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To: Director - FASB; Larry Smith; ktysiac@aicpa.org
Subject: Possible changes to not-for-profit accounting

I was pleased to see the article in the July Journal of Accountancy about the FASB considering changes on the model for not-for-profit accounting. However I am concerned that the approach of having only two reporting columns, unrestricted and restricted would be a step in the wrong direction, making the basic financial statements more difficult for a reader to understand the situation. I believe revision to the present not-for-profit model is essential, but needs much more discussion and debate. Therefore, I decided to write up the comments below, which could be published in the Journal along with views of others, to get the process going.

I am a retired CPA who had 25 years in the audit division of a major CPA firm, and then 20 years operating my own small firm which specialized in not-for-profit organizations. I have served and presently serve as board member, treasurer, finance committee member, and investment committee member for several not-for-profits. It is my considered opinion that the understanding of the financial status of not-for-profits today by board members, staff, and donors is much less than in the old days when the reporting was by funds, Operating, Restricted, Property, and Endowment, than today when it is by Unrestricted, Temporarily Restricted, and Permanently Restricted. I seriously believe the FASB should consider returning to fund accounting.

One of the earliest memories that I have about grade school is a math teacher telling the class that you cannot add apples and oranges and get a meaningful result. I see our present model as just that. The following schedule shows the different items that are combined in the present restricted categories in the financial statements of one or more environmental preservation organizations I am involved with. These organizations have the issue not present in most organizations of perpetually protecting property:

Unrestricted:

Operating Fund

Board Designated:

Funds Functioning as Endowment, both principal and appreciation

Legal Defense Fund, mandated to by accrediting organization

Organizational Advancement Fund

Revolving Fund to temporarily finance land purchases

Reserve Fund to carry organization through the year which spends most money in summer, but gets most major gifts in December

Preserved natural areas, not paid for by funds restricted for that purpose

Gift annuity funds

Building Fund

Office building

Equipment used in office and property stewardship

Temporarily Restricted:

Donor restricted for specific purposes, many different purposes

Donor restricted for spending in future time periods

Multi year grants

Endowment appreciation restricted for special purposes:

Unappropriated
Appropriated for spending in current year
Appropriated for past spending, not yet spent
Office building
Capital campaign in progress
Permanently Restricted:
Donor restricted endowment principal
Sanctuary land, organization commits to maintain permanently
Gift annuity funds to go to endowment on maturity
Stuffed animals, mounted fish, art work, photography, library, used for education
Charitable remainder unitrusts held by third parties, which will be received on death of present income beneficiaries.

As can be seen from above, the restriction categories include so many items that the total reporting of each category is adding apples and oranges and the totals make little or no sense. In order to develop a reporting model that is understandable it is necessary to ask what information a reader needs to understand the financial position and results of operations of a not-for-profit organization. I believe the following are the essential items needed for adequate understanding:

1. The results of regular ongoing operations, without inclusion of non-operating items. This would include in revenue a line for each of basic membership dues if applicable, amounts given by members in excess of basic dues, contributions by others, in some cases further broken down by foundations, governments, business, etc, fees and costs of fundraising and program events, actual investment dividends and interest received, additional endowment draw to bring up to an authorized responsible draw of 4 or 5% of the average of the last 12 quarters of endowment market value, and other miscellaneous items like royalties, rents, and fees, with a line for each significant item. Then would come the transfer from Temporarily Restricted. This should be divided as to transfers of restricted funds expended, time restrictions expired, and endowment appreciation utilized as mentioned above. Expenses should include a line for each significant program, and lines for fundraising and management and general. There would then be a total of net gain or loss from operations.
2. Any non-operating unrestricted items should be clearly disclosed in a non-operating section following the operating section. Items therein should include bequests, market value change of endowment, transfer of endowment appreciation appropriated for operations discussed above, costs or gains from legal settlements, gains or losses on sale of property, gains from maturity of gift annuities and charitable remainder unitrusts, and any other such items. The fact that market value changes with each period and bequests are received from time to time does not make them operating items just because they occur regularly. They must not be buried in operations if there is to be clear understanding of results of operations.
- 3 Transactions in temporarily restricted net assets, with clear separation of the three categories described above. In most cases there are several restricted funds within each category. It will not be practical to show all these in the basic statements, but the notes to the financial statements should clearly show for each significant category the beginning balance, the additions, and the transfers out.
4. The transactions in the endowment funds, both board designated and donor restricted, in one place. Presently the performance is very difficult to evaluate, being in all three restriction categories, and often combining income receiver with market value change, which need to be

separated for good understanding. Addition or deductions should be clearly described and as to whether donor required or board designated.

5 Transactions in property need to be clearly described. If major property is included in the Unrestricted Operating Fund, that needs to be disclosed, as otherwise donors may conclude that there is so much unrestricted money that the organization should be spending it rather than asking for more contributions. Since in most cases buildings are funded from capital campaigns and thus depreciation does not have to be budgeted to be recovered in operations, present accounting often shows an operating loss from the depreciation. Since salaries and expenses cannot be paid from the building, I think it makes sense for it to be treated as temporarily restricted with a transfer to operations to offset the depreciation which now must be included in operating expense. Thus the organization does not look like it had a lot of unrestricted funds available for spending. On the other hand equipment used in operations must generally be replaced from operating funds, so I believe that property should be divided between unrestricted and temporarily restricted, a treatment seldom seen.

