

# American Legacy Foundation And Affiliate

Consolidated Financial Report  
June 30, 2008

**McGladrey & Pullen**  
Certified Public Accountants

## Contents

---

<b>Independent Auditor's Report On The Consolidated Financial Statements</b>	<b>1</b>
<b>Consolidated Financial Statements</b>	
Consolidated Balance Sheets	2
Consolidated Statements Of Activities	3
Consolidated Statements Of Cash Flows	4
<b>Notes To Consolidated Financial Statements</b>	<b>5 – 14</b>
<hr/>	
<b>Independent Auditor's Report On The Supplementary Information</b>	<b>15</b>
<b>Supplementary Information</b>	
Consolidated Statement Of Functional Expenses – 2008	16
Consolidated Statement Of Functional Expenses – 2007	17
1724 Massachusetts Avenue – Schedules Of Building Expenses	18
M Street Holdings, LLC – Schedules Of Building Expenses	19

---

# McGladrey & Pullen

Certified Public Accountants

## Independent Auditor's Report

To the Board of Directors  
American Legacy Foundation  
Washington, D.C.

We have audited the accompanying consolidated balance sheets of American Legacy Foundation and Affiliate (the Foundation) as of June 30, 2008 and 2007, and the related consolidated statements of activities and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American Legacy Foundation and Affiliate as of June 30, 2008 and 2007, and the changes in their net assets and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*McGladrey & Pullen, LLP*

Gaithersburg, Maryland  
October 9, 2008

American Legacy Foundation And Affiliate

Consolidated Balance Sheets

June 30, 2008 And 2007

(In Thousands)

Assets	2008	2007
Cash and Cash Equivalents	\$ 147,634	\$ 182,235
Investments	1,027,246	1,060,652
Accrued Interest Receivable	1,978	1,110
Prepaid Expenses	635	582
Asset on Interest Rate Swap Agreements	-	981
Trades to be Settled	-	984
Property and Equipment, net	2,478	3,058
2030 M Street Building, net	26,800	26,945
1724 Mass. Ave. Building	28,853	20,831
Bond Issuance Costs, net	723	-
Other Assets	1,153	236
	\$ 1,237,500	\$ 1,297,614

Liabilities And Net Assets

Liabilities		
Grants payable	\$ 550	\$ 747
Trades to be settled	439	-
Accrued expenses	26,200	8,011
Loans payable	24,637	76,684
Bonds payable	28,000	-
Sublease liability	326	505
Refundable advances	-	120
Liability on interest rate swap agreements	1,293	-
Other liabilities	282	86
	81,727	86,153

Commitments and Contingencies (Notes 6 and 8)

Net Assets – Unrestricted	1,155,773	1,211,461
	\$ 1,237,500	\$ 1,297,614

See Notes To Consolidated Financial Statements.

American Legacy Foundation And Affiliate

Consolidated Statements Of Activities  
 Years Ended June 30, 2008 And 2007  
 (In Thousands)

	2008	2007
Revenue and support:		
Settlement proceeds:		
Base	\$ 25,000	\$ 25,000
Public education	164	1,712
Smokeless tobacco	18,616	16,606
Investment income	2,383	179,592
Rental income	3,270	2,846
Other income	7,948	4,443
<b>Total revenue and support</b>	<b>57,381</b>	<b>230,199</b>
Expenses:		
Program expenses:		
Counter marketing, communications and government affairs	66,827	60,289
Grants	13,526	12,087
Other programs	12,112	12,367
Schroeder Research Institute	225	-
	<b>92,690</b>	<b>84,743</b>
General and administrative	12,774	13,475
Building expenses	7,605	3,312
<b>Total expenses</b>	<b>113,069</b>	<b>101,530</b>
<b>Change in net assets</b>	<b>(55,688)</b>	<b>128,669</b>
Net assets:		
Beginning	1,211,461	1,082,792
Ending	<b>\$ 1,155,773</b>	<b>\$ 1,211,461</b>

See Notes To Consolidated Financial Statements.

