Public Roundtable Meeting

Presentation of Financial Statements of Not-for-Profit Entities
September 21, 2015
9:00 a.m. – 12:00 p.m.

Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut

AGENDA

Welcome and Introductions

We have arranged this roundtable meeting to listen to your views and to further develop our understanding of the issues you raised or alternatives you proposed in your comment letters.

We expect to cover each of the following topic areas:

Topic 1: Operating Measures

- Require or not require an operating measure?
- If require:
  - Mission dimension (including property, plant, and equipment and excluding interest expense)
  - Availability dimension (including internal transfers)
  - Healthcare performance indicator or net income equivalent
  - Other

Topic 2: Presentation of Operating Cash Flows

- Use of the cash flow statement
  - If used, by whom and for what purpose?
  - If not used, why?
- Direct method—require or continue to encourage?
- Indirect method—permit or continue to require?

Topic 3: Information Useful for Assessing Liquidity

- Qualitative and/or quantitative information
- Implementation guidance?
- Classified balance sheet and/or net assets limited as to use?

Topic 4: Other Topics

- Analysis of expenses by function and nature
- Investment return
- Changes in classes of net assets
- Other

Topic 1: Operating Measures

Relevant Basis from Proposed Accounting Standards Update:

BC52. The Board considered several alternative ways of defining operating activities. For purposes of the activity statement, they include distinguishing between revenues, expenses, gains, and losses of the period on the basis of whether they are the following:

a. From core or noncore activities

b. From delivering or producing goods, rendering services, or carrying out activities that constitute the entity's ongoing major or central operations, which is the conceptual basis for distinguishing revenues and expenses from gains and losses

c. From or directed at carrying out an NFP's purpose for existence….

BC54. …the Board decided that the notion in paragraph BC52(c) seems to best capture the essence of the other two alternatives without running the risk of omitting important activities that may be viewed by some as not being central, major, ongoing, or most important…

BC63. The Board considered several alternative ways of defining or describing resource inflows that are (or are not) available to fund the operating activities of the current period. For the purposes of the statement of activities, they include distinguishing between those revenues and gains (losses) of the period that meet the availability notion of the *operating* definition on the basis of whether they also are:

a. Without unmet donor-imposed restrictions

b. Without other unmet external contractual or legal limits

c. Without internal limits imposed by an NFP's governing board that limit their use to activities of future periods.

BC64. The Board decided that a combination of items (a) and (c) would best achieve the objective of communicating what makes resource inflows available to fund operating activities of the current period. The Board rejected item (b) because contractual and legal limits are too broad, not unique to NFPs, and tracking the reporting of such everyday occurrences would add undue complexities for NFPs and users of their financial statements….

BC69. The Board, thus, considered two rather opposing alternatives and variations of them. They are (a) require all governing board actions to be reflected on the face of the statement of activities, including those taken at the end of the period that may have had little bearing on the management of the current-period activities, or (b) preclude reflecting any governing board actions on the face of the statement and instead reflect those actions in an analysis provided in notes to financial statements. The Board decided to require that an intermediate measure of operations reflect the effects of all governing board actions that make resources unavailable (or available) for current-period activities. It also decided to require that those actions be reflected in a transparent way by requiring that transfers to and from current operations resulting from governing board actions be presented in a discrete section of the statement of activities. It also decided to require that section to be presented immediately after an intermediate measure of operations before transfers and immediately before an intermediate measure of operations after such transfers….

BC71. The Board decided that clear presentation of certain information about transfers on the face of the statement of activities with further disclosures in notes to financial statements could bring added transparency that would mitigate the concerns expressed by some stakeholders. Thus, the Board also decided… that if an NFP uses governing board designations, appropriations, and similar transfers, the entity should report them in accordance with the following presentation requirements:

a. All transfers should be reported in a separate, discrete section on the statement of activities.

b. All transfers should be reported after a subtotal—operating excess (deficit) of a not-for-profit entity—that includes operating revenues, support, expenses, gains, and losses and is before transfers.

c. At a minimum, an NFP should present on the statement of activities the aggregate amount of transfers out of operating activities separate from the aggregate amount of transfers into operating activities.

d. If all transfers are not displayed as discrete line items on the face of the statement of activities, an NFP should provide a note disclosure that provides details on amounts and types of transfers that are presented on an aggregated basis on the face of the statement of activities.

e. All NFPs should qualitatively describe in a note disclosure the purpose, amounts, and types of transfers that are used by the entity's governing board to manage operations (for example, whether transfers are done because of standing board policies, as one-time decisions, or for other reasons)….

