

# **Kerkering, Barberio & Co.**

**How to Read a Not for Profit Financial  
Statement**

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**Kerkering, Barberio & Co.**  
***Certified Public Accountants***

1990 Main Street, Suite 801, Sarasota, FL 34236

6320 Venture Drive, Suite 203, Lakewood Ranch, FL 34202

**941-365-4617 • [www.kbgrp.com](http://www.kbgrp.com)**

# Introductions

- Facilitator
  - Patricia Entsminger, CPA  
[pentsminger@kbgrp.com](mailto:pentsminger@kbgrp.com)
- Topics
  - Not for Profit Organizations
  - Donor Imposed Restrictions
  - NFP Financial Statements
  - Statement of Financial Position

# Introductions (Continued)

- Topics (Continued)
  - Statement of Activities
  - Statement of Cash Flows
  - Statement of Functional Expenses
  - Functional Expenses
  - What Donors are Evaluating
  - Notes to the Financial Statements
  - IFRS Update / FASB Update

# Not for Profit Organizations

- The primary purpose for financial statements of a not for profit (NFP) organization is to report information about the overall entity and to report aggregated information about the organization's net assets classified based on donor restrictions.
- Unlike other businesses, contributions are often received by NFP organizations and can contain donor imposed restrictions as to how the assets contributed can be used.
- Information about these restrictions is important and is the foundation for the format of financial statements issued by NFP organizations.
  - It is helpful in assessing the financial flexibility of a NFP to know information about the nature and amount of restrictions imposed by donors on the use of contributed assets, including potential effects on specific assets and on liabilities or class of net assets.

# Donor imposed restrictions

- Contributions received by NFP organizations are classified into one of three different categories:
  - Unrestricted: Unrestricted contributions are received by the organization without any restriction on how the asset(s) are used. These contributions are available immediately for operations to cover either administrative, program related, or fundraising costs.
  - Temporarily restricted: Contributions are received from the donor with stipulations on how or when the assets may be used or expended.
    - The donor restrictions often specify the purpose or the program for which the assets can be used.
    - Contributions pledged or promised are considered temporarily restricted for timing purposes until the contributions are actually received.
    - Temporary restrictions may also include other timing restrictions imposed by the donor.

# Donor imposed restrictions (continued)

- Permanently restricted: Contributions may be made to the organization's endowment fund.
  - Contributions to endowment funds require a gift to be invested in perpetuity.
  - For each gift, investment income/loss must be tracked separately.
  - Investment income from endowment funds are considered to be unrestricted unless the donor specifies a purpose or time restriction.
  - Depending on terms of the endowment contribution, investment losses may have to be restored by the organization so that the donor's original contribution is never reduced below the initial contribution.
- Contributions are recorded as restricted or unrestricted activity and closed to the applicable category of net assets at the end of each period.
- When restrictions have expired or have been fulfilled, the amount is recorded as a release of temporarily or permanently restricted net assets and support, or an increase to unrestricted net assets, thus all expenses of the organization are considered to be unrestricted activity.

# NFP Financial Statements

- A complete set of NFP financial statements includes:
  - Statement of financial position
  - Statement of activities
  - Statement of cash flows
  - Statement of functional expenses (required for voluntary health and welfare organization's only)
  - Notes to financial statements



# Statement of Financial Position

- The statement of financial position is equivalent to a balance sheet.
- Equity is reported as net assets rather than retained earnings or capital.
- Assets and liabilities should be presented in order of their relative liquidity.
- Net assets are classified as unrestricted, board designated unrestricted, temporarily restricted, or permanently restricted.

# Statement of Financial Position (Continued)

- All net asset restrictions are based on donors' restrictions at the time of contribution, with the exception of the board designated unrestricted net asset category.
  - Board designated unrestricted funds include any amounts/funds for which the board of the NFP has set aside to be used for a specific purpose.
- The total for each net asset category is presented. The Statement of Activities will show the detail of changes in net assets by net asset category, which should agree to the statement of financial position.
- Some organization's retain the right of variance power upon acceptance of all contributions. When variance power is retained by the NFP, the organization reserves the right to use the funds for whatever purpose they choose. While most NFP's still try to accommodate the donor's wishes, all contributions, other than timing restrictions, are reported as unrestricted contributions.

