APPENDIX O

Non-Profit Financial Reporting – The Statement of Activities

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Imagine for a moment that you donate $1 million to your favorite charity for the sole purpose of building a school for needy children. Imagine further that once you wrote that check, you were never able to determine to any degree of certainty exactly what became of your generous gift. It seems almost irrelevant at this point to decide whether or not you'd like the school named in your honor…..

Prior to a substantial overhaul of the financial statements of non-profit organizations, this could have been a story you warn your grandchildren about.

Prior to 1993, due to the absence of comprehensive uniform accounting and reporting standards, financial statements of non-profit organizations varied widely from organization to organization. Non-profit organizations typically had a multitude of reporting standards to choose from, and as a result, financial reporting was difficult to understand, lacked essential information, and presented significant problems comparing one organization to another. All of that changed when the primary financial accounting standards-setting body, the Financial Accounting Standards Board (or, as accountants refer to it affectionately, FASB) issued Statement of Financial Accounting Standards (FAS) 117.

FAS 117 was essentially developed to prescribe uniform standards of financial reporting for all non-profit organizations. It specified the form and content of the financial statements of non- profit organizations in order to enhance their reliability, usefulness and comparability. Three basic financial statements are now required, which are similar to the financial statements of for- profit entities (with some very marked differences):

1. **The Statement of Financial Position (similar to the Balance Sheet);**
2. **The Statement of Changes in Net Assets (similar to the Income Statement); and**
3. **The Statement of Cash Flows (for all intents and purposes, identical to the statement used by commercial enterprises).**

This article focuses on the Statement of Changes in Net Assets, the report used most widely by internal managers, donors and other external stakeholders to assess performance. Similar to the Income Statement used by for-profit entities, The Statement of Changes in Net Assets reports revenues and expenses. However, instead of net income or loss, the difference between revenues and expenses for a non-profit organization is referred to as the change (increase or decrease) in net assets.

Unrestricted, Temporarily Restricted, Permanently Restricted Net Assets

Unlike the financial statements of for-profit entities, the revenues and expenses of non-profit organizations are grouped into three categories, depending on the existence or absence of *donor- imposed restrictions*. This categorization is achieved by preparing the Statement in columnar format, where, in addition to a column for the total, transactions are grouped into the following categories: (1) Unrestricted, (2) Temporarily Restricted, and (3) Permanently Restricted.

Unrestricted – Represents revenues that are available for use at the organization's discretion., and related expenditures. Unrestricted resources are not subject to donor restrictions. For example, the organization may receive contributions from donors or fees for services which can be used for any purpose, most often to fund general operating expenses.

Temporarily Restricted - Includes resources which *are specifically restricted by the donor(s).* Restrictions may be based on: (1) time, or (2) use. An example of the former: A donor may make a contribution to the organization today, with the stipulation that the funds be used during the subsequent fiscal year. An example of a donor *use* restriction may be a contribution received to be used for a specific project. For example, in order to build new facilities or enhance existing facilities, many non-profit organizations undertake what is typically referred to as a capital campaign. In essence, funds and pledges are raised from various sources to be used to construct or enhance a facility. Quite often, this whole process may take several years. Until such time as temporarily funds are used for their intended purpose, they are reported as increases to temporarily restricted net assets.

Many non-profit organizations receive government grants, which funds are earmarked for use in a specific program. Until such time as these funds are spent to carry out that specific program, they are reported as an increase to temporarily restricted net assets.

Permanently Restricted – Represents resources that by donor restriction or operation of law are <u>unavailable</u> for use by the organization indefinitely. The most common forms of permanently restricted assets are endowment funds. Typically, endowment funds contributions are restricted by donors such that the funds must be permanently invested. The principal portion of that investment must remain intact in perpetuity, while the income generated by the investment may be used at the organization's discretion.

The Bottom Line

The difference between revenues and expenses in each category (unrestricted, temporarily restricted, and permanently restricted) is referred to as the *change in net assets* (increase or decrease). In an annual financial statement, the increase or decrease in each category of net assets for the year is added to the balances at the beginning of the year. The result is net assets at the end of the year – unrestricted, temporarily restricted and permanently restricted.

The balance in unrestricted net assets represents resources available to the organization to be used at its discretion. The balance in temporarily restricted net assets represents unspent funds which are restricted for one or more purposes, depending upon the donor(s) stipulations. Finally, permanently restricted net assets represent funds which are not available for use by the organization. Typically, the notes to the financial statements describe the components of both temporarily restricted and permanently restricted net assets, including the nature of each restriction.

Now let's revisit your $1 million contribution once again, this time availing ourselves of the full benefit of modernized financial statements of non-profit organizations.

In Year 1, you look at the Statement of Changes in Net Assets and are able to see your contribution reported in the temporarily restricted column as revenue. To make it simple, you are the only contributor to the capital campaign and the building is expected to cost $1 million. The building hasn't been started yet and you're aware of that, so your contribution hasn't been spent. Your contribution revenue flows through the Statement of Changes in Net Assets, untouched, and increases temporarily restricted net assets. The notes to the financial statements describe the various components of temporarily restricted net assets, including your $1 million, "which, as per donor restrictions is for the purpose of building a new school." This makes sense to you and accomplishes exactly what the revised reporting standard intended to accomplish – transparency and accountability.

Year 2 comes around, construction begins, and lo and behold, the building is completed by the end of Year 2, coincidentally at a cost of exactly $1 million. You see that your $1 million has been released from temporarily restricted net assets and spent on construction of the building. You look at the Statement of Financial Position and the cost of the new building is indeed $1 million. If the building had cost only $900,000, the financial statements would reflect the unused portion, $100,000, as a component of temporarily restricted net assets. If that had been the case, at your discretion you could have requested that the unused portion of your contribution be returned to you, or you could have authorized the organization to spend it any way they (or you) choose. I would guess that you authorize the remaining funds to be used to purchase computers for the kids. Of course this gives rise to another temporarily restricted contribution, but we won't get into that again.

By the way, the new school has been named in your honor.

The information contained in the Statement of Changes in Net Assets helps internal users, as well as external users, such as donors, creditors and others to: (1) evaluate the organization's performance during a particular period; (2) assess the organization's ability to provide services in the future; and (3) assess how the organization's management carried out its stewardship responsibilities during the period.