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Financial Accounting Standards Board
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LETTER OF COMMENT NO. *22*

Re: Proposed FSP FAS 117-a

Ladies and Gentlemen:

This letter is submitted on behalf of Yale University in response to the Board's request for comments on its proposed FASB Staff Position (FSP) on the net asset classification of donor-restricted endowment funds by institutions subject to an enacted version of the Uniform Prudent Management of Institutional Fund Act (UPMIFA). We appreciate the Board's effort to address issues raised in light of the adoption of UPMIFA in place of UMIFA in several states and its prospective adoption in most of the other states over the next few years. Unfortunately, the proposed guidance threatens to undermine the uniformity and consistency that the National Conference of Commissioners on Uniform States Laws (the "NCCUSL") seeks to promote in drafting uniform statutes including UPMIFA. In addition, the proposed guidance would complicate -- if not altogether frustrate -- the implementation of endowment spending policies that appropriately balance the need to provide appropriate current income to the operating budget with the need to maintain purchasing power of the underlying funds.

Paragraph 6 of the FSP states that, in the absence of explicit donor stipulations, not-for-profit organizations under UPMIFA must classify as permanently restricted such portion of endowment funds, if any, as is required to be retained permanently under the relevant law. It suggests that this normally would be accomplished by adjusting the permanently restricted net assets by an appropriate measure of the rate of inflation. The FSP further suggests that the Board's interpretation of relevant law should apply to all endowment funds and be consistent from year to year. The proposed FSP appropriately does not attempt to answer the question of what portion, if any, of an endowment fund is "required to be retained permanently under the relevant law," but it observes that laws referring to action within the purview of an organization's governing board or providing guidance as to what constitutes prudence (rather than establishing absolute ceilings on spending) do not in and of themselves extend donor-imposed restrictions and accordingly do not create temporarily or permanently restricted net assets. If the investment return on a fund falls short of the index selected to measure the purchasing power of the dollar, the organization would have to reclassify a portion of its temporarily restricted net assets, if available, or its unrestricted net assets to make up the difference. If the organization was unable to make such a reclassification, it would presumably be required to refrain from making any appropriation out of that fund unless and until investment

returns in excess of the contemporaneous rate of inflation permitted the purchasing power of the fund to be built back up beyond its initial level.

We urge the Board to consider the following issues before moving forward with the FSP.

The FSP suggests that institutions may choose the measure of inflation they deem most relevant to the purchasing power of their endowment funds, but it is clearly contemplated that each organization will apply the same measure of inflation to all of its endowment funds. A single measure of inflation may not provide useful information as to whether particular funds have maintained purchasing power with respect to their designated purposes. The purchasing power of the U.S. dollar may be largely irrelevant to funds that support activities that must take place outside of the country (e.g., funds established to support travel and research by students and faculty in foreign countries or funds established to support economic development programs in particular countries). For these funds, it may be far more relevant to know what has happened to the purchasing power of particular foreign currencies and the exchange rate between those currencies and the U.S. dollar than to know what has happened to the cost of living in the United States. Even within this country, investment returns equal to the overall rate of inflation are neither necessary nor sufficient to assure an institution's ability to sustain particular programs into the indefinite future, as the price of some good and services may rise at a rate well in excess of the overall rate of inflation while the price of other goods and services may actually fall.

The FSP is unclear as to whether its guidance is to be applied in a wholly prospective manner, or whether, instead, institutions -- or at least those institutions that have determined that they have a legal duty to preserve the purchasing power of their endowment funds -- would be required to determine whether they had met that obligation as to each such fund from the date of its establishment or from some other date (e.g., the date the relevant jurisdiction adopted the UMIFA statute). To require an institution to go back, say, 90 years to track the purchasing power of its older endowment funds since their inception or even 35 years to track purchasing power since the adoption of UMIFA would impose a significant administrative burden.¹ Moreover, grossing up permanently restricted net assets to reflect the purchasing power of gifts received 90 years ago might require a transfer from unrestricted net assets as large as, or in some cases several times the size of, the original gift.² Even assuming the institution has sufficient unrestricted net assets to make such transfer, it is likely that the institution had assumed the availability of such funds in its operating and capital plans for those prior 35 years or 90 years as

^{1/} The Yale Endowment consists of over 5,000 separate endowment funds established by gift or bequest. The oldest surviving endowed chair at Yale is the Dwight Professorship of Theology and Philosophy of Religion (f/k/a the Professorship of Didactic Theology), established in 1822 with an original gift of \$27,612 acquired through alumni subscription. As of June 30, 2000, the endowment supporting the professorship had a market value of \$290,000. Had the fund kept pace with inflation, however, the value would have amounted to approximately \$640,000 as of June 30, 2000.

