



Illinois CPA Society Not-For-Profit Committee: *Analysis of Impact of ASU 2016-14 on Financial Statement Presentation of Not-For-Profit Entities*

In 2016, the Financial Accounting Standards Board (FASB) issued new guidance on the presentation of financial statements for Not-For-Profit Entities: Accounting Standards Update 2016-14 (ASU 2016-14). One of the many changes in ASU 2016-14 was a new requirement for all not-for-profit entities (NFPs) to present expenses by both their natural and functional classification, which was previously only required for voluntary health and welfare organizations. Not-for-profit entities (NFPs) who complete IRS Form 990 – Return of Organization Exempt From Income Tax, specifically 501(c)(3) and (4) organizations, have been required to present these functional expenses in the return. ASU 2016-14 includes specific guidance on the allocation of expenses to programmatic functions, which is expected to reduce the overall percentage of expenses charged to programs than was historically the case. The impacts of these changes are expected to reach beyond the financial statements of the NFP and may result in lowered rankings from ratings agencies or in the most extreme cases, a loss of funding from grantors.

In some cases, these new instructions may result in a greater amount of expenses being allocated to supporting activities (fundraising or management and general) and less to program costs than in the past. As many donors and grantors expect to see a certain percentage of total costs used for programs, this may cause some consternation. Under ASU 2016-14 it may appear that that funds are now being diverted from programs, when that is not actually the case. In addition, application of the new allocation guidance could negatively impact NFPs that have received favorable charity rating scores from rating agencies. Historical program expense percentage levels may no longer be relevant for comparison purposes, as it would be difficult to go back and reallocate expenses according to the new definitions. Clarifying the new standards for donors would be helpful to ensure they understand that the activities of the NFP have not changed – only the method of allocating those same expenditures has changed. It also does not mean that NFP's have been doing anything incorrectly in the past – only that accounting standards have changed.

The ASU is effective for fiscal years beginning after December 15, 2017. For calendar year presentation, the first applicable period is December 31, 2018. For fiscal year-end NFPs, the fiscal year ending 2019 will be the first applicable year for implementing this guidance.

Key Definitions

Expenses can be classified in two ways:

- a. Natural Expense Classification: A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, professional services, supplies, interest expense, rent, utilities, and depreciation.¹

¹ FASB 958-720-20

² FASB 958-720-45-9

³ FASB 958-720-45-7

⁴ FASB 958-720-45-8



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- b. Functional Expense Classification: A method of grouping expenses according to the purpose for which costs are incurred. The primary functional classifications of a NFP are program services and supporting activities.¹

The new guidance requires that a schedule showing both classifications simultaneously must be presented in the financial statements or in the notes to the financial statements. See Appendix A for an example of this presentation.

Functional expense categories are further defined as follows:

- a. Program Services: Activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the NFP exists. Those services are the major purpose for and the major output of the NFP and often relate to several major programs.¹
- b. Supporting Activities: All activities of a NFP other than program services. Generally, they include the following:
 - 1. Fundraising activities: Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.¹ This includes publicizing and conducting fundraising campaigns, maintaining donor mailing lists, preparing and distributing fundraising materials, conducting fundraising events, and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.²
 - 2. Membership development activities: Soliciting for prospective members and membership dues, membership relations, and similar activities. However, if there are no significant benefits or duties connected with membership, the substance of membership development activities, may, in fact, be fundraising.¹
 - 3. Management and general activities: Supporting activities that are not directly identifiable with one or more program, fundraising, or membership-development activities.¹

Digging Deeper into Management and General Activities

ASU 2016-14 specifies the treatment of the following activities as management and general activities:

- a. Oversight
- b. Business management
- c. General recordkeeping and payroll
- d. Budgeting
- e. Financing
- f. Soliciting funds other than contributions and membership dues, administering government, foundation, and similar customer-sponsored contracts, including billing and collecting fees, and grant and contract financial reporting
- g. Disseminating information to inform the public of the NFP's stewardship of contributed funds

¹ FASB 958-720-20

² FASB 958-720-45-9

³ FASB 958-720-45-7

⁴ FASB 958-720-45-8



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- h. Making announcements concerning appointments
- i. Producing and disseminating the annual report
- j. Employee benefits management and oversight (human resources)
- k. All other management and administration except for direct conduct of program services, fundraising activities, or membership development activities.³

The costs of oversight and management usually include the salaries and expenses of the governing board, the chief executive officer of the NFP, and the supporting staff. If such staff spend a portion of their time directly conducting or supervising program services or categories of other supporting services, their salaries and expenses shall be allocated among those functions.⁴

One of the key changes under ASU 2016-14 is the inclusion of specific examples clarifying which activities constitute direct conduct or supervision of program or support services. For example, a person who supervises several employees in a program would be considered to be directly supervising that program, but the chief executive officer listening to and commenting on that supervisor's report in a management meeting would not be considered to be directly supervising that activity. If the chief executive officer generally has no involvement in the actual operation of the program, the oversight of those program supervisors is a management and general function, not a program function. Note that the default functional category for the CEO salary is management and general – the portion attributable to programs and fundraising should be documented in order for it to be allocated out of management and general.