BC99. Similarly, because all NFPs would now be required to provide standardized intermediate operating measures (before and after governing board transfers), the Board believes that there no longer is a compelling need to hold business-oriented health care NFPs to the higher standard that currently requires only those entities to present a performance indicator. The proposed amendments would neither preclude those entities from nor encourage them to provide that measure, but the Board believes that such a non-GAAP measure would add complexity, running the risk of confusing rather than helping users of their financial statements, and adding unnecessary costs to the reporting system.

Related Proposed Update Questions:

Question 7: Do you agree that intermediate measures of operations should include only those (a) resource inflows and outflows that are from or directed at carrying out an NFP's purpose for existence *and* (b) resources that are available for current-period operating activities before and after the effects of internal governing board appropriations, designations, and similar actions? If not, why?

Question 8: Do you agree that all internal transfers (governing board appropriations, designations, and similar actions that make resources unavailable or available for operations of the current period) should be reflected on the statement of activities immediately after an *intermediate measure of operations before transfers* and immediately before an *intermediate measure of operations after transfers?* If not all internal transfers, on what basis would you distinguish between those transfers that should and should not be reflected and how would you make that distinction operable? Do you also agree that reflecting those internal decisions (or lack of them) on the face of the statement rather than in notes will help an NFP communicate how its operations are managed without adding undue complexities? Why or why not?

Question 11: Do you agree that the addition of required intermediate measures of operations for all NFPs would make unnecessary the need for NFP business-oriented health care entities to also present their currently required *performance indicator*? Why or why not?

Main Discussion Points

- Require or not require an operating measure?
- If require:
  - Mission dimension (including property, plant, and equipment and excluding interest expense)
  - Availability dimension (including internal transfers)
  - Healthcare performance indicator or net income equivalent
  - Other

Topic 2: Presentation of Operating Cash Flows

Relevant Basis from Proposed Update:

BC75. The Board decided that information about an NFP's financial performance can be improved significantly by using the direct method of reporting cash flows from operating activities rather than the indirect method of reporting those cash flows. The Board observed that cash flows from investing activities and from financing activities have long been presented using the direct method and that reporting has been well understood. It also learned through its outreach activities that those NFPs that voluntarily elected to use the direct method of reporting in addition to the required indirect method found that their governing board members and external stakeholders found the direct method information to be more intuitive, understandable, and useful for their purposes.

BC76. NAC members and other stakeholders also said that in addition to being useful in assessing financial performance, cash flow information can be particularly important and sometimes crucial in assessing cash flow trends that affect an NFP's liquidity. They also said that, despite its importance, the statement of cash flows is underutilized. Some suggested that was attributable, in part, to the use of the more complex indirect method of reporting operating cash flows. Some added that if information presented in a statement of cash flows is not understandable, the utility of that statement is significantly diminished and in some cases may not be cost-justified.

BC77. The Board considered those comments and suggestions and conducted outreach to learn more about the cost of providing information using the direct method of reporting cash flows. In particular, the staff reached out to public universities that are required by GASB standards to report operating cash flows under both the direct and the indirect methods. It learned that the first-year implementation costs were primarily in the nature of training and mapping information available from existing systems and did not involve significant costs for new systems or significant ongoing costs or complexities. Moreover, most private colleges and universities and other NFPs that voluntarily elected to report operating cash flows using the direct method (along with the required information using the indirect method) had similar experiences and they continue to use that method. Those findings were similar for very large multicampus systems as well as mid-sized NFPs….

