GAAP Update and Advanced Technologies for Not-for-Profit Entities

Richard Cole, Supervising Project Manager, FASB
Candice Meth, Partner, EisnerAmper LLP
Not-for-Profit GAAP Update

Rick Cole, FASB Supervising Project Manager
Email: racole@fasb.org
October 2, 2017
Agenda

Today we will discuss:

Final Accounting Standards Updates

• Presentation of Financial Statements of NFP Entities
• Revenue Recognition
• Leases

Proposed Accounting Standards Updates

• Revenue Recognition of Grants and Contracts for NFP Entities
Presentation of Financial Statements of NFP Entities
NFP Financial Statements ASU—Key Objectives  
(recommended by FASB’s NFP Advisory Committee (NAC))

1. Update, not overhaul, the current model
2. Improve net asset classification scheme
3. Improve information in financial statements and notes about: financial performance, cash flows, and liquidity
4. Better enable NFPs to “tell their financial story”

Issued August 18, 2016, ASU No. 2016-14
Key Provisions of ASU No. 2016-14

**Net Asset Classification**
Updates net asset scheme, changes underwater endowment accounting, removes option for implied time restrictions on capital gifts, enhances disclosures

**Liquidity & Availability**
Quantitative and qualitative disclosures about liquidity and availability of resources

**Expenses**
Requirement to report expenses by function (already required) and nature, and an analysis showing the relationship between function and nature

**Statement of Cash Flows**
“Free choice”: indirect reconciliation no longer required for direct method

**Investment Return**
Present investment return net of external and direct internal investment expenses, no longer required to disclose netted expenses

**Phase II TBD**
Phase I

Cash Flow Statement

Continue to allow choice between the Direct Method and the Indirect Method in presenting operating cash flows

However, indirect reconciliation is no longer required for the Direct Method
## Operating Cash Flows

### Direct Method

<table>
<thead>
<tr>
<th>Description</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from donors for operations</td>
<td>$1,756,001</td>
<td>$1,390,824</td>
</tr>
<tr>
<td>Cash received from program fees and other</td>
<td>700,622</td>
<td>645,201</td>
</tr>
<tr>
<td>Cash payments to employees</td>
<td>(1,257,765)</td>
<td>(1,319,769)</td>
</tr>
<tr>
<td>Cash payments to vendors and others</td>
<td>(1,046,017)</td>
<td>(983,776)</td>
</tr>
<tr>
<td>Cash paid for interest</td>
<td>(47,878)</td>
<td>(32,922)</td>
</tr>
</tbody>
</table>


### Indirect Method

<table>
<thead>
<tr>
<th>Description</th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in net assets</td>
<td>$(97,821)</td>
<td>$(540,070)</td>
</tr>
<tr>
<td>Adjustments to reconcile change in net assets to net cash from operating activities-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>269,584</td>
<td>254,559</td>
</tr>
<tr>
<td>Contributions restricted for property purchases</td>
<td>(60,582)</td>
<td></td>
</tr>
<tr>
<td>(Gains) losses on investments</td>
<td>(22,060)</td>
<td>2,574</td>
</tr>
<tr>
<td>Changes in operating assets and liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grants and pledges receivable</td>
<td>(125,862)</td>
<td>27,305</td>
</tr>
<tr>
<td>Prepaid expenses and other assets</td>
<td>26,615</td>
<td>(2,300)</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>59,108</td>
<td>(44,825)</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>55,981</td>
<td>2,315</td>
</tr>
</tbody>
</table>

## Net Assets

<table>
<thead>
<tr>
<th>Current GAAP</th>
<th>Unrestricted</th>
<th>Temp. Restricted</th>
<th>Perm. Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revised GAAP</td>
<td>Without Donor Restrictions*</td>
<td>With Donor Restrictions*</td>
<td></td>
</tr>
<tr>
<td>Disclosures</td>
<td>Amount, purpose, and type of board designations **</td>
<td></td>
<td>Nature and amount of donor restrictions</td>
</tr>
</tbody>
</table>

* NFPs may choose to disaggregate further
** New disclosure requirement
Implementation – Balance Sheet

Net assets:
Without donor restrictions 125,056
With donor restrictions 162,268
Total net assets 287,324

Minimum presentation required

Alternative disaggregation allowed

Net assets:
Without donor restrictions -
  Undesignated 24,931
  Operating reserve 25,000
  Designated by the Board for capital projects 75,125
  Total 125,056

With donor restrictions -
  Time restricted for future periods 2,783
  Purpose restricted 11,066
  Endowment fund 148,419
  Total 162,268

