

# American Legacy Foundation And Affiliate

Consolidated Financial Report  
June 30, 2009

**McGladrey & Pullen**  
Certified Public Accountants

## Contents

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<b>Independent Auditor's Report On The Financial Statements</b>	<b>1</b>
<b>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 – 18</b>
<hr/>	
<b>Independent Auditor's Report On The Supplementary Information</b>	<b>19</b>
<b>Supplementary Information</b>	
Consolidated Statement Of Functional Expenses – 2009	20
Consolidated Statement Of Functional Expenses – 2008	21
1724 Massachusetts Avenue – Schedules Of Building Expenses	22
M Street Holdings, LLC – Schedules Of Building Expenses	23

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# 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, 2009 and 2008, and the related consolidated statements of activities and cash flows for the years then ended. These financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these 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, 2009 and 2008, 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  
September 30, 2009

American Legacy Foundation And Affiliate

Consolidated Balance Sheets  
June 30, 2009 And 2008  
(In Thousands)

Assets	2009	2008
Cash And Cash Equivalents	\$ 104,391	\$ 147,634
Investments	763,293	1,027,246
Accrued Interest Receivable	386	1,978
Prepaid Expenses	932	635
Trades To Be Settled	6,784	-
Property And Equipment, Net	1,362	2,478
1724 Mass. Ave. Building, Net	28,494	28,853
2030 M Street Building, Net	26,265	26,800
Bond Issuance Costs, Net	604	723
Other Assets	752	1,153
	\$ 933,263	\$ 1,237,500

**Liabilities And Net Assets**

Liabilities		
Grants payable	\$ 322	\$ 550
Trades to be settled	-	439
Accrued expenses	11,875	26,200
Loans payable	23,296	24,637
Bonds payable	28,000	28,000
Sublease liability	139	326
Refundable advances	120	-
Liability on interest rate swap agreements	2,956	1,293
Other liabilities	411	282
	67,119	81,727

Commitments And Contingencies (Notes 6 and 8)

Net Assets – Unrestricted	866,144	1,155,773
	\$ 933,263	\$ 1,237,500

See Notes To Consolidated Financial Statements.

American Legacy Foundation And Affiliate

Consolidated Statements Of Activities  
 Years Ended June 30, 2009 And 2008  
 (In Thousands)

	2009	2008
Revenue and support:		
Rental income	\$ 4,355	\$ 3,270
Other income	6,126	7,948
Investment (loss) income	(204,398)	2,383
Settlement proceeds:		
Base	-	25,000
Public education	-	164
Smokeless tobacco	-	18,616
<b>Total revenue and support</b>	<b>(193,917)</b>	<b>57,381</b>
Expenses:		
Program expenses:		
Counter marketing, communications and government affairs	51,093	66,827
Grants	12,851	13,526
Other programs	12,173	12,112
Schroeder Research Institute	1,412	225
	<b>77,529</b>	<b>92,690</b>
General and administrative	9,991	12,774
Building expenses	8,192	7,605
<b>Total expenses</b>	<b>95,712</b>	<b>113,069</b>
<b>Change in net assets</b>	<b>(289,629)</b>	<b>(55,688)</b>
Net assets:		
Beginning	1,155,773	1,211,461
Ending	<b>\$ 866,144</b>	<b>\$ 1,155,773</b>

See Notes To Consolidated Financial Statements.

