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Nonprofit sector sea change

By: Bernadette Starzee March 27, 2017 0

Big changes are on the horizon for how nonprofits classify net assets, disclose information and prepare financial statements.

Last summer – after three years of comment and revision – the Financial Accounting Standards Board adopted an update that replaced a reporting model that had been in place for more than two decades. Update 2016-14 is effective for annual financial statements issued for fiscal years beginning after Dec. 15, 2017 and for interim periods within fiscal years beginning after Dec. 15, 2018.

"This is a massive change," said **Brian Sackstein**, a director in the Melville office of accounting firm Marcum.

"The update will change the way financial statements look and the way information is provided within the financial statement," said David Rottkamp, not-for-profit practice leader at Grassi & Co. in Jericho. "The last time the nonprofit sector saw any significant changes to financial statements was the early 1990s. There are a lot of users of nonprofit financial statements – boards of directors, financial institutions, folks in government, creditors, donors and others – who want to understand what is happening at the organization, and FASB changed the reporting model to increase comparability and transparency."

Net assets are currently broken out into three categories on the financial statement – unrestricted, temporarily restricted and permanently restricted – and there has been a considerable amount of confusion about what belongs in each category, which has led to reporting inconsistencies.

"Let's say I'm a donor and I walk into a nonprofit and I hand them a check for $100,000 and I say, 'Don't spend it on anything, but the interest earned is for you to use free and clear," **Sackstein** said. "The $100,000 is considered to be permanently restricted."

An example of temporarily restricted assets is "if I go to the same organization and hand them $100,000 and I say, 'Use it for purchasing playground equipment for one of your locations,'" **Sackstein** said. "They take the money on Dec. 15 and they don't spend it until the next year. In the interim, the money is temporarily restricted" as it has been earmarked for the purchase of playground equipment.

With the update, there will only be two designations – net assets with donor restrictions and net assets without donor restrictions – but those restrictions must be detailed further in footnotes, **Sackstein** noted.

"You're using two buckets instead of three, but there is enhanced disclosure about each of the buckets," Rottkamp said.

"Organizations sometimes would receive restricted dollars and spend them inappropriately," **Sackstein** said. "For example, someone might hand them $100,000 and tell them not to spend it,

but then they had to make payroll, and so they used it for payroll and thought, 'When we get it back from other programs we'll pay it back.' It started to get muddy."

As part of the new requirements, nonprofits must enhance disclosures associated with underwater endowments.

"Say we have permanently restricted funds – someone hands us $100,000 and we take it and invest it in Google stock, and Google takes a plummet and that $100,000 is no longer worth that; it's worth $80,000," **Sackstein** said. "But the $100,000 was restricted; who's going to make up that $20,000?"

There has been some legislation allowing nonprofits to dip into the principal with certain stipulations, but "with Update 2016-14 you have to talk about it, so the reader of the financial statements understands what you've done," **Sackstein** said.

The update also requires disclosures related to liquidity.

"The new standard requires organizations to disclose both qualitative and quantitative information about their liquidity," said Gordon Siess, a partner and not-for-profit services leader at Baker Tilly in Melville. "This requirement is very new to nonprofits."

Organizations will have to list which assets are available to meet cash needs and describe how they manage their liquid resources, said Siess, who is in favor of this new requirement.

"Reporting about liquidity can be very useful information for users of financial statements," he said.

"It's common knowledge that in some of the failures of large and small nonprofits, the users of the financial statements didn't always see a clear picture of what was going on, especially regarding liquidity and from the financial sustainability perspective," Rottkamp said. "How nonprofits manage liquidity, how they define it and what they plan to do when they need to get more liquid is not in financial statements today. And there also must be the quantitative piece, to show which assets they have to meet the cash needs over the next year."

Another significant change calls for nonprofits to report expenses by both nature and function, Siess said.

Nature refers to the type of expenditure, such as rent or salaries, while function refers to the program it is used for.

"Currently, only nonprofits in the health and welfare field have to do this, but when it goes into effect, all nonprofits will have to report expenses by nature and function and reconcile the two," Siess said.

"Say a nonprofit spent $100 on the utility bill," **Sackstein** said. "We know what the functional classification is: to keep the lights on. But they will also have to look at what program is in that facility. Organizations will have to be very deliberate about how they spend money and how they classify it."

While the update doesn't become effective until the end of the year, nonprofits "need to start thinking about how they're going to implement reporting changes and gather data for the new footnotes that they will be including in their reporting, and getting systems in place for gathering that information," Siess said.