BC79. However, [since Statement 117, the Board] learned that requiring the indirect method is not providing many creditors, donors, and other users of NFP financial statements with operating cash flow information in a format that is most useful for them. In addition, requiring the indirect method itself comes with costs and complexities that do not optimally serve the needs of users of NFP financial statements. The indirect method of reporting cash flows for business entities reconciles operating cash flows to net income, which is a financial performance metric not required or particularly relevant to NFPs and users of their financial statements. Thus, the Board decided that requiring the direct method and permitting, but no longer requiring, the indirect method of reporting operating cash flows would lead to a significant increase in the usefulness of information helpful in assessing financial performance and liquidity and would reduce the complexity of information without imposing significant costs.

Related Proposed Update Questions:

Question 18: Do you agree that the direct method of presenting operating cash flows is more understandable and useful than the indirect method? Do you also agree that the expected benefits of presenting operating cash flows in that way would justify the one-time and ongoing costs that may be incurred to implement that method of reporting? If not, please explain why and suggest an alternative that might increase the benefits or reduce any operational concerns or costs.

<u>Main Discussion Points</u>

- Use of the cash flow statement
    - If used, by whom and for what purpose?
    - If not used, why?
- Direct method—require or continue to encourage?
- Indirect method—permit or continue to require?

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Topic 3: Information Useful for Assessing Liquidity

Relevant Basis from Proposed Update:

BC29. Thus, a major objective for the proposed amendments is to improve the quality of information users need to help them assess an NFP's liquidity and how it manages its exposure to liquidity risk. The Board considered various ways in which standards for that information might be improved. That included consideration of one or more of the following alternatives:

a. Require a classified (for example, current and noncurrent) statement of financial position

b. Require separate presentation of assets whose use is limited, similar to the requirement of paragraph 954-210-45-4 for business-oriented health care entities

c. Require information relating to liquidity to be added to and integrated within notes that are currently required for specific assets (for example, investment securities and contributions receivable)

d. Require information about how the entity manages liquidity and quantitative and qualitative information about the liquidity of assets and near-term demands for cash to satisfy existing obligations as of the reporting date

e. Require a combination of two or more of the above alternatives.

BC30. The Board observed that each of the above alternatives could provide information that is incrementally useful but not sufficient for a full understanding and assessment of an NFP's liquidity. That is, greater appreciation of an entity's management of, and exposure to, liquidity risk may require forward-looking information and management discussion of its plans and ability to raise capital and liquid resources, reduce cash outflows, or both, in the event of circumstances that generally are not foreseeable….

BC31. …Of the alternatives considered, the Board believes that alternative (d) of paragraph BC29 would be the most effective way to provide the needed information in a way that is understandable, useful, and auditable and would not require new systems or impose significant costs on NFPs. That is, NFPs would be required to provide information about how the entity manages liquidity and quantitative and qualitative information about the liquidity of assets and near-term demands for cash to satisfy existing obligations as of the reporting date. More specifically, that would include information about (a) the amount of financial assets at the end of the period, (b) the amount that, because of limitations, is not available to meet cash needs in the near term, (c) the amount of financial liabilities that require cash in the near term, and (d) the way an entity manages its liquidity, including the time horizon it uses in its management of liquidity….

Related Proposed Update Questions:

Question 1: Do you agree that the disclosures about the nature of donor-imposed restrictions and their effects on liquidity in notes to financial statements would help ensure that necessary information is not lost by combining the temporarily and permanently restricted classes of net assets into one donor restricted category for purposes of presentation in the statement of financial position (balance sheet)? If not, please identify the information lost and why it is necessary.

Question 4: Do you agree that providing information in notes to financial statements about financial assets and liabilities and limits on the use of those assets is an effective way to clearly communicate information useful in assessing an NFP's liquidity and how it manages liquidity without imposing undue costs? If not, why, and what alternative(s) would you suggest?

