Nonprofit Finance Fund®

August 20, 2015

Nonprofit Finance Fund (NFF) is pleased to submit this response to the Proposed Accounting Standards Update on the Presentation of Financial Statements of Not-For-Profit Entities.

Over the last 35 years as a lender and trusted advisor, NFF has analyzed, compared, and generated data from the audited financial statements of thousands of not-for-profit organizations that has driven both organizational and sector-wide decisions. We have drawn on our extensive work in the sector to inform our responses to the update.

Nonprofit Finance Fund's mission is to unlock the potential of mission-driven organizations through tailored investments, strategic advice, and accessible insights. Founded in 1980, we help organizations connect money to mission effectively through established and innovative approaches to social sector finance. We are a leading community development financial institution (CDFI) with over $300 million in assets under management; we have provided $575 million in financing and access to additional capital in support of over $1.5 billion in projects for thousands of organizations nationwide. NFF's Advisory Services team partners with nonprofits at any stage of their development and provides financial advice and customized tools to help them reach their mission- and program-related goals. NFF also speaks and publishes widely with the goal of spreading knowledge about social sector finance nationally.

We sincerely agree that the presentation of financial statements for not-for-profits can be improved to provide better comparability and more decision-useful information. We applaud the Not-for-Profit Advisory Committee (NAC) on its progress to date. We are also aware that NAC's membership includes large and well-established nonprofits, but not small and mid-sized nonprofits (the smallest not-for-profit on the NAC has annual revenues that have approached $100,000,000 in recent years, which is larger than 99% of all nonprofits). It is our hope that NFF's response can help speak for the small- and mid-sized organizations who will be bound by FASB's decision, but who do not have the internal capacity to respond directly. This update provides a unique opportunity to support the not-for-profit sector. As such, we look forward to the continued progress of this committee.

Sincerely,

Antony Bugg-Levine
CEO

Comments on the Proposed Accounting Standards Update to the Presentation of Financial Statements of Not-for-Profit Entities

Net Asset Classification (Q 1, 2)

We agree that the current classification of net assets uses confusing nomenclature and are pleased that NAC has offered a new net asset classification structure. However, we are concerned that combining temporarily restricted and permanently restricted net assets into one classification on the face of the balance sheet may cause some readers of financial statements to get a false sense of the nature of the organization's donor-restricted net assets. While we believe it is the responsibility of the reader to review the notes to the financial statements, and that the new note disclosure requirements would provide information with greater detail than is currently required, removing the full details of the nature of the restrictions on the face of the statement of financial position works against transparency and could lead to inaccurate conclusions. For example, consider two organizations that both have $10 million in net assets with donor restrictions. One organization has $100k restricted by purpose and $9.9 million in a permanently-restricted endowment. The other has $9.9 million restricted by purpose and $100k in a permanently-restricted endowment. The nature of the two organizations' net worth is very different, and the reader would lose this level of detail on the face of the balance sheet with the proposed change.

This concern is exacerbated when you consider the potential limitation the new reporting structure could pose for digitized financial information. There is a push for additional transparency in our sector. Following the U.S. Federal judge ruling in January, which ordered the Internal Revenue Service to produce nine nonprofit tax forms in a machine-readable format, the IRS announced that an electronic version of the Form 990 will be ready by early 2016.[i] As the sector continues to move toward financial transparency through digitized information, we predict audited financial statements of NFPs are highly likely to be digitized in mass for automated analysis by state agencies, funders, charity evaluators, researchers, and other interested parties. It is unlikely that the notes to the financial statements, which are nuanced and highly specific to each organization, can be digitized along with the statements themselves. Thus, analysis of digitized information will fail to include essential metrics to assess NFP finances. The two example organizations described in the previous paragraph, one with $9.9 million that can never be spent and the other with $9.9 million that will be available for use in the coming years, would present the same metric in their digitized analysis: $10 million in net assets with donor restrictions.

The reforms we make to financial statements now will be with us for decades. The reporting structure should be compatible with societal trends toward big data and digitized information. We encourage the NAC to consider a classified balance sheet presentation, including the presentation of net assets with donor restrictions (i.e. with current and noncurrent distinctions). Such a presentation would, at the very least, indicate what portion of net assets with donor restriction is expected to be available for use in the next year. A classified presentation would make Not-for-Profit audited financial statements more compatible with future projects that seek to gain information by digitizing large samples from the sector.

