



May 6, 2008

LETTER OF COMMENT NO. 44

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:

Please excuse the delay in sending my comment letter on the Exposure Draft, Proposed FSP FAS 117-a—*Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures* (issued 02/22/08). I have given my recommendation a lot of thought, and my decision did not come easily, particularly since I have spent most of the past 17 years supporting the Board's financial reporting framework for not-for-profit organizations.

I served as a member of the FASB staff from November 1991 to February 1997, and I have worked in various consulting capacities with the Board since that time. I worked as an assistant project manager or project manager on the following FASB pronouncements:

- FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*
- FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*
- FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*
- FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others.*

In addition, I also served as the project manager for a time on the ongoing project of mergers and acquisitions involving not-for-profit organizations and as a member of the codification team for the not-for-profit industry topic.

I ask that the Board reconsider the existing net asset classification. I believe that the Board should retain a framework with three net asset classes but rename permanently restricted net assets to "net assets restricted for perpetual support." The renamed class should be redefined as the part of an organization's net assets that result from the following:

- Contributions or other inflows 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
- Contributions or other inflows restricted by a donor to creating or adding to an endowment that must exist in perpetuity (a donor-restricted permanent endowment, not a donor-restricted term endowment)
- Asset enhancements and diminishments (such as investment income, net realized and unrealized gains, and net realized and unrealized losses) of assets held to satisfy the donor-imposed restrictions described in the previous two bullets.
- Reclassifications from (or to) other classes of net assets as a consequence of a donor-imposed stipulation of a permanent or perpetual nature.

Appendix A explains the reasons for my request. I recognize that my position differs greatly from the current FASB framework. It would require that the Board re-expose a position, and thereby slow down the completion of the project. I realize that it would also require the Board to overturn a few of its decisions in earlier projects.

I suggest that to answer the short-term needs of its constituency, the Board should issue an FSP limited to the decisions in paragraphs 6–10 of the Exposure Draft. Those paragraphs essentially clarify the use of the existing guidance found in paragraph 22 of Statement 117, paragraph 12 of Statement 124, and EITF Topic No. D-49, “Classifying Net Appreciation on Investments of a Donor-Restricted Endowment Fund.” The only disclosure I would require in that limited FSP is a disclosure of the law in the jurisdiction and the limitations it puts on the ability to spend the donor-restricted permanent endowment.

*By issuing a limited FSP to clarify the application of the current guidance in UPMIFA jurisdictions, the Board will buy the extra time it needs to re-examine the framework and to consider the necessary disclosures. I believe that is the best answer for the not-for-profit sector and the users of their financial statements, and the Board should not sacrifice the better answer for the expedient answer.*

Sincerely,

Susan Weiss Budak

## **Implementation of Statement 117 and Classification in UMIFA Jurisdictions**

As explained in paragraph 129 of Statement 117, the Board concluded in its financial statements project that a definitive interpretation of the Uniform Management of Institutional Funds Act (UMIFA) was not necessary or critical to the issue of classification of net assets. Similar to what it proposes in this Exposure Draft, the Board concluded that if the law of the relevant jurisdiction, as interpreted by an organization's governing board, places permanent restrictions on some part of the net appreciation, that amount should be reported as permanently restricted net assets in the organization's financial statements. In the absence of such a law or a donor's explicit or clear implicit permanent restriction, net appreciation should be reported as unrestricted if the endowment's income is unrestricted or temporarily restricted if the endowment's income is temporarily restricted by the donor.

In that earlier project, the Board allowed that governing boards could determine the portion of the endowment fund's appreciation that had to be maintained permanently and report that amount as an increase in permanently restricted net assets—in fact, the Board illustrated that interpretation in paragraph 161, Note E because organizations told the Board that donor-restricted permanent endowments are managed to grow in value over time. However, when implementing Statement 117, the organizations and their auditors ultimately decided that since net appreciation is expendable under their state laws, net appreciation would not be reported in permanently restricted net assets. The amount reported by organizations in UMIFA jurisdictions as permanently restricted net assets is the historic dollar value of the donor-restricted permanent endowment—the minimum amount that must be retained permanently under UMIFA.