## American Legacy Foundation And Affiliate

### Consolidated Statements Of Cash Flows Years Ended June 30, 2009 And 2008 (In Thousands)

	2009	2008
<b>Cash Flows From Operating Activities</b>		
Change in net assets	\$ (289,629)	\$ (55,688)
Adjustments to reconcile change in net assets to net cash used in operating activities:		
Realized and unrealized loss on investments	224,814	29,962
Other investment gain	(461)	(824)
Gain on disposal of property and equipment	(11)	-
Depreciation	2,548	2,536
Change in interest rate swap agreements asset/liability	1,663	2,274
Amortization of bond issuance costs	119	15
Changes in assets and liabilities:		
(Increase) decrease in:		
Accrued interest receivable	1,592	(868)
Trades to be settled	(7,223)	1,423
Other assets	401	(917)
Prepaid expenses	(297)	(53)
Increase (decrease) in:		
Accrued expenses	(14,325)	18,189
Grants payable	(228)	(197)
Sublease liability	(187)	(179)
Refundable advances	120	(120)
Other liabilities	129	196
<b>Net cash used in operating activities</b>	<b>(80,975)</b>	<b>(4,251)</b>
<b>Cash Flows From Investing Activities</b>		
Proceeds from sale of property and equipment	11	29
Purchase of property and equipment	(538)	(9,862)
Proceeds from sale of investments	4,045,868	5,610,965
Purchases of investments	(4,006,268)	(5,606,697)
<b>Net cash provided by (used in) investing activities</b>	<b>39,073</b>	<b>(5,565)</b>
<b>Cash Flows From Financing Activities</b>		
Principal payments on loan payable	(1,341)	(52,047)
Bond issuance costs	-	(738)
Proceeds from bonds payable	-	28,000
<b>Net cash used in financing activities</b>	<b>(1,341)</b>	<b>(24,785)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(43,243)</b>	<b>(34,601)</b>
<b>Cash And Cash Equivalents</b>		
Beginning	147,634	182,235
Ending	<b>\$ 104,391</b>	<b>\$ 147,634</b>
<b>Supplemental Disclosures Of Cash Flow Information</b>		
Cash paid for interest	<b>\$ 1,621</b>	<b>\$ 3,294</b>
Cash paid for income taxes	<b>\$ 131</b>	<b>\$ 5</b>

See Notes To Consolidated Financial Statements.

## American Legacy Foundation And Affiliate

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

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#### 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 attorneys general 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, attorneys general and experts in the medical, education and public health fields.

The functions of the Foundation shall be:

1. 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.
2. 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.
3. 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.
4. 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.
5. 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.
6. Developing other innovative youth smoking and substance abuse prevention programs.
7. Providing targeted training and information for parents.

## American Legacy Foundation And Affiliate

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

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

The functions of the Foundation shall be (Continued):

8. 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.
9. 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.
10. 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, 2009 and 2008.

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)

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#### 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.

Securities transactions, interest and dividends: Securities transactions are recorded on a trade-date basis and are carried at fair value. Realized gains and losses on securities transactions are determined on a specific identification basis and are included as net realized gain on investments in the accompanying consolidated statements of activities. The difference between the cost and the fair value of open investments is reflected as the net change in unrealized appreciation (depreciation) on investments in the accompanying consolidated statements of activities. Interest income is recognized under the accrual basis. Dividend income is recognized on the ex-dividend date.

Valuation of investments: Investments are presented in the financial statements at fair value in accordance with accounting principles generally accepted in the United States of America. Investments in securities traded on a national securities exchange, or reported on the NASDAQ national market, are stated at the last reported sales price on the day of valuation; other securities traded in the over-the-counter market and listed securities for which no sale was reported on that date are stated at the last quoted bid price, except for short sales positions and call options written, for which the last quoted asked price is used. Short-term notes are stated at amortized cost, which approximates fair value. Restricted securities and other securities for which quotations are not readily available are valued at fair value as determined by the Foundation. Warrants are recorded at fair value, which is based on the sum of the amount, if any, by which the estimated fair value of the underlying securities exceeds the exercise price of the warrants plus the amount of the fair value of the option feature of the warrant.

Government-sponsored enterprises and commercial paper are stated at cost plus accrued interest, which approximates fair value.