Liquidity (Q 4)
We are heartened by the new liquidity disclosure and the flexibility it allows nonprofits. NFF's National State of the Nonprofit Sector Survey consistently shows that most nonprofits have extremely limited cash and frequently face liquidity challenges: in 2015, 35% of nonprofits reported having two months or less of cash on hand.[ii] The fact that a nonprofit's cash on hand is frequently restricted to pay for particular expenses further exacerbates the problem.

In addition to providing useful information for external users of financial statements, we believe that requiring nonprofits to disclose their methods for managing liquidity will elevate the conversation. When the IRS Form 990 was last changed, the addition of a check box to indicate whether a nonprofit had a conflict of interest policy caused the sector to consider conflict of interest policies a "best practice" or a "must have," and nonprofit boards around the country began formally adopting such policies. The requirement to disclose liquidity measures in the audited financial statements could have the same effect, and cause nonprofit leaders to work toward a better liquidity position so the notes to their financial statements will present a more favorable liquidity picture in future years.

Operating Measure, Transfers, and Nonprofit Business Models (Q 6, 7, 8, 10, 14, 15, 16)
We recommend against FASB adopting the proposed operating measure for nonprofits at this time. The proposed operating measure removes from operations those activities that are not "directed at carrying out an NFP's purpose for existence," which in practice excludes investing and financing activity from the operating measure. We believe the primary purpose of financial statements is to present the financial condition of an organization and periodic changes of that condition. They serve secondary purposes of disclosing likely evidence of malfeasance or unjust enrichment and communicating the nature of activities undertaken. They are not intended to measure the mission delivery of an organization, nor will they ever effectively do so. Adding a metric that presumes to do so both undermines the core purpose and invites misuse. Accounting standards should be limited to expressing the financial condition and change thereof. The proposed operating measure would not enhance comparability or add useful decision-making information for the vast majority of NFP financial statements. Instead, it would add undue complexity to the statement of activities and create confusion in the market place about what an NFP should consider non-operating activity.

If proposed, we would not object to an operating measure that segregates day-to-day activity from unusual and non-recurring events. In NFF's own analysis of NFPs, we begin by determining which revenues and expenses are non-operating, and segregate them from the organization's operating or business model activity. NFF considers activities that are unusual, large, and non-repeating to be non-operating. Funds raised during a capital campaign or a large, one-time bequest are examples of non-operating activity. We understand NAC considered similar criteria for the operating measure, and determined these criteria would have been too open to interpretation to be adopted. Unfortunately, the operating measure that was ultimately proposed cannot be considered a reasonable, useful, or accurate measure of most NFPs' operations.

We object to the notion that investing activities are not “directed at carrying out an NFP’s purpose for existence.” In the for-profit world, where most revenue and expenses are clearly connected to the entity’s core business, such treatment of investing activities is reasonable. We expect a for-profit to generate revenue from its main activity – the reason it is in business. In the not-for-profit world, however, an NFP’s main activity – its mission – rarely generates sufficient revenue to pay for itself. To sustain their work, NFPs usually run “subsidy businesses” that do not directly deliver on mission, but instead generate surpluses to fund mission activities. Common subsidy businesses include grant writing, individual giving programs, special events, earned-income ventures, facility rental, and investing. Investing is one type of subsidy business in a long line of subsidy businesses that NFPs may run to fund their mission. Treating income and expense from investing as non-operating activities, while treating all other subsidy businesses as operating activities, would create confusion among users of NFP financial statements about the nature and necessity of subsidy businesses. We do not believe investing should be treated as a non-operating activity.

