Mind The GAAP: Financial Reporting Impact Of New Accounting Standards For Not-For-Profits.

In April of this year, the Financial Accounting Standards Board ("FASB") circulated a series of proposed changes to generally accepted accounting principles ("GAAP") applicable to certain not-for-profits. These changes, which are intended to provide clearer information to donors, creditors, and other users of financial statements, may have a significant impact on not-for-profit financial reporting (which has remained largely unchanged for nearly twenty years) and will, among other things, (i) impact the reporting of operating performance in an entity's statement of activities and related metrics in the statement of cash flows, (ii) require the use of the direct method for preparing the statement of cash flows, and (iii) modify the reporting disclosure of net assets and "underwater" endowments.

The new standards will apply to most not-for-profit organizations, including public charities and private foundations, but not to entities that provide dividends, lower costs, or economic benefits to owners, members or participants such as mutual insurance entities, credit unions, farm and rural electric cooperatives, or employee benefit plans.

FASB has not offered a timeline for when these GAAP changes will take effect and they remain subject to revision.

Some highlights of the proposed changes are:

Defining Operating Activities

Not-for-profit entities (other than healthcare entities) are currently required to report their "change in net assets," a metric which is similar to the comprehensive income of a for-profit business. While entities now have flexibility regarding how that metric is calculated, the proposed standards will require the classification of all revenues, expenses, gains, losses or other changes in net assets as either operating or nonoperating activities, with operating activities consisting of all resources derived from or directed at carrying out an entity's mission and available for use in the current reporting period.

Cash Flows

The proposed operating activity reporting changes will be reflected on the statement of cash flows. Specifically, certain expenditures, gifts of cash to acquire property and equipment, and cash invested for programmatic purposes will be classified as operating cash flows. Returns from non-programmatic investments will be considered investing inflows, while interest on financing will be classified with financing activities. In addition, entities will be required to report operating activity cash flows using direct method reporting (which generally involves breaking out cash flows on a line item basis, rather than showing net income as modified by certain adjustments).

Net Asset Reporting

Currently, not-for-profit entities classify net assets as unrestricted, temporarily restricted and permanently restricted. Under the proposed standards, a new category, "net assets with donor-imposed restrictions," will replace the temporarily restricted and permanently restricted categories, with the differences among funds being described in the footnotes to the financial statements. In addition, the unrestricted category will be renamed "net assets without donor restrictions."

Underwater Endowments

Finally, the proposed standards will change the way entities report so-called "underwater" endowment funds. An endowment fund is considered to be "underwater" if the fair value of the assets and accumulated returns of the fund are less than the historical amount of the gift. Currently, GAAP requires entities to report a deduction in net assets without donor restrictions to the extent of the deficit. Under the proposed standards, entities will present the entire endowment fund, including whatever is underwater, in "net assets with donor restrictions" and disclose (i) the aggregate fair value of the underwater endowment funds, (ii) the original gift amount or the amount the entity must maintain according to donor requirements or the law, and (iii) the amount by which funds are underwater.

Apart from the administrative and reporting impact on not-for-profits, these changes may influence how donors view a not-for-profit's health and prospects. Not-for-profits can expect more questions about their financials, both because of these changes, in the near term, and because the proposed standards will lessen the similarities between for-profit and not-for-profit reporting.

Staff and board members of not-for-profit entities should familiarize themselves with the proposed changes, and should plan to meet with their auditors and counsel to evaluate how the new standards may affect their financial reporting and to determine whether any bookkeeping changes should be implemented in advance to prepare.

Patterson Belknap Webb & Tyler LLP

Article by Dahlia B. Doumar and Justin Zaremby

Last Updated: December 14 2015

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.