FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Discussion Paper about FASB's Agenda

February 3, 2016

PURPOSE OF THIS MEETING

1. The purpose of this Board meeting is for the Board members to discuss the potential financial reporting issues that may be included in an Agenda Discussion Paper (Agenda DP). Based on research and outreach activities performed thus far, the staff plans to discuss the following potential financial reporting issues with the Board:

    a. Asset Retirement Obligations
    b. Consolidations
    c. Inventory and Cost of Sales
    d. Pensions and Other Postretirement Employee Benefit Plans
    e. Capitalization of Development Costs
    f. Distinguishing Liabilities from Equity
    g. Performance Statement/Other Comprehensive Income, Cash Flow Statement, and Segment Reporting

BACKGROUND INFORMATION

2. In May 2014, the Board issued ASU 2014-09, *Revenue from Contracts with Customers*, and in January 2016, the Board issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Liabilities*. In 2016, the Board expects to issue final standards on Leases and Financial Instruments—Credit Losses. The issuance of those documents completes many of the major projects on the Board's agenda and creates capacity for the FASB to focus on other financial reporting issues that are important to stakeholders. Consequently, the Board has consulted with its advisory groups and other stakeholders over the past six months about:

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a. What financial reporting issues are most in need of attention in applying U.S. GAAP and

b. What should be the Board's priority in addressing those issues.

3. The Board began that consultation process in June 2015 by conducting its periodic Financial Accounting Standards Advisory Council (FASAC) survey about FASB agenda priorities. This year, the survey was extended to other advisory groups, including the Investor Advisory Committee, the Not-for-Profit Advisory Committee, the Small Business Advisory Committee, the Emerging Issues Task Force, and the Private Company Council.

4. The Board continued its consultation process by seeking input about potential financial reporting issues in November 2015 from members of the Academic Resource Group (ARG). The Board also sought input from participants of the Financial Reporting Issues Conference (FRIC) in January 2016.

RESULTS OF FASAC SURVEY, ARG MEETING, AND FRIC

FASAC Survey

5. The following table is a summary of the top five financial reporting issues reported by each advisory group in the 2015 FASAC survey:

Topic	**EITF**	**FASAC**	**IAC**	**NAC**	**PCC**	**SBAC**
Financial Performance Reporting	X	X	X	X	X	
Cash Flow Classification	X	X	X	X	X	X
Pensions and OPEB		X	X	X		X
Liabilities versus Equity	X		X		X	X
Intangible Assets	X	X				X
Other Comprehensive Income	X				X	X
Consolidations					X	
Segment Reporting			X			
Inventory and Cost of Sales						
Collaborative Arrangements				X		
Equity Method				X		
Income Taxes		X				

ARG Meeting

6. In November 2015, the ARG met to discuss their views about the most significant unresolved financial reporting issues. The ARG also provided input on how the Board should identify financial reporting issues as candidates for agenda consideration. Feedback from this group largely was consistent with feedback from the respondents of the FASAC survey.

Financial Reporting Issues Conference (FRIC)

7. In January 2016, an agenda priorities discussion was held during the FRIC to provide the Board with more input about how it should prioritize its agenda. Prior to the conference, participants were asked to submit a list of what they believe are the top five financial reporting issues that the Board should add to its agenda. The top five results are as follows:

    a. Financial Performance Reporting
    b. Liabilities versus Equity
    c. Intangible Assets
    d. Pensions and Other Post-Employment Benefits
    e. Other Comprehensive Income.

8. Participants responding with those broad topics identified a variety of different issues within those topics that they believed warranted standards-setting attention.

FINANCIAL ACCOUNTING STANDARDS BOARD

Board Meeting Handout

Financial Statements of Not-for-Profit Entities

February 3, 2016

PURPOSE OF THIS MEETING

1. At its February 3, 2016 meeting, the Board will continue its consideration of feedback received from stakeholders on the April 2015 proposed FASB Accounting Standards Update, *Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954): Presentation of Financial Statements of Not-for-Profit Entities* (the proposed Update). The Board redeliberations will focus on the following issues, which are being addressed in Phase 1 of the project on Financial Statements of Not-for-Profit Entities:

   (a) Reporting of investment return and disclosure of investment expenses

   (b) Reporting of expenses by nature and an analysis of expenses by function and nature

   (c) Providing enhanced disclosure about cost allocations and improved guidance on management and general activities.