Furthermore, direct internal investment expenses, such as the portion of staff salaries spent managing investments, should not be netted against income from investments. As explained above, investing activities represent just one type of subsidy business a nonprofit may run. We object to netting direct internal investment expenses against investment income for the same reason we would object to netting development staff salaries against individual donations: such a treatment hides the true size of an NFP’s operations. Netting investing activity, while presenting all other subsidy businesses as gross, is arbitrary and detracts from comparability. Only those organizations that engage in an investing subsidy business would show the net results of the activity, and thus, appear smaller than they are. It is true that we hope net investment income is positive and supports mission, rather than investing activity drawing resources away from mission, but this is true for all subsidy businesses run by nonprofits. We hope that the development department “pays for itself” and then some. We expect earned-income ventures to cover their costs and contribute profits to mission. For universities, foundations, or other large institutions with sizable endowments, there may be value to reporting net results from investing. Let them report such activity in the notes. For every other organization, the measure would be immaterial at best and add undue complexity and confusion to the Statement of Activities.

In addition, we do not agree that financing activities fall outside of an NFP’s purpose for existence. Because access to capital is essential to operating an NFP, it is arbitrary to segregate the expense associated with accessing capital. Access to capital, such as a bridge loan, allows an organization to continue running programs, even when grantor funds are late. Access to a line of credit allows an organization to deliver services and incur related expenses upfront while waiting for government reimbursement. Indeed, this is a pervasive issue--according to our 2015 State of the Nonprofit Sector Survey, 46% of nonprofits report that the federal government is delinquent with their payments, and 58% report that they receive state government payments late.[iii] To suggest that financing activities, like the above examples, are not “directed at carrying out an NFP’s purpose for existence” is to ignore the environment in which NFPs operate.

We encourage NAC to revisit operating measures for NFPs, and propose a measure that provides relevant information to users of the financial statements – information that will contribute to an understanding of an NFP's business model, assessment of their financial health, and does not attempt to measure activity related to carrying-out its mission. Until such a measure is identified, FASB should not implement an operating measure.

Functional and Natural Expenses (Q 13)

We are in favor of the new proposed requirement to report expenses by *nature*. This information allows outside parties to better understand how an organization deploys resources to achieve its mission. Most NFPs track expenses by nature, and many voluntarily choose to present this information as part of their audited financial statements. Thus, there likely would be minimal cost or effort to implement this requirement.

We encourage FASB to go one step further and remove the outdated and misguided requirement that NFPs report expenses by *function*. The reporting of functional expenses was once thought to indicate how efficient, committed, or even honest an organization was at using resources to achieve its mission. Charity watch dog groups used the ratio spent on programs to rank NFPs and recommend or advise against donating to them. While well intended, the consequence of such measurement has created what has been called *the nonprofit starvation cycle*: In order to appear efficient in the eyes of donors, nonprofits underspend on necessary administration and development functions, leaving them financially weakened and undercutting their mission in the long term.[iv]

Reporting expenses by function also gives a false sense of comparability. The accounting guidance to determine which function an expense belongs to is vague, which results in an opportunity for manipulation. The allocation of expenses to program, management and general, or fundraising is often influenced by the aggressiveness of management, driven by pressure from funders to show a high percentage spent on program. Thus, allocating expenses by function is inconsistently applied from organization to organization.

Opportunity for misuse aside, reasonable people disagree over what costs should be considered program, management and general, or fundraising. For example, should the teacher of an after school program be considered 100% program expense? What if he spends time filling out time cards and attending staff meetings? What if he chats with donors who visit his classroom, and tells them about the supplies his students need? There is ambiguity in how to allocate the teacher's salary between functions. Should an exhibit at the local art museum be considered 100% program expense? What if a private donor reception is held on opening night? How should the salaries of gallery docents be allocated? What if the gallery docents also process gallery sales? In this case as well, there is room for disagreement over how to allocate the exhibits expenses between functions. A measure this open to interpretation should not be part of audited financial statements. Functional expenses do not enhance comparability, nor do they provide useful information to users of NFP financial statements.

NFPs spend scarce resources attempting to honestly report their functional expenses: running time studies to determine how many hours each staff member spends on fundraising, maintaining a complicated chart of accounts so every expense can be reported by function, and turning each phone bill into a lengthy journal entry of functional allocations with back-up detail for the audit. Procedures for auditing the presentation of functional expenses are also costly and time consuming.