Question 5: Most business-oriented health care NFPs are required to present a classified balance sheet. Continuing care retirement communities and other NFPs may choose to sequence their assets and liabilities according to their nearness to cash as an alternative to using a classified balance sheet. As a result of the proposed requirement to provide enhanced disclosures of information useful in assessing liquidity, would there no longer be a need to hold business-oriented health care NFPs to the more stringent standard for their balance sheets? If not, why?

Main Discussion Points

- Qualitative and quantitative information
- Implementation guidance?
- Classified balance sheet and/or net assets limited as to use?

Topic 4: Other Topics—Analysis of Expenses by Nature and Function

Relevant Basis from Proposed Update:

BC92. Nonetheless, although the Board's current project does not pursue that more comprehensive type of revenue and expense reporting within financial statements or notes, the Board believes that reporting of expenses by nature is useful in assessing an NFP's service efforts and its financial performance. Information about expenses by their nature also can be useful in distinguishing relatively fixed costs from variable or discretionary costs, which can be useful in assessing an entity's sustainability. In addition, the Board observed that because substantially all entities track and manage their expenses by natural classifications, the cost to provide that information is minimal. As a result, the Board decided to extend to all NFPs the requirement to report operating expenses by both their nature and their function (and nonoperating expenses by nature with function permitted). It also decided to allow flexibility to present operating expense by either classification on the face of the statement of activities with the other in notes and to extend that presentation flexibility to voluntary health and welfare organizations by no longer requiring a separate basic statement of expenses by function and nature. The Board notes that would result in a more evenhanded reporting standard that is consistent with its precept of setting standards that are neutral (avoid extending preferences for particular types of entities).

BC93. The Board also decided to require all NFPs to provide in one location an analysis of all expenses, with operating expenses by function and nature. The location and format for that information are flexible, and the Board believes it likely would be included in notes. More important, the Board observed that donors are especially interested in information that is useful in assessing how an NFP uses its resources and its stewardship for the resources entrusted to them. Information that clearly shows the nature of operating expenses (for example, internal salaries and benefits, external professional fees, rent or building costs, heat, light, and power) and how they relate to an NFP's programs and supporting activities is most useful for those donors' purposes.

Related Proposed Update Questions:

Question 13: Do you agree that reporting operating expenses by both their function and nature together with an analysis of all expenses (other than netted investment expenses) provides relevant and useful information in assessing how an NFP uses its resources and, thus, should be required? Why or why not?

Topic 4: Other Topics—Investment Return

Relevant Basis from Proposed Update:

BC100. The Board also believes that complexity can be reduced and comparability of information can be improved by requiring investment returns (other than from programmatic investing) to be presented net of investment expenses—as a net investment return. The proposed amendments also would reduce costs by no longer requiring the disclosure of all investment expenses. The Board was asked by FinREC and other stakeholders to reconsider the requirements for reporting investment returns and related expenses because of the difficulties of identifying all investment expenses and because of diversity in practice in the degree to which NFPs net their investment expenses within investment return. The Board observed that expenses charged by external investment managers, such as embedded fees charged by hedge funds, mutual funds, and funds of funds, generally are disclosed in annual reports and proxy statements. However, because NFPs may move their assets in and out of such funds at various times during a particular reporting period, and because the fund's year-end often differs from an NFP's fiscal year-end, the Board believes the cost and effort to determine those fees would be impractical. That is, the Board believes the costs to obtain that information would exceed the benefit that it might provide to users of financial statements, in part because most users find the net investment return to be most relevant, comparable, and useful.

BC101. The Board also understands, however, that donors, creditors, and other users of an NFP's financial statements generally find information about how an NFP utilizes its resources, including information about its expenses, to be particularly useful. Thus, the Board is concerned that not requiring information about any investment-related expenses because of difficulties in identifying some investment expenses may be too great of a sacrifice of useful information. The Board acknowledges that (a) donors are especially interested in assessing how resources are used, including the extent to which they are directed at achieving an NFP's mission, and (b) creditors are especially interested in understanding the relationships of expenses to revenues and the extent to which expenses are fixed or variable and the degree to which they are discretionary—that is, whether the expense can be readily increased or decreased to meet urgent needs and other short-term changes in demands. Accordingly, the Board decided to require disclosure of the aggregate amount of direct salaries and benefits of personnel involved in investing activities because generally (1) there are no difficulties in identifying those expenses, and (2) information about those expenses is particularly useful to donors, creditors, and others. The Board believes not requiring disclosure of all expenses but requiring disclosure for certain most important expenses strikes a reasonable balance between the need to provide useful information without imposing undue costs.