2. The staff will seek the Board's tentative decisions to affirm or modify the proposed Update for the above issues.

TOPIC 1: REPORTING OF INVESTMENT RETURN AND DISCLOSURE OF INVESTMENT EXPENSES

3. The staff will seek the Board's tentative decision to affirm or modify the proposed Update that would (a) require not-for-profit entities (NFPs) to report investment return net of external and direct internal investment expenses and (b) no longer require NFPs to disclose investment expenses that have been netted, other than any internal salaries and benefits.

Background Information

4. In the proposed Update, the Board proposed to require external and direct internal investment expenses to be netted against investment return, to remove the current disclosure requirement of paragraph 958-225-50-1 in the *FASB Accounting Standards Codification*® (Accounting Standards Codification), which requires NFPs to disclose the amount of investment-related expenses netted against investment revenues if that amount is not disclosed on the face of the statement of activities, and to no longer require NFPs to display the investment return components in the endowment net assets rollforward as is currently required in paragraph 958-205-50-1B(e).

5. The basis for the Board's decision on the netting of external and direct internal investment expenses against investment return is described in paragraph BC100 of the proposed Update:

> 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.

6. In the proposed Update, the Board also proposed to require an NFP to disclose the amount of internal salaries and benefits, if any, that have been netted against investment return to address concerns about the potential loss of relevant salary and benefit related information.

7. The basis for the Board's decision on the disclosure of the amount of internal salaries and benefits, if any, that have been netted against investment return is described in paragraph BC101 of the proposed Update:

> 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.

8. The decisions on the netting of external and direct internal expenses against investment return and the disclosure of internal salaries and benefits were exposed for comment as part of the proposed Update issued on April 22, 2015. The comment period for the proposed Update ended on August 20, 2015. The FASB received 264 comment letters. The staff and certain Board members also held 10 workshops to solicit feedback in 5 cities across the United States and participated in various outreach calls, including with 2 major financial institutions that lend to NFPs. Additionally, three public roundtables were held—two in Norwalk, Connecticut and one in Los Angeles, California—on September 21 and October 6, 2015, respectively.

9. At the September 10 and 11, 2015 NAC meetings, NAC members discussed feedback on the proposed netting of investment expenses against investment

return. NAC members were generally supportive. The disclosure of netted salaries and benefits was not discussed at the meeting.

Issue 1: Reporting of Investment Return

10. Current generally accepted accounting principles (GAAP) provides the option to report investment return net of related expenses or on a gross basis. However, if it is reported net, there is a requirement to disclose the details that comprise the net result. The proposed Update would require NFPs to present investment return net of external and direct internal investment expenses. Some comment letter respondents expressed concern about using the term "direct" rather than "related" for internal investment expenses. Added clarity about what constitutes a direct internal investing activity may help to address these concerns and promote greater comparability and faithful reporting. In the staff's view, direct internal investing activities are those activities principally related to generating investment return, which is achieved through investment management and strategy.

Questions for the Board
1. Does the Board agree with the staff's view of direct internal investing activity and prefer the staff to provide implementation guidance?
2. Does the Board want to affirm the proposal to require investment expenses to be netted against investment return?

Issue 2: Disclosure of Netted Investment Expenses

11. The proposed Update would remove the current requirement to disclose netted investment expenses, other than internal salaries and benefits.

Alternatives

12. Based on the feedback received on the proposed Update and from various outreach activities, the staff has developed the following alternatives for the Board's consideration:

    (a) Alternative 1—Affirm the proposal to require disclosure of internal salaries and benefits that are netted against investment return, but no longer require the disclosure of any other investment expenses that are netted against investment return

(b) Alternative 2—Modify the proposal to no longer require the disclosure of any investment expenses that are netted against investment return.

13. The staff is not proposing an alternative to retain current GAAP (disclose all netted investment expenses) because there were very few respondents suggesting that the Board do so.

