useful to show activities and balances related to land, building, and equipment separate from their operating activities.
    - *Operating and investments* – Some organizations have substantial amounts in endowment and similar types of investments and find it helpful to report this information separately.
- *Fund information* – For some organizations, fund information remains important for external financial reporting. Columns can be used for each fund as long as certain totals for the entity are reported.

Organizations also have the flexibility of different columns among the financial statements. For example, an organization 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 organization may display information in the financial statements. Again, organizations have a significant amount of flexibility in financial statement formats. However, in all cases, organizations must report the basic information that focuses on the entity as a whole.

KNOWLEDGE CHECK

7. Which is true of the use of columns?

    a. Organizations may report columns in the financial statements to convey a variety of information.
    b. Organizations never find it useful to break out operating activities from other activities.
    c. Fund information is never important for external financial reporting.
    d. The statement of activities must report four columns of information.

Case Study

Case Study Background Information

The New River Performing Arts, Inc. (NRPA) is a private NFP located in the mountains of Virginia. The organization owns a local theater that is an historic landmark. It can hold 400 people. The organization 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. NRPA depends on private contributions to cover approximately one-third of the costs of operations.

Recently, NRPA hired Tom Chase as their accountant. Tom is a business graduate of the local community college and has five years of accounting experience with the town of Dublin. 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, Tom has prepared the statement of operations for the year just ended. He used the three classes of net assets described in the book and elected to report the functional classification of expenses on the face of the statement.

On the following page is the statement of operations prepared by Tom.

New River Performing Arts, Inc.
Statement of Operations
Year Ended June 30, 201X
(in thousands)

	Unrestricted	Temporarily Restricted	Permanently Restricted
Operating revenues			
Symphony activities			
Box office and tour	$70,500		
Media and other revenues	10,502		
Theatrical presentations	5,025		
Interest and dividends	3,030		
Other income	1,208		
Total operating revenues	90,265		

Case Study (continued)

New River Performing Arts, Inc. Statement of Operations Year Ended June 30, 201X (in thousands)			
	Unrestricted	**Temporarily Restricted**	**Permanently Restricted**
Operating expenditures			
Program expenditures			
Symphony activities			
Performances	110,150	2,420	
New productions	5,203	3,548	
Other expenditures	1,414		
Theatrical presentations	8,222	1,515	
	124,989	7,483	
Supporting services			
Symphony Hall	7,556		
General management	9,652		
	17,208	-	
Total operating expenditures	142,197	7,483	
Loss from operations	(51,932)	(7,483)	
Contributions	$82,452		
Less:			
Transfers of restricted gifts	(10,435)	9,035	1,400
Depreciation	(12,517)		
Fund-raising expenditures	(15,005)		
Other Support and expenditures	44,495	9,035	1,400
Change in net assets	(7,437)	1,552	1,400
Net assets			
Beginning of year	52,817	15,087	50,005
End of year	$ 45,380	$ 16,639	$ 51,405

Case Study Exercise

Please review the statement prepared by Tom. Describe any deficiencies you observe in the statement.