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Considering the Effect of Accounting Changes on Users of Financial Statements

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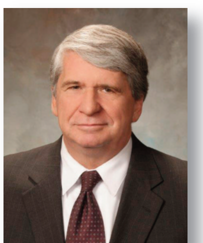

When auditors of not-for-profit organizations can provide the optimal level of assurance on an organizations' financial statements, the report will say "the financial statements present fairly, in all *material* respects, the financial position of the organization and the changes in its net assets and cash flows." The question naturally arises, then: what is meant by "material"? Auditing standards define materiality as something that could influence "the judgment of a reasonable person relying on the information." Thus, materiality is not only quantitative but qualitative as well.

With that in mind, it is advisable to consider the many recent accounting changes and what *material* effect they will have on the users of financial statements.

Going concern issues

In August 2014, the Financial Accounting Standards Board (FASB) released Accounting Standards Update (ASU) 2014-15, revising the criteria for considering going concern basis for calendar years beginning in 2016. Prior to this, auditors had to consider whether an organization is likely to continue in operation for a year following the date of the financial statements.

If an organization had a financial structure that made this difficult to attest to, such as a negative net assets balance, they could put off their audit until later in the year, shortening this period to a few months. The new ASU changes the date when the clock starts on the year of viability. Henceforth, auditors must consider whether an organization will continue in operation for a year following the *issuance* of financial statements.

Since no auditing procedures can be performed after issuance, this change eliminates the delay strategy and forces auditors to address going concern in the auditors' report. Bringing the issue up in the auditors' report could raise concerns among grantors and donors.

Extraordinary items

In January 2015, FASB released ASU 2015-01, eliminating the concept of extraordinary items, beginning in calendar year 2016. FASB felt there was no clear way to define the concept of "unusual and infrequent" on a ubiquitous basis, so they concluded they could achieve uniformity in financial reporting only by ending the practice of using a line on the statements for

continued on page 2

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continued from page 1

these items. Going forward, if an organization faces some unexpected calamity, such as earthquake damage, they can no longer separate this out from the operating expenses on their statement of activities. This could have a large negative effect on the operating income and financial ratios of organizations in the year of such events.

Debt financing costs

In April 2015, FASB released ASU 2015-03, changing the way debt financing is presented on the financial statements. Beginning in calendar year 2016, organizations must reclassify capitalized financing costs from the asset side of the statement of financial position and, instead, classify it as a subtraction from liabilities. Thus, total assets will be lower than in prior years for organizations that had previously recognized financing costs as an asset.

Revenue recognition

In May 2014, FASB released ASU 2014-09, clarifying the recognition of revenue from contracts with customers. Beginning in calendar year 2018, organizations must recognize revenue from contracts, such as research and development grants, based on the achievement of major milestones in the contracts rather than on the percentage of time spent.

Since considerable effort may be required before a milestone can be said to be achieved, this may tend to delay revenue recognition, depressing the bottom line of organizations' statements of activity in the early years of multi-year contracts. The new revenue recognition requirements will be applied retroactively upon implementation, so not-for-profits need to start identifying contracts and customers now.

Not-for-profit financial statement presentation

In August 2016, FASB released ASU 2016-14, making numerous changes in the presentation of not-for-profit financial statements, beginning in calendar year 2018. This standard includes requirements in the areas of net assets, investment return, functional expenses, and operating cash flows. Additionally, organizations will now have to provide detailed information about liquidity and how they plan to use available cash to cover expenses for the year following the date of the financial statements. The information is required to be both narrative and tabular. If an organization has borrowed from their restricted funds to cover general expenses, this will have to be disclosed.

Leases

In February 2016, FASB released ASU 2016-02, a long anticipated attempt to align accounting principles in the United States with internationally recognized standards. This change in accounting may be the most impactful of the current batch of new standards.

Under the changes, organizations will be required, beginning in calendar year 2019, to recognize a liability for any leases under which they are obligated to make payments. They will also recognize an asset of the same amount. So net assets won't change. But for formulas such as debt-to-equity ratios, which are standard in loan covenants, the effect will be huge. The impact will be largest for new leases. The ratio as currently formulated will increase significantly, placing many borrowers into default.

Although it may seem that nothing has changed, financial institutions may perceive a differentiation of risk between organizations with large new leases and those without. The time for organizations to address this with their lenders is now, while they still have some leverage.

Changes to financial statements are here... and are coming. UHY advisors are available on a consulting basis to analyze organizations' existing relationships and consider the impact of accounting changes, including pro forma drafts of how current financial statements would look when the changes have been implemented.