American Legacy Foundation And Affiliate

Consolidated Statements Of Cash Flows  
Years Ended June 30, 2008 And 2007  
(In Thousands)

	2008	2007
Cash Flows From Operating Activities		
Change in net assets	\$ (55,688)	\$ 128,669
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Realized and unrealized loss (gain) on investments	29,962	(150,533)
Other investment gain	(824)	(804)
Loss on disposal of property and equipment	-	13
Depreciation	2,536	2,241
Change in interest rate swap agreements asset/liability	2,274	(690)
Amortization of bond issuance costs	15	-
Changes in assets and liabilities:		
(Increase) decrease in:		
Accrued interest receivable	(868)	(293)
Trades to be settled	1,423	(11,188)
Other assets	(917)	192
Prepaid expenses	(53)	(71)
Increase (decrease) in:		
Accrued expenses	18,189	(45)
Grants payable	(197)	(1,152)
Sublease liability	(179)	(272)
Refundable advances	(120)	120
Other liabilities	196	(15)
<b>Net cash used in operating activities</b>	<b>(4,251)</b>	<b>(33,828)</b>
Cash Flows From Investing Activities		
Proceeds from sale of property and equipment	29	-
Purchase of property and equipment	(9,862)	(22,191)
Proceeds from sale of investments	5,610,965	3,173,431
Purchases of investments	(5,606,697)	(3,113,483)
<b>Net cash (used in) provided by investing activities</b>	<b>(5,565)</b>	<b>37,757</b>
Cash Flows From Financing Activities		
Principal payments on loan payable	(52,047)	(1,340)
Advances on line of credit notes, net	-	706
Bond issuance costs	(738)	-
Proceeds from bonds payable	28,000	-
<b>Net cash used in financing activities</b>	<b>(24,785)</b>	<b>(634)</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(34,601)</b>	<b>3,295</b>
Cash And Cash Equivalents		
Beginning	182,235	178,940
Ending	<b>\$ 147,634</b>	<b>\$ 182,235</b>
Supplemental Disclosures Of Cash Flow Information		
Cash paid for interest	\$ 3,294	\$ 3,895
Cash paid for income taxes	\$ 5	\$ 193

See Notes To Consolidated Financial Statements.

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 1. Nature Of Activities And Significant Accounting Policies

Nature of activities: American Legacy Foundation and Affiliate consists of two entities: American Legacy Foundation (the Foundation) and M Street Holdings, LLC (the Company).

In November 1998, a coalition of 46 state attorney generals successfully settled their civil cases with the tobacco companies. As a result, the settling states and the participating tobacco manufacturers entered into two separate settlement agreements: the Master Settlement Agreement (MSA) and the Smokeless Tobacco Master Settlement Agreement (STMSA). The two settlement agreements provided for the establishment and initial funding of a Section 501(c)(3) organization to reduce tobacco usage in the United States. Pursuant to these agreements, an organization named Master Settlement Agreement Foundation (MSA Foundation) was created in March 1999, and later renamed American Legacy Foundation. The Foundation's mission is to build a world where young people reject tobacco and anyone can quit. The purpose for which the Foundation was formed is to support (1) the study of and programs to reduce youth tobacco product usage and youth substance abuse in the United States, and (2) the study of and educational programs to prevent diseases associated with the use of tobacco products in the United States.

The Foundation is governed by a Board of Directors, which is comprised of state governors, legislators, attorney generals and experts in the medical, education and public health fields.

The functions of the Foundation shall be:

Carrying out a nationwide sustained advertising and education program to: (a) counter the use by youth of tobacco products, and (b) educate consumers about the cause and prevention of diseases associated with the use of tobacco products;

Developing and disseminating model advertising and education programs to counter the use by youth of substances that are unlawful for the use or purchase by youth, with an emphasis on reducing youth smoking; monitoring and testing the effectiveness of such model programs and, based on the information received from such monitoring and testing, continuing to develop and disseminate revised versions of such model programs, as appropriate;

Developing and disseminating model classroom education programs and curriculum ideas about smoking and substance abuse in the K-12 school system, including specific target programs for special at-risk populations, monitoring and testing the effectiveness of such model programs and ideas and, based on the information received from such model programs or ideas, continuing to develop and disseminate revised versions of such model programs, as appropriate;

Developing and disseminating criteria for the effectiveness cessation program; monitoring and testing the effectiveness of such criteria; and continuing to develop and disseminate revised versions of such criteria, as appropriate;

Commissioning studies, funding research, and publishing reports and factors that influence youth smoking and substance abuse, and developing strategies to address the conclusions of such studies and research;

Developing other innovative youth smoking and substance abuse prevention programs;

Providing targeted training and information for parents;

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 1. Nature Of Activities And Significant Accounting Policies (Continued)

The functions of the Foundation shall be (Continued):

Maintaining a library of Foundation-funded studies, reports and other publications related to the cause and prevention of youth smoking and substance abuse that will be open to the public;

Tracking and monitoring youth smoking and substance abuse, with a focus on the reason for any increases in or failures to decrease youth smoking and substance abuse, and what actions can be taken to reduce youth smoking and substance abuse; and

Receiving, controlling, and managing contributions and funds provided by other entities for further purposes described in the Foundation's certificate of incorporation.

