Part Two – A Deeper Dive into ASU 2016-14 Implementation Issues

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The Winter **Nonprofit Standard Newsletter** took a more in-depth look at certain changes under Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities* and the implementation considerations.

In this issue, we will examine two additional areas of the ASU: Expense reporting and reclassification upon expiration of donor-imposed restrictions.

Expense Reporting

As we noted in the Fall **Nonprofit Standard Newsletter**, once ASU 2016-14 is adopted, all nonprofits are required to present expenses by nature and by function, as well as an analysis of these expenses in one location by both nature and function. This analysis can be presented on the face of the statement of activities, as a separate statement (not a supplemental schedule) or in the notes to the financial statements.

As a quick refresher, functional expense classifications are generally shown as:

- **Program services**: Activities that result in goods and services being distributed to beneficiaries, customers or members that fulfill the purposes or mission for which a nonprofit exists
- **Supporting services**, which often include:
    - **Management and general**: Activities generally include oversight of the nonprofit and financial management
    - **Fundraising**: Activities undertaken to induce potential donors to contribute to the organization
    - **Membership development**: Activities undertaken to solicit new members and retain existing members

The ASU has modified the definition of management and general activities. The revised definition is "supporting activities that are not directly identifiable with one or more program, fundraising or membership development activities." Thus, activities that represent direct conduct or direct supervision of program or other supporting activities require allocation from management and general activities. Additionally, certain costs benefit more than one function and, therefore, should be allocated. For example, information technology generally can be identified as benefiting various functions such as management and general (for example, accounting, financial reporting and human resources), fundraising and programs. Therefore, information technology costs generally would be allocated among functions receiving direct benefit.

The expense analysis required by ASU 2016-14 should show the disaggregated functional expense classifications, such as program services and supporting activities by their natural expense classification, such as salaries, rent, depreciation, interest, professional fees and such.

If there are expenses that are reported by a classification other than their natural classification, such as when a nonprofit shows costs of goods sold and includes salaries in this presentation, these expenses should still be segregated and shown in the analysis by their natural classification within each function.

However, the external and direct internal investment expenses that are netted against investment return (as required by the ASU) should not be included in this analysis of expenses by nature and function.

In addition, gains and losses incurred by the nonprofit on such items as a loss on the sale of equipment or an insurance loss or gain should not be shown in this analysis of expenses.

It is also important to note that the ASU does not change any current generally accepted accounting principles (GAAP) related to the allocation, reporting and disclosures of joint costs.

The expense analysis presented is required to be supplemented with enhanced disclosures about the allocation methods used to allocate costs among the functions. In developing this disclosure, a nonprofit should assess which activities constitute direct conduct or direct supervision of a program or supporting function, and, therefore require an allocation of costs. An example of a disclosure regarding the allocation of costs is provided below (this is an excerpt from the ASU at section 958-720-55-176):

> **Note X. Methods Used for Allocation of Expenses from Management and General Activities**
>
> The financial statements report certain categories of expenses that are attributable to one or more program or supporting functions of the Organization. Those expenses include depreciation and amortization, the president's office, communications department and information technology department. Depreciation is allocated based on square footage, the president's office is allocated based on estimates of time and effort, certain costs of the communications department are allocated based on estimates of time and effort, and the information technology department is allocated based on estimates of time and costs of specific technology utilized.

The revised ASU provides specific examples of direct conduct and supervision as it relates to the determination of certain types of expenses. These are contained at sections 958-720-55-171 through 958-720-55-176 in the ASU. The ASU provides examples of allocations of a chief executive officer, chief financial officer, human resources department and the grant accounting and reporting function. In these sections it notes that the cost of the human resource department is not generally allocated to any specific program, and that instead all costs would remain as a component of management and general activities because benefits administration is a supporting activity of the entire entity.

Nonprofits should review the clarifications in the ASU with regard to the allocation of expenses and review their allocation methodologies to determine if there are any changes that are necessary. Once the organization determines the correct allocation approach, they will need to decide where they want to present this analysis in their financial statements and develop the format. Some organizations may also need to evaluate the different programs and supporting activities they have historically presented to determine if the presentation is concise. In addition, the organization will have to develop the wording for its allocation methodology disclosure.

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Reclassification upon Expiration of Donor-Imposed Restrictions

If a nonprofit has received funds restricted to the purchase or construction of property, plant or equipment or a donation of such an asset with an explicit donor-imposed restriction on the length of time that the asset must be used, then net assets with donor restrictions should be reclassified as net assets without donor restrictions in the statement of activities as the restriction expires. The amount that is reclassified may or may not be the same as the amount of depreciation recorded on the asset. The amount reclassified each year should be based on the length of time of the explicit time restriction for the use of the asset. However, the depreciation should be based on the useful economic life of the asset.

If the donor does not specify how long the donated assets or assets constructed or acquired with cash restricted for the acquisition or construction must be used, then the restrictions on the long-lived assets, if any, expire when the assets are placed in service.

The entire amount of the contribution of property, plant or equipment, or cash shall be reclassified from net assets with donor restrictions to net assets without donor restrictions when the asset is placed in service if there are no explicit restrictions noted by the donor with regard to how long the long-lived asset is to be used.

When examining the effect of the ASU on your organization you should look at whether you have any contributions of long-lived assets that are being reclassified over time without any explicit stipulation of a time period for the use of the asset. If these assets have already been placed in service, the amount of these long-lived assets should be reclassified from net assets with donor restrictions to net assets without donor restrictions upon adoption of the ASU.

In addition, the organization will have to modify its policy with regard to the receipt of contributions for the construction of long-lived assets or donated long-lived assets. Upon adoption of the ASU, an organization will have to recognize revenue without donor restrictions when the donated assets are placed in service absent any explicit donor stipulations otherwise. In the past, organizations had an option to either follow the placed-in-service approach or to place an implied time restriction on the long-lived assets.

Interested in learning more about changes to nonprofit financial reporting under ASU 2016-14? I recently co-authored a book on the topic with my colleagues from BDO's Institute for Nonprofit Excellence℠ and LangCPA Consulting. The third edition of "How to Read Nonprofit Financial Statements: A Practical Guide" has numerous illustrations and exercises to help readers feel quickly at home with the format of nonprofit financial statements.

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