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ETHICS POSITION PAPER #1
THE CAPITALIZATION OF COLLECTIONS

Preface

The American Association for State and Local History (AASLH) issues periodic *Position Papers* to assist individuals and institutions in implementing specific components of the Association's *Statement of Professional Standards and Ethics* (revised 2002). Adopted by the Council on June 21, 2003, *Ethics Position Paper #1* provides practical guidelines for interpreting, adopting, and implementing the Association's position on the ethics of capitalizing an institution's collections.

Introduction

Whether or not to capitalize collections is one of the most important decisions that a museum or historical organization will make. It has the potential of playing a major role in the organization's long-term financial strategy and can make a significant impact on its relationship to governmental agencies and the public. AASLH believes that collections are not financial assets, but constitute a separate category of resource directly fulfilling institutional missions, legal responsibilities, and fiduciary obligations. Reflecting these values, the *AASLH Statement of Professional Standards and Ethics* is specific: "Collections shall not be capitalized or treated as financial assets."

Powerful forces may argue on behalf of capitalization. Decision-makers must be knowledgeable about accounting standards and legal requirements and understand the arguments both for and against capitalization. Decisions regarding capitalization must be made consciously at the highest level and in a public manner, and they must be implemented through consistent and definitive policies and procedures. Institutional leaders must be prepared to present their decision persuasively to other public and private decision-makers.

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Definitions

Collections are items or groups of items that are owned by an organization and have been formally accessioned for the exclusive purposes of research, education, interpretation, and exhibition. They may include personal property—artifacts, documents, photographs, maps, ephemera, etc.—and real property, such as historic buildings, structures, and grounds. *Collections* are different from other organizational property in that they are acquired, recorded, and managed solely to meet the institution's fiduciary purposes, in accord with its articles of incorporation, bylaws, and collection policies and procedures.

Capitalization is the act of establishing a cash value on property as an asset within the institution's financial reports. The purchase costs of capital items are not expensed, but are added to the total accrued value of the institution's assets. If donated, the value of capital items is treated as income and increases the value of the organization's assets. A collection is capitalized only if and when it is defined and treated as a financial asset by the institution's policies, practices, and financial statements. An institution may choose to identify its capitalized collections as a type of fixed asset or as a separate category of asset. Although an institution may apply depreciation to capitalized collections as a pro-rated expense, as a general rule collections *appreciate* in value, and a depreciation schedule is not applicable.

If collections are *not* capitalized, their value will not be identified within an organization's financial statements as a financial asset. Non-capitalized collections still must be identified as a separate item with an identified cash value, which may appear on the appropriate financial statement, within an auditor's note explaining the institution's significant financial policies, or both. Such identification, however, does not constitute or suggest capitalization, unless so specified by the financial policies and identified as financial assets within the financial statements themselves.

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The sole act of placing a cash value on a collection does not necessarily capitalize it. Appraising a collection for insurance purposes, for instance, establishes a value in case of damage or loss, but it does not by itself capitalize the collection. Appraisal in and of itself offers unique challenges. Some items may have *historical* value because of the stories they tell far in excess of their monetary value, while other items may fluxuate widely in value in accord with a fickle market over time. In addition, if an item literally cannot be replaced, how does an institution identify a replacement value?

An institution also may place a cash value on the collection for political or public relations purposes without capitalizing it. A state historical agency, for instance, might place a cash value on its research collection for the purpose of documenting the state's investment over time or to argue for expanded budgetary support without capitalizing that collection. Conversely, if a historical organization uses the value of a collection as collateral against a loan to improve its facilities, those collections are being treated as capitalized financial assets, regardless of any institutional policies and financial statements to the contrary.

The AASLH Position on Capitalization

First stated in the ***AASLH Statement of Professional Standards and Ethics*** in1990 and repeated without revision in 2002, the Association's position on the capitalization of collections is clear*: "Collections shall not be capitalized or treated as financial assets."* Why?

First and foremost, 501(c)(3) non-profit corporations and government agencies own, manage, interpret, and share historical resources in fiduciary trust on behalf of the citizens within the states in which they are incorporated. Even though a historical organization may be a private corporation, its collections are considered part of the public domain. Thus, when an institution owns and manages a collection, it acts as a fiduciary agent of a broader community. That is why museums and historical organizations are exempt from certain taxes—because of

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the public value of what they do, including and especially care of the *public's* collections.