In order to meet the general goals and specific focus areas set forth above, the Foundation is organized into four major sections: one for administration, fiscal, personnel, legal and board relations; a second section focusing on public education by means of counter-marketing tobacco use, public relations and government affairs; a third section focusing on grant-giving for research-commissioned studies, program initiatives related to the Foundation's goals, and the rigorous evaluation of the Foundation's programs; and a fourth section focusing on advancement of research and policy in the field of tobacco control and cessation.

In December 2002, the Foundation purchased the property at 2030 M Street, NW, Washington, D.C., through M Street Holdings, LLC, a single-member LLC, 100% owned by the Foundation. Space in the building was occupied by the Foundation and is leased to other tenants. The Foundation vacated the building during the year ended June 30, 2008 once the new headquarters building was completed. The M Street building is now used as rental property. The Foundation's control, combined with its economic interest, supports consolidation of the Company.

A summary of the Foundation's significant accounting policies follows:

Principles of consolidation: The consolidated financial statements include the accounts of the Foundation and the Company. All material intercompany transactions have been eliminated.

Basis of accounting: The accompanying consolidated financial statements are presented in accordance with the accrual basis of accounting, whereby, revenue is recognized when earned and expenses are recognized when incurred.

Basis of presentation: The consolidated financial statement presentation follows the recommendations of the Financial Accounting Standards Board (FASB) in its Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*. Under SFAS No. 117, the Foundation is required to report information regarding its financial position and activities according to three classes of net assets: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. The Foundation had no temporarily or permanently restricted net assets at June 30, 2008 and 2007.

Cash and cash equivalents: For purposes of the consolidated statements of cash flows, the Foundation considers all short-term, highly liquid debt instruments to be cash equivalents, including commercial paper, money market funds, and certificates of deposit, purchased with an original maturity of three months or less.

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 1. Nature Of Activities And Significant Accounting Policies (Continued)

Financial risk: The Foundation maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Foundation has not experienced any losses in such accounts. The Foundation believes it is not exposed to any significant financial risk on cash.

The Foundation invests in various equity, debt, and alternative investments. Such investments are exposed to various risks such as market and credit. Due to the level of risk associated with such investments and the level of uncertainty related to changes in the value of such investments, it is at least reasonably possible that changes in risks in the near term could materially affect investment balances and the amounts reported in the consolidated financial statements.

Investments: Equity securities with readily determinable fair values and all investments in debt securities are reported at fair value. Realized and unrealized gains and losses are recorded as a component of investment income in the consolidated statements of activities. The fair value of investments is estimated using quoted market prices, except for alternative investments for which quoted market prices are not available. The estimated fair value of certain alternative investments, such as venture/private equity funds, hedge funds, commodity funds, and partnerships is based upon valuations provided by external investment managers as of June 30, 2008 and 2007. At June 30, 2008 and 2007, alternative investments and partnerships comprised approximately 20% and 17% of total investments, respectively. The Foundation believes the carrying amount of these financial instruments is a reasonable estimate of fair value.

Inventory: Inventory consists of bracelets, pins, necklaces and key chains and is stated at the lower of cost or market. Management determines the allowance for obsolete inventory by identifying nonmarketable items and by using historical experience applied to recent sales. There was no allowance for obsolescence, based on management's evaluation of the salability of inventory, at June 30, 2008 and 2007.

Property and equipment: The Foundation capitalizes all property and equipment purchased with a cost of \$5,000 or more. Property and equipment is recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets, which range from three to 39½ years. Leasehold improvements are amortized using the straight-line method over the lesser of the estimated useful lives of the assets or the related lease terms.

Fair value of financial instruments: The carrying amounts including cash and cash equivalents, receivables, accounts payable and accrued liabilities, and current maturities of long-term borrowings, approximate fair value because of the short maturity of these instruments. The carrying amount of long-term debt approximates fair value because the interest rates on these instruments fluctuate with market interest rates offered to the Foundation for debt with similar terms and maturities.