Question for the Board
3. Does the Board prefer to affirm or modify/withdraw its decision to require disclosure of the amount of internal salaries and benefits that are directly related to and netted against investment return, but to no longer require disclosure of other netted investment expenses?

Other Considerations

14. The Board may want to consider the following other issues:

(a) Reporting of net investment return for NFPs that present a performance indicator

(b) Display of investment return components in the endowment net assets rollforward

(c) Functionalization exception for investment expenses.

Reporting of Net Investment Return for NFPs That Present a Performance Indicator

15. The Board's tentative decision to require investment return to be reported net of external and direct internal investment expenses creates an issue for business-oriented health care NFPs. Paragraph 954-225-45-4 requires these types of NFPs to present a performance indicator, which is an intermediate measure intended to be the equivalent of income from continuing operations. The reporting of net investment return for NFPs that present a performance indicator was not viewed as a significant issue under the proposed Update because, in light of the Board's proposal to require standardized intermediate measures of operations, it proposed to remove the requirement for business-oriented health care NFPs to present a

performance indicator. However, because the issue of whether to require NFPs to present an operating measure has been moved to Phase 2, the performance indicator will remain a requirement at this time and, thus, this display issue arises. As a consequence, the staff believes that it would be beneficial to provide guidance on how net investment return might be presented by NFPs that also must present the performance indicator, which could be similar to the below:

Items of revenues

Items of expenses (by nature or function)

Investment return, net

Less: Unrealized gain (loss) on AFS debt securities

Performance Indicator

Add: Unrealized gain (loss) on AFS debt securities

Change in net assets without donor restrictions

Display of Investment Return Components in the Endowment Net Assets Rollforward

16. Paragraph 958-205-50-1B(e) of the proposed Update would no longer require the display of the investment return components in the endowment net assets rollforward because continuing to require disclosure of the return components would conflict with and could undermine the Board's tentative decision for investment expenses. The proposed Update did not ask an explicit question about this proposed change.

Functionalization Exception for Investment Expenses

17. The proposed Update would require NFPs to provide an analysis of expenses by function and nature. Consistent with the Board's tentative decision for investment expenses, paragraph 958-205-45-6 of the proposed Update states, "External and direct internal investment expenses that have been netted against investment return need not be included in the functional expenses analysis." Although the proposed Update did not explicitly ask respondents about their views on the proposal to exclude netted investment expenses from the required functional expenses

analysis, Question 13 of the proposed Update asked respondents if they agreed with requiring "an analysis of all expenses (other than netted investment expenses)…".

Questions for the Board
4. Does the Board have any objections to adding the proposed implementation guidance for the reporting of net investment return for NFPs that present a performance indicator? 5. Does the Board want to affirm its tentative decision on the display of investment return components in the endowment net assets rollforward? 6. Does the Board want to affirm its tentative decision on the functionalization exception for investment expenses?

TOPIC 2: EXPENSES BY NATURE AND AN ANALYSIS OF EXPENSES BY FUNCTION AND NATURE

18. The staff will seek the Board's tentative decision to affirm or modify the proposed Update that would require NFPs to (a) report expenses by nature and (b) provide an analysis of operating expenses by function and nature.

Background Information

19. In the proposed Update, the Board proposed to improve the reporting of expenses by:

    (a) Requiring NFPs to report expenses by their nature and retaining the requirement to report expenses by function

    (b) Continuing to allow NFPs the flexibility to present expenses by either function or nature, or by both, on the face of the statement of activities

    (c) Requiring NFPs to provide an analysis of all expenses by function and by nature in one location—in the statement of activities, in a separate statement of expenses (currently called a statement of functional expenses), or in a schedule in the notes. That analysis would include all expenses, both operating and nonoperating, but would neither require nor preclude functionalization of nonoperating expenses. Although the staff thinks this analysis would typically be provided in the form of a matrix, that specific format would not be required.

