

The financial reporting framework

Could changes to the not-for-profit model impact for-profit entities?



The highlights all companies need to know

- The FASB has proposed sweeping changes to the not-for-profit financial reporting model ¹ and has two similarly focused for-profit financial reporting research projects on its agenda. One research project is on the financial performance statement and the other will consider classification guidance in the statement of cash flows. We support the FASB's efforts to enhance financial reporting by increasing transparency and improving the relevance of the information required to be reported.
- While some of the proposed not-for-profit changes reflect areas of reporting that are unique to not-for-profit organizations, other areas deal with changing fundamental aspects of the underlying U.S. reporting model. As such, for-profit business entities may want to view those broader areas of the not-for-profit proposal as a potential bellwether for the business entities financial performance reporting and cash flow research projects, and consider commenting on those areas as part of the not-for-profit proposal.
- The FASB has indicated that it is committed to considering the interaction with the cash flow and financial performance reporting research projects before finalizing the not-for-profit standard. We commend the FASB for this decision.
- Obtaining feedback on the not-for-profit proposal from the broader group of constituents—including business entities—prior to finalizing the not-for-profit standard will provide the FASB with the opportunity to thoughtfully consider the needs of all stakeholders, and assess changes in the areas of intersection, with a focus on improvements to overall financial reporting for all constituents. Such a process will help maintain consistency and comparability, where appropriate.

¹ Proposed ASU, *Presentation of Financial Statements of Not-for-Profit Entities*, issued April 22, 2015

Fundamental changes may be on the horizon

The FASB has two research projects related to financial reporting on its agenda for business entities. The financial performance reporting research project for business entities seeks to develop frameworks for defining an operating performance metric and distinguishing between recurring and nonrecurring items that can be consistently and effectively used by all business entities. The second project will consider cash flow classification for business entities. In addition, the Board has asked the Emerging Issues Task Force to consider nine specific issues related to cash flow classification.

The FASB also recently released its exposure draft on financial statement presentation for not-for-profits. This project was initiated in response to a request from the Board's Not-for-Profit Advisory Committee to add projects that would improve the information provided by not-for-profits to their stakeholders in several areas, including net asset classification, the definition of an operating metric, and the usefulness of the statement of cash flows.

The not-for-profit exposure draft reflects the influence of an earlier, more far-reaching financial statement presentation project that re-envisioned the entire U.S. financial reporting framework for business entities and proposed to redefine the notion of "operating" activities.

The FASB's proposal represents a fundamental change in financial reporting for not-for-profits.

Could history repeat itself?

The FASB's prior financial statement presentation project envisioned financial statements that would group financial information into prescribed "operating," "investing," and "financing" categories, similar to the approach used in the statement of cash flows today. This would have promoted consistency across the primary financial statements.

In each of the financial statements, "operating" classification would have applied to transactions associated with assets and liabilities used in carrying out an entity's day-to-day business activities. Using these new definitions as an anchor, buildings and equipment used in operations would be considered "operating assets." Changes in those assets that affected income (for example, depreciation or gains on disposal) would have been operating in the income statement,

and cash payments to acquire capital assets would have been similarly captioned in the statement of cash flows.

Operating activities would have, by definition, excluded transactions arising from financing or investing activities. The FASB believed that excluding from operations those activities that were associated with the more generic "investing" and "financing" categories would provide users with a clearer focus on the operating activities of a particular entity. The FASB also believed that this approach would foster greater comparability in reporting operations across the spectrum of companies.

Work on this project was suspended in 2011 while the FASB focused on higher-priority convergence projects.

Not-for-profit entities project

Today, the financial reporting model used by not-for-profit entities is based on the reporting model used by U.S. business entities, adjusted as necessary for the unique characteristics of not-for-profit entities. For example, not-for-profits do not have "owners" in the traditional sense. Also, revenue may arise from contributions, rather than amounts "earned" in transactions with customers.

The FASB's current proposal to revise the not-for-profit financial reporting model reflects the influence of the earlier financial statement presentation project for business entities. Picking up on the theme of consistency from the earlier project, the proposal would better align the definitions of "operations" used in not-for-profit statements of activities and statements of cash flows. In order to create this alignment, the FASB proposes changes in the way certain transactions are classified in the statement of cash flows (e.g., acquisitions of property, plant and equipment would be included in cash flows from operations). The FASB would also require not-for-profits to use the direct method for cash flow reporting purposes.