Valuation of long-lived assets: The Foundation accounts for the valuation of long-lived assets under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the long-lived asset is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Assets to be disposed of are reportable at the lower of the carrying amount or fair value, less costs to sell.

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 1. Nature Of Activities And Significant Accounting Policies (Continued)

Interest rate swap agreements: The fair value of interest rate swap agreements are the estimated amount that the financial institutions would receive or pay to terminate the swap agreements at the reporting date, taking into account current interest rates and the current credit worthiness of the swap counter parties.

Revenue and support: The Foundation receives revenue that is derived from the two settlement agreements: the MSA and the STMSA. Certain payments received pursuant to the settlement agreements can be utilized at the Foundation's discretion. Other payments are intended to assist the Foundation in carrying out a nationwide sustained advertising and education program.

These agreements contain various provisions and conditions that ultimately will determine the amount and timing of payments to be received. Consequently, revenue is recognized at the time payments either are received or can be reasonably estimated and are receivable.

Allocation of expenses: Expenses are either directly charged to program services as incurred, or proportionately allocated to functional categories, based on various allocation methods.

Income taxes: The Foundation is generally exempt from federal income tax under Internal Revenue Code (IRC) Section 501(c)(3). In addition, the Foundation has been classified as an organization that is not a private foundation. Income, which is not related to its exempt purposes, less applicable deductions, is subject to federal and state corporate income taxes. The Company is a single-member LLC and, as such, is a "disregarded entity" for federal income tax purposes, pursuant to Section 7701 of the IRC. At June 30, 2008 and 2007, the Foundation had unrelated business income related to debt financed rental income.

The Foundation adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, during the year ended June 30, 2008. For the period from the Foundation's inception to June 30, 2008, no unrecognized tax provision or benefit existed.

Deferred income taxes are provided using the liability method, whereby, deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of the changes in tax laws and rates of the date of enactment.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above would be reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Management believes there were no positions that would result in additional tax liability.

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 1. Nature Of Activities And Significant Accounting Policies (Continued)

Estimates: The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Recent and upcoming accounting pronouncements: In September 2006, FASB issued SFAS No. 157, *Fair Value Measurements*. This standard defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurement. SFAS No. 157 also emphasizes that fair value is a market based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under SFAS No. 157, fair value measurements are disclosed by level within that hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, except for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis for which delayed application is permitted until fiscal years beginning after November 15, 2008. The Foundation has not yet completed its analysis on the effects of these interpretations and has not determined if the adoption of SFAS No. 157 will have a material impact on its financial statements.

#### Note 2. Investments

Investments at June 30, 2008 and 2007, consist of the following:

	2008	2007
U.S. equity securities	\$ 338,451	\$ 393,653
Global Ex U.S. equity securities	228,385	257,395
Fixed income	174,217	133,494
Absolute/hedge funds	132,463	114,169
Emerging markets	81,381	96,917
Inflation hedging	56,146	61,324
Venture/private equity	16,203	3,700
	<u>\$ 1,027,246</u>	<u>\$ 1,060,652</u>

Investment income at June 30, 2008 and 2007, consists of the following:

	2008	2007
Interest, dividends, and accretion income	\$ 31,521	\$ 28,255
Realized and unrealized (loss) gain on investments	(29,962)	150,533
Other investment gain	824	804
<b>Total investment return</b>	<u>\$ 2,383</u>	<u>\$ 179,592</u>

Custodial and investment advisory fees of \$4,492 and \$4,196 at June 30, 2008 and 2007, respectively, are reflected in general and administrative expenses in the consolidated statements of activities.

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

#### Note 2. Investments (Continued)

Subsequent to year-end, the credit and liquidity crisis in the United States and throughout the global financial system has resulted in substantial volatility in financial markets and the banking system. These and other economic events have had a significant adverse impact on investment portfolios. As a result, the Foundation's investments have likely incurred a significant decline in fair value since June 30, 2008. In addition, certain nonreadily marketable investments are significantly less liquid than they have been historically and in some cases the counter parties have imposed redemption restrictions.