A number of issues in not-for profit accounting have been discussed above in describing what a reader needs to be able to determine from the financial statements to gain understanding. There are a number of other issues that I present these below in the hope that by dealing with these FASB will promote better understanding.

1. I do not think it particularly helpful to show the present three restricted columns in the Statement of Financial Position. It would make more sense to do so if we move to the funds categories rather than the restriction categories
2. The sometimes present treatment of dividing the investment into current and non-current, with only permanently restricted in non-current is not helpful. Again it implies to donors that there are a lot of excess spendable assets.
3. I think it entirely appropriate to have in the basic statements some sub columns within the three restricted categories, but auditors usually resist this, and refuse to do it. I think the FASB should state that more columns are acceptable, and are preferable in some situations such as where there is a capital campaign in progress, the results of which need to be in the basic statements. Auditors argue that the detail is in the notes if anybody wants it. I believe most readers will not read pages of notes, and the goal should be to get as much important information as possible in the basic statements. One approach to this I have been able to get auditors to follow at times is to have the Comparative Statement of Financial Position show in Net Assets a detail of the various components of each category. Then a reader can easily see changes and may be motivated to follow up the detail in the notes. I do believe that if there are important sub categories within the three restriction categories, these should be scheduled in the notes. .
4. In the case of property which the organization states is permanently to be maintained for wildlife preservation, and auditor has maintained that it is not permanently restricted unless purchased from donor gifts for land purchase. I believe the organization's policy, not legal restrictions should govern..
5. Some organizations value purchased and donated conservation easements at \$1 instead of cost or donated value. This brings up the issue of valuing assets at lower of cost or market. Clearly there would be little market for buying a conservation easement from a conserving organization. Likewise there would be little market for a property that had deed restrictions that it could never be developed. The concept of carrying at lower of cost or market should be reconsidered for conservation properties. One organization has 170 properties. It would be a hopeless project to

try to evaluate them for market value annually, but showing the accumulated costs does tell how much the organization has invested in preserved land, a meaningful number..

6. The Statement of Cash Flows offers problems for invested funds held in a broker's account. Auditors think that purchases and sales of investments must be shown. However usually, and I think correctly, the cash shown should be what is in the bank, not what is in the broker's account, where any cash in in a money market investment. I think cash flow should show cash sent to and withdrawn from the broker's account. If auditors think that purchases and sales must be shown, it could be in the notes. Cash flow statements also often mistreat items like gifts for endowment and income earned on endowment, apparently because of confusion on what is cash.

7. Fees charges by investment managers, which I think need to be shown to evaluate performance, seldom appear. Often fee, income received, and market change are combined in one number. These are three significant items and need to be separated.

8. There needs to be better guidance of what is reported as program, fundraising, and management expenses, including consistent reporting on investment management fees, which may be in management expenses or reported net as noted above.

9. Any responsible staff person of a not-for-profit organization needs to be alert to any opportunities that may occur in contacts with actual and potential donors to promote financial support of the organization, and all spend some time there Dealing with donors is a major part of the role of most executive directors and some program directors. The allocation of salaries is a significant problem. The basis used varies from detailed daily time records maintained by staff to arbitrary beginning of year or year end judgements. I doubt it makes sense to allocate time of program people to fundraising, although they do it I doubt that detailed daily time records should be required. Some small organizations put all Executive Director time in management, put really a lot is program management which is program expense,

10. The issue of volunteer time also needs attention. The accounting principle seems to be that ordinary volunteers do not count, but that if there is a professional service by a professional that would otherwise have to be purchased it should be recorded, but that seldom is and I do not think it should be. If time for me as a CPA and a broker advisor were recorded for investment management, and an attorney who does some volunteer work at an organization I am involved with was recorded as legal expense at professional rates, management expense would be significantly increased and would look excessive.

11. Inclusion of gift annuities and charitable remainder unitrusts in Unrestricted or Permanently Restricted where they eventually years later go is misleading and may lead a reader to conclude that there is more than actual unrestricted funds available for spending or that return on endowment is low. I think it better that they be in Temporarily Restricted until the funds are received on death of the beneficiary.

12 I would reconsider the whole concept of Temporarily Restricted contributions and grants being net assets. Industry treats funds received in advance of when earned as liabilities. Thus a magazine subscription paid in advance is a deferred liability brought into income over the subscription period. Variation in funds received in advance causes total net assets to fluctuate in a misleading manner. I think the industry model should be looked at for not-for-profit accounting..

13. Prospective donors to endowments are often interested in the allocation of investments between equity, fixed income, and other categories often found today. Sometimes that is clear, but often obscure why the mutual fund category is used with no description the the funds. That information is more wanted than the three categories used to value the investments.

Well the above is enough for now, but I hope it will encourage the Journal to publish more articles on the subject and encourage the FASB to hear more views from not-for-profit boards, staffs, and donors on the subject of possible changes in presentation and accounting principles for not-for-profit financial statements.

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