Even if we could rely on the accuracy of the functional expense numbers reported, the measure would be ill-conceived. The reporting of functional expenses exacerbates the myth that NFPs are somehow able to operate programs without an administrative structure to manage, measure, and execute; that, somehow, programs can continue to exist without dedicated and systematic fundraising efforts to pay for them. The attempt to segregate interwoven and complementary expenses according to the “function” they serve is an exercise in futility. All resources spent in an NFP are spent in order to successfully deliver on programs (with obvious exceptions made in cases of fraud). Whether a nonprofit is training and retaining exceptional staff in the development department or maintaining essential software and IT, the absence of such spending means that programs shrink or collapse. Certainly, not all spending in an NFP is efficient. But functional expenses tell us nothing about efficiency. Audited financial statements will not tell us the best spending opportunities available to an NFP in a given year, nor should they. It may be that the most efficient change in spending an NFP can make is to hire an HR Manager to address low morale among program staff and sort out costly payroll issues that have plagued the organization for years. We cannot pretend that the resulting increase to spending on the management and general function provides decision-useful information about the organization’s financial health or management’s spending decisions.

The end result is a measure that does not add information about the financial health or viability of the organization, further exacerbates the nonprofit starvation cycle, is easily manipulated, gives a false sense of comparability, and is costly to implement. Reporting expenses by function is actively harmful to NFPs, and should not be required in audited financial statements.

Questions for Respondents[v]

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.)**

We agree that the current classification of net assets uses confusing nomenclature and are pleased that NAC has offered a new net asset classification structure. However, we are concerned that combining temporarily restricted and permanently restricted net assets into one classification on the face of the balance sheet may cause some readers of financial statements to get a false sense of the nature of the organization's donor-restricted net assets. While we believe it is the responsibility of the reader to review the notes to the financial statements – and the new note disclosure requirements would provide information with greater detail than is currently required – removing the full details of the nature of the restrictions on the face of the statement of financial position works against transparency and could lead to inaccurate conclusions. For example, consider two organizations that both have $10 million in net assets with donor restriction. One organization has $100k restricted by purpose and $9.9 million in a permanently restricted endowment. The other has $9.9 million restricted by purpose and $100k in a permanently restricted endowment. The nature of the two organizations' net worth is very different, and the reader would lose this level of detail on the face of the balance sheet with the proposed change.

This concern is exacerbated when considering the potential limitation the new reporting structure could pose for digitized financial information. There is a push for additional transparency in our sector. Following the U.S. Federal judge ruling in January, which ordered the Internal Revenue Service to produce nine nonprofit tax forms in a machine-readable format, the IRS announced that an electronic version of the Form 990 will be ready by early 2016.[vi] As the sector continues to move toward financial transparency through digitized information, we predict audited financial statements of NFPs are highly likely to be digitized en masse for automated analysis by state agencies, funders, charity evaluators, researchers, and other interested parties. It is unlikely that the notes to the financial statements, which are nuanced and highly specific to each organization, can be digitized along with the statements themselves. Thus, analysis of digitized information will fail to include essential metrics to assess NFP finances. The two example organizations described in the previous paragraph, one with $9.9 million that can never be spent, the other with $9.9 million that will be available for use in the coming years, would present the same metric in their digitized analysis: $10 million in net assets with donor restrictions.

The reforms we make to financial statements now will be with us for decades. The reporting structure should be compatible with societal trends toward big data and digitized information. We encourage the NAC to consider a classified balance sheet presentation, including the presentation of net assets with donor restrictions (i.e. with current and noncurrent distinctions). Such a presentation would, at the very least, indicate what portion of net assets with donor restriction is expected to be available for use in the next year. A classified presentation would make Not-for-Profit audited financial statements more compatible with future projects that seek to gain information by digitizing large samples from the sector.

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.)**

   We agree that underwater endowments should be shown within net assets with donor restrictions. The current presentation, where unrestricted net assets are reduced by the underwater endowment, has caused a great deal of confusion among nonprofit leaders: Does this mean we need to "pay back the endowment" because the market is down? Is our unrestricted cash restricted now? The new presentation will resolve this confusion.

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.)**

   Yes. As the Board's basis for conclusion argues, understanding an NFP's liquidity risk is important for the external observer. Too often, liquidity is ignored not only by the external reader (creditors, donors, grantors, and other users of financial statements), but also by the NFP itself. We believe that this change could have a positive effect field-wide by making the discussion of liquidity risk a best practice. Of the four alternatives described in BC29, we agree that (d) is the most effective, particularly as it allows flexibility for NFPs to discuss the nuance of restrictions and time horizons. The other alternatives, particularly BC29 (a) and (b), do not allow for this nuance.