#### Note 3. Property And Equipment

Property and equipment and accumulated depreciation at June 30, 2008 and 2007, consist of the following:

	Estimated Useful Lives	2008			
		Cost	Accumulated Depreciation	Net	Depreciation Expense
Furniture and fixtures	7 years	\$ 1,776	\$ 979	\$ 797	\$ 154
Computers and software	3 years	2,330	1,842	488	657
Office equipment	5 years	1,205	610	595	199
Improvements	8 – 10 years	568	471	97	59
Intangible assets	3 years	1,500	999	501	503
Vehicles	5 years	1,132	1,132	-	-
		<u>8,511</u>	<u>6,033</u>	<u>2,478</u>	<u>1,572</u>
1724 Mass Ave.	39½ years	29,130	277	28,853	277
2030 M Street	39½ years	30,343	3,543	26,800	687
		<u>\$ 67,984</u>	<u>\$ 9,853</u>	<u>\$ 58,131</u>	<u>\$ 2,536</u>
	Estimated Useful Lives	2007			
		Cost	Accumulated Depreciation	Net	Depreciation Expense
Furniture and fixtures	7 years	\$ 1,393	\$ 921	\$ 472	\$ 174
Computers and software	3 years	2,603	1,473	1,130	810
Office equipment	5 years	809	491	318	167
Improvements	8 – 10 years	568	412	156	60
Intangible assets	3 years	1,375	502	873	373
Assets in progress	-	109	-	109	-
Vehicles	5 years	1,419	1,419	-	11
		<u>8,276</u>	<u>5,218</u>	<u>3,058</u>	<u>1,595</u>
1724 Mass. Ave.	39½ years	20,831	-	20,831	-
2030 M Street	39½ years	29,698	2,753	26,945	646
		<u>\$ 58,805</u>	<u>\$ 7,971</u>	<u>\$ 50,834</u>	<u>\$ 2,241</u>

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 4. Loans Payable And Interest-Rate Swap Agreements

During the year ended June 30, 2007, the Foundation had a revolving master borrowing line with a financial institution for \$30,000. The effective interest rate on the line was at the London Interbank Offered Rate (LIBOR) plus 0.1%. The note was paid in full during the year ended June 30, 2007, and was closed.

During the year ended June 30, 2007, the Foundation entered into an "advised line of credit note" in the amount of \$30,000. The effective interest rate is based on either: LIBOR (as adjusted) plus 0.09%; the greater of Prime minus 2% or 1%; or a negotiated rate. The Foundation chooses its interest method at the time advances on the line are requested. At June 30, 2008 and 2007, the Foundation chose the LIBOR option for its interest rate. The balance outstanding at June 30, 2007, was \$30,000. The note matured on March 31, 2008 and was paid in full during the year ended June 30, 2008.

The Foundation had another revolving master borrowing line with a financial institution for \$30,000. This line was used for operating expenses. The effective interest rate on the line was LIBOR plus 0.1%. The note was paid in full during the year ended June 30, 2008, and was closed.

During the year ended June 30, 2008, the Foundation entered into another revolving master borrowing line with a financial institution for \$10,000. This line is used for 2030 M Street financing. The effective interest rate on the line was LIBOR plus 0.12%. The line matures on June 1, 2009. The balance outstanding at June 30, 2008, was \$10,000.

The Foundation obtained a loan with a financial institution for \$20,000, with a LIBOR-based interest rate plus 25 basis points. Related to this loan, the Foundation entered into an interest-rate swap agreement at a fixed rate of 5.34% in exchange for LIBOR plus 0.1%. The notional amount was \$14,749 and \$16,089 at June 30, 2008 and 2007, respectively. The Foundation's intent is to reduce overall interest expense while maintaining an acceptable level of risk from exposure to increases in interest rates. The Foundation has adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which requires the Foundation to recognize all of its derivative instruments as either assets or liabilities in the consolidated balance sheets at fair value. The accounting for change in fair value (i.e., gain or loss) of the derivative instrument is recognized as a component of changes in net assets in the consolidated statements of activities. The Foundation has recognized a liability at June 30, 2008 in the amount of \$721 and recognized an asset at June 30, 2007 in the amount of \$158 in the consolidated balance sheets, and the related unrealized loss of \$(879) and \$(133) as a component of changes in net assets in the consolidated statements of activities at June 30, 2008 and 2007, respectively.

Principal payments are made over the term of the loan with the final payment due in 2019. The balance outstanding at June 30, 2008 and 2007, was \$14,637 and \$15,978, respectively.

