Comments on FSP FAS 117-a Submitted by Susan N. Gary April 17, 2008



LETTER OF COMMENT NO.

I am writing to comment on the proposed FASB Staff Position on Statement 117 (FSP FAS 117-a). I am a professor at the University of Oregon School of Law, and I served as Reporter to the Drafting Committee that developed the Uniform Prudent Management of Institutional Funds Act (UPMIFA). I am writing on my own, and my comments should not be taken as the comments of the Uniform Law Commission or of the Drafting Committee of UPMIFA.

Legal Restrictions - Four Categories of Funds

Before addressing the FSP, I would like to explain how legal restrictions affect the way a charity manages its funds. From a legal standpoint, these funds may be subject to different types of donor-imposed restrictions. I will describe four categories of funds, and then refer to these four categories in these comments (these categories are my designation and do not have independent meaning). I will refer to the Board or Board of Directors as the people with the highest level of fiduciary responsibility for managing the funds. Some charities are organized as charitable trusts, and these comments are equally applicable to trustees of charitable trusts.

Note that when I use the terms "unrestricted" and "restricted" with respect to the way accountants report funds, I am referring to asset classes and not to legal restrictions.

Category 1. Funds received from donors for the general purposes of the charity, and funds received from fees (museum admissions, fees for services, etc.).

These funds are subject to general fiduciary duties of care and loyalty. The Board of Directors must manage the funds as a prudent investor (under either UPMIFA or trust law), and the Board must use the funds for the benefit of the charity and its purposes. The Board has substantial discretion over how and when the funds are spent.

Accountants report these funds as unrestricted. A lawyer would also consider these funds unrestricted.

Category 2. Funds received from donors for a specific purpose, e.g. to build a new building for the charity.

The Board is still subject to the duties of care and loyalty, and in addition the Board can use the funds only for the restricted purpose. If other needs arise, the Board cannot use these funds for those other needs. Under UPMIFA, unless the charity is to spend the fund in the current year (unlikely for a building fund), the fund is classified as an "endowment" with a time limitation (when the building is built). The fund is not a perpetual endowment.

Under UMIFA accountants report the entire amount as temporarily restricted. A lawyer would probably view the legal restriction in the same way.

Category 3. Funds received from donors to be held as an endowment for the general purposes of the charity.

These funds must be managed in a way that preserves the fund over time. The Board can distribute some amount of the fund each year, if doing so is prudent under the UPMIFA standard, but must retain enough in the fund to maintain the viability of the fund over time. Although the comments to UPMIFA talk about maintaining the "purchasing power" of the fund, the Drafting Committee chose not to include the term in the statute because the intent of the statute is not to require a charity to maintain purchasing power based on an external standard. Rather, the charity must review the factors outlined in UPMIFA and make a determination of appropriate spending, keeping in mind the donor's intent that some amount be spent and some amount be set aside so that the fund will last in perpetuity. UPMIFA directs the charity to consider the "duration and preservation of the fund" and the purposes of the fund in making any spending decisions.

Under UMIFA accountants report amounts contributed, termed historic dollar value ("hdv"), as permanently restricted and the appreciation as unrestricted. Lawyers strongly disagree with this characterization of the funds. An endowment fund cannot be spent as easily as the type of unrestricted fund described in Category 1. A board must consider the duration of the fund as an important factor. Duration of a fund is not a factor in making spending decisions for the type of fund described in Category 1.

Category 4. Funds received from donors to be held in an endowment for a specified purpose. Endowed scholarships are typically set up this way.

The charity must manage the funds as an endowment (as explained in Category 3 above) and can only use the funds for the specified purpose.

Under UMIFA accountants report hdv as permanently restricted and amounts above hdv as temporarily restricted. Lawyers probably view this fund in the same way, although a lawyer might view an amount greater than hdv as not available for spending (closer to permanently restricted, although perhaps not permanent), especially if the fund were an old fund with a significant amount of appreciation.

Comparing the Categories

From a legal standpoint, Category 1 is truly unrestricted – the Board can spend the money as needed, under the fiduciary duties of care and loyalty. The Board is always subject to fiduciary duties, but no other restrictions on purpose or time of use apply in Category 1.

Category 2 is restricted to a specific purpose, but the Board could spend the entire fund this year for that purpose.

Categories 3 and 4, both donor-restricted endowment funds, are subject to restrictions as endowments. The donor-imposed restriction is that the Board manage the fund to maintain its viability in perpetuity (or at least for a very long time). The difficulty is that unless a gift instrument spells out the amount of spending, the Board must determine spending after considering a list of factors, with a particular concern that the fund be maintained in perpetuity. Donors intend that the fund – and not just hdv – be maintained on a longterm basis. Category 4 adds a purpose restriction.