While, many expenses are related only to one specific function; others, especially costs such as salaries and benefits, occupancy or IT, may have to be allocated across two or more functions. ASU 2016-14 also has guidance regarding the decision-making process for allocating costs between functions where an expense can be shown to impact more than one function. Examples regarding allocations are shown in Appendix B.

These specific definitions of how to classify certain expenses functionally are required so that there will be more consistency between NFP's. As previously noted, in certain cases, this may result in a larger percentage of overall expenses being recorded as supporting services (fundraising or management and general), and a lower percentage being recorded as program service expenses. This is especially true for NFP's that have a large portion of their total expenses attributed to salaries rather than other expense categories.

Concerns Around the Functional Allocation of Expenses

For many years, NFP's have been indirectly "encouraged" by outside reporting agencies such as the Better Business Bureau, GuideStar and Charity Navigator to show a greater percentage of program expenses to total expense. Charity Navigator, for example, provides the specific program percentage needed to reach the highest score for program expense allocations. Higher program expenses are considered to be indicative of a more efficient, better-managed organization. This was identified in the Nonprofit Overhead Cost Project, a study performed jointly by the Center on Nonprofits and Philanthropy at the Urban Institute and the Center on Philanthropy at Indiana University, which noted that donors and charity watchdogs use "overhead costs and fundraising cost ratios as stand-ins for

¹ FASB 958-720-20

² FASB 958-720-45-9

³ FASB 958-720-45-7

⁴ FASB 958-720-45-8



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measures of program effectiveness.” The value of these ratios has often resulted in inconsistent treatment of certain expenses, and perhaps a slight tendency to load programs more aggressively with expenses that may now have to be classified as supporting activities. As a result of ASU 2016-14, NFPs are provided a framework for the allocation of their functional expenses to provide greater consistency across NFPs and aim for better comparability in financial reporting. It is hoped that these outside reporting agencies will take these new accounting standards into consideration when evaluating NFPs and focus more on NFP accomplishments and mission effectiveness.

Next Steps

NFPs will need to assess the impact of this change on their financial statements and related IRS Form 990's and address any significant reductions in program expense ratios with users of those documents. A sample letter that may be given to banks, donors, grant making organizations, etc. by an NFP to help explain these changes is shown in Appendix C. Additionally, NFPs may consider adding additional disclosures to their financial statements to better explain how the NFP utilizes its funds. NFPs have significant latitude to describe their activities on the IRS Form 990 and should take every opportunity to tell their story that goes beyond the amounts presented to reduce any potential impact of ratio calculations performed by rating agencies.

Please refer to the FASB Accounting Standards Codification for specific questions regarding ASU 2016-14, or contact your accounting or auditing firm for assistance in applying the guidance to your organization.

¹ FASB 958-720-20

² FASB 958-720-45-9

³ FASB 958-720-45-7

⁴ FASB 958-720-45-8

Appendix A – Sample Presentation of Expenses by Nature and Function

	Program Activities				Supporting Activities			Total Expenses
	A	B	C	Programs Subtotal	Management and General	Fund-raising	Supporting Subtotal	
Salaries and benefits	\$7,400	\$3,900	\$1,725	\$13,025	\$1,130	\$960	\$2,090	\$15,115
Grants to other organizations	2,075	750	1,925	4,750				4,750
Supplies and travel	890	1,013	499	2,402	213	540	753	3,155
Services and professional fee	160	1,490	600	2,250	200	390	590	2,840
Office and occupancy	1,160	600	450	2,210	218	100	318	2,528
Depreciation	1,440	800	570	2,810	250	140	390	3,200
Interest	171	96	68	335	27	20	47	382
Total Expenses	<u>\$13,296</u>	<u>\$8,649</u>	<u>\$5,837</u>	<u>\$27,782</u>	<u>\$2,038</u>	<u>\$2,150</u>	<u>\$4,188</u>	<u>\$31,970</u>

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Appendix B – Sample Allocations of Expenses

Case A: Chief Executive Officer Allocation

958-720-55-172 The broad responsibilities of a chief executive officer generally include administrative and programmatic oversight. At Not-for-Profit Entity A (NFP A), the chief executive officer spends a portion of time directly overseeing the research program. Additionally, a portion of time is spent with current and potential donors on fundraising cultivation activities. A portion of the chief executive officer's compensation and benefits and other expenses would be allocated to the research program and to the fundraising function representing the portion of time spent on those activities because they reflect direct conduct or direct supervision. If the remainder of the chief executive officer's time is spent indirectly supervising the other areas of NFP A, including the administrative areas, those activities would not constitute direct conduct or direct supervision, and the ratable portion of compensation and benefit amounts would remain in management and general activities.²