Related Proposed Update Questions:

Question 14: Do you agree that requiring investment income to be reported net of external and direct internal investment expenses will increase comparability and avoid imposing undue costs to obtain information about all investment fees (for example, embedded fees of hedge funds, mutual funds, and funds of funds)? If not, why?

Question 15: Do you agree that the disclosure of the amount of all investment expenses is unnecessary but that disclosure of internal salaries and benefits that are netted against investment return is of sufficient relevance, not too costly to obtain, and thus should be required? Why or why not?

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Topic 4: Other Topics—Changes in Classes of Net Assets

Relevant Basis from Proposed Update:

BC22. The Board decided to propose replacing the current requirement to present on the face of the statement of financial position the amount for each of three classes of net assets—unrestricted, temporarily restricted, and permanently restricted. Instead, in addition to the currently required display of the amount of net assets, the proposed amendment would require NFPs to present the amounts for two classes of net assets: *net assets with donor restrictions* and *net assets without donor restrictions*.

BC23. The Board believes that the proposed amendment and its more precise terminology would improve financial reporting in several ways. First, combining the permanently restricted and temporarily restricted classes would reduce complexity. Second, the previous distinction between those two classes has become blurred because changes in laws, among other things, now permit entities, within the bounds of prudence, to spend from a *permanently* restricted endowment even though the amount of the endowment has fallen below the original amount of the endowed gift. Thus, the Board expects that eliminating the current distinction would avoid misunderstanding about the use of the notion of permanence. Third, the Board believes more detailed distinctions about the nature and types of donor-imposed restrictions, including more relevant information about how they affect the availability of resources, can be provided more effectively in notes to financial statements and, thus, increase the understandability of information about the part of net assets that is restricted by donor stipulations. Accordingly, the proposed amendments would retain the current requirements of paragraph 958-210-50-3(d) through (e) to provide information about the nature and amounts of different types of donor-imposed restrictions and underscore the importance of information about how those restrictions affect the use of resources. To provide that information, NFPs could present disaggregated, descriptive line items on the face of the statement of financial position or aggregated amounts on the face with the details in notes to financial statements. Most important, the enhanced disclosure would help to ensure that creditors, donors, and other users would not lose relevant information regardless of the presentation methods chosen….

BC25. The Board also decided to revise the terminology that describes net assets that are not subject to donor-imposed stipulations. Stakeholders have told the Board that too often donors and others have misunderstood the term *unrestricted net assets*. That class of net assets is defined as “the part of net assets of a not-for-profit entity (NFP) that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations” (Master Glossary). However, despite its definition, the term *unrestricted* implies, and some users have thought, that part of net assets is without contractual, legal, or any other type of restriction. As a result, creditors, donors, and other users could reach the wrong conclusion about an entity’s financial position, particularly its financial flexibility and liquidity. Although the proposed change in terminology for that class of net assets does not change the substance of its definition, the Board believes the revised terminology would bring greater understanding.

Related Proposed Update Questions:

Question 1: Do you agree that the disclosures about the nature of donor-imposed restrictions and their effects on liquidity in notes to financial statements would help ensure that necessary information is not lost by combining the temporarily and permanently restricted classes of net assets into one donor restricted category for purposes of presentation in the statement of financial position (balance sheet)? If not, please identify the information lost and why it is necessary.

Question 2: Do you agree that the aggregated amount by which endowment funds are underwater should be classified within *net assets with donor restrictions* rather than *net assets without donor restrictions*? If not, why?