^{2/} When received in 1918, the \$17 million bequest of John William Sterling (Class of 1864) was the largest gift Yale University had received up to that date. The current purchasing power of that amount is \$238 million. Fulfilling an obligation to maintain \$238 million of permanently restricted assets in that account could require a significant reduction in the University's temporarily restricted or unrestricted funds.

well as for the next few years. To suggest that there should be a retroactive adjustment would imply that perhaps an institution was unlawfully utilizing such appreciation in the past. In addition, unrestricted net assets may have figured explicitly or implicitly in the willingness of lenders to extend credit to an institution or the interest rate and other terms and conditions at which such credit was made available or in the rating assigned to the institution's general debt obligations by the rating agencies. The burdens and disruptions resulting from retrospective application suggest that in any event the FSP should be introduced with respect to existing endowment funds on a prospective basis, i.e., only measure preservation of purchasing power as against income in the first effective year of the FSP.

The FSP leaves it to each organization to determine whether it is legally obligated to preserve the purchasing power of endowment gifts and, if such obligation is determined to exist, which measure of inflation to choose and, apparently, the date from which this obligation is deemed to arise. Obviously, there is a possibility of innumerable permutations with each organization applying a different set of rules. In practice, these organizations will likely turn to their legal counsel to answer the question of whether they are required by law to retain and treat as permanently restricted an amount equal to no less than the purchasing power of each endowment gift, and legal counsel will naturally turn to the courts and attorneys general of their respective states for an answer to this question. The FASB staff has said that it envisions a process of consultation involving attorneys, accountants, board members of charitable organizations and relevant government regulators (including attorneys general) moving each state toward some sort of consensus as to whether there is in that state a legal obligation to preserve purchasing power. The result could undercut uniformity among the states, which was a goal of the Commissioners. In the process, historic dollar value – as the starting point in the calculation of purchasing power³ – could be re-consecrated in at least some states as the overriding and determinative factor in judging board members' conduct despite the Commissioners having deliberately stripped it of that role in favor of a general, multi-factor standard of prudence.⁴

We think the Uniform Law Commissioners appropriately identified the preservation of purchasing power as one of several factors to be considered in managing and investing institutional funds. In fact, Yale has consistently identified the mission of Yale's Endowment as providing a substantial, stable flow of resources to support the University's programs and activities through the operating budget, and preserving the purchasing power of those dedicated

³/ Historic Dollar Value $(1 + \sum_{t=1}^T \text{Inflation}) = \text{Purchasing Power}_T$.

⁴/ "(1) In managing and investing an institutional fund, the following factors, if relevant, must be considered: (A) general economic conditions; (B) the possible effect of inflation or deflation; (C) the expected tax consequences, if any, of investment decisions or strategies; (D) the role that each investment or course of action plays within the overall investment portfolio of the fund; (E) the expected total return from income and the appreciation of investments; (F) other resources of the institutions; (G) the needs of the institution and the fund to make distributions and to preserve capital; and (H) as asset's special relationship or special value, if any, to the charitable purposes of the institution ." Uniform Prudent Management of Institutional Funds Act (NCCUSL, 2006) §3(e)(1).

assets through time. A clear and ineluctable trade-off exists between the two aspects of this mission.⁵ To the extent that the University is uncompromisingly strict about maintaining the purchasing power of the Endowment, great volatility is introduced into the flow of resources to the operating budget. To the extent that the University is focused solely on providing a sizable and stable flow of resources to the operating budget, the purchasing power of the Endowment is at risk. The tension between these goals can be managed by following a sensible, long-term spending policy that balances present needs and future desires⁶ and by establishing an investment framework that provides a strong likelihood of consistent, high rates of return⁷.

An interpretation of UPMIFA or other laws that requires an annual sequestration of the portion of realized and unrealized gain required to protect purchasing power threatens to disrupt the approach that Yale (and similar institutions) have chosen in balancing the goals of preserving purchasing power of the endowment and providing a stable stream of resources to the operating budget. Just as there have been periods of several consecutive years over which investment returns have exceeded the target rate of spending by more than the rate of inflation, it is entirely possible that for a particular year or even over a period of several years investment returns could exceed inflation by less than the target payout rate or even fall short of the inflation rate. Some institutions may have sufficient unrestricted funds to make the transfers to permanently restricted net assets required to maintain purchasing power while continuing to fund the program that the endowment fund is intended to finance, but other institutions may not have sufficient unrestricted assets to do this and may be forced to retrench until investment performance brings endowed funds above their historic cost adjusted for changes in the value of the dollar since their

⁵ See D. Swensen, *Pioneering Portfolio Management* (New York: The Free Press, 2000), at 29.