# Statement of Financial Position (Continued)

- Assets unique to NFP's include:
  - Pledges receivable or promises to give: represent unconditional, legally enforceable agreements of donors to provide contributions in a future period.
    - May include contributions to be received each year for several years. These multi-year promises are discounted to the present value of amounts to be received in future years.
  - Split interest agreements: received from donors under an agreement in which the organization has a beneficial interest in the asset but the organization is not the sole beneficiary.
    - Includes contributions of charitable lead and remainder trusts, gift annuities, pooled income funds, etc. Reported at fair value based on estimating or discounting the organization's interest in the asset, depending on what type of asset is involved.

# Statement of Financial Position (Continued)

- Liabilities unique to NFP's include:
  - Liabilities relating to split interest agreements: 100% of assets involved have been provided to the organization, however, the portion of the asset to benefit a third party is reported as a liability.
  - Agency liabilities: Occasionally, funds are provided to the NFP as an agent of the funds without being given the rights to the funds.
    - This may include pass-through funds, which are provided to the NFP to hold with instruction to provide the funds to a designated beneficiary at a designated time.
    - May also include funds provided to a NFP to be pooled and managed with the NFP's for investment purpose only. The purpose of this is to utilize the NFP's fund managers and benefit from ability to be included in a significant portfolio of investments.
    - Assets received/held by the NFP are included in the assets of the organization, but offset by an agency liability.

# Statement of Activities

- The statement of activities is equivalent to the income statement.
- Instead of reporting net income, the statement will report changes in net assets.
- Presentation is one of three formats:
  - Format A presents all activity in one column
  - Format B presents activity in three columns based on restriction
  - Format C presents activity in two statements, highlighting unrestricted activity in one statement and summarizing all activity in the second statement.

# Statement of Activities (Continued)

## Format A – Single Column

- Changes in net assets are reported in three separate sections: changes in unrestricted net assets, changes in temporarily restricted net assets and changes in permanently restricted net assets.
- The changes in unrestricted net assets section most closely mirrors a business entity's income statement.
  - Revenues and gains are presented first with a total for unrestricted revenues and gains.
  - Next, net assets released from restrictions are presented. The unrestricted section always contains amounts reported as additions to unrestricted net assets and may or may not include restriction types.

# Statement of Activities (Continued)

## Format A - Single Column (Continued)

- Changes in unrestricted net assets section (continued)
  - The expenses and losses are presented after the releases, followed by a total increase or decrease in unrestricted net assets.
- The changes in temporarily restricted net assets sections reports all temporarily restricted activity
  - Revenues, gains and any losses are presented.
  - Net assets released from restrictions are show as a reduction to temporarily restricted net assets.
  - These releases relate to expenses paid by the organization to satisfy purpose restrictions or assets released for operations due to satisfaction of time constraints.

# Statement of Activities (Continued)

## Format A - Single Column (Continued)

- Changes in permanently restricted net assets present all activity relating to permanent restrictions.
  - Activity normally includes contributions and investment income. If permanently restricted investments do not contain a restriction on the income earned on permanently restricted investments, activity will also include a release of net assets representing income earned.
- The statement presents the total changes in net assets of all three categories and reconciles beginning and ending net assets, which flow to the statement of financial position.



# Statement of Activities (Continued)

## Format B – Three Columns

- Presents activity in the same format as the changes in unrestricted net assets section of Format A, with revenues and releases then expenses with total changes in net assets reconciling beginning and ending net assets.
- Each net asset category is presented in a separate column.
- Releases of net assets are shown as an increase or support in the unrestricted column and as a decrease or negative amount in the temporarily and permanently restricted net asset columns.