By capitalization, however, an institution makes a conscious decision to treat its collections just like any of its other financial assets, no different than bank accounts, investments, office equipment, or real estate. It should not be forgotten that the primary purpose of a collection is to fulfill the fiduciary purpose of the institution. The primary purpose of a financial asset is to be managed in such a way as to achieve financial stability and health for the organization.

As financial assets, capitalized collections are in danger of being used as security, attached by lien, sold, or otherwise encumbered to meet outstanding financial debts and obligations. If the institution is a unit of government, such as a city or state museum, the governing body might be forced to sell all or portions of the collections, just like office equipment or a fleet of trucks, to meet payroll or to pay off bonded debt. This is not why the institution acquired its collections, why they have value, or why a donor received a tax deduction for contributing a collection to an institution. Capitalization of collections clearly violates the public's fiduciary interests in the collections.

Even if an institution does not capitalize its collections, it must take care not to treat those collections as if they were financial assets. During times of financial crisis, an institution might be tempted to sell collections to cover operating expenses, like utilities and salaries, or as security to obtain a line of credit. Not only is this bad financial practice that puts the institution's (and public's) collections at risk, but also it is unacceptable in meeting the institution's fiduciary obligations. Neither economic conditions nor bad financial management are excuses for treating collections as financial assets.

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Pressures to Capitalize Collections

<u>FASB & GASB.</u> The Financial Accounting Standards Board (FASB) of the Financial Accounting Foundation established the standards for the capitalization of collections by private, non-profit institutions in its Statement of Financial Accounting Standards No. 116 (FASB 116), first published in 1993, which is repeated by the Government Accounting Standards Board (GASB). FASB 116 and its GASB equivalent establish standards and procedures for reporting collections on audited financial statements, whether or not they are capitalized. But, neither FASB nor GASB standards require that museums capitalize their collections. Paragraph 11 (pp. 3-4) of the FASB Statement reads as follows.

> *An entity need not recognize contributions of works of art, historical treasures, and similar assets if the donated items are added to collections that meet all of the following conditions:*
>
> *a. Are held for public exhibition, education, or research in furtherance of public service rather than financial gain*
> *b. Are protected, kept unencumbered, cared for, and preserved*
> *c. Are subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.*

There are three key elements in this definition of collections. First, the purpose of collections is not to provide for the financial health of the institution. Second, collections are to remain unencumbered—that is, they are not to be used a security against debt. And third, proceeds from the sales of collections can be used only to enhance the collection.

Condition "c" has nourished rigorous debate within the professional community, even more than among auditors, on how tightly the acquisition requirement should be applied. Some professional associations demand that proceeds from sales of collections can only be used "to acquire other items for the collection." Other organizations, such as the American Association of Museums and the American Association for State and Local History, allow a broader interpretation. The *AASLH Statement of Professional Standards and Ethics* requires

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that "collections shall not be deaccessioned or disposed of . . . for any reason other than the preservation or acquisitions of collections." There is general agreement among all professional organizations, however, that capitalization is contrary to responsible care of the collections and that, at the minimum, any proceeds from sale of collections must be used only for activities—specifically replacement and direct care—that maintain an equivalent value *within the collections*.

Public Agencies. City, county, and state governments are increasingly pressed to identify all of their potential assets in order to obtain the best bond rating and lowest interest rates against long-term debt. It is not surprising that they look at the publicly owned collections as one of the last unidentified sources of financial value. In some cases, auditors may instruct governments to capitalize their museum collections under the guise of GASB requirements. But, once again, GASB standards do not require the capitalization of collections. The bottom line question is this: If a government is in default of its debts, is it actually willing to sell the public's heritage to fund that debt?

Governing Boards. Governing boards of private non-profit museums also are under pressure to show the strongest possible bottom line on their financial reports. The FASB definition of collections is exactly the issue that the board must address. Are the institution's collections different than its other assets? If the answer is "Yes," then the decision is obvious, and the board will act to protect its collections and will not capitalize them. If the answer is "No," then the institution should re-examine its mission, commitment to the public trust, and non-profit status.

