

April 18, 2008



LETTER OF COMMENT NO. 28

Mr. Russell G. Golden
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Proposed FSP FAS 117-a

Dear Mr. Golden:

I am an accounting professor at the University of Idaho and former director of finance for a large United Way operating agency. I have also been on a United Way local board and involved with making allocations to member agencies. My final qualification is that of donor to various not-for-profit organizations. I am a member of the Accounting Principles Council of the National Association of College and University Business Officers (NACUBO) and, as a consequence, have been involved in months of debate regarding the impact of UPMIFA on financial accounting and reporting by not-for-profit colleges and universities. Since I participated in the development and review of the NACUBO comment letter, my comments here will emphasize areas where my opinions and suggestions may differ.

Question 1— is the guidance for net asset classification of donor-restricted endowment funds for not-for-profit organizations subject to UPMIFA appropriate and can it be applied consistently? If not, why not?

In the discussions I've been involved with, there is a notable lack of agreement on (a) what the law intends, (b) what FASB intends, and (c) a bias toward changing nothing about current treatment (historic dollar value) for endowment accounting. Everyone wants specific guidance that the FASB has been unwilling to provide in the past and in the proposed FSP. So I have to conclude that there is NOT adequate guidance and the FSP will lead to a diversity of practices.

A serious problem relates to asking trustees to make a complex determination regarding legal requirements and how those legal requirements affect or do not affect financial reporting. Having worked with volunteer boards, I can anticipate a reaction of denial and the appointment of subcommittees to look into the issues – a process sure to consume hours, days and even months. What will really happen, in most cases, is that management and the finance staff will come up with an interpretation and get it passed by a board who won't understand many of the issues. To do otherwise will require considerable efforts to bring board members up-to-speed on both the law (UMIFA or UPMIFA) and accounting standards. And they are still going to want legal counsel! At one point, I thought I had a solution – refer to the “institution's interpretation”

or the “entity’s interpretation” rather than the “board’s interpretation” of law. Of course, this really isn’t a solution even if it might be a more accurate description of the likely process.

The underlying problem is the three classes of net assets described in accounting standards. My attitude toward the three-class structure has certainly evolved over time. It “sounded fine” at the conceptual framework stage – I doubt most of us realized the consequences and pitfalls back then. By the time I was commenting on the exposure drafts that became SFAS No. 116 and 117, my major concerns were over temporarily restricted net assets (TRNA) and the problems with matching revenues and expenses. Even then, however, I was also concerned with the usefulness of the unrestricted net assets (URNA) which included unexpendable amounts such as land, buildings and equipment as well as lack of accountability for quasi-endowments that would fall under the board-designated URNA classification. Not having worked for not-for-profit organizations with endowments, the issues related to permanently restricted net assets (PRNA) were unknown territory and our comment letter echoed views derived from the higher education experience of my co-chair on the Government and Nonprofit Section’s (American Accounting Association) committee. It was a year or two later before I became involved with research related to higher education financial reporting. At that point, I recall being surprised that the realized gains and/or investment income in excess of the spending formula were NOT being added back to PRNA. Most surprising was the fact that a growing portion of URNA was actually part of the endowment fund – something not at all clear from most financial statements.

Given current standards and the state of disclosure that exists now, I strongly support the additional disclosures described in the exposure document. However, disclosure is not a satisfactory substitute for fixing a set of standards that have never really provided useful information about net assets.

In this case, the UPMIFA act clearly states that “...assets in an endowment fund are donor-restricted assets until appropriated for expenditure...” I’ve heard the argument that accounting and legal terminology do not have to map one-to-one. However, in this case, there is no reason for a difference other than the definition and interpretation of PRNA as something that cannot be reduced by action of management (CON6, para. 92). In the UPMIFA environment, a donor that wants a gift maintained and used in perpetuity is making a permanent restriction but one not linked to a specific dollar amount. Over time, the donor would anticipate a growing investment supporting expenditures in increasing amounts in at least nominal dollars. In this situation, the net assets related to the original gift could increase or decrease in any particular year depending on “facts and circumstances” that include consideration of “long and short term needs of the institution in carrying out its ... purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.” {from Section 6 of UPMIFA}

At least half of the concerns I’ve heard regarding the exposure document might be solved if FASB clarifies the definition of PRNA so that it does not automatically preclude decreases below the amount of the original gift. As I understand it, the reason most institutions ended up classifying everything except historic dollar value as unrestricted or temporary restricted was the fear that in a “bad year” spending would have to be reduced to preserve historic dollar value.