20. For voluntary health and welfare organizations (VHWOs) that are currently required to present expenses by function and by nature in a matrix format in the statement of functional expenses, the decisions reached would allow them the same presentation and disclosure flexibility as other NFPs in how they communicate information about expenses. Paragraph BC92 of the basis for conclusions of the proposed Update noted that extending that flexibility to VHWOs "would result in a more evenhanded reporting standard that is consistent with [the Board's] precept of setting standards that are neutral…"

21. The basis for the Board's decisions to require NFPs to report all expenses by nature and operating expenses by function and to provide an analysis of all expenses by function and nature can be found in paragraphs BC87 through BC93 of the proposed Update.

22. At the September 10 and 11, 2015 NAC meetings, NAC members discussed feedback on the proposed display of operating expenses by their nature and function. NAC members were generally supportive; however, a preparer with a health care NFP and a preparer with a higher education NFP expressed concern that the proposed display of operating expenses in an NFP's GAAP compliant financial statements could differ from its reporting in its Internal Revenue Service Form 990 filing, which, for example, would be unconsolidated or may report expenses by programs at more highly aggregated amounts. One of these members suggested that natural expense reporting is useful for comparison purposes but expressed concern that providing an analysis of expenses by function and nature may not be significantly useful for health care organizations. In addition, a preparer with a religious organization expressed concern that the costs and complexity of the analysis may outweigh the benefits for NFPs that consolidate.

Issue 1: Expenses by Nature

23. Current GAAP requires NFPs to provide information about expenses reported by their functional classification either on the statement of activities or in the notes to

the financial statements (paragraph 958-720-05-4), but it does not require information about expenses reported by their natural classification. The proposed Update would require expenses to also be reported by nature (other than netted investment expenses).

24. Based on the feedback received from outreach performed, the staff has developed the following alternatives for the Board to consider on reporting expenses by their nature:

   (a) Alternative 1—Affirm the proposal to require NFPs to report expenses by their nature (other than netted investment expenses)

   (b) Alternative 2—Do not require NFPs to report expenses by their nature (maintain current GAAP).

Question for the Board
7. Which alternative does the Board prefer?

Issue 2: Analysis of Expenses by Function and Nature

25. The proposed Update would require all NFPs to provide in one location an analysis of all expenses (other than netted investment expenses) with operating expenses by function and nature. The location and format for that information would be flexible; NFPs could provide the information either on the face of the statement of activities, in a separate statement, or in the notes.

26. Based on the feedback received on the proposed Update and from various outreach activities, the staff has developed the following alternatives for the Board's consideration:

   (a) Alternative 1—Affirm the proposal to require all NFPs to report an analysis of all expenses (other than netted investment expenses)

   (b) Alternative 2—Require all NFPs, except business-oriented health care NFPs that are within the scope of Topic 954, Health Care Entities, to report an analysis of all expenses (other than netted investment expenses) and consider this issue for those NFPs either in conjunction with the research project on Financial Performance Reporting or as part of Phase 2 of the NFP project

(c) Alternative 2´—Allow business-oriented health care NFPs that are within the scope of Topic 954 the option to provide either an analysis of all expenses (other than netted investment expenses) or segment reporting

(d) Alternative 3—Require all NFPs, except business-oriented NFPs (both health care and other), to report an analysis of all expenses (other than netted investment expenses)

(e) Alternative 4—Do not require NFPs to report an analysis of expenses but retain current GAAP that requires VHWOs to provide that information in a statement of functional expenses.

Question for the Board
8. Which alternative does the Board prefer?

Issue 2A: Types of Expenses to be Reported by Function

27. The Board's original decision to require an analysis of operating expenses by function and nature and to require the natural presentation of nonoperating expenses while neither requiring nor precluding presentation by function was made with the intent to also require an operating measure. However, the Board voted to have the consideration of the requirement of an operating measure moved to Phase 2 of the Financial Statements of Not-For-Profit Entities project. Therefore, some NFPs will continue to use a self-defined operating measure and some will not. The NFPs that do not choose to present an operating measure will also not present separate operating expenses and will, therefore, be unable to provide an analysis of operating expenses by function and nature. As a result, the Board will need to decide which expenses to require reporting by function and nature if the Board still desires that NFPs be required to provide an analysis of expenses by function and nature. Question 6 of this handout asks the Board if it would like to affirm that investment expenses that are netted against investment return need not be reported or disclosed by function and nature.

