



COUNCIL *on* FOUNDATIONS



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LETTER OF COMMENT NO. 19

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VIA E-mail to director@fasb.org
File Reference: Proposed FSB FAS 117-a

Dear Mr. Golden:

The Council on Foundations is a membership organization of more than 2,100 grantmakers. Our membership includes private foundations, community foundations and other public charity grantmakers, and corporate giving departments. These comments respond to proposed FASB staff position 117-a, which provides guidance to accountants on net asset classification of endowment funds in states that have enacted the Uniform Prudent Management of Institutional Funds Act (UPMIFA). For the reasons outlined below, the Council is concerned that proposed FAS 117-a would undermine UPMIFA's purpose of repealing the historic dollar value floor. Further, the Council encourages FASB to go beyond this proposed staff interpretation to reexamine the asset classifications adopted in FAS 117 to enable financial statement users to have a clearer picture of an organization's financial position.

The Council participated as an observer in the drafting of UPMIFA largely because of our concern that section 2 of the Uniform Management of Institutional Funds Act (UMIFA) was inappropriately limiting expenditures from endowed funds by authorizing institutions to appropriate for expenditure only that portion of the appreciation of an endowed fund that exceeded historic dollar value. UPMIFA replaces historic dollar value with a provision that allows institutions to adopt prudent spending rules based on the value of an endowment fund. The Council supports this change.

UPMIFA's approach to spending reflects and complements the total-return investment policy that was pioneered by UMIFA and continues in UPMIFA. UPMIFA's spending rule approach also reflects how most grantmakers determine spending from endowments. In addition, the UPMIFA approach recognizes the fact that in a world where investment is primarily for growth (appreciation), rather than for the production of current income (interest/dividends), drawing distinctions between principal and income has become a largely meaningless exercise. The precise spending rule a foundation adopts will reflect many factors, including the targeted rate of return intended to be achieved through its asset allocations, assumptions with respect to the

effect of inflation, and its investment costs.¹ Decisions also balance the factors enumerated in UPMIFA, including the goal of preserving the purchasing power of the foundation's endowment over the long term.²

An important aspect of investing for total return is the long-term performance of the assets that make up the investment portfolio, not the short-term results. Foundations understand that there will be years in which portfolio growth is greater than inflation and spending, but there will also be years in which the value of the portfolio declines. A prudent spending policy provides the discipline to avoid improvident increases in spending in the good years, while allowing institutions to continue spending in years when the value of the endowment declines in the expectation that gains in future years will allow the endowment to recoup current losses.

An example of how this works can be seen in analysis done for the Council on Foundations regarding how the federal five-percent payout for private nonoperating foundations has affected the purchasing power of foundation endowments over time.³ That study applied a 5.5 percent spending rate⁴ to the average value of a portfolio with an asset allocation that mirrored average allocations used over time by foundations. Using this methodology, a foundation established in 1950 with a gift of \$1,000 would have had an endowment with a real (inflation-adjusted) value of \$1,982 at the close of 1998. What is significant for the present discussion, however, is that the real value of that portfolio would have been below \$1,000 from 1973 through 1984, with lows of \$715 in 1974 and \$745 in 1981. Although hypothetical, this analysis illustrates the fact that an institution can prudently continue expenditures from a fund that has substantially declined in value without, over the long term, impairing the value of that fund.

The Council believes that the drafters of UPMIFA understood that yearly fluctuations in the value of an endowment do not mean that an institution is failing to preserve what used to be thought of as "principal." Rather, they understood the need to look at this issue over the long term, understanding that investment losses in one year would be offset by gains in another. With this approach to endowment, we believe the drafters intended that charitable institutions with endowments could continue expenditures even in years when the value of an endowment declined and even if that decline caused the endowment to be worth less than its historic dollar value.

¹ See, e.g., demarche Associates, Inc., *Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix* (3d ed., Council on Foundations, June 1, 1999)

² Section 4(a) of UPMIFA enumerates seven factors for boards to consider: (1) the duration and preservation of the endowment fund; (2) the purposes of the institution and the endowment fund; (3) general economic conditions; (4) the possible effect of inflation or deflation; (5) the expected total return from income and the appreciation of investments; (6) other resources of the institution; and (7) the investment policy of the institution.

³ This requirement, in effect, imposes a minimum spending rule on private foundations equal to five percent of the average value of the foundation's investment portfolio. The federal requirement is a minimum. Foundations can elect a higher rate.

⁴ The additional 50 basis points captured the average cost of managing investments. De Marche at 5-6. Investment management costs are excluded from the five percent calculation.

As previously stated, the Council is concerned that proposed FAS 117-a would defeat the purpose of repealing the historic dollar value floor by requiring institutions with endowments to select a permanent value for the endowment that must be preserved. Although the amount so selected might be different than what would have resulted from mechanical application of UMIFA's historic dollar value floor, the practical effect is much the same. FAS 117-a would effectively limit institutions' ability to continue spending from funds that decline in value relative to the amount selected. This follows from the FASB staff decision that reporting should continue to adhere to FAS 124 so that reductions in the value of a fund below the designated value would have the effect of reducing the institution's unrestricted assets.