Case B: Chief Financial Officer Allocation

958-720-55-173 The chief financial officer at Not-for-Profit Entity B (NFP B) has primary responsibility for (a) accounting and reporting, (b) short-term budgeting and long-term financial planning, (c) cash management, and (d) direct oversight of NFP B's endowment. A portion of the chief financial officer's compensation and benefits and other expenses would be allocated to management and general activities for the accounting and reporting, the short-term budgeting and long-term financial planning, and cash management functions because they benefit the overall organization. A portion also would be allocated to investment expenses for management of the investment strategy of the endowment and would be netted against investment return. However, any portion of time spent supervising the accounting for investments or other fiduciary oversight would not be allocated to investment expenses because that time is related to an accounting and general management activity that benefits the overall organization and should be allocated to management and general activities.³

¹ FASB 958-205-55-21 (Note F)

² FASB 958-720-55-172

³ FASB 958-720-55-173

⁴ FASB 958-720-55-174

⁵ FASB 958-720-55-175

Case C: Human Resources Department Allocation

958-720-55-174 The human resources department at Not-for-Profit Entity C (NFP C) generally is involved in the benefits administration for all personnel of NFP C. The human resources department's related costs would not be allocated to any specific program. Rather, those costs would remain a component of management and general activities because benefits administration is a supporting activity for the entire entity. ⁴

Case D: Grant Accounting and Reporting Allocation

958-720-55-175 Not-for-Profit Entity D (NFP D) receives federal grants and employs an accountant who is responsible for grant accounting and reporting. In some cases, under the terms of the grant agreement, a fiscal report is required to be filed that details expenses incurred and charged against the grant. The fiscal report is not part of the direct conduct or direct supervision of the grant but rather is an accounting function. Therefore, the grant accountant's compensation and benefits would not be allocated to the programmatic area. However, a scientific report prepared by a principal investigator who is responsible for the research activity would be indicative of direct conduct and/or direct supervision of the grant activity, and the principal investigator's compensation and benefits would be allocated to the grant. ⁵

¹ FASB 958-205-55-21 (Note F)

² FASB 958-720-55-172

³ FASB 958-720-55-173

⁴ FASB 958-720-55-174

⁵ FASB 958-720-55-175

Appendix C – Letter to Interested Parties

To Whom It May Concern,

In 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-14. The ASU’s intention is to improve identified issues within financial reporting for not-for-profit (NFP) entities. The ASU results in a change to Generally Accepted Accounting Principles (GAAP). One of the specific areas addressed is “inconsistencies in the type of information provided about expenses of the period – for example some, but not all NFPs provide information about expenses by both nature and function.”¹ To address this concern, the ASU requires all NFP organizations to report amounts of expenses by both their natural classification and functional classification and to disclose the methods used to allocate costs among programmatic activities and support functions. Support functions consist primarily of fundraising activities or management and general activities.

The ASU also includes revisions to certain sections of the FASB Accounting Standards Codification concerning its description of management and general activities. These changes include specifically identifying the following activities as management and general: payroll processing and recordkeeping, administering contracts (including billing, collecting fees, and financial reporting) and human resources management.² In addition, the ASU provides additional guidance and examples about which activities constitute direct conduct or supervision of program or support functions.³ Due to these changes, cost allocations for many NFPs may shift from programmatic activities to support functions, especially related to salary allocations.

Our organization has implemented ASU 2016-14 for the year ended *[insert year-end]*. Because of this implementation and our efforts to ensure our financial reporting is in alignment with GAAP, we have revised the allocation methodology of our functional expenses to conform with the revised definition of management and general activities, as described above. This change has resulted in an increase in our management and general expense allocation and a reduction in our programmatic allocations.

We strive to use every dollar of funding we receive to execute on our mission to the fullest extent possible. Historically an organization’s success at carrying out mission-related activities has been viewed through the lens of a program ratio. Due to the adoption of this new ASU, our program ratio has decreased. We want you to know that we have not reduced our efforts to carry out our mission but have instead adjusted our allocations to be in accordance with GAAP.

If you have any questions or would like additional information, please contact *[insert contact name – i.e. Jane Doe]* at *[(XXX) XXX-XXXX]*.

Sincerely,

[Insert Contact Name]

[Insert Organization Name]

¹ FASB Accounting Standards Update No. 2016-14 pg. 1

² FASB 958-720-45-7

³ FASB 958-720-55-171 through 958-720-55-176