Total net assets 287,324
“Underwater” Endowments

Revised net asset classification

- To be reflected in net assets with donor restrictions rather than in net assets without donor restrictions

Enhanced disclosures

- In addition to aggregate amounts by which funds are underwater (current GAAP), also disclose aggregate of original gift amounts (or level required by donor or law) for such funds, fair value, and any governing board policy, or actions taken, concerning appropriation from such funds
Expiration of Capital Restrictions

Gifts of cash restricted for acquisition or construction of PP&E

In absence of explicit donor restrictions, NFPs would be required to use the placed-in-service approach (*no more implied time restrictions*)

- Healthcare NFPs are already required to do so
Liquidity and Availability of Resources

NFPs required to provide:

**Qualitative** information on how an NFP manages its liquid available resources and its liquidity risk (in the notes)

**Quantitative** information that communicates the availability of an NFP’s financial assets at the balance sheet date to meet cash needs for general expenditures within one year (on the face and/or in the notes)
Quantitative Disclosure for Financial Assets Availability Example

The following chart represents XYZ’s financial assets available to meet cash needs for general expenditures within 1 year of June 30, XX. Due to the nature of the restrictions from contributions received from donors, XYZ has omitted all restricted contributions.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets, at year-end*</td>
<td>$234,410</td>
</tr>
<tr>
<td>Less those unavailable for general expenditures within one year, due to:</td>
<td></td>
</tr>
<tr>
<td>Contractual or donor-imposed restrictions:</td>
<td></td>
</tr>
<tr>
<td>Restricted by donor with time or purpose restrictions</td>
<td>(11,940)</td>
</tr>
<tr>
<td>Subject to appropriation and satisfaction of donor restrictions**</td>
<td>(144,500)</td>
</tr>
<tr>
<td>Investments held in annuity trust</td>
<td>(4,500)</td>
</tr>
<tr>
<td>Amounts held by bond trustees</td>
<td>(30,200)</td>
</tr>
<tr>
<td>Board designations:</td>
<td></td>
</tr>
<tr>
<td>Quasi-endowment fund, primarily for long-term investing**</td>
<td>(36,600)</td>
</tr>
<tr>
<td>Amounts set aside for liquidity reserve</td>
<td>(1,300)</td>
</tr>
<tr>
<td>Financial assets available to meet cash needs for general expenditures within one year</td>
<td>$5,370</td>
</tr>
</tbody>
</table>

*Total assets, less nonfinancial assets (e.g., PP&E, inventory, prepaids)

**Excludes amounts that have been appropriated for next 12 months that do not have purpose restrictions
Expense Reporting

Report expenses, either on the face of financial statements or in the notes, by:

- Analysis (disaggregate function by nature) **
- Function *
- Natural classification

* currently required in GAAP
** choice of location; Board may explore segment reporting as an option instead for HC in Phase 2
## Analysis of Expenses - Presentation in the notes or in a separate statement

<table>
<thead>
<tr>
<th></th>
<th>Program Services</th>
<th>Supporting Activities</th>
<th>Total Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Program A</td>
<td>Program B</td>
<td>Program Subtotal</td>
</tr>
<tr>
<td>Salaries, benefits, and taxes</td>
<td>$7,400</td>
<td>$5,625</td>
<td>$13,025</td>
</tr>
<tr>
<td>Grants to other organizations</td>
<td>2,075</td>
<td>2,675</td>
<td>4,750</td>
</tr>
<tr>
<td>Supplies and travel</td>
<td>890</td>
<td>1,512</td>
<td>2,402</td>
</tr>
<tr>
<td>Services and professional fees</td>
<td>160</td>
<td>2,090</td>
<td>2,250</td>
</tr>
<tr>
<td>Office and occupancy</td>
<td>1,160</td>
<td>1,050</td>
<td>2,210</td>
</tr>
<tr>
<td>Depreciation</td>
<td>1,440</td>
<td>1,370</td>
<td>2,810</td>
</tr>
<tr>
<td>Interest</td>
<td>171</td>
<td>164</td>
<td>335</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>$13,296</strong></td>
<td><strong>$14,486</strong></td>
<td><strong>$27,782</strong></td>
</tr>
</tbody>
</table>
## Analysis of Expenses - Presentation on face of the statement of activities

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Grant activities -</td>
<td></td>
</tr>
<tr>
<td>Grants</td>
<td>12,125</td>
</tr>
<tr>
<td>Salaries, benefits and taxes</td>
<td>1,808</td>
</tr>
<tr>
<td>Occupancy costs</td>
<td>970</td>
</tr>
<tr>
<td>Depreciation</td>
<td>845</td>
</tr>
<tr>
<td>Supplies</td>
<td>1,255</td>
</tr>
<tr>
<td>Other</td>
<td>56</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>17,059</td>
</tr>
</tbody>
</table>

| Management and general -        |       |
| Salaries, benefits and taxes    | 452   |
| Occupancy costs                 | 243   |
| Depreciation                    | 211   |
| Supplies                        | 314   |
| Other                           | 14    |
| **Total**                       | 1,234 |

| Total expenses                  | 18,293|
Expense Reporting (cont’d.)