No one (governing board or auditor) wanted to be in the situation of reporting a greater amount as permanently restricted. If circumstances changed and the governing board determined that it needed to use a portion of the net appreciation that was previously classified as permanently restricted (which would be legal for the governing board to decide), the financial statements of that future year would show that a portion of the permanently restricted net assets had been appropriated and spent. By representing in the financial statements that the law required the organization to keep an amount intact and maintained in perpetuity, and then later spending that amount (or a portion thereof), readers of the financial statements could construe that (at best) the governing board was not very intelligent in fulfilling its fiduciary responsibilities or (at worst) that the governing board had just done something illegal.

A second problem with an invasion of an endowment that the governing board had previously classified as permanently restricted net assets is that it presents the auditor with the problem of whether to believe the governing board's representation regarding the remainder of the donor-restricted endowments classified as permanently restricted. If a governing board represents that it will retain an amount permanently, and then it spends a portion of that amount, can the representation regarding the remainder be believed? We've encountered similar problems with museum collections. Management does not recognize its collections as assets in its financial statements and represents that the

collections meet the criteria in paragraph 11 of Statement 116. Those criteria include the representation that the organization will use proceeds from the sale of collection items only to purchase additional items from the collection. If a collection item is sold and the proceeds are used to expand gallery space, put in a climate-control system, or pay the electric bill, the auditor is left to deal with the question of whether the collection actually meets the requirements of Statement 116. If it does not, the organization has a GAAP exception because the collection should be capitalized.

In implementing Statement 117, corporate counsel, outside auditors, industry associations, state CPA societies, and others encouraged governing boards to report as permanently restricted net assets the minimum amount that the law required to be retained permanently. Historic dollar value became the safe harbor around which governing boards, auditors, and lawyers coalesced. Current practice seems to have interpreted only historic dollar value as permanently restricted.

### **Implementation of the Exposure Draft's Conclusions**

If the Board continues its present course and issues FSP FAS 117-1 as exposed, I believe that one of two possibilities will occur:

- Organizations will again look to the minimum amount that must be classified as permanently restricted net assets, and classify nothing in permanently restricted net assets if a donor-restricted endowment lacks explicit donor stipulations to retain a specific amount permanently. I have observed this in the implementation of Statement 117 by community foundations, because many of those foundations have standardized gift agreements that permit invasions of the original gift. [See Report on Classification of Net Assets by Community Foundations issued by the Council on Foundations in 1997.]
- Organizations will agree on a safe harbor amount to classify as permanently restricted net assets; most likely, that safe harbor will be the historic dollar value of donor-restricted permanent endowments. The amount will be neither an amount the organization intends to maintain as a perpetual endowment, nor will it be an amount the law requires to be maintained permanently.

(Some have said there is a third possibility—that organizations will classify as much of its donor-restricted permanent endowment in permanently restricted as possible, so as to appear more in need of contributions for operating purposes. I do not think that will be the case, or that classification would have resulted from implementation of paragraph 22 of Statement 117 in UMIFA jurisdictions.)

If the first of the two possibilities occurs, permanently restricted net assets will be a net asset class with little use in practice. Permanently restricted net assets would be used only for three types of net asset restrictions: permanently restricted collection items of the few museums that capitalize their collections, contributed land that must be used in perpetuity for a restricted purpose, and an endowment for which the donor explicitly stipulated a specific portion to be retained in perpetuity. There would be almost nothing classified in permanently restricted net assets. I do not believe that was the intent of the

drafters of FASB Concepts Statement No. 6, *Elements of Financial Statements* (see paragraphs 100, 120, 121), who used the term, “endowment principal,” a term undefined in that Statement but which in common usage generally includes unappropriated net appreciation and sometimes unspent income.

