

Nonprofit Notes

Painting an Accurate Picture of Your Not-for-Profit: Net Asset Classification Matters

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Picture this scenario: a not-for-profit organization has \$10 million in total net assets and classifies the assets with donor restrictions at 25%, when restricted funds should have been classified at 95%. To its board of directors, management and donors, the organization appeared fiscally healthy with only 25% restricted net assets and seemingly ample resources to support operations. However, having only 5% of its net assets free of donor restrictions, the organization's actual financial flexibility was drastically overstated.

A scenario such as this causes more than a financial statement issue. It creates an error that can affect budgeting, operating decisions and stakeholder understanding about which resources are available for general operations versus which must be used for specific donor-designated purposes.

Knowing total net assets only won't paint the entire picture. It is critical to know the true financial flexibility and operating health of your not-for-profit. To do that, it is first necessary to know applicable accounting guidance, determine donor intent and grant terminology, and understand the risks of incorrect classifications.

Know Relevant Accounting Guidance

Under Generally Accepted Accounting Principles (GAAP), FASB Accounting Standards Codification (ASC) 958-210 dictates that not-for-profits are required to classify net assets into two categories: net assets with, and without, donor restrictions. Below is what you'll need to know about each:

- **Net Assets with Donor Restrictions:** Resources are subject to specific, externally imposed stipulations, such as:
 - **Time:** The donor dictates when the contribution can be used or requires the funds to be held until a specific date or event occurs (e.g., a gift received in one year that cannot be spent until the next year).
 - **Purpose:** The contributed funds must be used for a certain program, project or activity (e.g., repair flooring in an education center or pay artists for a concert at the annual gala).
 - **Perpetuity:** The principal balance of the original contribution is required to remain permanently restricted. Income generated on the principal must be used for purposes expressed by the donor.
- **Net Assets without Donor Restrictions:** Includes undesignated funds, operating funds, investment in property, plant and equipment and board-designated funds, which the board has approved for specific use.

Determine Donor Intent and Grant Terminology

In order to ensure accurate classification, your organization should establish a formal documented process for understanding donor intent and grant terminology. This includes reviewing gift agreements, grant awards, award letters, donor correspondence and any amendments to determine whether restrictions exist and, if so, whether they relate to purpose or timing.

Once a donor restriction is identified, your not-for-profit should develop a process for tracking use and monitoring compliance relative to the restriction. Your organization should also understand the release mechanism in terms of what event or expenditure satisfies the restriction. Such a process will help ensure that financial statements and internal reports distinguish resources that are legally or contractually limited versus those that are unrestricted and available for general operations.

Returning to our original example, the \$10 million net asset balance — and the percentage reported in each category — is not, by itself, the concern. Rather, the key issue is whether those classifications reliably reflect the applicable accounting guidance and the terms of gifts and grants. If they do not, the financial picture presented to the board, management and donors may overstate or understate the resources available to support general operations. These inaccuracies can create financial reporting and operational risks, as detailed next.

Understand the Risks of Incorrectly Classifying Net Assets

Risks of incorrectly classifying net assets can materially affect your organization's financial flexibility and operating health. Key risks include budgeting and cash-flow issues, financial-statement misstatements and misrepresentations. Examples of each are provided below:

- **Budgeting and Cash-Flow Issues:** \$100,000 of donor-restricted net assets at an early-education center is incorrectly classified as without donor restrictions. That money is included in the budget for repairs on vans used to transport students on field trips. The donor restriction, however, requires the funds to be used for classroom materials. If the organization did not have sufficient unrestricted cash on hand to pay for the repairs, the misclassification would lead to an unanticipated shortfall and cause donor resources to be used inconsistently with their intent.

Once identified, management must revise the budget and determine how to fund the repairs from unrestricted operating resources, additional fundraising or other available financing.

- **Financial Statement Misstatements:** A \$500,000 donation was received at year-end. The donor stipulated that \$250,000 could be used after 18 months and the other \$250,000 used at any time. The organization recorded the entire \$500,000 as net assets without donor restrictions, causing a misstatement in the financial records.
- **Financial Statement Misrepresentation to Users and Potential Donors:** A series of donations were made to a museum to purchase new art exhibits. A misclassification error caused \$1.5 million of these funds to be recorded as net assets without donor restrictions. The actual resources available for general use amounted to \$10,000 and projected general operating expenses exceeded \$500,000. The misclassification led users and potential donors to conclude that the organization was in a stronger financial position than actual, affecting future giving decisions.

Paint an Accurate Picture to Drive Better Decision-Making

While you already know that having an accurate picture of your net asset classifications will drive better business decisions for your not-for-profit, it's also important to have complete transparency regarding your organization's financial needs. This clarity can help you direct donor funds to where they're needed most. Consider these simple tips:

- **Net Assets without Donor Restrictions:** Includes undesignated funds, operating funds, investment in property, plant and equipment and board-designated funds, which the Board has approved for specific use.
- **Clearly Communicate Your Funding Needs:** Communicate with potential donors the need for unrestricted funds or specify purposeful funding needs.
- **Determine Your Liquidity Needs:** Assess resources available for general expenditures within one year by considering donor restrictions that limit short-term use.
- **Develop a Strategy:** To help you budget and plan, understand your donor time and purpose restrictions, as well as your organization's management and administrative needs.

How We Can Help

Accurate net asset classification is essential to evaluating your organization's financial and operating health. Our [Not-for-Profit Services](#) team can help your management team interpret applicable accounting guidance and understand how donor-imposed restrictions affect financial reporting. We can also provide insight to identify and track restricted resources and evaluate which funds are available for general operations to support budgeting, planning and strategic decision-making.

Contact Us

If you have any questions, please contact your PKF O'Connor Davies client service team or:

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