Investments in other investment partnerships are valued at fair value based on the applicable percentage ownership of the underlying partnerships' net assets as of the measurement date, as determined by the Foundation. In determining fair value, the Foundation utilizes valuations provided by the underlying investment partnerships. The underlying investment partnerships value securities and other financial instruments on a fair value basis of accounting. The estimated fair values of certain investments of the underlying investment partnerships, which may include private placements and other securities for which prices are not readily available, are determined by the general partner or sponsor of the respective other investment partnership and may not reflect amounts that could be realized upon immediate sale, nor amounts that ultimately may be realized. Accordingly, the estimated fair values may differ significantly from the values that would have been used had a ready market existed for these investments. The fair value of the Foundation's investments in other investment partnerships generally represents the amount the Foundation would expect to receive if it were to liquidate its investment in the other investment partnerships excluding any redemption charges that may apply.

## American Legacy Foundation And Affiliate

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

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

Financial instruments with off-balance-sheet risk: In connection with its trading activities, the Foundation enters into transactions with a variety of securities and derivative financial instruments. These derivative financial instruments may have market and/or credit risk in excess of the amounts recorded in the consolidated balance sheets.

Market risk: Market risk arises primarily from changes in the market value of financial instruments. Theoretically, the Foundation's exposure is equal to the notional value of contracts purchased and unlimited on such contracts sold short.

Exposure to market risk is influenced by a number of factors, including the relationships between financial instruments, and the volatility and liquidity in the markets in which the financial instruments are traded. In many cases, the use of financial instruments serves to modify or offset market risk associated with other transactions and, accordingly, serves to decrease the Foundation's overall exposure to market risk. The Foundation attempts to control its exposure to market risk through various analytical monitoring techniques.

Concentrations of credit risk: The Foundation is engaged in various trading and brokerage activities in which counterparties primarily include broker-dealers, banks, and other financial institutions. In the event counterparties do not fulfill their obligations, the Foundation may be exposed to risk. The risk of default depends on the creditworthiness of the counterparty or issuer of the instrument. It is the Foundation's policy to review, as necessary, the credit standing of each counterparty.

In the normal course of its business, the Foundation enters into contracts and agreements with certain service providers, such as clearing and custody agents, trustees and administrators that contain a variety of representations and warranties and which provide general indemnifications and guarantees against specified potential losses in connection with their activities as an agent of, or providing services to, the Foundation. The Foundation's maximum exposure under these agreements is unknown, as this may involve future claims that could be made against the Foundation and have not yet occurred. The Foundation expects the risk of any future obligation under these arrangements to be remote and has not recorded any contingent liability in the financial statements for these indemnifications.

Investment in other limited partnerships funds: The money managers of underlying investment partnerships funds in which the Foundation invests, may utilize derivative instruments with off-balance-sheet risk. The Foundation's exposure to risk is limited to the amount of its investment.

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, 2009 and 2008.

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 3 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.

## American Legacy Foundation And Affiliate

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

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

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.

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: Through the year ended June 30, 2008, the Foundation received revenue that was 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 were intended to assist the Foundation in carrying out a nationwide sustained advertising and education program.

These agreements contained various provisions and conditions that ultimately determined the amount and timing of payments that were received. Consequently, revenue was recognized at the time payments either were received or were 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, limited liability company (LLC) and, as such, is a "disregarded entity" for federal income tax purposes, pursuant to Section 7701 of the IRC. At June 30, 2009 and 2008, 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.

## American Legacy Foundation And Affiliate

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

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

Income taxes (continued): 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.

Use of estimates: The preparation of consolidated financial statements in conformity with generally accepted accounting principles 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: Effective July 1, 2008, the Foundation adopted SFAS No. 157, *Fair Value Measurements*, issued by FASB. SFAS No. 157 defines the fair value of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, and sets out a fair value hierarchy. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and lowest priority to unobservable inputs (Level 3). Inputs are broadly defined under SFAS No. 157 as assumptions market participants would use in pricing as asset or liability. The Foundation has added the required disclosures in Note 8 to the financial statements.

Subsequent events: The Foundation evaluated subsequent events for potential required disclosures through September 30, 2009, which is the date the consolidated financial statements were available to be issued.

