



THE ART INSTITUTE OF CHICAGO

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Re: Comment Letter on FASB Exposure Draft on Not-For-Profit Entities

Dear Director and Board:

On behalf of the Art Institute of Chicago, I would like to submit the following comments and views for your consideration in regard to the exposure draft for Not-For-Profit Entities.

First of all, I appreciate the FASB's desire to clarify reporting for nonprofit organizations. In particular, the following recommendations are to be applauded:

- The reduction in net asset classes to those with and without donor restriction. I have spent years interpreting the three net asset classes for various stakeholders, but I have found temporarily restricted net assets complicated to explain and subject to incorrect interpretation.
- The new rules proposed for underwater endowments and the elimination of the need for transferring unrestricted net assets to cover deficits in underwater endowments. I think the accompanying note showing the underwater endowment deficits against historic principal amounts will allow board members and other users of the financial statements to interpret the significance of underwater endowments: their materiality, issues around investment performance, and the availability of endowment resources.
- The recommendation that expenses be classified by function and natural classification. This tends to align the financial statements more closely with institutional budgets, which are most often prepared using natural expense classifications, and it allows users of the financial statements better analysis as to expense trends.

However, I would like to make some broad comments about the growing complexity of our financial statements and my concern that they will be accessible to an increasingly limited audience. Unlike for-profit entities, our statement users are not always business people, bankers, or regulators who are experts in navigating financial statements. Our statements should be readable by a lay public, to include donors, trustees who are not business people, and staff, who should be able to interpret their financial statements so they can understand the use of institutional resources for mission and explicate the numbers for their donors and various audiences. I strongly believe that promoting financial literacy for our program staff is imperative in developing the next generation of nonprofit leaders. The more esoteric our financial statements, the more difficult this is going to be.

The proliferation of notes proposed in this exposure draft, the abstractness of the transfers in and out of operating activities (and in again in certain situations, as for plant assets...), and the divergence from for-profit statements

(in cash flows, for example) may conduce to providing more information, but not more clarity for the uninitiated. I suspect that the desire to “standardize” reporting for nonprofit organizations is a platonic ideal rather than a realizable objective. Over time, the idiosyncratic nature of nonprofits will lead to the same proliferation of quirks in financial statement reporting that exists today.

Finally, I would add my voice to my colleague institution, the Toledo Museum, in the following: “Although we understand the intent of the Board, in general we concur with the alternative views expressed by Messrs. Golden and Kroeker. We believe that the users of the financial statements would be better served if the effort in developing guidance for both not-for-profits and for-profits were coordinated to avoid unnecessary differences in reporting. Most of our board members and major donors work with for-profit entities within our community and to continue to create accounting and reporting differences will add to confusion rather than reduce it.”

**Question 1:** *Do you agree that the disclosures about the nature of donor-imposed restrictions and their effects on liquidity in notes to financial statements would help ensure that necessary information is not lost by combining the temporarily and permanently restricted classes of net assets into one donor restricted category for purposes of presentation in the statement of financial position (balance sheet)? If not, please identify the information lost and why it is necessary. (See paragraphs BC22–BC23 and BC27–BC32.)*

Yes, we agree.

**Question 2:** *Do you agree that the aggregated amount by which endowment funds are underwater should be classified within net assets with donor restrictions rather than net assets without donor restrictions? If not, why? (See paragraph BC24.)*

Yes, we agree.

**Question 3:** *Do you agree that disclosures describing the NFP’s policy on spending from underwater endowment funds, together with the aggregated original gift amount or the amount that is required to be maintained by donor or by law, would provide creditors, donors, and other users with information useful in assessing an NFP’s liquidity and potential constraints on its ability to provide services without imposing undue costs? Why or why not? (See paragraph BC32.)*

Yes, we agree.

**Question 4:** *Do you agree that providing information in notes to financial statements about financial assets and liabilities and limits on the use of those assets is an effective way to clearly communicate information useful in assessing an NFP’s liquidity and how it manages liquidity without imposing undue costs? If not, why, and what alternative(s) would you suggest? (See paragraphs BC27– BC31.)*

No. The standards being applied to nonprofits in this pronouncement are more burdensome than those applied to for-profits, and the liquidity recommendations are unduly subjective, which will lead to a proliferation of different approaches to the notes and will undoubtedly increase the cost of our audit. One of our colleagues in the auditing profession notes the following: “The only times we see disclosures on liquidity with for-profit organizations is when there are going concern issues, but nothing to the extent of what is being proposed in the Exposure Draft. For-profits do have classified balance sheets, which give some level of liquidity metrics to the reader.... The other main concern is that a proposed disclosure that is based on very subjective information could be subject to manipulation. Also, auditors have raised concerns about how that disclosure would be audited. Many people have suggested a breakout on the balance sheet might be more appropriate.”