In addition, "operating excess (deficit)" would become a required GAAP operating performance metric for not-for-profits. The operating measure would be driven by new concepts of "mission" and "availability." "Mission" would focus on activities associated with the organization's core purpose. By definition, it would include activities associated with the use of the entity's property and equipment, and excludes transactions associated with financing or investing activities. The concept of availability contemplates donor restrictions and board limitations regarding when certain resources can be used.

The need for all preparers to stay informed

The process

The FASB has generally endeavored to minimize differences in reporting between not-for-profit organizations and business enterprises except where warranted by not-for-profit entities' unique transactions and characteristics. A guiding principle has been that common definitions and reporting help enhance users' understanding of information included in financial statements. We agree with this perspective.

We believe that financial statement users generally benefit from a core financial reporting model that applies to all of the FASB's constituents – public business entities, private companies and not-for-profits.

Further maintaining comparability, as warranted, between not-for-profits and their commercial counterparts helps reduce complexity in determining the similarities and differences among these entities regarding their financial condition and cash flow prospects.

Stakeholder feedback from all constituents

Given the FASB has issued an exposure draft for not-for-profits before commencing formal deliberations on potentially similar matters for business entities, business entities may want to consider whether the not-for-profit proposal is an indicator for what might be headed their way in the financial performance reporting and cash flow research projects.

We encourage business entities to submit comments on the areas where the not-for-profit proposal could intersect with the research projects for business entities. Providing early input may help better inform the FASB in its not-for-profit deliberations, and help frame discussions as the research projects for business entities get underway.

The FASB has indicated that they are committed to considering areas of overlap with the cash flow and financial performance reporting research projects before finalizing the not-for-profit standard. We commend the FASB for this decision. Obtaining feedback from both its for-profit and not-for-profit constituents will allow the FASB to thoughtfully consider the needs of all stakeholders and determine whether the benefits of any proposed differences in the models outweigh the costs.

Conclusion

We support the continued focus by the FASB on enhancing overall financial reporting for all entities. In addition, not-for-profits have certain unique characteristics and transactions, and we support the FASB's efforts to enhance the transparency and usefulness of financial reporting.

As the FASB considers changes to core reporting concepts underlying U.S. financial reporting, such as the definition of operating activities and related classification of cash flows, we encourage the Board to maintain the notion of a common framework to the greatest extent practicable, which enhances the understanding of information across a broad group of users. However, differences between for profit and not-for-profit models may be warranted in circumstances where the conceptual benefits outweigh the cost.

As these projects progress, stakeholders need to stay engaged to ensure they are educated on the potential changes, and understand the implications for processes, systems, and controls, as necessary.

Questions and answers

Q: What are some areas of the not-for-profit reporting project that are unique to that sector and therefore warrant special consideration?

A: Significant time and effort has been invested in the not-for-profit financial reporting project in consideration of potential improvements in areas unique to not-for-profits. Aspects of the project that do not intersect with for-profits include, but are not limited to:

- simplifying the reporting of donor-restricted net asset classes,
- enhanced liquidity disclosures, including information on financial assets that are restricted due to external and internal designations that impact how liquidity is managed,
- proposed improvements in reporting total-return investing results, and
- enhancements to the reporting associated with endowments and “quasi-endowments,” and the interaction of these concepts with an operating measure.

Q: What are the implications for business-oriented not-for-profits?

A: Some not-for-profit organizations use a tailored version of the not-for-profit financial reporting model that attempts to parallel the financial reporting used by business entities. The linchpin of that model is an earnings measure called the “performance indicator,” which is analogous to income from continuing operations of a business enterprise. Use of this model is required for not-for-profit health care organizations whose primary source of revenue is fees for health-related services (rather than contributions), but it is also voluntarily applied by other types of business-oriented nonprofits that want to report like business entities.

Those that use the earnings measure apply reporting concepts similar to those of business entities (e.g., use of “other comprehensive income,” classification of marketable securities as trading or available for sale) that facilitate comparison with their for-profit counterparts.

The proposed model would remove the requirement for not-for-profit health care organizations to use a business reporting model, and subject them to the same requirements as other not-for-profit organizations. In particular, it would remove the requirement to report an earnings measure that is consistent with the earnings measure reported by business enterprises, and instead focus on reporting broad categories of “operating activities” and “nonoperating activities” along with the new required operating measure. Transactions associated with investing activities, financing activities, and many items of other comprehensive income would be grouped as “nonoperating” under this approach. However, the FASB has indicated that not-for-profit health care entities (and presumably, other business-oriented not-for-profits) could continue to voluntarily provide the performance indicator as a non-GAAP measure, as long as they comply with the parameters established by the new concepts of “operating” and “nonoperating” activities.

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