During the year ended June 30, 2007, the Foundation entered into a revolving master borrowing line with a financial institution for \$30,000. The effective interest rate on the line is LIBOR plus 0.09%. The balance outstanding at June 30, 2007, was \$20,706. The note matured during the year ended June 30, 2008 and has an outstanding balance of \$0 at June 30, 2008.

During the year ended June 30, 2007, the Foundation entered into a second interest-rate swap agreement, whereby, the Foundation has agreed to a fixed rate of 3.925% in exchange for a floating rate (USD-SIFMA Municipal Swap Index). The notional amount was \$28,000 at June 30, 2008 and 2007. The Foundation has recognized a liability at June 30, 2008 in the amount of \$572 and recognized an asset at June 30, 2007 in the amount of \$822 in the consolidated balance sheets, and the related unrealized (loss) gain of \$(1,394) and \$822 as a component of changes in net assets in the consolidated statements of activities at June 30, 2008 and 2007, respectively.

American Legacy Foundation And Affiliate

Notes To Consolidated Financial Statements  
(In Thousands)

**Note 4. Loans Payable And Interest-Rate Swap Agreements (Continued)**

Principal payments at June 30, 2008, are due in future years as follows:

Years Ending June 30,	
2009	\$ 11,341
2010	1,341
2011	1,341
2012	1,341
2013	1,341
Thereafter	7,932
	<u>\$ 24,637</u>

**Note 5. Bonds Payable**

During the year ended June 30, 2008, in connection with the purchase of an office building, the Foundation obtained financing through the financing of \$28,000, in District of Columbia revenue bonds. These variable revenue bonds mature, subject to prior redemption, on December 1, 2038.

Future maturities on bonds payable at June 30, 2008, are due as follows:

Years Ending June 30,	
2009	\$ 500
2010	520
2011	540
2012	560
2013	585
2014 – 2038	25,295
	<u>\$ 28,000</u>

**Note 6. Rental Income**

The following is a schedule of approximate future minimum rental income receivable by the Foundation, as lessor, under noncancelable operating leases:

Years Ending June 30,	
2009	\$ 4,432
2010	4,660
2011	4,830
2012	5,006
2013	5,201
2014 – 2018	28,816
	<u>\$ 52,945</u>

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### **Note 7. Retirement Expense**

The Foundation maintains an employees' 401(k) savings plan. Employees who are at least 21 years of age are eligible for enrollment and participation in the first month following the completion of 90-days of employment. The Foundation contributes 15% of the base compensation for each employee. Participants may elect to defer their compensation subject to statutory limitations of the Internal Revenue Service. Expenses related to the retirement plan amounted to \$1,023 and \$1,070 at June 30, 2008 and 2007, respectively.

During the year ended June 30, 2007, the Foundation established a deferred compensation plan to provide certain eligible employees the ability to defer a portion of their compensation to provide supplemental retirement benefits under code section 457. The plan is funded entirely from the compensation of the participants and vest with the employees immediately. At June 30, 2008 and 2007, participants in the 457(b) plan had deferred balances, including income earned, totaling \$113 and \$68, respectively.

During the year ended June 30, 2008, the Foundation established a deferred compensation plan to provide certain eligible employees the ability to defer a portion of their compensation to provide supplemental retirement benefits under code section 457. The plan is funded entirely from the compensation of the participants and the participants will become fully vested by January 1, 2014, with forfeiture if employment ends either voluntarily or involuntarily, before this date. At June 30, 2008, participants in the 457(f) plan had deferred balances, including income earned, totaling \$101.

## American Legacy Foundation And Affiliate

### Notes To Consolidated Financial Statements (In Thousands)

---

#### Note 8. Commitments And Contingencies

##### Operating Leases

The Foundation leases office space and equipment under noncancelable operating lease agreements. Minimum future lease payments are as follows:

Years Ending June 30,	Minimum Lease Commitments	Sublease Income	Net Lease Commitment
2009	\$ 719	\$ 534	\$ 185
2010	547	410	137
	<u>\$ 1,266</u>	<u>\$ 944</u>	<u>\$ 322</u>

On January 31, 2000, the Foundation entered into a lease agreement for office space with 15,043 square feet under a ten-year term, and an additional 6,379 square feet under a five-year term that ended in March 2005. The lease includes scheduled rent increases, which are being amortized on a straight-line basis, over the term of the lease. Total operating lease expenses under all office and equipment leases were \$160 and \$158 at June 30, 2008 and 2007, respectively. The Foundation has a sublease liability in the amount of \$326 and \$505 at June 30, 2008 and 2007, respectively, stemming from rental space at 1001 G Street, for which the Foundation is still under contract. The liability will be reduced ratably over the life of the lease.