We believe that until more guidance is prescribed for for-profit entities, this proposal should be deferred or that nonprofits should instead provide a classified balance sheet in line with current requirements for for-profit organizations.

**Question 5:** *Most business-oriented health care NFPs are required to present a classified balance sheet. Continuing care retirement communities and other NFPs may choose to sequence their assets and liabilities according to their nearness to cash as an alternative to using a classified balance sheet. As a result of the*

*proposed requirement to provide enhanced disclosures of information useful in assessing liquidity, would there no longer be a need to hold business-oriented health care NFPs to the more stringent standard for their balance sheets? If not, why?*

See response to question 4.

**Question 6:** *Do you agree that requiring intermediate measures of operations would provide users of NFP financial statements with more relevant and comparable information for purposes of (a) assessing whether the activities of a period have drawn upon, or have contributed to, past or future periods and (b) understanding the relationship of resources used in operations of a period to resource inflows available to fund those operations? Do you also agree that classifying and aggregating information in that way would not require major system changes? If not, why? (See paragraphs BC38–BC47.)*

The wide variety of nonprofit organizations and their unique natures should allow for some flexibility in the presentation of an operating measure. In regard to question 17, below, I describe the impact of certain proscriptions as to operating expense on the interpretation of a museum’s collecting and deaccessioning activities.

We also disagree with the listing of interest expense as a non-operating expense. Grant Thornton in their paper entitled “Will the FASB’s changes to the nonprofit financial model better help you tell your financial story?” notes that “The operating measure used by bond rating agencies includes interest expense as an operating cost...” In our own organization, budgets must be balanced including the cost of debt, and this will cause a divergence between our accountability to budgets and our audited financial results. I suspect that this proposed change will result in some vagaries in the “transfers” section because some of us will move interest expense into operating and out of non-operating so that there is more alignment between the operating measure results and budget reporting.

Finally, we agree with Macalaster College, which opposes including endowment and plant assets in operating: “The amount of these gifts can vary wildly from year to year, which would make the intermediate measure of operations jump up and down, when in reality, true operations may be very steady.”

Let me suggest instead that the operating measure, until further guidance is released for both the not-for-profit and for-profit sectors, be defined by the nonprofit in notes to the financial statement and an explanation provided as to what is included and not included in the operating measure.

**Question 7:** *Do you agree that intermediate measures of operations should include only those (a) resource inflows and outflows that are from or directed at carrying out an NFP’s purpose for existence and (b) resources that are available for current-period operating activities before and after the effects of internal governing board appropriations, designations, and similar actions? If not, why? (See paragraphs BC48–BC74.)*

See response to question 6.

**Question 8:** *Do you agree that all internal transfers (governing board appropriations, designations, and similar actions that make resources unavailable or available for operations of the current period) should be reflected on the statement of activities immediately after an intermediate measure of operations before transfers and immediately before an intermediate measure of operations after transfers? If not all internal transfers, on what basis would you distinguish between those transfers that should and should not be reflected and how would you make that distinction operable? Do you also agree that reflecting those internal decisions (or lack of them) on the face of the statement rather than in notes will help an NFP communicate how its operations are managed without adding undue complexities? Why or why not? (See paragraphs BC46–BC47 and BC67–BC74.)*

The proposed presentation of transfers is confusing; I would particularly cite the example provided by FASB on reporting the transfers related to a donor’s contribution toward the acquisition of PP&E.

Additionally, separating endowment spending between true and quasi-endowment (so that the spending from true endowment is shown as operating and the spending from quasi-endowment comes through transfers) will complicate comparability among different organizations; currently, the common practice is to show all investment

spending for operating on the same line. As a statement user and board member, I find the total spending in the Statement of Activities most helpful; it allows me to quickly analyze spending as a percentage of market value in investments in the Statement of Financial Position. If I want to understand the distinction between true and quasi-endowment, I can easily find this in the notes, and I find the notes for net assets most helpful.

Please see response to question 6.