If the second possibility occurs, the amount in permanently restricted will be merely an arbitrary amount. It will not be useful to creditors and other users of financial statements, because, although classified as permanent, it might be expendable under law if it were prudent to do so. Further, the amount in the other two net asset classes, which would appear to be expendable, may not be so because it might not be prudent to appropriate them for expenditure. The net assets of a donor-restricted permanent endowment are composed of both permanently restricted and expendable (unrestricted and/or temporarily restricted) portions, but that there is no objective rule under UPMIFA that determines the amount of either portion. As explained in the Prefatory Note to UPMIFA, “After a fund has been in existence for a number of years, historic dollar value may become meaningless . . . historic dollar value does not provide adequate protection for the fund.”

### **A New Definition of “Permanently Restricted Net Assets”**

There is no useful presumption about the nature of the net assets of a donor-restricted permanent endowment under UPMIFA. UPMIFA makes no distinctions between the original gift, net gains or losses, or investment income (dividends, interest, rents, etc). Under that law, the net assets of a donor-restricted permanent endowment (barring explicit donor stipulation) is a homogenous resource from which governing boards can prudently draw after considering the appropriate factors, which include the duration and preservation of the fund.

The proposed standards would require a governing board to make a decision that the law does not require. A periodic decision to expend prudently is not the same as a decision to retain permanently. Because the amounts of unrestricted, temporarily restricted, and permanently restricted net assets cannot objectively be determined, and because at the present stage of development of the law any decision about a permanent portion would be at best a guess, any determination by a governing board likely results in an overstatement of at least one net asset class and an understatement of at least one other. Any reporting is dubious that allows an amount that is legally expendable at the discretion of the board to be classified as permanently restricted. Likewise, any reporting is dubious that reports as unrestricted an amount that is not expendable. Therefore, no presumption should be made.

Thus, I believe that the Board should create a framework that works with the homogeneous nature of the resources of a donor-restricted permanent endowment fund. I suggest that the new framework be very similar to the existing framework, but that permanently restricted net assets be renamed "net assets restricted for perpetual support." That revised class of net assets would include everything that permanently restricted currently contains, but also contain the unappropriated net appreciation and unappropriated net investment income of donor-restricted permanent endowment funds. (Although UMIFA is silent as to whether unappropriated investment income is part of the

endowment fund, I would include unappropriated investment income in the revised net asset class even in UMIFA states for consistency across jurisdictions.) Board-designated endowments and donor-restricted term endowments would not be reported with net assets restricted for perpetual support.

The new classification would be useful to creditors and other users of financial statements because it puts the entire donor-restricted permanent endowment in a single net asset class and does not reflect any portion as more (or less) expendable than any other part. Users of financial statements will know where to look and, via disclosures, what laws govern the endowment's use and how the organization intends to administer its use. I suggest a parenthetical disclosure on the face of the statement of financial position to let creditors know the portion of net assets restricted for perpetual support that is truly permanent (that is, explicit donor stipulations of a permanent nature—net assets related to certain collections, gifts of land, and the few endowments that do not fall under UMIFA or UPMIFA's rules of construction).

### **Release of Restrictions**

The new classification would require the Board to reverse its previous decisions in paragraph 127 of Statement 117, paragraph 70 of Statement 124, and in EITF Topic No. D-49. The Board would have to accept that an act of appropriation is the act that releases the time restriction on the net assets classified in the perpetual support class. I realize that attributing significance to an act of appropriation allows management intent to influence the classification of net assets, and that the Board has appropriately tried to classify items in financial statements based on economic characteristics rather than management intent. However, the Board's decision to classify amounts as permanently restricted based on the governing board's interpretation of the law likewise introduces *management intent into the classification of net assets*. It seems this is a case where there is no answer that can avoid that result.

Another positive result of the revised framework is that it avoids one aspect of classification of net assets of donor-restricted permanent endowment that I have always found troublesome. Net appreciation of donor-restricted permanent endowments is often classified as unrestricted, either because there are no restrictions on use of the endowment's income or because the restrictions on the use of the net appreciation are deemed fulfilled in accordance with paragraph 17 of Statement 116. (That paragraph requires that if an organization incurs an expense for which temporarily restricted net assets are available, the restriction is fulfilled to the extent of the expense incurred.)

