What the New FASB Accounting Standards Will Mean for Your Nonprofit

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By Ruth McCambridge 9/13/2016

This article comes from a conversation with Hilda H. Polanco.

The Financial Accounting Standards Board (FASB) issued a new nonprofit accounting standard in mid-August that's meant to help nonprofits to tell their story more transparently through their financials. FASB's guidance has informed the way nonprofit financial statements have been organized since 1993; in the more than 22 years since, many practitioners have expressed frustration with the oddness of the picture presented to the outside world. Many of the problems can be traced back to a few quirks of nonprofit finance—in particular, the lack of fungibility and the amount of restricted money in many of the revenue streams for nonprofits.

FASB Chairman Russell Golden said in a statement:

> *While the current not-for-profit financial reporting model held up well for more than 20 years, stakeholders expressed concerns about the complexity, insufficient transparency, and limited usefulness of certain aspects of the model. […] The new guidance simplifies and improves the face of the financial statements and enhances the disclosures in the notes.*

So this effort is right on time. With the new emphases and expectations on transparency, nonprofits must learn how to present their financials in a way that will make sense to stakeholders, and these new guidelines will likely help. But, the most significant value will be in the clarity that can be reached internally among those who must make sense of financial information for management and governance purposes.

The new guidance will be the standard for fiscal years beginning after December 15, 2017. For calendar year organizations, that will be calendar 2018. For fiscal year organizations, which typically end on June 30th, it will be the fiscal year beginning July 1, 2018. However, early adoption is allowed, and that means you don't have to wait for these years. If an organization wants to implement it for calendar 2017, they can do so and take 2016, the year we're in, as sort of a mock period just to implement what it would look like.

The new standards began taking shape after FASB formed its Not-for-Profit Advisory Committee (NAC) in 2009 in an effort to keep the board informed on not-for-profit perspectives in financial reporting. The NAC advised that certain areas of the not-for-profit financial reporting model could be improved.

Hilda Polanco of FMA has followed the goings-on during that period. This article provides some overarching reasons why nonprofit staff and boards generally should pay attention to the implications of the changes and then, for the financial nerds among you, we direct you to an FASB webinar this afternoon (if you're reading on Tuesday, September 13th) where you can hear it all from the horse's mouth.

Though Polanco says she is happy with all the outcomes, which are grouped into five sections, she is particularly interested in three: the simplification of the classification of net assets, the tracking of liquidity, and changes in the presentation of expenses.

On the **classification of net assets**, Polanco says that in the past, "Nonprofits were required to disclose three categories of assets: restricted, temporarily restricted, and permanently restricted. But now there will only be two classes of net assets, one without donor restriction and one with donor restriction. It's simpler, and the streamlined approach basically allows those endowments that used to be in permanently restricted to be grouped with other restrictions that may be more time-limited."

"As a result," she adds, "the statement of activities that shows the revenues associated with these classifications will also be simpler. It will have only two columns. In that area, for those organizations that have endowments that are underwater[1], there will be additional disclosures required. What were the original principal dollars, what's unrestricted that has been un-appropriated from the endowment and the unrealized gains? So, there will be enhanced disclosures in cases where in the past it used to be a more complicated presentation. So, that's the first change, the net asset classification."

The second change is in the area of **tracking liquidity**, or how many dollars an organization has in cash or something close to cash. Polanco says, "This is obviously an important component of short- and long-term financial health, the ability to be able to meet your cash requirements from your operations. There will be a reconciliation in the footnotes that shows, at the end of the year on your balance sheet, what resources are available for use in the following year. There will also be additional disclosures about management strategies to have cash available. This is a very significant improvement to understanding the financial health of a nonprofit."

The third change Polanco sees as critical is in the **presentation of expenses**. These, she says, will not be a big change for voluntary health and welfare organizations, as "those nonprofits have always had to show the program versus the overhead allocation. Now, this is going to apply to everyone."

> *With a few organizations sort of pushing the envelope a little bit in that area, the additional disclosures are going to require there be some explanation as to the allocation methodology used to allocate the expenses and what the end results are. They'll be able to have a choice whether they disclose it in the footnotes or in the financials themselves, but they will be required. In addition to doing it in the 990, which you always had to, now you'll have to do it in the audit, and it will be an important part of the disclosure.*

Polanco believes these three changes in presentation and footnotes will help boards and staff be more strategic in their financial management by illuminating some of the more critical aspects of financial health.