⁶ Yale's payout rule balances the objectives of preserving purchasing power and providing substantial current support by using a long-term target payout rate of 5.25% combined with a smoothing rule that adjusts spending gradually to changes in Endowment market value. The payout under the payout rule is equal to 80% of the prior year's spending plus 20% of the long-term payout rate applied to the previous year's beginning Endowment market value, with the sum adjusted for inflation. The payout formula has been further adjusted, by the addition of a floor and a ceiling centered on the target payout rate and the implementation of a special additional dividend commencing in fiscal 2009 that is projected to bring spending to at least 5% per year. By incorporating the previous year's payout, the rule eliminates large fluctuations, enabling the University to plan for its operating budget needs: over the last 25 years, annual changes in spending have been only half as volatile as annual changes in Endowment value. By adjusting spending toward the long-term rate of 5.25% of value, the rule ensures that spending levels will be sensitive to fluctuating Endowment levels, providing stability in long-term purchasing power.

⁷ Quantitative and qualitative studies of investment markets have led Yale to adopt a well-defined investment philosophy as a solid investment framework that provides a strong likelihood of consistent, high rates of return. That investment philosophy has three related tenets: first, the goals of providing substantial resources to the operating budget and maintaining purchasing power of funds require investment in assets with high expected returns, principally equities, broadly defined; second, the need to protect the portfolio against poor returns from a single asset class requires diversification among different asset classes that are expected to respond to fundamental economic forces in varying ways; and, third, pursuit of active management opportunities by applying research-intensive, value-oriented strategies in less efficient markets will likely produce incremental returns for funds that have a sufficient scale and level of management expertise to pursue them.

inception.⁸ The Commissioners consciously rejected the notion of giving the preservation of purchasing power absolute preference over providing a steady stream of income to the operating budget in furtherance of the programs for which donors have dedicated their gifts. But that is exactly what might be forced on some institutions under certain circumstances if the attorney general or courts of a state accept FASB's invitation to find a legal requirement to maintain purchasing power. A rule focused exclusively on preservation of purchasing power and assigning no weight to the role of endowment as a buffer might prevent any spending from endowment gifts received shortly before or during a period of poor market performance and thereby disrupt the programs that donors sought to support.⁹

Mandatory reclassification of gain into the permanently restricted category might produce other conflicts for institutions classified as private (non-operating) foundations, which are required to distribute annually for charitable purposes an amount no less than 5% of their net investment assets. Noncompliant entities face a series of increasing and ultimately confiscatory excise taxes on the unspent amount. If investment returns failed to exceed inflation by 5% or more over a period of one or several years,¹⁰ then an institution that is unable or unwilling to

^{8/} Between 1968 and 1982, during a period when high inflation, poor market performance and high levels of spending eroded endowments throughout the country, Yale saw the real value of its endowment decline by more than 50 percent in spite of the infusion of substantial amounts of new gifts. With inflation (at 7.4% per annum) exceeding average annual returns on domestic stocks (5.9% per annum), bonds (7.0% per annum) and cash (6.3% per annum), investors found no place to hide during the seventies. A spending policy focused solely on endowment purchasing power preservation – spending only annual returns in excess of inflation – would have failed to release any distribution to the operating budget in twelve of twenty years between 1960 and 1979 and all but one year of the seventies, highlighting the impracticability of a single-minded focus on asset protection. Faced with the difficult choice of spending from its endowment at a rate that was clearly not sustainable for the indefinite long run or further slashing the University's academic programs, the Corporation demonstrated a preference for using the Endowment to reduce the impact of financial shocks. Now, there may be those that argue that the University's reliance during this period on its Endowment as a buffer against a hostile financial environment was excessive, although it is difficult to overstate the long-term damage that an educational institution may suffer if it begins shutting down academic programs for financial reasons or ceases to attract and retain faculty of the highest caliber during a temporary period of financial stress. However, no one has suggested that the correct course of action during that extended period was to cease endowment spending altogether until funds had accumulated sufficient gains to restore their full purchasing power. But at least with respect to some funds, that would have been the outcome resulting from a rule assigning lexicographic primacy to accumulation of assets in the permanently restricted category until purchasing power has been preserved. Again, the question is not whether preservation of purchasing power is a factor that must be given great weight in fashioning an endowment spending policy. It most certainly is. The question rather is whether it is the sole factor that should be taken into account in fashioning a prudent spending policy.