Please consider a highly simplified example. A donor establishes an endowment fund with a gift of \$135,000 to be held in perpetuity, the earnings to support scholarships in accounting. The university invests the gift in one share of Berkshire Hathaway A stock. The stock pays no dividends, but appreciates \$15,000 during the current year. Under existing standards in a UMIFA state, the \$15,000 is reported as unrestricted net assets if the university grants \$15,000 or more in scholarships for accounting—even though the single share of stock has not been sold and the university did not remove any assets from the donor-restricted permanent endowment fund for granting the scholarship. The

university reports to the donor that the endowment fund is worth \$150,000 at year's end. I believe that \$15,000 is still part of the endowment fund and that it is different in nature than other unrestricted net assets, such as those arising from tuition or unrestricted contributions. Many lawyers share that view.<sup>1</sup>

I believe the current classification inappropriately reports the \$15,000 net assets as unrestricted; they are different from other unrestricted net assets by virtue of being a part of a donor-restricted permanent endowment fund. Because of my discomfort about combining the two, I have always encouraged organizations to make the disclosures illustrated in Note E of Appendix C of Statement 117 and to disclose the components of unrestricted net assets on the face of the statement of financial position to make clear that not all unrestricted net assets are alike.

UPMIFA considers the donor-restricted permanent endowment to be a homogenous resource from which governing boards can prudently draw after considering the appropriate factors. Therefore, the current standards for release of restrictions is even more troublesome to me. When releasing restrictions, how can it be determined when the prudently expendable portion of the endowment has been exhausted and the permanent portion will be invaded? If the class "net assets restricted for perpetual support" is created, then I suggest that the net assets of a donor-restricted permanent endowment fund are subject to a time restriction until appropriated for expenditure by the governing board. Only amounts that have been appropriated by the governing board would be available to meet restrictions. The remainder would be unavailable because the governing board has not yet used the power, granted to it by the law, to appropriate a portion of the endowment—the net assets are still subject to time restrictions. Footnote 5 of Statement 116 states, "temporarily restricted net assets with time restrictions are not available to support expenses until the time restriction has expired." For net assets restricted for perpetual support, I would modify that to "net assets restricted for the perpetual support are not available until the time restriction has expired via an appropriation by the governing board."

### **Encouragement to Address the Framework Now**

Because of my experience as a FASB staff member, I understand the commitment that would be required to change the framework. In paragraph A6 of the Exposure Draft, the Board said that a change in the framework would be best done after the completion of the

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<sup>1</sup> David Ormstedt, then assistant attorney general of the state of Connecticut, was an advisor to the Board during the financial statements project. Mr. Ormstedt told the Board that the action of the governing board is significant, and he preferred the term "restricted" to describe the net appreciation of an endowment fund in the absence of a governing board action. The staff explained the word "restricted" as used in Concept Statement No. 6 is limited to donor-imposed restrictions on assets and enhancements to those assets that are similarly restricted by law. Mr. Ormstedt understood, but said that "unrestricted" is too inexact a term to describe the net appreciation, because the governing board has a responsibility to consider the facts and circumstances of each case when utilizing net appreciation. Susan Gary, reporter for the committee of the Uniform Law Commission that drafted UPMIFA, has made similar comments regarding donor-restricted endowments under UPMIFA, and comments about the restricted nature of the endowment appear in the Comments to Section 4 of UPMIFA as well.

not-for-profit phases of the Board's conceptual framework project. I am concerned that because of the many demands on its agenda, the need for a revised framework for not-for-profit organizations will never be addressed or will be addressed far in the future. The changes I propose above would move the U.S. GAAP model closer to the standards for not-for-profit organizations in Canada as I understand them, and the AcSB currently has a not-for-profit organization project on its agenda. (That project is considering classification of net assets, but endowment accounting would be unaffected by the AcSB's current plans.) A reconsideration of the framework is as timely now as it would be in the future, and if addressed now, I would volunteer to assist the Board in its efforts.