NFPs required to provide qualitative disclosures about methods used to allocate costs among program and support functions

ASU also provides enhanced guidance on allocations from M&G expenses
- Key concept: **direct conduct** or **direct supervision**
Reporting of Investment Return

How to present?

- **Net presentation** of investment expenses against investment return on the face of the statement of activities
  - Netting limited to external and **direct** internal expenses
  - May report net return in **multiple**, appropriately labeled lines (e.g., from different portfolios, in different net asset classes, or in operating versus nonoperating)

What to disclose?

- Disclosure of investment expenses **no longer required**
  - If reported, carefully label and don’t include in expense analysis
  - No longer require disclosure of investment return **components**
Effective Date, Early Adoption, and Transition

**Effective Date:** For fiscal years beginning after 12/15/2017 (e.g., CY 2018, FY 2018-19)

- Interim financials the following year

**Early Adoption:** Permitted, but must apply the regular transition provisions.

**Transition:**

- For year of adoption: apply all provisions.
- For comparative years presented: apply all provisions, except can choose not to present:
  - Analysis of expenses by nature and function*, and/or
  - Disclosures around liquidity and availability of resources
  - *unless already required to do so under current GAAP
Revenue Recognition
Revenue Recognition—Scope

All contracts with customers, except:
- Lease contracts
- Insurance contracts
- Financial instruments
- Guarantees
- Nonmonetary exchanges in the same line of business to facilitate sales to customers

Contracts not with customers are excluded:
- Contributions
- Collaborative arrangements
Revenue Recognition—Model

- Core Principle:

  Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

- Steps to apply the core principle:
  1. Identify contract(s) with the customer
  2. Identify performance obligations
  3. Determine transaction price
  4. Allocate transaction price
  5. Recognize revenue when (or as) a performance obligation is satisfied
Revenue Recognition—Effective Date

Original effective dates
- CY 2017 (FY 2017-18) for public entities* (including interim)
- CY 2018 (FY 2018-19) for nonpublic entities (no interim, just annual period; interims in subsequent years)
- Nonpublic entities may adopt early, but no earlier than public entities

Deferred effective dates
- CY 2018 (FY 2018-19) for public entities* (including interim)
- CY 2019 (FY 2019-20) for nonpublic entities (no interim, just annual period; interims in subsequent years)
- Early adoption permitted, but not before original effective date

* Public entities include NFPs with publicly traded conduit (or direct) debt
Leases
Lessee Accounting Overview

**Balance Sheet**
- Finance ("Type A")
  - Right-of-use (ROU) asset
  - Lease liability
- Operating ("Type B")
  - Right-of-use (ROU) asset
  - Lease liability

**Income Statement**
- Finance ("Type A")
  - Amortization expense
  - Interest expense
- Operating ("Type B")
  - Single lease expense on a straight-line basis

**Cash Flow Statement**
- Finance ("Type A")
  - Cash paid for principal and interest payments
- Operating ("Type B")
  - Cash paid for lease payments

Classification is similar to that in Topic 840, *Leases*

Recognition and measurement exemption for short-term leases

Other than public business entities may use risk-free rates for measurement of all lease liabilities
# Leases—Effective Date

<table>
<thead>
<tr>
<th>Public Companies*</th>
<th>All Other Organizations</th>
<th>Early Application</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (CY 2019; FY 2019-20)</td>
<td>• Fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020 (CY 2020; FY 2020-21)</td>
<td>• Permitted for all organizations</td>
</tr>
</tbody>
</table>

* “Public Companies” refers to the following: (1) public business entities; (2) a not-for-profit entity that has issued or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market; and (3) an employee benefit plan that files or furnishes statements with or to the SEC. **(Same effective date as revenue recognition standard)**
Revenue Recognition of Grants and Contracts by Not-for-Profit Entities

Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made
Grants and Contracts to NFPs—Background

Project added to FASB’s Technical Agenda to **improve and clarify** existing guidance

ASU 2014-09, *Revenue from Contracts with Customers*, including related disclosures, heightened the issue

Raised question as to whether grants and contracts are in scope of that guidance (reciprocal or nonreciprocal)

Long-standing diversity in practice in classifying grants and contracts, particularly from governmental entities