28. Based on the feedback received from the outreach performed, the staff has developed the following alternatives for the Board, which to some extent are dependent on the decision reached for Issue 2:

(a) Alternative 1—Require NFPs that choose to present a self-defined measure of operations to report *operating* expenses by both their function and nature together with an analysis of all expenses (other than netted investment expenses) by nature and require NFPs that do not choose to present a self-defined measure of operations to report *all* expenses by both their function and nature together with an analysis of all expenses (other than netted investment expenses)

(b) Alternative 2—Require all NFPs to report *all* expenses by both their function and nature together with an analysis of all expenses (other than netted investment expenses).

Question for the Board
9. Which alternative does the Board prefer?

Issue 2B: Flexibility in Presentation of the Analysis

29. The proposed Update would allow NFPs flexibility in the presentation of the analysis of expenses by function and nature. The analysis could be provided either on the face of the statement of activities, in a separate statement, or in the notes. Furthermore, VHWOs would no longer be required to report a separate statement of expenses by function and nature but would be afforded the same flexibility here as other NFPs.

Question for the Board
10. Does the Board want to affirm its decision to allow NFPs flexibility in the presentation of the analysis of expenses by function and nature?

TOPIC 3: ENHANCED DISCLOSURE ABOUT COST ALLOCATIONS AND IMPROVED GUIDANCE ON MANAGEMENT AND GENERAL ACTIVITIES

30. The staff will seek the Board's tentative decision to affirm or modify the proposed Update that would require NFPs to (a) report enhanced disclosures about cost

allocations and (b) refine the definition of, and better illustrate, management and general activities.

Background Information

1. In the proposed Update, the Board also proposed that notes to financial statements should include a description of the method(s) used to allocate costs among program and support functions. The Board also decided to refine the definition of management and general activities in the Accounting Standards Codification and to provide additional implementation guidance to better depict the types of costs that can be allocated among program and/or support functions and those that cannot be allocated. These two decisions were exposed for comment as part of the proposed Update, although no explicit questions were asked on these decisions.

Alternatives

2. The proposed Update would require disclosure of a qualitative description of methods used to allocate costs among program and support functions, refine the Accounting Standards Codification's definition of management and general activities, and provide additional implementation guidance to better depict the types of costs that can be allocated among program and/or support functions and those that should not be allocated. Current GAAP defines management and general activities as:

> Activities that are not identifiable with a single program, fundraising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an entity's existence.

3. The proposed Update would refine the management and general activities definition as follows:

> Supporting activities that are not identifiable with one or more program, fundraising, or membership-development activities.

4. In addition, the proposed Update notes the following in paragraph 958-720-45-2A:

> Activities that represent direct conduct or direct supervision of program or support activities would require allocation. Additionally, certain costs benefit more than one function and, therefore, shall be allocated. For example, information technology generally can be

identified as benefitting various functions, such as accounting and financial reporting, human resources, fundraising, and program delivery. Information technology costs generally would therefore be allocated among the functions receiving direct benefit.

5. Paragraphs 958-720-55-171 through 55-176 of the proposed Update provide examples of which activities would and would not constitute direct conduct or supervision of program or support functions and an example footnote disclosure on the cost allocation method used to allocate costs among functions. These examples include CEO, CFO, human resources department, and grant and accounting and reporting allocations.

6. Based on the feedback received on the proposed Update and from various outreach activities, the staff has developed the following alternatives for the Board's consideration:

   (a) Alternative 1—Affirm the proposals to require enhanced disclosures of cost allocations, refine the Accounting Standards Codification's definition of management and general activities, and provide additional implementation guidance to better depict the types of costs that can be allocated among program and/or support functions and those that cannot be allocated

   (b) Alternative 2—Retain current GAAP, which does not require such disclosure of cost allocations.

Questions for the Board
11. Does the Board want to affirm its decision to require NFPs to provide enhanced disclosures about the method(s) used to allocate costs among program and support functions? 12. Does the Board want to affirm its decision to refine the Accounting Standards Codification's definition of management and general activities and provide additional implementation guidance to better depict the types of costs that can be allocated among program and/or support functions and those that should not be allocated?