##### Investments

In connection with certain private equity investments, the Foundation has committed to making additional investments, totaling approximately \$69,370 over the next several years.

##### Contingency

The Foundation participates in a federally-assisted grant program that is subject to a financial and compliance audit by the federal agency or their representative. As such, there exists a contingent liability for potential questioned costs that may result from such an audit. Management does not anticipate any significant adjustments as a result of such an audit.

##### Litigation Settlement

During the year ended June 30, 2008, the Foundation received \$2,740 from a litigation settlement. This amount is included in other income in the consolidated statements of activities.

# McGladrey & Pullen

Certified Public Accountants

## Independent Auditor's Report On The Supplementary Information

To the Board of Directors  
American Legacy Foundation  
Washington, D.C.

Our audits were made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The supplementary information which follows is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements and in our opinion is fairly stated, in all material respects, in relation to the basic consolidated financial statements taken as a whole.

*McGladrey & Pullen, LLP*

Gaithersburg, Maryland  
October 9, 2008

## American Legacy Foundation And Affiliate

### Consolidated Statement Of Functional Expenses

Year Ended June 30, 2008

(In Thousands)

	Counter Marketing, Communications And Government Affairs		Other Programs	Schroeder Research Institute	General And Administrative	Building Fund		Total
	Grants	1724 Mass. Avenue				2030 M Street		
Salaries	\$ 1,775	\$ 411	\$ 3,054	\$ 121	\$ 2,997	\$ -	\$ -	\$ 8,358
Fringe benefits	616	149	1,077	25	1,030	-	-	2,897
Deferred compensation agreements	-	-	-	-	146	-	-	146
	2,391	560	4,131	146	4,173	-	-	11,401
Occupancy	-	-	-	-	160	-	-	160
Telephone	54	4	63	1	174	-	-	296
Postage and shipping	14	8	19	1	20	-	-	62
Supplies	9	1	14	4	270	-	-	298
Computer expense	22	13	20	8	186	-	-	249
Printing and publications	50	1	68	-	23	-	-	142
Equipment rental, repairs and maintenance	1	-	2	-	34	84	255	376
Depreciation	77	2	2	-	1,491	277	687	2,536
Auditing/accounting/payroll processing	-	-	-	-	142	-	-	142
Temporary services	21	6	31	-	50	-	-	108
Meeting expense	164	4	1,257	1	97	-	-	1,523
Travel and lodging	313	30	204	11	137	-	-	695
Fellowships/scholarships	-	-	14	-	-	-	-	14
Sponsorship/contributions	302	269	175	-	270	-	-	1,016
Honorarium	1	24	35	-	-	-	-	60
Meals and entertainment	34	4	53	1	17	-	-	109
Professional development	25	10	28	-	41	-	-	104
Consulting	38	-	52	-	382	-	-	472
Contract services	62,784	936	2,980	17	(3)	-	-	66,714
Grants	-	11,525	2,074	-	-	-	-	13,599
Custodial and investment advisory fees	-	-	-	-	4,492	-	-	4,492
Legal fees	-	-	-	-	424	-	27	451
Insurance	29	-	-	-	217	13	33	292
Interest expense	-	-	-	-	1,242	633	1,306	3,181
Unrealized loss on interest rate swap	-	-	-	-	-	1,394	880	2,274
Other building operating expenses	38	20	68	2	153	60	149	490
Income tax expense	-	-	-	-	-	-	5	5
Real estate taxes	-	-	-	-	-	208	543	751
Other expenses	-	-	-	-	6	245	806	1,057
<b>Total expenses</b>	<b>66,367</b>	<b>13,417</b>	<b>11,290</b>	<b>192</b>	<b>14,198</b>	<b>2,914</b>	<b>4,691</b>	<b>113,069</b>
Overhead allocations	460	109	822	33	(1,424)	-	-	-
	<u>\$ 66,827</u>	<u>\$ 13,526</u>	<u>\$ 12,112</u>	<u>\$ 225</u>	<u>\$ 12,774</u>	<u>\$ 2,914</u>	<u>\$ 4,691</u>	<u>\$ 113,069</u>