American Legacy Foundation And Affiliate

Notes To Consolidated Financial Statements  
(In Thousands)

Note 2. Investments

Investments at June 30, 2009 and 2008, consist of the following:

	2009	2008
Short-term investments	\$ 24,487	\$ 39,845
Mutual funds	131,358	166,779
U.S. stocks	175,741	226,161
Foreign exchange traded stocks	56,490	86,923
Commingled/common trust funds	243,541	358,870
Hedge funds	18,638	68,276
Fund of funds	67,500	64,187
Private equity funds	35,190	16,205
Other	10,348	-
	<u>\$ 763,293</u>	<u>\$ 1,027,246</u>

Investment income at June 30, 2009 and 2008, consists of the following:

	2009	2008
Interest, dividends, and accretion income	\$ 19,955	\$ 31,521
Realized and unrealized loss on investments	(224,814)	(29,962)
Other investment gain	461	824
<b>Total investment (loss) return</b>	<u>\$ (204,398)</u>	<u>\$ 2,383</u>

Custodial and investment advisory fees of \$3,832 and \$4,492 at June 30, 2009 and 2008, 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)**

Alternative investments are less liquid than the Foundation's other investments. The following table summarizes these investments by strategy type at June 30, 2009 and 2008:

Alternative Investment Strategy	2009		2008	
	Number Of Funds	Fair Value	Number Of Funds	Fair Value
Long/short hedge	2	\$ 18,638	3	\$ 68,276
Fund of funds	3	67,500	2	64,187
Private equity	15	35,190	8	16,205
Other	1	10,348	-	-
	<u>21</u>	<u>\$ 131,676</u>	<u>13</u>	<u>\$ 148,668</u>

Alternative investments include limited partnerships, limited liability corporations, and off-shore investments funds. Included in investments of the limited partnerships are certain types of financial instruments, including, among others, futures and forward contracts, options, and securities sold but not yet purchased, intended to hedge against changes in the market value of investments. The financial instruments, which involve varying degrees of off-balance-sheet risk, may result in loss due to changes in market value (market risk).

**Note 3. Property And Equipment**

Property and equipment and accumulated depreciation at June 30, 2009, consist of the following:

	Estimated Useful Lives	2009			
		Cost	Accumulated Depreciation	Net	Depreciation Expense
Furniture and fixtures	7 years	\$ 1,323	\$ 699	\$ 624	\$ 180
Computers and software	3 years	2,275	2,136	139	393
Office equipment	5 years	1,216	785	431	176
Improvements	8 – 10 years	568	531	37	60
Intangible assets	3 years	1,500	1,369	131	371
Vehicles	5 years	752	752	-	-
		<u>7,634</u>	<u>6,272</u>	<u>1,362</u>	<u>1,180</u>
1724 Mass Ave.	39½ years	29,335	841	28,494	563
2030 M Street	39½ years	30,613	4,348	26,265	805
		<u>\$ 67,582</u>	<u>\$ 11,461</u>	<u>\$ 56,121</u>	<u>\$ 2,548</u>

American Legacy Foundation And Affiliate

Notes To Consolidated Financial Statements  
(In Thousands)

Note 3. Property And Equipment (Continued)

Property and equipment and accumulated depreciation at June 30, 2009, 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	-	-
		8,511	6,033	2,478	1,572
1724 Mass. Ave.	39½ years	29,130	277	28,853	277
2030 M Street	39½ years	30,343	3,543	26,800	687
		\$ 67,984	\$ 9,853	\$ 58,131	\$ 2,536

Note 4. Loans Payable And Interest-Rate Swap Agreements

During the year ended June 30, 2008, the Foundation entered into a 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 the London Interbank Offered Rate (LIBOR) plus .12%. On June 30, 2009, the line was amended and restated so that the interest rate was changed to LIBOR plus .90% and the maturity date was extended to June 1, 2010. The balance outstanding at June 30, 2009, 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 .1%. The notional amount was \$13,408 and \$14,749 at June 30, 2009 and 2008, 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 follows 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 in the amounts of \$1,425 and \$721 in the consolidated balance sheets, and the related unrealized loss of \$(704) and \$(879) as a component of changes in net assets in the consolidated statements of activities at June 30, 2009 and 2008, respectively.