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.)**

   While we agree that an operating measure could add tremendous value to readers of financial statements, we recommend against FASB adopting an operating measure for nonprofits at this time. Indeed, in NFF's own analysis of NFPs, we often segregate non-operating expenses and revenue from an organization's operating activity. The NAC considered many of those items that NFF considers non-operating when determining what guidelines to set around operating measure (unusual, large, and non-repeating). While we understand the reasons for not proposing these measures (that these criteria were too vague or open to broad interpretation and judgment), the proposed operating measure does not add value to the financial statements, and in fact, the proposed presentation could add unnecessary complexities and potential confusion for donors, creditors, and other users of financial statements.

For instance, consider an organization whose core, mission-related business does not generate sufficient revenue to cover expenses. In order to continue to operate, it successfully established an endowment that generates enough income to cover one-third of its expenses. If this income is classified as non-operating, the resulting operating picture looks as if this organization is generating sizable deficits, yet it has strategically chosen to subsidize its business by creating and maintaining an endowment.

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.)**

The proposed operating measure removes from operations those activities that are not "directed at carrying out an NFP's purpose for existence," but essentially excludes only investing and financing activity from the operating measure. While FASB is proposing that investing and financing activities be classified as non-operating, there are organizations for which the proposed definition of operating (mission and availability) does not necessarily meet the NFP's operating reality. In the for profit world, we would expect a business to generate revenue from its main activity – the reason they are in business. Thus, an operating measure that segregates operating activity from investing activity is logical. In the not-for-profit sector the organization's core business – its mission – rarely generates sufficient revenue to pay for itself. In order to continue to deliver on mission, nonprofits run "subsidy businesses" that may have little, if anything, to do with achieving mission, but that generate surpluses sufficient to fund mission activities. Common subsidy businesses include grant writing, individual giving programs, galas, earned-income ventures, rental income, and investing.

In addition, we do not agree that financing activities fall outside of an NFP's purpose for existence. Access to capital is essential to operating a not-for-profit, and therefore it is arbitrary to segregate the associated expense. Examples of financing activities that are clearly directed as carrying out a not-for-profit's purpose for existence include a line of credit or bridge loan so an organization can continue running programs when a grant check is late or a government payment is delayed or paid on a reimbursement basis.

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.)

While we appreciate the flexibility that is intended in the proposal to use internal transfers on the statement of activities and additional transparency in the disclosures, the presentation of these internal transfers (to any degree of specificity) on the statement in lieu of the disclosures is not useful and is likely to produce more confusion than clarity. The transfer disclosure is useful for stakeholders to understand the governing financial practices of an NFP's boards and management.

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.)

The FASB has stated that most real estate transactions meet the "mission test" and therefore the gift to acquire property should be considered a part of operations (e.g., a gift to build a college dormitory or to construct a theater). We do not agree that gifts of, or for, the acquisition of property should be considered a part of operating revenue for the following reasons: 1) the classification may cause difficulty in assessing ongoing operating trends, and 2) the classification could be misleading to non-accounting individuals (e.g., board members of small and/or mid-sized organizations).

1. The classification may cause difficulty in assessing operating trends: Operating revenue, like operating expenses, is meant to be consumed within a given year. Instead, a gift to acquire a building or property, for example, is intended to assist in the purchase or construction of a long-term asset and is not a consumable item akin to paper or supplies. Even organizations for which a real estate acquisition is integral to the mission, such as universities or community-development corporations, may still benefit from segregating the gifts made for the acquisition of long-lived assets in order to understand the underlying health of core operations and analyze financial trends.

2. The classification may create a misleading picture: If the gift of, or for, a long-lived asset is included in operating revenue, it could greatly distort the operating picture of an organization. For example, the inclusion could create a very large surplus for the year(s) the organization is receiving the gift(s). Those who are not accustomed to reviewing NFP accounting statements could draw the incorrect conclusion that the organization is generating strong operating surpluses when, in fact, the opposite may be true.

An alternative method to classify long-lived assets would be to recognize the gift of, or for, the long-lived asset in the Non-operating Activities section of the Statement of Activities.