## American Legacy Foundation And Affiliate

### Consolidated Statement Of Functional Expenses

Year Ended June 30, 2007

(In Thousands)

	Counter Marketing, Communications And Government Affairs		Other Programs	General And Administrative	Building Fund		Total
	Grants				1724 Mass. Avenue	2030 M Street	
Salaries	\$ 1,934	\$ 388	\$ 3,282	\$ 2,676	\$ -	\$ -	\$ 8,280
Fringe benefits	688	137	1,163	910	-	-	2,898
	2,622	525	4,445	3,586	-	-	11,178
Occupancy	-	-	-	158	-	-	158
Telephone	62	4	70	115	-	-	251
Postage and shipping	27	6	26	22	-	-	81
Supplies	20	1	15	160	-	-	196
Computer expense	20	17	13	449	-	-	499
Printing and publications	106	2	61	12	-	-	181
Equipment rental, repairs and maintenance	2	-	-	55	-	246	303
Depreciation	121	7	12	1,455	-	646	2,241
Auditing/accounting/payroll processing	-	-	-	151	-	-	151
Temporary services	41	3	24	38	-	-	106
Meeting expense	258	-	724	77	-	-	1,059
Travel and lodging	224	29	290	113	-	-	656
Fellowships/scholarships	-	-	12	-	-	-	12
Sponsorship/contributions	365	291	254	1	-	-	911
Honorarium	-	22	24	-	-	-	46
Meals and entertainment	23	2	50	14	-	-	89
Professional development	21	8	24	39	-	-	92
Consulting	8	-	101	420	-	-	529
Contract services	55,585	291	2,234	494	-	-	58,604
Grants	188	10,727	2,953	-	-	-	13,868
Custodial and investment advisory fees	-	-	-	4,196	-	-	4,196
Legal fees	-	-	-	287	-	8	295
Insurance	29	-	-	227	-	25	281
Cost of sales	-	-	11	-	-	-	11
Interest expense	-	-	-	2,599	-	1,480	4,079
Unrealized (gain) loss on interest rate swap	-	-	-	133	(822)	-	(689)
Fundraising	-	-	62	-	-	-	62
Other building operating expenses	-	-	-	-	-	1,022	1,022
Income tax expense	-	-	-	-	-	193	193
Real estate taxes	-	-	-	-	-	514	514
Other expenses	50	44	62	199	-	-	355
<b>Total expenses</b>	<b>59,772</b>	<b>11,979</b>	<b>11,467</b>	<b>15,000</b>	<b>(822)</b>	<b>4,134</b>	<b>101,530</b>
Overhead allocations	517	108	900	(1,525)	-	-	-
	<b>\$ 60,289</b>	<b>\$ 12,087</b>	<b>\$ 12,367</b>	<b>\$ 13,475</b>	<b>\$ (822)</b>	<b>\$ 4,134</b>	<b>\$ 101,530</b>

American Legacy Foundation And Affiliate

1724 Massachusetts Avenue – Schedules Of Building Expenses

Years Ended June 30, 2008 And 2007

(In Thousands)

	2008	2007
Operating expenses:		
Real estate taxes	\$ 208	\$ -
Utilities	129	-
Grounds and security	53	-
Repairs and maintenance	84	-
Cleaning	48	-
Bond fees	33	-
Management fees	15	-
Bond issuance amortization	14	-
Administrative	13	-
Insurance	13	-
<b>Total operating expenses</b>	<b>610</b>	<b>-</b>
Interest expense	633	-
Unrealized loss (gain) on interest rate swap	1,394	(822)
Depreciation	277	-
<b>Total building expenses</b>	<b>\$ 2,914</b>	<b>\$ (822)</b>

American Legacy Foundation And Affiliate

M Street Holdings, LLC – Schedules Of Building Expenses

Years Ended June 30, 2008 And 2007

(In Thousands)

	2008	2007
Operating expenses:		
Real estate taxes	\$ 543	\$ 514
Utilities	411	550
Repairs and maintenance	255	246
Grounds and security	169	136
Cleaning	161	140
Administrative	116	114
Management fees	66	68
Insurance	33	25
Permits and other taxes	32	14
Legal fees	27	8
Total operating expenses	1,813	1,815
Interest expense	1,306	1,480
Unrealized loss on interest rate swap	880	-
Depreciation	687	646
Income tax expense	5	193
Total building expenses	\$ 4,691	\$ 4,134