Problems with FAS 117 and FSP FAS 117a

The overall problem with FSP FAS 117-a and FAS 117 is that the available buckets — permanently restricted, temporarily restricted, and unrestricted — do not make sense in the context of a fund that is donor-restricted as an endowment, without a purpose restriction. FAS 117 did not track the law correctly, and the new draft guidance continues the existing problems and may create additional problems. The best solution is to wait on issuing any guidance and to begin a project to create new asset classes for endowments. I know that this will take time, but there are two risks of issuing guidance now. One is that the FASB may then be lulled into thinking that the problem has been addressed, and the other is that the new guidance may make the accounting problems worse.

With respect to the application of FAS 117 to UMIFA, the problem is that the fund described in Category 3 is, for legal purposes, a restricted fund. Section 4 of UMIFA provides:

The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Section 6.

Section 6 says:

In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.

¹ "Endowment" for purposes of these comments means a fund to which a donor has contributed money or assets with the intent that the gift be held as an endowment, whether or not the fund is subject to a purpose restriction. For legal purposes, this is a donor-restricted endowment. These comments do not discuss board-designated endowments.

This means that the board can spend appreciation in the amount that is prudent, applying an "ordinary business care and prudence" standard, and part of prudence with respect to an endowment is that the endowment should be maintained over a long period of time. Although the standard in Section 6 applies to all decisions, the board should not apply the standard in the same way to all decisions. The board must apply the standard "under the facts and circumstances prevailing at the time of the action or decision." The statement that appears in FAS 117, that the decision about endowment spending "is similar to the fiduciary responsibilities that exist for all charitable resources," is wrong from a legal standpoint. An endowment, even without a purpose restriction, is different from a current operating account. The two types of funds should not be spent in the same way and should not be reported in the same way.

Paragraph 124 of FAS 117 states:

Interpretations differ about the extent to which, if at all, the standard of ordinary business care and prudence precludes an institution's use of net appreciation. Some constituents believe that the Uniform Act supports the traditional view that gains on investments of endowments are not expendable unless the governing board makes an affirmative judgment that it is prudent to spend those gains. Others, including Board members, believe that the responsibility to exercise ordinary business care and prudence in determining whether to spend net appreciation is similar to the fiduciary responsibilities that exist for all charitable resources under an organization's control. That latter view is consistent with page 5 of the Prefatory Note to the Uniform Act, which says:

The Uniform Act authorizes expenditure of appreciation subject to a standard of business care and prudence. It seems unwise to fix more exact standards in a statute. To impose a greater constriction would hamper adaptation by different institutions to their particular needs.

The standard of care is that of a reasonable and prudent director of a nonprofit corporation—similar to that of a director of a business corporation—which seems more appropriate than the traditional Prudent Man Rule applicable to private trustees.

Paragraph 124 of FAS 117 misunderstands the Prefatory Note to UMIFA and misunderstands the legal effect of the standard under which a governing board operates. The Prefatory Note states that the intent of UMIFA is to provide a discretionary standard rather than a fixed definition of "income" that should be spent. The Note does not state or imply that a governing board can spend from an endowment fund without respecting the fact that the fund is restricted as an endowment fund. The second paragraph of the

Prefatory Note quoted by FAS 117 discusses the difference between a so-called "business standard" and a "trust standard" for fiduciary duties. Again, the standard is one that applies to all decisions, but the director must consider the particular circumstances that affect a decision.

A board cannot spend an endowment fund in the same way it can spend a currently operating fund (Category 1). Yet, FAS 117 seems to direct accountants to classify a significant part of a Category 3 endowment - all amounts above hdv - as unrestricted. A non-accountant reading the accounting statement may see "unrestricted" and assume that the Board can spend that amount. If the Board cannot spend the amount without deference to the restriction that the fund be held as an endowment, labeling the amounts as unrestricted is misleading. Stated another way, why should the accounting rules treat a portion of an endowment fund (the portion not permanently restricted) the same as the rules treat a fund available for current operating expenses? The way a Board can use the two funds is entirely different, and it makes sense for the accounting rules to reflect the differences.

From a charity's perspective, the differences in the way the board makes spending decisions are much greater between a Category 1 fund (current operating expenses) and a Category 3 fund (endowment), than are the differences between a Category 3 endowment and a Category 4 endowment.