**Question 9:** *Do you agree that to promote comparability, the Board should eliminate one of the two optional methods for reporting expirations of donor restrictions on gifts of cash or other assets to be used to acquire or construct long-lived assets? Do you also agree that requiring the expiration of those donor restrictions on the basis of the placed-in-service approach rather than the current option to present a release from restriction over the useful life of the acquired long-lived asset is most consistent with the underlying notions of the intermediate measures of operations? If not, why? (See paragraph BC66.)*

We agree with the Toledo Museum: “We do not agree that the elimination of the placed-in-service approach would improve comparability. There are valid reasons to use either of the 2 currently approved methods, and both methods should remain as options.”

I would add that by requiring the “placed in service” approach, many institutions will opt to create another column on their Statement of Activities to show PP&E activity separately so that depreciation expense which is no longer covered by a release of donor restriction does not distort the bottom line in the operating section of the Statement. I don’t believe that these “workaround” measures will simplify our financial statements.

**Question 10:** *Do you agree that gifts of, or for, property, plant, and equipment (long-lived assets) should be considered operating revenue and support when received (or when placed in service in the case of a gift to acquire a long-lived asset)? Do you also agree that because the long-lived asset is not immediately fully available to be utilized in the current period, an NFP should be required to present a transfer from operating activities to other activities for the amount of the gifted asset or portion of the asset funded by restricted gifts? If not, why? (See paragraphs BC72–BC74.)*

We do not agree that gifts of/for property, plant and equipment should be considered operating revenue when received. Again, we reference the letter from our colleagues at Macalaster College on the potentially distortive appearance that these gifts might have on what are essentially stable operations.

**Question 11:** *Do you agree that the addition of required intermediate measures of operations for all NFPs would make unnecessary the need for NFP business-oriented health care entities to also present their currently required performance indicator? Why or why not? (See paragraph BC99.)*

See response to question 6.

**Question 12:** *Do you think the flexibility currently allowed by GAAP to present a statement of activities as either a single statement or two articulating statements and to use either a single-column or a multicolumn format should be retained or narrowed? If narrowed, why and in what ways?*

We believe that flexibility should be retained.

**Question 13:** *Do you agree that reporting operating expenses by both their function and nature together with an analysis of all expenses (other than netted investment expenses) provides relevant and useful information in assessing how an NFP uses its resources and, thus, should be required? Why or why not? (See paragraphs BC87–BC93.)*

Yes, we agree.

**Question 14:** *Do you agree that requiring investment income to be reported net of external and direct internal investment expenses will increase comparability and avoid imposing undue costs to obtain information about all investment fees (for example, embedded fees of hedge funds, mutual funds, and funds of funds)? If not, why?*

(See paragraph BC100.)

We agree that investment income should be reported net of expenses.

**Question 15:** *Do you agree that the disclosure of the amount of all investment expenses is unnecessary but that disclosure of internal salaries and benefits that are netted against investment return is of sufficient relevance, not too costly to obtain, and thus should be required? Why or why not? (See paragraph BC101.)*

We do not agree that disclosing internal salaries and benefits are relevant to the financial statement user. Why should this be required when an organization might use an outsourced CIO and be allowed to net those costs against investment returns without similar disclosure? For a small office like ours, disclosure of this information would disclose the salaries of our staff and would be so immaterial as to serve no purpose in regard to meaningful financial analysis. The effectiveness of the management of an institutional endowment is best measured by looking at net returns as a percentage of the endowment total.

**Question 16:** *Do you agree that interest expense, whether incurred on short-term or long-term borrowing, and fees and related expenses incurred for access to lines of credit and similar cash management and treasury activities are not directed at carrying out an NFP's purposes and, thus, should not be classified as operating activities? If not, why? (See paragraphs BC59–BC60.)*

No, we do not agree. See response to question 6.

**Question 17:** *Do you agree with the following implementation guidance:*

- a. *Equity transfers between NFPs that are under common control and are eliminated in a parent entity's consolidated financial statements and equity transactions between financially interrelated entities should be presented within operating activities unless they are not available for current-period use in carrying out the purpose for the reporting entity's existence? If not, why? (See paragraph BC62(a).)*
- b. *Immediate write-offs of goodwill generally should be presented within operating activities? If not, why? (See paragraph BC62(b).)*
- c. *Immediate write-offs of acquisitions of noncapitalized items for a permanent collection should be presented within the operating activity section if acquired with net assets without donor restrictions? If not, why? (See paragraph BC62(c).)*

- a. n/a.
- b. n/a.