The sharp market declines in the first part of this decade caused many funds created in the latter part of the 1990s to be worth less than when they were created. We are beginning to see signs that this is occurring again for funds created in the last few years. UPMIFA was intended to allow institutions holding these funds to continue prudent expenditures from these "underwater" funds both because market theory holds that they will regain value in time and because there is a strong social value in encouraging spending at times of greater need if a board believes such spending is prudent.

FASB staff considered four scenarios for reporting endowments that are subject to UPMIFA.⁵ The Council believes that a version of scenario three would provide complete and accurate reporting that takes into account both the ability of the board to determine a spending policy for an endowed fund as well as special situations, such as those discussed below, where the board may have other authority under special circumstances to remove restrictions. However, to achieve this end, we believe FASB needs to go beyond the proposed staff interpretation to reexamine the asset classifications adopted in FAS 117. The Council is particularly concerned that FAS 117 has had the effect of causing most accountants to community foundations to classify their endowments as unrestricted when, in fact, the endowments are subject to binding donor restrictions. This problem will only be exacerbated by the decision of the Internal Revenue Service to use FAS 117 definitions as the basis for new requirements for reporting endowments.⁶

The classification of community foundation endowments as unrestricted is based on the definition of "permanently restricted net assets" in the FAS 117 Glossary. That definition states, in part, that the term applies to assets, "whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization ..."⁷ Accountants for community foundations have concluded that because community foundations have the power, in highly limited circumstances, to alter or remove a donor restriction, all assets at community foundations are unrestricted by the

⁵ Section 4(a) of UPMIFA states, "Unless stated otherwise in the gift agreement, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution."

⁶ Internal Revenue Service, Draft Instructions for Schedule D, "the definitions of endowments and types of endowments are governed by SFAS 117, paragraphs 14 through 17," http://www.irs.gov/pub/irs-tege/990_instructions_schd_040708.pdf (April 7, 2008). The IRS is accepting comments on the draft through June 1, 2008.

⁷ Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 116: Financial Statements of Not-for-Profit Organizations, June 1993, at p. 78 (emphasis supplied).

operation of this definition.⁸ The resulting statements, at best confuse donors and boards and, at worst, may lead community foundation boards to misinterpret the amount they can lawfully expend from these funds. Although such reporting may be considered consistent with FAS 117, the result overstates the flexibility the community foundation has over the funds because it disregards restrictions placed on the funds and the standards that apply to the removal of those restrictions. As a matter of law, assets contributed to a community foundation subject to a lawful donor restriction are restricted funds and remain as such unless circumstances arise that cause the community foundation's board to invoke its variance power. Accordingly, we believe that community foundation financial statements should reflect the restricted nature of these funds. It is hard to ignore that this potential overstatement of the flexibility afforded to an organization through the variance power is similar to the overstatement that the Board sought to avoid when it rejected the view that funds subject to UPMIFA should not be classified as permanently restricted net assets. A reexamination of FAS 117 should include consideration of a fourth class of "conditionally-restricted" funds. We also think that it would be helpful if charities with endowed funds could distinguish between those that have a purpose restriction and those that are unrestricted except for the endowment restriction.

Although we understand that comment is sought only on the guidance contained in proposed FAS 117-a, and that 117-a was intended to address new issues arising from the enactment of UPMIFA, the issue of fund classification is an UPMIFA issue. UPMIFA grants all institutions holding an endowment fund a power over smaller funds that is analogous to the variance power. Section 6(d) of UPMIFA provides that an institution may unilaterally release restrictions that it finds to be, "unlawful, impracticable, impossible to achieve, or wasteful." The exercise of this power is limited to small funds (the drafters suggested \$25,000) that have been in existence for a significant period of time (the drafters suggested 20 years) and requires the charity to put the fund to a related use. Section 6(d) requires notice to the state Attorney General, but does not require that he or she consent. Will this result in the reclassification of all endowment funds that fall within a state's bracketed amounts as unrestricted assets since the institution can now unilaterally remove donor restrictions for those funds?

The Council appreciates this opportunity to comment on proposed staff position 117-a and related matters. We encourage FASB to move toward an accounting treatment of endowed funds that clearly recognizes the legal restrictions that apply to such funds. We believe this may

⁸ The variance power is among the powers granted to a community foundation by its organizing documents. In its most usual formulation, the variance power authorizes community foundations to modify donor restrictions on the distribution of funds for any specified charitable purposes or to specified charitable purposes or to specified organizations if the community foundation's governing body determines that the restriction has become, "unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served." Treas. Reg. 1.170A-9(e)(1)(v)(B)(1). As stated, this power clearly allows the modification of purpose restrictions; it is less clear that a community foundation could invoke this power to remove an endowment restriction.

require a reevaluation of the classifications adopted in FAS 117 and of the interaction between restricted and unrestricted assets in FAS 124.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Janne Gallagher", with a long, sweeping horizontal stroke extending to the right.

Janne G. Gallagher
Vice President and General Counsel