Because we do not believe the gift should be included in operating revenue from the outset, answering the second question is not applicable.

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?

The flexibility should be retained. Current flexibility enables NFPs to present information in the clearest format possible.

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.)

We are in favor of the new proposed requirement to report expenses by *nature*. This information allows outside parties to better understand how an organization deploys resources to achieve its mission. Most NFPs track expenses by nature, and many voluntarily choose to present this information as part of their audited financial statements. Thus, there likely would be minimal cost or effort to implement this requirement.

We encourage FASB to go one step further and remove the outdated and misguided requirement that NFPs report expenses by *function*. The reporting of functional expenses was once thought to indicate how efficient, committed, or even honest an organization was at using resources to achieve its mission. Charity watch dog groups used the ratio spent on programs to rank NFPs and recommend or advise against donating to them. While well-intended, the consequence of such measurement has created what has been called *the nonprofit starvation cycle*: In order to appear efficient in the eyes of donors, nonprofits underspend on necessary administration and development functions, leaving them financially weakened and undercutting their mission in the long term.[vii]

Reporting expenses by function also gives a false sense of comparability. The accounting guidance to determine which function an expense belongs to is vague, resulting in an opportunity for manipulation. The allocation of expenses to program, management and general, or fundraising is often influenced by the aggressiveness of management, driven by pressure from funders to show a high percentage spent on program. Thus, allocating expenses by function is inconsistently applied from organization to organization.

Opportunity for misuse aside, reasonable people disagree over what costs should be considered program, management and general, or fundraising. For example, should the teacher of an after school program be considered 100% program expense? What if he spends time filling out time cards and attending staff meetings? What if he chats with donors who visit his classroom, and tells them about the supplies his students need? There is ambiguity in how to allocate the teacher's salary between functions. Should an exhibit at the local art museum be considered 100% program expense? What if a private donor reception is held on opening night? How should the salaries of gallery docents be allocated? What if the gallery docents also process gallery sales? In this case as well, there is room for disagreement over how to allocate the exhibits expenses between functions. A measure this open to interpretation should not be part of audited financial statements. Functional expenses do not enhance comparability, nor do they provide useful information to users of NFP financial statements.

NFPs spend scarce resources attempting to honestly report their functional expenses: running time studies to determine how many hours each staff member spends on fundraising, maintaining a complicated chart of accounts so every expense can be reported by function, and turning each phone bill into a lengthy journal entry of functional allocations with back-up detail for the audit. Procedures for auditing the presentation of functional expenses are also costly and time consuming.

Even if we could rely on the accuracy of the functional expense numbers reported, the measure would be ill-conceived. The reporting of functional expenses exacerbates the myth that NFPs are somehow able to operate programs without an administrative structure to manage, measure, and execute; that, somehow, programs can continue to exist without dedicated and systematic fundraising efforts to pay for them. The attempt to segregate interwoven and complementary expenses according to the "function" they serve is an exercise in futility. All resources spent in an NFP are spent in order to successfully deliver on programs (with obvious exceptions made in cases of fraud). Whether a nonprofit is training and retaining exceptional staff in the development department or maintaining essential software and IT, the absence of such spending means that programs shrink or collapse. Certainly, not all spending in an NFP is efficient. But functional expenses tell us nothing about efficiency. Audited financial statements will not tell us the best spending opportunities available to an NFP in a given year, nor should they. It may be that the most efficient change in spending an NFP can make is to hire an HR Manager to address low morale among program staff and sort out costly payroll issues that have plagued the organization for years. We cannot pretend that the resulting increase to spending on the management and general function provides decision-useful information about the organization's financial health or management's spending decisions.

The end result is a measure that does not add information about the financial health or viability of the organization, further exacerbates the nonprofit starvation cycle, is easily manipulated, gives a false sense of comparability, and is costly to implement. Reporting expenses by function is actively harmful to NFPs and should not be required in audited financial statements.