<table>
<thead>
<tr>
<th>Issue 1: Reciprocal Versus Nonreciprocal</th>
<th>Issue 2: Conditional Versus Unconditional</th>
</tr>
</thead>
<tbody>
<tr>
<td>Many NFPs treat federal grants/contracts with governmental entities as exchanges (regardless of substance)</td>
<td>Stakeholders find it difficult to distinguish between a conditional and unconditional contribution → causing diversity in application</td>
</tr>
<tr>
<td>Some equate the government with general public—issue is whether government receives direct commensurate value in return (because the public benefits)</td>
<td>If funds are provided with certain stipulations, there’s difficulty in distinguishing whether contribution is conditional, restricted, or both.</td>
</tr>
<tr>
<td>Many believe the government doesn’t give “contributions”</td>
<td>Diversity in application of “remote” notion — whether likelihood of failing to meet a condition is remote. (Some NFPs believe any condition within their control has remote likelihood of not being met.)</td>
</tr>
</tbody>
</table>
Issue 1: Reciprocal vs. Nonreciprocal Transactions: Key Clarifications to the Scope of Subtopic 958-605

The proposed ASU would clarify and refine existing guidance in Subtopic 958-605 by adding paragraphs that would clarify the scope of the Subtopic as well as illustrative examples.

• The resource provider is not synonymous with the general public, even a governmental entity. If a resource provider receives value indirectly by providing a societal benefit, this would be considered a nonreciprocal transaction.

• If the primary beneficiary of a grant or contract is a third party, an NFP must use judgment to determine if the transaction is reciprocal or nonreciprocal.

• Furthering a resource provider’s mission or “feel good” sentiment does not constitute commensurate value received.

• The type of resource provider should not override the substance of the transaction.
Issue 2: Conditional vs. Unconditional Contributions

For a Donor-Imposed Condition to Exist:

Proposed ASU

- A right of return/release must exist; and
- The agreement must include a barrier
  - Indicators and examples to help in determination

Alternative Rejected

- A right of return/release must exist.
- Would have required a probability assessment about whether it is likely a recipient NFP will fulfill the stipulations.
• General examples of technology applications for not-for-profits
• Technological applications for: Accounting Standards Update (“ASU”) 2016-14—*Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*
• Technological applications for: ASU 2016-02 *Leases* and ASU 2016-10—*Revenue from Contracts with Customers*
• Advantages and pitfalls of new technology
Traditional Methods

- Spreadsheets in excel
- Research conducted using both publications and online databases
- Accountant observation and judgement
Leveraging Technology

- Cloud-based general ledger packages with more sophisticated modules
- IDEA software - data-mining abilities. Examples - look for how many hours got coded to particular project, search for entries made at night or on weekends, etc.
- Cell phone applications
- IBM Watson
- “Hosted” websites – use of third parties
General Examples of Technology Impacting Nonprofits

• Electronic medical record software aiding in reimbursement requests
• Inventory counting software available as a cell phone app
• Crowd funding third-party platforms
• Hosted websites with cybersecurity monitoring
• Data mining software such as IDEA that can be used for analytics, look for patterns, spot anomalies, etc.
• **Import all of your records** including spreadsheets, and exported data from databases, accounting programs, ERP systems and T&E applications in formats such as PDFs, plain text (.txt), print-report (.prn), ODBC and SAP. Then create one document from these multiple sources, using the fields you desire.

• Quickly visually pinpoint patterns, trends and outliers.

• Excellent self-audit tool, test journal entries, etc.

• Search a particular attribute for further investigation. For example, upload all expense reports for a year and determine how many times a subordinate approved his/her boss’s expenses.
Leveraging Technology for New Accounting Guidance
Main areas where technology can aid organizations:

• Liquidity
• Expense allocation
• Endowment
Liquidity

This disclosure requirement has a quantitative aspect that may be best addressed using technology:

• Requirement is to identify the most liquid assets, not subject to restrictions, that can be used to pay near-term operating expenses.

• Restructure general ledger into a **classified balance sheet presentation** – not required for not-for-profits but would help identify the number to be disclosed in the financial statements faster, and using reliable methodology.

• Group investments in general ledger based on redemption terms to carve out those that can be easily redeemed in the near future.
Expense Allocation by Nature and Function

This disclosure requirement is new for some organizations, while others have always included this information in the financials (but often is based on a manually prepared excel spreadsheet).