Regarding purchase and sale of collection items, for a museum, it may seem to make perfect sense to consider this a mission-related activity and to take the further logical step that it is therefore an operating activity. However, in actual practice, this issue is more complicated. Because of the opportunistic nature of collecting and the significant expense that attaches to it, many museums do not budget for this activity on an annual basis, but reflect collecting “below the line” in non-operating activity. The expense is wildly volatile from year to year, dependent upon resources available for purchases from donors, endowed funds, and deaccessioning. In a worst-case scenario, a collection item might be sold resulting in a huge gain in income that is not—in fact—available for operating purposes, according to the museum's deaccession policy, which aligns with the American Alliance of Museums' *Code of Ethics*, Collection Stewardship and the Association of Art Museum Directors' *Art Museums and the Practice of Deaccessioning* guidance. In a subsequent year, when those funds are expended, expenses would be wildly inflated and could result in a material operating deficit. This proposed change in accounting should not be legislated, as it has specific implications for the art museum world, and possibly for other collecting institutions as well.

**Question 18:** *Do you agree that the direct method of presenting operating cash flows is more understandable and useful than the indirect method? Do you also agree that the expected benefits of presenting operating cash flows in that way would justify the one-time and ongoing costs that may be incurred to implement that method of reporting? If not, please explain why and suggest an alternative that might increase the benefits or reduce any operational concerns or costs. (See paragraphs BC75–BC80.)*

While I personally believe that financial statements should eventually include cash flows statements calculated using the direct method as the most clear and logical approach, I think it is wrong to mandate this change for nonprofits while the for-profit world is exempted from this change. For nonprofits, this will lead to:

1. Implementation expense. To require this of nonprofits (and not of for-profits) will lead to bolted-on systems being developed, when it will be much more cost-efficient to have the larger for-profit world be the first adopters so that software systems will be adapted for this change in a cost-efficient manner that will then benefit the non-profit industry's ability to comply. In a study of the transition of public universities to the direct method in 1999 under GASB 34, it was noted that: "There is a cost of preparation on the direct method that is fairly sizable compared to the indirect method." To burden nonprofits with this additional expense ahead of the for-profit world seems to penalize those institutions least likely to be able to afford the additional cost.
2. Most users of our financial statements—because of their growing complexity—are people in the business community. They are accustomed to seeing the cash flows statement presented using the indirect method. As the response letter from CNA notes: "...we have Trustees who serve or have served on both our boards as well as the boards of for-profit entities and we think it would be confusing for Board members to see different types of cash flow statements." Until the for-profit world adopts this standard, we should be allowed the flexibility to use either method. I would recommend a postponement of this proposal until it is required for the for-profit world.

In sum, we agree with Messrs. Golden and Kroeker that: "The reporting in the statement of cash flows is currently fundamentally aligned for NFPs and business enterprises.... Messrs. Golden and Kroeker do not believe that the nature of changes in cash, or other differences of NFPs when compared with other entities for which the Board establishes standards, is sufficient to warrant a fundamentally different approach."

**Question 19:** *Does the indirect method's reconciliation of cash flows from operations to the total change in net assets provide any particular type of necessary information that would be lost if, as proposed, that method is no longer required? If so, please identify the potentially omitted information and explain why it is useful and whether it should be provided through disclosure rather than requiring use of the indirect method. If you suggest that requiring the indirect method is necessary, would you require that the amount for cash flows from operations be reconciled to the amount of the (a) change in net assets, (b) change in net assets without donor restrictions, or (c) proposed intermediate measure of operations before or after transfers? Why? (See paragraphs BC75–BC80.)*

See response to question 18. We believe that the reconciliation of cash flows to the change in net assets is an advantage in the indirect method.

**Question 20:** *Do you agree that although operating activities is defined differently for the statement of cash flows than for the statement of activities, more closely aligning line items presented in the statement of cash flows with the proposed operating classification for the statement of activities will increase understandability even though that reporting would be somewhat different from current requirements for business entities? If you believe that reporting items in the two financial statements would not be sufficiently aligned, please indicate how their alignment might be further improved. (See paragraphs BC81–BC86.)*

See response to question 18.

**Question 21:** *Are there any particular proposed amendments in this Update that would require a longer period to implement than other amendments? If so, please explain.*

We have noted in the above questions those amendments which we believe should be postponed pending an alignment of nonprofit and for-profit practices.

**Question 22:** *Are there reasons for any particular size or type of NFP to need a longer time frame to implement the proposed amendments in this Update? If so, please explain.*

See answer to question 21.

I appreciate your consideration of the comments we have provided, and would be willing to respond to any questions you might have. You can reach me at 312-499-4265, or at my email address: [asowden@artic.edu](mailto:asowden@artic.edu).

Thank you.

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