> *Unrestricted net assets, which are sometimes called reserves, include things like buildings and other illiquid net assets, value you don't have immediate access to and that's unavailable to pay your bills. So, you may look very strong on your balance sheet with a high level of reserves—but you can't really pay your bills with a building, not on a weekly basis as payroll becomes due.*
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> *On the flip side, organizations may have cash in the bank, but that doesn't mean the organization can spend that cash in any way it may need. So, on the one hand, it may be that much of what you have isn't really liquid, and, on the other hand, what you have that is liquid, you can't spend freely. Understanding that, what is available for operations and what's restricted for the future is going to be, I think, a really important enhancement.*

But, Polanco cautions, "This is by no means just about the numbers. This is why I think it's a helpful movement. The numbers sometimes don't speak for themselves unless they are presented properly and the enhanced disclosures will require a different standard for that presentation."

> *There are enhanced disclosures in a few areas that I think are going to allow the financial team, the development team and, again, board and management to be on the same page to really consider the critical components of financial health. Things like the liquidity measure that I mentioned; they'll be able to really think about that and the organization's ability to meet operating expenses and debt payments that loom around the corner. They'll be able to talk about any underwater endowments and what their strategy might be for those if they exist. They'll talk about their cost allocations and what the rationale is for that.*
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> *Again, the real value is in being able to see the issues and to discuss them from the same page.*

Polanco also believes that the sooner nonprofits get started implementing some of the changes, the better, so that they can begin to cohere their story by the numbers. "I think it should start internally because organizations are going to have to think about the disclosures more," she said.

> *I think the numbers themselves will actually be easier to calculate. There's a lot of simplicity in this, but it won't be just the numbers. Actually, oftentimes we see organizations that report internally one way, and then the audit comes up—and when the audit is presented in accordance with GAP, those financials look different. I would encourage organizations, both management teams and boards, to start thinking this way as they prepare financials internally so that the first phase of this is an education for the board and management to see things in the same way. I would say that organizations should focus on things like, "What is my availability of cash for the coming year? What are the limitations on this cash? Did I receive cash in June for the summer camp in July? Do I have cash for a multi-year grant? What are the limitations on how I can use it?"*
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> *Oftentimes, limitations are placed by boards. For example, there's a board-designated reserve at an organization, and this disclosure will require a conversation that basically says, "Are these board-designated funds really available for operations in the coming year?" We often hear "rainy-day reserves," but no one really understands the definition of rain—"Why? Is it raining yet?" Or, if we use some of those funds for the rainy day, do we have to put them back in the future? When I am disclosing how much I have available in liquid assets for the coming year, do I put in my reserve for operations because that's what the board intends, or does the board have the reserve tied up in long-term stock where it's not going to be available?*
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> *So, I think that will be a really healthy discussion shaped by the disclosure, but it will force some conversations that maybe aren't happening today and that will add clarity. With all of that, the sooner they can start thinking about that internally and start to do, like, a mock presentation of what this looks like, the more they will get used to thinking this way well before it's required, and the better the presentations will be.*

Board and staff, she says, will need to educate themselves or allow themselves to be educated.

> *I think, in an ideal world, the organization's leadership is receiving that education and training—either, again, from the outside accounting firm that they're working with, or from education like what NPQ shares with the community. They need to proactively say, "Okay, this is going to be the bridging of what we say publicly in our development materials, and in annual reports and this is what our audits are going to say around our financial health and sustainability. Let's make sure these stories are the same financial story and that it's an enhanced financial story." It begins with the leadership teams*

> *being aware of what this means.*
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> *We've often said that the 990, being that it's such a publicly available document, is really a document that development should understand and own almost as much as finance. Well, in this enhanced disclosure, particularly around liquidity, the development team and its ability to explain this information, they're usually the ones handing the audited financials to a donor, that's going to be important. That whole team needs to understand this.*
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> *Then, the board needs to be educated, like anything else, and that education often doesn't come from the outside. Maybe access is not easily available, so the leadership team are the ones really educating the board. But they do have the annual audit, and I think every accounting firm should be proactively volunteering to come to a board meeting and explain how these changes will affect the audit and how they can prepare. We don't want to wait until the first year we have to implement it to have these conversations.*

As Polanco points out, change doesn't come easily, and more regulation and greater disclosure often feels like just one more thing on someone's to-do list. But this idea of telling your financial story is really important—for fundraising purposes, for the board to understand its own story, for potential new board members. She encourages everyone to think of this as an opportunity: "We have to do it anyway from a compliance place with audits; let's think about it from a more proactive business perspective."

Notes

1: An "underwater" endowment is a permanent endowment where the market value is less than the historic dollar value (HDV), which is the accumulated original gifts adjusted for amounts required to be added to it, either by the donor or by law.