• Can this process be automated? *Partially*
• Restructure general ledger into **cost centers** – this will help pull direct costs into the proper functional category of program, management and general or fund-raising.
• Indirect costs will still manually need to be allocated over a selected basis such as square footage or salary hour (judgement involved). However, once cost centers are established, the left over overhead costs should shrink and should save time in the manual allocation process.
Endowment

Tracking these individual funds is time consuming and typically based on a manually prepared excel spreadsheet.

- Can this process be automated? Sure!

-FUNDRIVER®

Shift into automatic


- With new requirement for more robust disclosures on spending from underwater funds, it is critical to do modeling! Extrapolate investment results over the course of the year and show the Board what applying the approved spend rate will do to individual funds. Arm the Board with frequent information so they can make informed decisions. That decision will soon be disclosed in the financial statements!
WATSON

Each purchased instance of Watson requires a user to input “biases” which WATSON will then apply going forward. As Watson goes through the analysis, it will ask questions. Based on the answers to those questions it “learns” and will never need to ask those questions again.
Teach Watson the decision tree, feed all leases into WATSON and let it classify each lease accordingly, which then informs the appropriate accounting treatment.

**Software Applications for ASU 2016-02 Leases**

1. **Does ownership transfer at the end of the lease term?**
   - **No**
   - **Is the lessee purchase option reasonably certain to be exercised?**
     - **No**
     - **Is the lease term a major part of the remaining economic life (i.e. 75%)?**
       - **No**
       - **Is the present value of the lease payments (as well as any guaranteed residual value substantially all of the fair value of the asset (i.e. 90%)?**
         - **No**
         - **Is the asset a specialized asset that doesn’t have any alternative use to the lessor?**
           - **No**
           - **Operating Lease**
         - **Yes**
       - **Yes**
       - **Finance Lease**
     - **Yes**
   - **Yes**
   - **Finance Lease**
Software Applications for ASU 2016-10 Revenue Recognition – Contracts with Customers
Using WATSON for Revenue Recognition Contracts with Customers—Tuition, Membership, etc.

Same concept as leases, once Watson is taught the identifying factors, it will review all contracts and determine when revenue gets recognized.

<table>
<thead>
<tr>
<th>1. Identify the Contract(s) with the Customer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does not allow for termination prior to performance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Identify the Separate Performance Obligations in the Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Account for each good or service separately if they are &quot;distinct&quot;</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. Determine the Transaction Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract terms AND customary practices</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4. Allocate the Transaction Price to the Separate Performance Obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocation of consideration is based on standalone selling prices at contract inception</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>5. Recognize Revenue When or As Performance Obligations are Satisfied</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer obtains CONTROL of the good or service</td>
</tr>
</tbody>
</table>
Leveraging Technology for Tax Guidance
Using WATSON to Determine the Existence of UBIT

The Trifecta of UBIT:

• It is a trade or business
• It is regularly carried on
• It is not substantially related to furthering the exempt purpose of the organization

Let’s Call These Meth’s Biases!

If I feed a year’s worth of rental income general ledger data into IDEA to look for “regularly carried on” and I also feed rental contracts into Watson to look for terms that trigger UBIT, the combination of these procedures will likely identify UBIT rental activities.
Example - Qualified Corporate Sponsorships

Teach Watson to Cull Through Contracts and Look for Attributes:

• These contract items are generally **Ok**:
  – Display logo, allow them to give out samples, allow them to be the exclusive sponsor, give them a table at your gala

• These contract items could trigger **Tax**: (will cause payment to be advertising and not contribution)
  – Nonprofit is required to tell event goers that they should buy the commercial entity’s products
  – Nonprofit is required to promote the commercial entity using language as to why they are “better” or “cheaper” than their competitors
  – In return for sponsorship, nonprofit is required to give commercial entity something of commensurate/substantial value
Advantages and Pitfalls of New Technology
Advantages

• Efficiency – hours of time saved!
• Real-time results allow for better monitoring of operations
• Long-term cost savings - cut down on staffing
• Accuracy and consistency- avoid mistakes due to human error
**WATSON**

If Watson is given incorrect biases at its initial learning stages, that will compromise the integrity of the output.

If the input is invalid or an aggressive interpretation of the accounting guidance, the output will be perhaps less reliable than a “reasonable person’s” evaluation, on a case-by-case basis.
Who Regulates These Applications

Vendors may go through SSAE 16 audit or have independent parties test their software to validate the accuracy but there may be no requirement to do testing. Important Considerations:

- If a SOC 1 report is issued as a result of a SSAE 16 audit, is it being reviewed annually by the user?

- Does the user annually evaluate the relationship with the service provider and determine if there are better/more reliable options available?

- If reliance on information technology becomes so paramount, do not-for-profits need to start undergoing annual IT audits in addition to financial statement audits? Who determines if that is required?
Questions?