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.)**

Direct internal investment expenses, such as the portion of staff salaries spent managing investments, should not be netted against income from investments. Investing activities represent just one type of subsidy business a nonprofit may run. We object to netting direct internal investment expenses against investment income for the same reason we would object to netting development staff salaries against individual donations: such a treatment hides the true size of an NFP's operations. Netting investing activity is arbitrary and detracts from comparability. Only those organizations that engage in an investing subsidy business would show the net results of the activity, and thus, appear smaller than they actually are. It is true that we hope net investment income is positive and supports mission, rather than investing activity drawing resources away from mission, but this is true for all subsidy businesses run by nonprofits. We hope that the development department "pays for itself" and then some. We expect earned-income ventures to cover their costs and contribute profits to mission. For universities, foundations, or other large institutions with sizable endowments, there may be value to reporting net results from investing. Let them report such activity in the notes. For every other organization, the measure will be immaterial at best and add undue complexity and confusion to the Statement of Activities.

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 agree that the disclosure of all investment expenses is unnecessary. As described in question 14, we oppose netting salaries and benefits against investment return for the same reason we would object to netting development staff salaries against individual donations: such a treatment hides the true size of an NFP's operations. Netting investing activity is arbitrary and detracts from comparability. Only those organizations that engage in an investing subsidy business would show the net results of the activity, and thus, appear smaller than they are. It is true that we hope net investment income is positive and supports mission, rather than investing activity drawing resources away from mission, but this is true for all subsidy businesses run by nonprofits. We hope that the development department "pays for itself" and then some. We expect earned-income ventures to cover their costs and contribute profits to mission. For most organizations, the measure will be immaterial at best and add undue complexity and confusion to the Statement of Activities.

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.)

We do not agree that financing activities fall outside of an NFP's purpose for existence. Because access to capital is essential to operating an NFP, it is arbitrary to segregate the expense associated with accessing capital. Access to capital, such as a bridge loan, allows an organization to continue running programs even when grantor funds are late. Access to a line of credit allows an organization to deliver services and incur related expenses upfront while waiting for government reimbursement. Indeed, this is a pervasive issue--according to our 2015 State of the Nonprofit Sector Survey, 46% of nonprofits report that the federal government is delinquent with their payments, and 58% report that they receive state government payments late.[viii] These are examples of financing activities that are clearly directed at carrying out an NFP's purpose for existence. If they are not, then by the same logic, accounting fees, legal fees, and even the electric bill are probably not directed at carrying out an NFP's purpose.

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.)

Statements of cash flow are seldom used by casual observers and are typically the domain of trained professionals. We do not believe that the statement of cash flow will become more widely used as a result of the recommended change. We would also argue that the direct method is less familiar for those who do find the statement of cash flows useful: primarily professionals who have spent their careers reading and analyzing the indirect method.

Given our opinion that the statement of cash flows will not become more widely used if the direct method is required, the one-time and ongoing costs incurred to implement the direct method of reporting are not justified.

In addition, we do not believe that the required presentation method for the statement of cash flows should be different for NFPs and for-profit entities. Given that a significant portion of the readers and preparers of NFP financial statements come from commercial backgrounds, it will be helpful for the form and standards to be congruent. Therefore, it is our recommendation that NFPs have the option to choose either method of presentation.

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[i] Perry, Suzanne. "IRS Plans to Begin Releasing Electronic Nonprofit Tax Forms Next Year," *Chronicle of Philanthropy*. June 30, 2015.
[ii] "2015 State of the Nonprofit Sector Survey," Nonprofit Finance Fund. April 2015.
The State of the Nonprofit Sector Survey has been conducted since 2009, and the 2015 survey analyzed responses from 5,451 not-for-profit organizations from all 50 states, the District of Columbia, and Puerto Rico. Respondents represent a broad range of missions and operating expenses. http://www.survey.nff.org.
[iii] Ibid.

[iv] Gregory, Ann Goggins and Don Howard. "The Nonprofit Starvation Cycle." *Stanford Social Innovation Review*. Fall 2009.
[v] Please note that NFF chose not to respond to all questions; as such, some are omitted.
[vi] Perry, Suzanne. "IRS Plans to Begin Releasing Electronic Nonprofit Tax Forms Next Year," *Chronicle of Philanthropy*. June 30, 2015.
[vii] Gregory, Ann Goggins and Don Howard. "The Nonprofit Starvation Cycle." *Stanford Social Innovation Review*. Fall 2009.
[viii] Ibid.