# Statements of Activities (Continued)

## Format C – Two Statements

- The first statement is the Statement of Unrestricted Revenues, Expenses, and Other Changes in Unrestricted Net Assets and presents only unrestricted activity in the same manner as the unrestricted activity presented in the unrestricted net asset section of Format A.
- The second statement is a Statement of Changes in Net Assets. This statement is presented similarly to Format A, however, the unrestricted net asset section is replaced with only the totals on the Statement of Unrestricted Revenues, Expenses, and Other Changes in Unrestricted Net Assets.

# Statement of Cash Flows

- The statement of cash flows can be presented using the indirect method or the direct method.
- Most organizations use the indirect method.
- The indirect method reconciles changes in net assets as reported on the statement of activities to the net increase or decrease in cash over the previous year.

# Statement of Cash Flows (Continued)

- Cash flows are presented in the following categories:
  - Operating cash flows: shown as adjustments to Changes in Net Assets.
    - Include changes in balances of assets and liabilities from one year to the next.
    - Non cash operating adjustments include adding depreciation and amortization expense back to changes in net assets.
  - Investing cash flows: include purchases and sales of fixed assets and investments.
  - Financing cash flows: include loan/bond proceeds, repayments of loan principal, annuity payments, etc.

# Statement of Functional Expenses

- Required only for voluntary health and welfare entities, however, may be presented for other types of organizations.
- Presents expenses both by natural classification and by functional classification.
- Functional classification includes program expenses, management and general expenses and fundraising expenses.
- All organization's are required to present a total for each functional classification.
  - May be done by listing expenses in the statement of activities by function or in the notes of the financial statements.

# Functional Expenses

- Program Service Expenses
  - Further the organization's exempt purposes
  - May include
    - Lobbying expenses
    - Unrelated trade or business expenses
    - Costs to secure a grant
    - Costs to conduct research

# Functional Expenses (Continued)

- Management & General Expenses
  - Related to overall operations & management
  - Wages of chief executive and his or her staff
  - Investment management fees must be reported here
  - Lobbying expenses if not directly related to exempt purpose
  - Board meeting, committee meetings, staff meetings (not costs of that relate to fundraising or specific program services)
  - General legal services
  - Accounting & auditing
  - General liability insurance
  - Office management, human resources, and other centralized services

# Functional Expenses (Continued)

- Fundraising Expenses
  - Incurred in soliciting contributions, gifts, and grants
    - Including allocable overhead costs
  - Publicizing and conducting fundraising campaigns
  - Soliciting bequests and grants from foundations or other organizations, or government grants
  - Conducting fundraising events that generate contributions



## Functional Expenses (Continued)

- Some expenses are directly related to and can be assigned to a single major program or service or a single supporting activity. Other expenses relate to a combination of programs or supporting activities.
  - Examples: salaries of persons who perform more than one kind of services and the rental of a building used for various purposes.

## Functional Expenses (Continued)

- When expenses cannot be directly identified with a program or supporting service, the organization should use a reasonable method to allocate expenses to each function.
  - Often includes time studies of key personnel or allocation based on square footage.
  - Must be systematical and consistently applied.

# What Donors are Evaluating

- In conjunction with the other information provided by the organization (on Form 990 and/or in the FS if made public), potential donors are looking at efficient use of funds and want to see:
  - Minimal administrative expenses
  - Amount of fund-raising efforts
  - Majority of funds used to further programs and provide services
- Potential donors want their contributions used to provide programs/services

# What Donors are Evaluating (Continued)

- Websites and donors use functional expense information to evaluate organization efficiency and some sites issue scores
- Popular ways to evaluate financial information include the following ratios:
  - Program expenses / Total functional expenses
  - Administrative expense / Total functional expenses
  - Fund-raising expense / Total functional expenses
  - Fund-raising expense / Amounts raised or Contributions; a measure of fundraising efficiency

# Notes to the financial statements

- Should provide a description of the nature of the NFP's activities, programs, significant assets and liabilities, net asset classifications, and net asset releases.
- Note 1 typically provides an overview of the significant policies the organization utilizes for recording assets, liabilities, and all activity of the NFP.