Differences between UMIFA and UPMIFA in the Standard to Determine Spending

As the foregoing discussion indicates, the UMIFA prudence standard was one that intended that the Board consider the fact that a fund was operating as an endowment fund when making a spending decision. The statutory language was not entirely clear, and UPMIFA clarifies and strengthens the language. UPMIFA directs, very specifically, the Board to consider "the duration and preservation of the fund" in making spending decisions. UMIFA contained this concept, but because UMIFA permitted spending of appreciation only above hdv (although ordinary income could probably be spent even when a fund was underwater), the statute did not focus as much language on protecting the longterm viability of the fund. Without hdv, the drafters of UPMIFA wanted the statute to be clear that the donor-imposed restriction that the fund be held as an endowment must be followed by the charity.

UPMIFA also explains that "assets in an endowment fund are donor-restricted assets until appropriated for expenditure" This phrase reflects the concern that an endowment fund would be viewed as not subject to a donor restriction unless the fund included a purpose restriction. UPMIFA attempts to clarify that legally a charity cannot spend endowment funds simply by applying ordinary fiduciary concepts of care and loyalty. The donor intends that the fund be protected, and that donor intent serves to restrict the way the charity manages the fund.

Specific Comments on FSP FAS 117-a

Paragraph 6

The concept works as a concept, but I am not sure whether there is any way to make this work for accounting purposes. The difficulty is that no one-size-fits-all formula works for all charities. UPMIFA provides that each board must determine, each year, the amount to set aside for future use and the amount to spend. Of the amount set aside for future use, some part of that could be treated as permanently restricted, but figuring out a way to determine that amount that will work for all or most charities may be impossible. The risk is that an easy way out may lead to bad results. For example, a board might decide simply to continue to maintain hdv as permanently restricted. That amount might be too high or too low and would not be correct for every charity.

C.4 provides an example of a footnote that sets out an "Interpretation of Relevant Law." I am concerned that this interpretation in the example provided by the FSP will be seen as the "correct" way to interpret the law. In most circumstances it will be incorrect. The Drafting Committee considered requiring, as a legal matter, the retention of the "purchasing power" of a fund. We determined that doing so was contrary to the purposes of UPMIFA. I have been told that if a fund established in the 1970s maintained the purchasing power of its 1970s dollars, the charity would no longer be able to spend from the fund. UPMIFA clearly does not intend this result. UPMIFA intends for a charity to manage a fund in a way that continues to grow the value of the fund but that also allows for annual spending. The interpretation in the example could result in a charity's labeling the entire amount in its endowment as "permanently restricted." The legal rules -UPMIFA – would permit spending from the endowment, but a charity might be reluctant to do so if the accounting rules labeled the entire endowment as permanently restricted. Also, if the charity did spend "permanently restricted" assets, a negative amount would be indicated and it might appear to an unskilled reader that other funds were reduced by a drop in an endowment fund.

If the purchasing power example becomes part of the final FSP, then additional examples should be provided to avoid the implication that this is the best and perhaps only way to interpret the law. The problem with creating another example, and the reason the purchasing power approach is appealing, is that the way UPMIFA actually operates cannot be quantified in a way that makes accounting from year to year easy. If I were interpreting UPMIFA as the relevant law, I would explain that each year the Board will decide what amount to add to the permanently restricted Category, after first considering all the factors listed in UPMIFA.

Paragraph 8

The EITF Abstracts, Topic No. D-49 states: "Paragraph 168 of Statement 117 defines a donor-imposed restriction as "a donor stipulation that specifies a use for a contributed assets that is more specific than broad limits resulting from the nature of the organization" An endowment is a restriction that is more specific. A Board must use prudence in making all its decisions about a charity's funds, but with respect to an endowment, the Board must make decisions that take into consideration the donor's intent that the fund be

a long-term fund. UMIFA did not make this entirely clear. UPMIFA does. Now would be a good time, given the clarity provided by UPMIFA, to change the accounting rules to reflect the fact that a donor restriction that a fund be held as an endowment be treated as a specific restriction – because it is.

Paragraph 9

Paragraph 9 says that "acting to appropriate funds or exercising prudence in doing so" does not create or extend donor restrictions. That is true. An endowment fund, however, must be managed under a donor-imposed restriction. The Board cannot make spending decisions based on general concepts of prudence, but rather must comply with the donor-imposed restriction that the fund be managed as an endowment (a time restriction – see Category 3 above). Paragraph 9 suggests that a Board would simply be applying the rules of prudence it would apply to all its funds. It cannot. An endowment fund is different from a fund set up for current operating expenses, and that difference is the result of a donor-imposed restriction.