Principal payments are made over the term of the loan with the final payment due in 2019. The balance outstanding at June 30, 2009 and 2008, was \$13,296 and \$14,637, respectively.

## American Legacy Foundation And Affiliate

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

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

Principal payments at June 30, 2009, are due in future years as follows:

Years Ending June 30,	
2010	\$ 11,341
2011	1,341
2012	1,341
2013	1,341
2014	1,341
Thereafter	6,591
	<u>\$ 23,296</u>

Relating to a bond transaction (See Note 5), the Foundation has 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 \$27,500 and \$28,000 at June 30, 2009 and 2008, respectively. The Foundation has recognized a liability in the amounts of \$1,531 and \$572 in the consolidated balance sheets, and the related unrealized loss of \$(959) and \$(1,394) as a component of changes in net assets in the consolidated statements of activities at June 30, 2009 and 2008, respectively.

#### Note 5. Bond Transaction

During the year ended June 30, 2008, in connection with the purchase and renovation of an office building, the Foundation entered into a promissory note agreement with the District of Columbia (D.C.) through a D.C. Revenue Bonds transaction (American Legacy Foundation Issue, Series 2008). The Foundation borrowed \$28,000 from D.C. with interest accruing at variable rates through a remarketing process as stipulated in the Indenture of Trust between D.C. and the Bond Trustee. The interest rate in effect at June 30, 2009, was 3.10%. The Foundation has the option to prepay the note in whole or in part at anytime without penalty. The note matures on December 1, 2043. However, the note may become due prior to the maturity date in certain circumstances as stipulated in the financing agreements.

In connection with this transaction, the Foundation entered into a Standby Bond Purchase Agreement with the Bond Trustee and a financial institution whereby the financial institutions would provide liquidity to purchase the bonds in the event the bonds were not marketable.

Subsequent to June 30, 2009, the Foundation has issued a Remarketing Memorandum which in effect cancels the Standby Bond Purchase Agreement and provides for the Foundation to provide "self liquidity" in the event the bonds needed to be re-purchased in the marketing process.

## American Legacy Foundation And Affiliate

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

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#### 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,

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2010	\$	4,544
2011		4,694
2012		4,854
2013		5,030
2014		5,202
2015 – 2019		28,386
	\$	<u>52,710</u>

#### 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 \$1,183 and \$1,023 at June 30, 2009 and 2008, respectively.

The Foundation has 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, 2009 and 2008, participants in the 457(b) plan had deferred balances, including income earned, totaling \$128 and \$113, 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 IRC §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 and 2009, participants in the 457(f) plan had deferred balances, including income earned, totaling \$179 and \$101, respectively.

## American Legacy Foundation And Affiliate

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

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#### Note 8. Fair Value Measurements

During the year ended June 30, 2009, the Foundation adopted SFAS No. 157, *Fair Value Measurements*. This statement establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. SFAS No. 157 applies to all assets and liabilities that are being measured and reported on a fair value basis. SFAS No. 157 requires new disclosure that establishes a framework for measuring fair value in GAAP and expands disclosure about fair value measurements. This statement enables the reader of the financial statements to assess the inputs used to develop those measurements by establishing a hierarchy for ranking the quality and reliability of the information used to determine fair values. The statement requires that assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. The type of investments included in Level 1 include listed equities and listed derivatives. As required by SFAS No. 157, the Foundation does not adjust the quoted price for these investments, even in situations where the Foundation holds a large position and a sale could reasonably impact the quoted price.

Level 2: Inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly; and fair value is determined through the use of models or other valuation methodologies. Investments which are generally included in this category include corporate bonds and loans, less liquid and restricted equity securities and certain over-the-counter derivatives. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement.