# Notes to the financial statements (Continued)

- Significant policies generally include:
  - Revenue recognition and receivables
  - Valuation information pertaining to split interest agreements
  - Valuation policies relating to cash equivalents, investments, and other assets
  - Depreciation method
  - Contributions and net asset classification
  - Significant estimates used

# Notes to the Financial Statements (Continued)

- Generally the notes should also include detailed information pertaining to each significant class of assets and liabilities presented on the statement of financial position.
- This would include specific details and information useful regarding the valuation and significant terms associated with the asset or liability.

# Notes to the Financial Statements (Continued)

- Subsequent events should also be included in the notes of the financial statements.
  - Identifies significant transactions entered into after year end
  - Also includes the date through which subsequent events have been considered for disclosure.



# Notes to the Financial Statements (Continued)

- Net Asset disclosure should include the balance of restriction type by net asset classification.
- Also includes restriction releases by restriction type for each net asset classification.

# Notes to the Financial Statements (Continued)

- May identify commitments and contingent liabilities not reported in the statement of financial position.
- Should also identify areas representing risks to the NFP, such as concentration of asset risk, market risk, reliance on customers or vendors, etc.

# Notes to the Financial Statements (Continued)

- Transactions with related parties should also be disclosed.
  - Related parties include board members, companies owned by board members, employers of board members, businesses or employers of relatives of employees or board members.
  - Disclosure should include the related party, the terms of the arrangement or transaction, a description of the transaction and the amount of transaction.

# Notes to Financial Statements Endowment Funds

- All organization's with endowment funds should have disclosure of information to enable users of financial statements to understand the net asset classifications, net asset composition, changes in net asset composition, spending policy(ies) and related investment policy(ies) of endowment funds.

# Notes to Financial Statements Endowment Funds (Continued)

- Disclosures must include:
  - Description of board's interpretation of laws
  - Description of endowment spending and investment policies
  - Composition of endowments by net asset class
  - Roll-forward of beginning and ending balances by net asset class including investment income, appreciation/depreciation, contributions, expenses, reclasses, and other changes.
  - The aggregate amount of deficiencies of all donor restricted funds

(See example)

# FASB Update

- FASB Accounting Standards Codification becomes the single authoritative source for GAAP.
  - Effective for periods ending after September 15, 2009
  - Changes references included in financial statements
    - Old: SFAS No. 157, Fair Value Measurements
    - New: The Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification

# FASB Update (Continued)

- Fair Value Disclosures
  - Tabular disclosures required for subsequent measurements
    - Generally includes, investments, beneficial interests, asset impairments
    - Generally does not include contributions receivable or payable, nonfinancial assets
  - Classifies investments based upon input valuations with reconciliation of level 3 inputs

# FASB Update (Continued)

- Guidance on NFP Mergers & Acquisitions added to FASB's Business Combinations Topic.
  - Distinguishes between mergers and acquisitions
  - Carryover basis accounting:
    - Mergers: combine statements of financial position without step-ups to FV.
    - Acquisitions: Assets / Liabilities of acquirer at FV with recognition of goodwill or inherent contribution



# IFRS Update

- IFRS: International Financial Reporting Standards
- Currently the International Accounting Standards Board and the Financial Accounting Standards Board are working to converge IFRS and US GAAP.
- Current target date for completion is June 2011.
- Will effect all types of entities, including NFP's.

# IFRS Update (Continued)

Project	Expected date of completion
Financial Instruments	1 <sup>st</sup> quarter of 2011
Fair Value Measurements	4 <sup>th</sup> quarter of 2010
Consolidations	TBD
Revenue Recognition	2 <sup>nd</sup> quarter of 2011
Financial Statement Presentation	TBD
Financial Instruments with characteristics of equity	TBD
Insurance	TBD
Leases	TBD

# Questions



Thank You!



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