Paragraphs 11 and 12

I agree that disclosures will be useful, particularly if the accounting rules themselves do not accurately reflect the legal status of the funds (e.g., reporting as unrestricted funds that are in fact subject to a donor-imposed restriction). Subparagraphs a-d seem useful. I am unclear about the usefulness of subparagraph e. UPMIFA directs a charity to use total-return investing strategies. Why is it helpful to distinguish between investment income and appreciation, presumably classified according to a state's Principal and Income Act? I do not understand the purpose served. Indicating the amount added to permanently restricted net assets each year would be helpful.

Appendix A

A1. Based on the discussion set forth above of how legal restrictions affect funds held by charities, and assuming that accounting statements should reflect the legal situation of funds held be charities, I strongly recommend that FASB create a new asset class for endowments as soon as possible. The difficulty faced by the drafters of the FSP is that the existing classes simply do not work. The FASB is left trying to fit a square peg into a round hole.

A6. In rejecting View 1, the FSP notes that designating the entire fund as temporarily restricted "has the potential to mischaracterize a donor-restricted endowment fund as 'just another expendable fund.'" This is exactly my concern with classifying a significant portion of an endowment fund as unrestricted. To a charity manager, a creditor, or a donor, the designation of a portion of a fund as unrestricted makes that portion of the endowment look like "just another expendable fund."

A.7. The FSP retains the guidance in Statement 124. This provision has already caused problems for charities and will cause more under UPMIFA. As I understand it, if an

endowment fund goes underwater, the loss will affect other unrestricted net assets held by the charity. That is, a fund that is truly unrestricted (a fund that provides for current operating expenses), will show a loss even though that fund will never be used to make up the loss in the endowment fund. An endowment fund may find its spending limited when it goes underwater, but the charity is under no legal obligation to make up the loss in the endowment fund by transferring assets from other funds held by the charity. Thus, reflecting a loss against another fund is misleading.

If Statement 124 continues to apply, a charity will have a strong incentive to set an endowment fund's permanently restricted amount very low to avoid "losses."

Response to Specific Questions Asked

- 1. I think a determination of permanently restricted assets cannot be made on a basis that is consistent for all charities. I recommend leaving things as they are (no FSP) until a new asset class can be created. If the FASB determines that guidance must be issued, then I recommend treating all endowment funds, whether the fund includes a purpose restriction or not, as temporarily restricted. After the board authorizes spending, the amount authorized should be considered unrestricted.
- 2. The disclosures are helpful, except for 12.e which requires differentiation between investment income and appreciation. If accounting rules normally list all types of income, then this may be appropriate, but an endowment will no longer need to track ordinary income and appreciation separately.
- 3. I think the disclosures will be helpful for all charities, regardless of state law (UMIFA, UPMIFA, or something else).
- 4. I recommend delaying the effective date until at least June 15, 2009. I think waiting for a new asset class is a better course. I do not think creating a new asset class needs to take a long time, and I think the issue is sufficiently important to warrant the necessary time and resources. If the FASB goes ahead and issues guidance, I think that giving charities another year to implement the new guidance will be important.

General Comments

The law in this area is, and will continue to be, statutory law. Very few cases on UMIFA exist, and I do not of any that address spending decisions. I expect that few, if any, cases will be brought with respect to the spending rule of UPMIFA. Thus, the legal guidance is there in the statutes – UMIFA, UPMIFA, and in a few states some other statute. I have tried to explain the legal rules in these comments, because these rules should inform the accounting rules.

I think accounting rules that ignore legal restrictions create problems for charities and for others that need to use financial statements to understand the financial situation of charities. A non-CPA using an accounting statement may not understand that "restricted"

and "unrestricted" when used in connection with an asset class have a meaning to accountants that is different from the words' legal meanings and different from the words' ordinary meanings. I have heard from lawyers about charities that spend money from endowment funds reported as "unrestricted" by accountants, before talking to lawyers who could explain that the funds are in fact restricted from a legal standpoint and cannot be spent. It seems to me that an accounting statement would be more useful if the statement reflected legal restrictions imposed on a charity's use of funds.

More specifically, it does not make sense to use the same asset class (unrestricted) for funds that are not equally available for spending. It makes sense to have different asset classes for different types of funds. It does not make sense to report a current operating account in the same way as a portion of an endowment fund. This problem has existed under UMIFA and is not a problem created by the FSP.

For all these reasons I urge the FASB to undertake the development of a new asset class or new asset classes for endowment funds. Until that happens, all donor-restricted endowments should be treated the same way.

I also request that if FASB does decide to issue new guidance, and if, based on the comments received during this comment period, the guidance changes from FSP FAS 117-a, that an additional comment period be provided on the revised guidance.

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