What we need is a “mostly PRNA” definition or maybe even simpler, a “Perpetually Restricted Net Assets” classification!

Question 2 – Are the proposed disclosures about an organization’s endowment funds needed, and do they provide sufficient transparency in the new UPMIFA environment? If not, please explain which disclosures are needed or what additional disclosures are needed.

I’m generally in favor of the expanded disclosures, particularly since I think it may require a long period of time before the underlying problem with the net asset classifications can be addressed. Specific comments are noted below:

- The paragraph 12a disclosure is associated with the problems discussed at length in my answer to Question 1 above.
- Paragraph 12 b and c disclosures will often provide merely brief boilerplate platitudes regarding investment and spending policies. However, for many smaller organizations, the required disclosure may trigger useful discussion regarding the need to have such policies at all. Therefore, I think the advantages outweigh the costs.
- Paragraph 12d is generally fine but I don’t think the “cumulative amount of investment return, if any, contained in the permanently restricted net asset class...” will be useful. It is an unfortunate remnant of the old emphasis on maintaining historic dollar value. The disclosure of the current amounts added to PRNA in the table required by Paragraph 12e should be sufficient information.

If these suggestions are accepted, the example disclosures related to Paragraph 12d would not need the narrative disclosure after the table. However, the comparable narrative under the table related to Paragraph 12e should probably be retained if the classification decision remains in the hands of the board of directors.

Question 3 – Do you agree with the Board’s decision to require that organizations provide the additional disclosures even if they are not yet subject to a version of UPMIFA? If not, why not?

Yes. Most of these disclosures are long overdue. In various research projects over the years, I’ve looked at hundreds of annual reports from colleges and universities and other not-for-profit entities with endowments. Disclosures of spending and investment policies are fairly common but it is almost always impossible to tell how much of total net assets is part of what is managed as donor-restricted endowment funds. Information about quasi-endowments has become even rarer. To my mind, UPMIFA is a good opportunity (call it an excuse) to repair a serious defect in transparency.

Question 4 – Do you agree with the Board’s decision to make the provisions of the FSP effective for fiscal years ending after June 15, 2008, with early application permitted as long as the organization has not previously issued annual financial statements for that fiscal year? If not, why not?

Sophisticated organization like colleges and universities can probably provide almost all of the disclosures – smaller not-for-profit entities might have more trouble. However, a strong

argument in favor of a quick implementation is the substantially revised Form 990. For fiscal years beginning in 2008, tax-exempt organizations will be responsible for completing Form 990, Schedule D, Section V which is pretty much identical to the disclosures required in Paragraph 12e. Note that the IRS is only requiring one year of disclosures on the 2008 return but will ultimately be asking for five years. Therefore, I recommend an implementation date no later than for fiscal years beginning before December 31, 2008.

Concluding Comments

One of the most compelling concerns I've heard was voiced by a CPA with a client who wanted to know how much of the URNA was available for new program initiatives. This would not be an easy question to answer – even after the expanded disclosures required under this proposed FSP. The FASB really needs to take another look at financial reporting for not-for-profit entities. Donors and board members alike want simple answers to fairly straight-forward questions: How much did we receive during the year and from what sources? What did we spend it on? Did we operate within our means? Do we have enough left over to take care of commitments for the future?

Sometimes we forget that charities and other not-for-profits are often run by smart and well-meaning people who know next to nothing about accounting rules. I remember when my executive director wanted to spend the accumulated depreciation to replace equipment. While we accountants understand that net assets are essentially a plug figure (assets less liabilities) and can't actually be "spent" at all, lots of financial statement users look at "unrestricted net assets" and assume it is a measure of liquidity or sustainability. They think of it as "expendable." We've only had a little over a decade of putting endowment returns in excess of spending policy in URNA and TRNA. I imagine the new disclosures will reveal that the portion of endowments already being reported outside of PRNA is quite large. Think about the impact in another couple of decades. If accounting practices continue down the present path, it is possible that the PRNA will be a tiny fraction of the total amount restricted under UPMIFA. That just doesn't make sense!

The disclosures under the proposed FSP will be very helpful. However, they are not the solution. I hope to see the day when "unrestricted" is a meaningful category. In fact, I'd be happier with the GASB net asset groups that at least remove plant, property and equipment out of expendable unrestricted. In addition, I think we might need a new or revised classification of net assets that matches the nature of the perpetual restrictions that create endowment funds.

Thanks for the opportunity to comment – I didn't start out with the intention of writing four pages. However, I hope the Board and staff find my suggestions constructive and useful.

Sincerely,

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