Level 3: Inputs are unobservable for the asset or liability and include situations where there is little, if any, market activity for the asset or liability. The inputs into the determination of fair value are based upon the best information in the circumstances and may require significant management judgment or estimation. Investments that are included in this category generally include equity and debt positions in private companies and general and limited partnership interests in corporate private equity and real estate funds, debt funds, funds of hedge funds and distressed debt. In determining the appropriate levels, the Foundation performs a detailed analysis of the assets and liabilities that are subject to SFAS No. 157. At each reporting period, all assets and liabilities for which the fair value measurement is based on significant unobservable inputs are classified as Level 3.

American Legacy Foundation And Affiliate

Notes To Consolidated Financial Statements  
(In Thousands)

Note 8. Fair Value Measurements (Continued)

The table below presents the balances of assets measured at fair value on a recurring basis by level within the hierarchy.

	Total	Level 1	Level 2	Level 3
<b>Assets</b>				
Cash equivalents				
Repurchase agreements	\$ 33,156	\$ -	\$ 33,156	\$ -
Short-term corporate notes	3,200	-	3,200	-
State Street institutional reserve fund	28,040	-	28,040	-
Deposits held at futures broker	14,642	14,642	-	-
<b>Total cash equivalents</b>	<b>79,038</b>	<b>14,642</b>	<b>64,396</b>	<b>-</b>
Short-term investments	24,487	-	24,487	-
Mutual funds	131,358	131,358	-	-
U.S. stocks	175,741	175,741	-	-
Foreign exchange traded stocks	56,490	56,490	-	-
Commingled/common trust funds	243,541	-	238,355	5,186
Hedge funds	18,638	-	-	18,638
Fund of funds	67,500	-	-	67,500
Private equity funds	35,190	-	-	35,190
Other	10,348	-	-	10,348
<b>Total investments</b>	<b>763,293</b>	<b>363,589</b>	<b>262,842</b>	<b>136,862</b>
	<b>\$ 842,331</b>	<b>\$ 378,231</b>	<b>\$ 327,238</b>	<b>\$ 136,862</b>
<b>Liabilities</b>				
Liability on interest rate swap agreements	\$ 2,956	\$ -	\$ 2,956	\$ -

The changes in Level 3 assets measured at fair value on a recurring basis are summarized as follows:

Balance, July 1, 2008	\$ 148,669
Purchases of investments	39,948
Sales of investments	(32,518)
Realized and unrealized losses on investments:	
Net realized gain on investments	5,981
Net change in unrealized depreciation on investments	(25,218)
<b>Balance, June 30, 2009</b>	<b>\$ 136,862</b>

## American Legacy Foundation And Affiliate

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

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#### Note 9. 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
2010	\$ 547	\$ 410	\$ 137

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 \$329 and \$160 at June 30, 2009 and 2008, respectively. The Foundation has a sublease liability in the amount of \$139 and \$326 at June 30, 2009 and 2008, 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 \$76,233 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.

#### Note 10. Concentration Of Revenue

During the year ended June 30, 2008, 76% of the Foundation's revenue was derived from settlement proceeds. There were no settlement proceeds during the year ended June 30, 2009.

# 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  
September 30, 2009

American Legacy Foundation And Affiliate

Consolidated Statement Of Functional Expenses

Year Ended June 30, 2009

(In Thousands)