^{2/} "Endowments serve a number of important purposes for educational institutions: allowing greater independence, providing operational stability, and facilitating educational excellence." D. Swensen, *Pioneering Portfolio Management* (New York: The Free Press, 2000), at 24.

^{10/} As noted (see footnote 4), annual returns on domestic stocks, bonds and cash failed to keep pace with inflation throughout the decade of the seventies, let alone consistently exceed inflation by 5% per annum. More recently, many institutions reported back-to-back negative endowment returns for the two years following the collapse of the telecom bubble in 2000, and at least some of the endowment funds of these institutions must have had their purchasing power and perhaps even their historic dollar value impaired. Some of these institutions might have been able to borrow funds or scrape together sufficient unrestricted resources to maintain a mandated 5% spending level

divert unrestricted funds to support the operation of programs funded by its donor-restricted endowment might find itself unable to make the required 5% distribution out of at least some of its more recently established endowment funds. Might an institution then be required to pay an excise tax on the spending shortfall that eventually reaches 100%?

In summary, the Board should withdraw or modify its proposed guidance in order to (i) consider implementation issues; (ii) investigate the potential conflict between reclassification of assets to preserve purchasing power, on the one hand, and consistent application of either reasonable spending rules or federally mandated minimum spending rates in the case of private foundations and certain other entities, on the other hand; and (iii) weigh whatever benefit the Board sees in its proposals against the cost of undermining the uniformity that the NCCUSL sought to promote in drafting the UPMIFA statute.¹¹

We appreciate the Board's efforts to draft, circulate for comment and promulgate formal guidance applicable to what for institutions in at least a dozen states will be the first audited financial statements covering a year during which UPMIFA is the applicable law. However, we do not believe that retention of the current practice of booking the value of gifts and bequests received by an institution as permanently restricted assets will create confusion among those reading financial statements or encourage imprudent decisions by institutions. To be sure, as UPMIFA replaces UMIFA, preservation of historic dollar value loses its singular status as a measure of prudent conduct; but historic dollar value remains a key data point in the life story of any gift or bequest. It is the amount that comes in the door when a gift or bequest designated as endowment is received by the institution. To determine whether the institution behaves in a prudent fashion with respect to the endowment fund thereby established, one needs to look at the investment and spending decisions that the institution makes over a period of time as it seeks to balance the competing demands of preserving the purchasing power of the gift and providing income to the institution's operating budget in support of the particular uses, if any, designated by the donor who made the gift. In assessing those investment and spending decisions one needs to look not only at the results, which over an extended period – though not necessarily over any short period – reflect the quality of the decision making, but also at the principled policies, the analytic processes and the due diligence brought to bear in the course of making those decisions. (We welcome that Board's efforts in promoting the kind of disclosures that will assist not only

while making mandated transfers of unrestricted assets to the permanently restricted net asset category, but it seems highly likely that many of them will not be in a position to pull off this feat of financial legerdemain. At the very least, the FASB should determine that it will not be putting institutions in a potentially irresolvable conflict before it adopts the proposed guidance and elevates purchasing power preservation above other considerations.

¹¹/ The proposed FSP also included a set of minimum disclosures about an institution's endowment (both donor-restricted and board-designated funds) that would be required whether or not the institution is subject to UPMIFA. Yale generally endorses these disclosure requirements, although the focus on the amount of investment gain being added to permanently restricted assets on account of the organization's interpretation of relevant law -- as opposed, for example, to investment gain being added to permanently restricted assets based on some other rationale (e.g., because such action is deemed consistent with a long-term spending policy and otherwise prudent even though not mandated by law) -- is misplaced.

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the institution's trustees or overseers but also other interested constituencies in assessing the institution's management of its endowment on an informed and constructive basis.)

Measuring prudence under UPMIFA is not as simple as determining only whether in any particular year the institution either avoided impairing the historic dollar value of any endowment fund or preserved the purchasing power of every endowment fund: all the factors incorporated in section 3(e)(1) the statute are potentially relevant in forming a judgment on this matter.

We believe that booking the original amount of a gift or bequest as permanently restricted and including a footnote explaining that a portion of historic dollar value may be appropriated for expenditure in support of the designated purposes if consistent with a spending policy satisfying the requisite standard of prudence under UPMIFA and otherwise in conformance with applicable law will provide interested parties with the appropriate point of departure for determining whether the overseers of a charitable organization have discharged their fiduciary obligations with respect to endowment management in a prudent manner. We urge the Board to avoid facilitating actions that could undermine interstate uniformity and override the determination of the Commissioners in drafting the statute – and implicitly of the state legislatures in adopting it – as to the definition and determination of prudence.

Sincerely,



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