Other: Insurance Companies, Donors, Press & Public. Insurance companies, particularly those covering directors' and officers' liability, have been known to request that collections be capitalized in order to improve the balance sheet. They should be resisted. Similarly, donors, the press, and select individuals in the public may inquire as to why the collections are not

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capitalized. In most instances, an institution can use those inquiries to make and strengthen its case that the public interest is not served by capitalization.

Consequences of Capitalizing or Not Capitalizing Collections

Consequences of Capitalization. The greatest threat of capitalization is the potential loss—even if distant—of the collection to the public domain. If an institution chooses to treat its collection as just another financial asset, then it is subject to all of the conditions applied to those assets, including encumbrance and potential loss. This violates the fiduciary relationship of the institution to the citizens of the state in which it is incorporated, its obligations to the collections' donors, and probably its articles of incorporation and very mission as an institution. And it poses a potential public relations disaster. Picture the headline: "History Museum places public's heritage at risk to pay salaries."

Consequences of Non-Capitalization. The chief financial consequence of not capitalizing collections is that hundreds of thousands and perhaps millions of dollars of potential assets will not appear on the balance sheet. Some auditors and board members may suggest that this negatively affects the public picture of the institution's financial health. Since collections cannot be used to support the daily operations of an institution, the decision to not capitalize actually represents the most accurate financial position. By consciously choosing to protect its (and the public's) collections, an institution acknowledges the public trust for which it receives substantial benefits, honors its mission, and makes a strong public statement of commitment. Picture an alternative headline: "History Museum commits to protecting public heritage at all costs."

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Guidelines for Action

Know the Requirements. It is important to know first hand what is required and what is not required regarding financial recordation of collections. Every institution should obtain a copy of GASB's *Statement of Financial Accounting Standards No. 116* or FASB's *Statement of Government Accounting Standards No. 116*, whichever is appropriate. Don't let someone else interpret the standards for you. Be prepared to make the case for non-capitalization based upon what is allowed and what is in the best interests of the public and your institution.

Obtain Legal and Accounting Counsel. *There are no legal or accounting prohibitions that prevent any institution from choosing not to capitalize its collection.* Engage auditors and attorneys with extensive non-profit experience and detailed knowledge of FASB/GASB 116 and their implications. Public institutions must hold detailed and regular discussions with the senior government auditing and legal agents to which they report.

Involve all Stakeholders Early, Publicly, and Often. An institution is acting in the public interest when it decides to protect its collections, and it is appropriate to involve the public in the discussion. Do not be afraid of making the discussion public or of involving the press in the discussion before there is a crisis. It is equally important for governmental institutions that their governing and advisory bodies, overseeing agencies, and authoritative public officials understand that collections are not assets to be traded for salary support, bond ratings, or garbage contracts. The earlier and more publicly all of the stakeholders understand the decision and why it was made, the greater is the chance that a public crisis can be avoided.

Make a Conscious Decision. The governing authority is well advised to act consciously, publicly, and officially when it adopts a policy of non-capitalization. The decision must be thoroughly and openly discussed and its implications understood. This is especially true if the institution is a governmental agency, where the public nature of the discussion often may provide the strongest defense against the pressures to capitalize. It may be valuable to revisit

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the issue on a regular basis—every three to five years—to introduce new governing board members to the issues, re-engage key external constituencies, and reaffirm the institution's values.

Implement the Decision in the Institution's Policies and Procedures. An institution's policies and procedures provide the best protection against challenges to the decision not to capitalize collections. It is particularly critical that collection policies and procedures restrict the use of funds generated by the sale of collections or the recovery of insurance payments on damaged or lost collections. The more tightly the policies restrict those proceeds to the acquisition and direct care of collections, the more easily they can be defended against challenges.

Conclusion

Because historical museums and organizations act in public trust, the public interest must be paramount in any decision involving the acquisition, care, interpretation, and use of collections. Therefore, institutional leaders must deliberate carefully before making any decision that might put the collections at risk. Since no accounting standards require that collections be capitalized, any institution that chooses the course of capitalization is making a conscious decision to treat its collections as financial assets, and that decision automatically places those collections at potential risk. AASLH believes that such risk, and therefore the act of capitalizing collections, is inconsistent with the institution's fiduciary responsibility to the collections it maintains and the citizens it serves.

For additional information or assistance, contact the AASLH Standing Committee on Standards and Ethics, 1717 Church Street, Nashville, TN 372003-2991.