	Counter Marketing, Communications And Government Affairs		Other Programs	Schroeder Research Institute	General And Administrative	Building Fund		Total
	Affairs	Grants				1724 Mass. Avenue	2030 M Street	
Salaries	\$ 2,036	\$ 467	\$ 3,299	\$ 789	\$ 2,885	\$ -	\$ -	\$ 9,476
Fringe benefits	816	202	1,210	269	1,063	-	-	3,560
Relocation expense	1	-	5	52	-	-	-	58
Long-term Care	-	-	9	-	45	-	-	54
Deferred compensation agreements	4	-	18	16	153	-	-	191
	<u>2,857</u>	<u>669</u>	<u>4,541</u>	<u>1,126</u>	<u>4,146</u>	-	-	<u>13,339</u>
Occupancy	-	-	166	-	155	-	-	321
Telephone	51	3	65	7	173	-	-	299
Postage and shipping	14	10	36	-	20	-	-	80
Supplies	11	1	10	14	226	-	-	262
Computer expense	26	13	33	38	236	-	-	346
Printing and publications	47	-	35	1	7	-	-	90
Equipment rental, repairs and maintenance	-	-	2	-	28	-	-	30
Depreciation	51	1	1	-	1,127	563	805	2,548
Auditing/accounting/payroll processing	-	-	-	-	148	-	-	148
Temporary services	16	-	7	-	3	-	-	26
Meeting expense	145	2	569	1	89	-	-	806
Travel and lodging	209	21	263	22	134	-	-	649
Fellowships/scholarships	-	-	15	-	-	-	-	15
Sponsorship/contributions	182	267	172	-	-	-	-	621
Honorarium	-	17	17	-	-	-	-	34
Meals and entertainment	42	3	47	5	23	-	-	120
Professional development	18	6	27	3	50	-	-	104
Consulting	160	-	32	40	61	-	-	293
Contract services	46,772	580	3,066	2	105	-	-	50,525
Grants	-	11,152	2,348	-	-	-	-	13,500
Custodial and investment advisory fees	-	-	-	-	3,832	-	-	3,832
Legal fees	-	-	-	6	289	-	2	297
Insurance	36	-	-	-	216	15	26	293
Interest expense	-	-	-	-	-	1,238	935	2,173
Unrealized loss on interest rate swap	-	-	-	-	-	959	704	1,663
Other building operating expenses	63	17	79	10	184	265	362	980
Income tax expense	-	-	-	-	-	-	131	131
Real estate taxes	-	-	-	-	-	291	634	925
Other expenses	-	-	-	-	-	438	824	1,262
<b>Total expenses</b>	<u>50,700</u>	<u>12,762</u>	<u>11,531</u>	<u>1,275</u>	<u>11,252</u>	<u>3,769</u>	<u>4,423</u>	<u>95,712</u>
Overhead allocations	393	89	642	137	(1,261)	-	-	-
	<u>\$ 51,093</u>	<u>\$ 12,851</u>	<u>\$ 12,173</u>	<u>\$ 1,412</u>	<u>\$ 9,991</u>	<u>\$ 3,769</u>	<u>\$ 4,423</u>	<u>\$ 95,712</u>

American Legacy Foundation And Affiliate

Consolidated Statement Of Functional Expenses  
 Year Ended June 30, 2008  
 (In Thousands)

	Counter Marketing, Communications And Government Affairs		Other Grants Programs	Schroeder Research Institute	General And Administrative	Building Fund		Total
						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

1724 Massachusetts Avenue – Schedules Of Building Expenses  
 Years Ended June 30, 2009 And 2008  
 (In Thousands)

	2009	2008
Operating expenses:		
Real estate taxes	\$ 291	\$ 208
Utilities	188	129
Repairs and maintenance	162	84
Cleaning	114	48
Grounds and security	106	53
Administrative	37	13
Bond issuance amortization	34	14
Bond fees	32	33
Management fees	30	15
Insurance	15	13
Total operating expenses	1,009	610
Interest expense	1,238	633
Unrealized loss on interest rate swap	959	1,394
Depreciation	563	277
Total building expenses	\$ 3,769	\$ 2,914

American Legacy Foundation And Affiliate

M Street Holdings, LLC – Schedules Of Building Expenses  
 Years Ended June 30, 2009 And 2008  
 (In Thousands)

	2009	2008
Operating expenses:		
Real estate taxes	\$ 634	\$ 543
Utilities	435	411
Repairs and maintenance	268	255
Grounds and security	164	169
Cleaning	158	161
Administrative	82	116
Management fees	67	66
Insurance	26	33
Permits and other taxes	13	32
Legal fees	1	27
Total operating expenses	1,848	1,813
Interest expense	935	1,306
Depreciation	805	687
Unrealized loss on interest rate swap	704	880
Income tax expense	131	5
Total building expenses	\$ 4,423	\$ 4,691