

Accounting for Endowments

Robert J. Lane

June 2011

Overview

- Endowment funds
- Uniform Management of Institutional Funds (UMIFA)
- Underwater funds
- Uniform Prudent Management of Institutional Funds Act (UPMIFA)
- FSP 117-1
- Disclosure requirement – even if UPMIFA does not apply
- Wrap up

Endowment Funds

- Definition – An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP)
- Use of assets may be permanently restricted, temporarily restricted, or unrestricted
- Generally established by donor-restricted gifts and bequests to provide either of the following:
 - A permanent endowment - provides a permanent source of income
 - A term endowment - provides income for a specified period

Endowment Funds (Continued)

- Alternatively, an NFP's governing board may earmark a portion of unrestricted net assets as a Board-Designated Endowment Fund
- The portion of an endowment to be maintained permanently is classified as permanently restricted net assets
- The portion of an endowment to be maintained for a specified term or purpose is classified as temporarily restricted net assets
- Funds that have no donor-imposed restrictions as to the use or purpose are classified as unrestricted net assets
 - These funds may be earmarked and designated by the Board

UMIFA

The Uniform Management of Institutional Funds Act (1972)

- Developed and promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL)
- Established uniform standards for the management, investment, and expenditure of the endowment funds of NFP institutions
- Prior to UMIFA, institutions could only spend a “prudent” amount of interest and dividends from an endowment
- UMIFA allowed the institution to include asset appreciation

UMIFA (Continued)

- Allowed endowments to:
 - invest in any kinds of assets
 - pool endowment funds for investment purposes
 - delegate investment management to other persons (professional investment advisors)
- Prohibited spending from an “underwater fund”

Underwater Funds

- Definition – A fund whose current value is below the value of the gift at the time it was given by the donor
- Under UMIFA, spending abilities from an underwater fund were limited until the fund regained historical dollar value (HDV)
- Limitations depended on state law:
 - Could spend only interest and dividends
 - Could spend at a reduced rate
 - Could not spend at all

Disadvantages of UMIFA

- Market declines in 2001 and 2002 left institutions struggling to cover expected revenue from recently established endowments that had fallen below their HDV
- New endowments did not have sufficient time to appreciate before the funds were needed for operations
- Sufficient resources were available in the endowments
- However, rigid restrictions limited the institution's ability to utilize those resources
- Organizations were forced to cut programs, lay off employees, increase borrowings, and increase service fees
- Market declines in 2008 and 2009 made the situation even worse

Disadvantages of UMIFA

Per a 2010 survey by the *Association of Governing Boards*:

Survey participants reported the following spending practices prior to the enactment of UPMIFA:

- 41.5 percent of all institutions and foundations surveyed suspended all distributions from funds at or below HDV;
- 38.2 percent continued distributions in accordance with their normal spending rule;
- 16.9 percent distributed only interest and dividends for underwater funds; and
- 3.4 percent made distributions at some other reduced rate

Disadvantages of UMIFA

Per a 2010 survey by the *Association of Governing Boards*:

Institutions and foundations reported that they currently follow or plan to follow the practices listed below for spending from underwater endowments (for which gift agreements do not dictate particular practices), **subsequent to** enacting UPMIFA:

- 46.9 percent are continuing distributions in keeping with their normal spending rule;
- 25.1 percent are suspending distributions from funds at or below HDV;
- 9.7 percent are distributing only interest and dividends;
- 8.2 percent have established a threshold at which they will suspend distributions from underwater accounts.
- 4.3 percent have established a tiered system in which the distribution rate for underwater funds decreases incrementally and is eventually suspended when the fund value drops to a designated percentage of HDV

What is the *Uniform Prudent Management of Institutional Funds Act* (UPMIFA)?

UPMIFA

Why the switch from UMIFA to UPMIFA?

- UMIFA is an old law...on the books since 1972
- Updates the “prudence standard” that applies to the management and investment of charitable funds
- Modernizes the rules governing expenditures from endowment funds
- Adopts provisions governing the release and modification of restrictions on charitable funds to permit more efficient management

UPMIFA (Continued)

So what is UPMIFA?

- UPMIFA is the Uniform Prudent Management of Institutional Funds Act
- Drafted in July 2006
- UPMIFA replaced UMIFA as the primary source of law governing the investment, management and expenditure of donor-generated funds

UPMIFA (Continued)

- As of April 30, 2011, 47 states have enacted UPMIFA and 2 others have introduced legislation to enact UPMIFA or a version of it
- Florida introduced it during 2011, Bill #HB599/SB952
- Mississippi introduced it during 2011, Bill #SB2454
- Intended to clarify the language of UMIFA
- Provides institutions with greater flexibility to distribute funds from endowments that may have plunged in value

UPMIFA (Continued)



UPMIFA (Continued)

- Guides NFPs on the management and investment of funds
- Provides rules on spending from endowment funds
- Permits the release of restrictions on the use and management of charitable funds

UPMIFA (Continued)

- UPMIFA eliminates the concept of historical dollar value
 - Allows institutions to make distributions from underwater funds (value has fallen below the value at the time the fund was created)
- UPMIFA establishes a “prudence” standard
 - Requires institutions to make spending decisions with “the care that an ordinarily prudent person, in a like position, would exercise under similar circumstances”
- The Act does not require a specific amount be set aside as principal
 - Assumes the institution will act to preserve the purchasing power of the fund while still providing that some amounts be spent for the purposes of the endowment

Prudent Expenditure Considerations

These seven factors must be considered when determining if an expenditure is prudent:

1. Duration and preservation of the endowment fund
2. Purposes of the institution and the endowment fund
3. General economic conditions
4. Possible effect of inflation or deflation
5. Expected total return – income and appreciation of investments
6. Institution's other resources
7. Institution's investment policy

UPMIFA Endowment Spending

- Revised rules emphasize perpetuation of spending power
 - Not merely original dollars contributed
- These rules apply only to donor-restricted funds
 - NOT board designated funds
- NFP can spend the amount deemed prudent after considering:
 - Donor's intent
 - Purpose of the fund
 - Other relevant economic factors

UPMIFA Endowment Spending (Continued)

- Does not mean the NFP can spend funds for unrestricted purposes
- Applies a more carefully articulated prudence standard to guide decisions about spending
- Encourages NFPs to establish a spending policy responsive to short-term fluctuations in fund value
- Donor restrictions agreed to by the NFP will control the management of the fund

UPMIFA Endowment Spending (Continued)

Examples

- If a donor creates a fund that can only spend 4% each year, then the restriction will govern the spending from the fund to only 4%
- But if the donor restricts the fund by indicating the charity should “spend only income” or “hold the fund as an endowment” then the rules of UPMIFA apply to spending
- There must be specific instructions from the donor on spending or the rules of UPMIFA will apply
- UPMIFA will apply to NFP funds created both before and after the enactment

Optional Imprudence

Also included was an optional provision creating a rebuttable presumption that spending an amount in any year that is in excess of 7% of the average of a fund's value over a three-year period is imprudent

- Still must consider:
 - Individual gift agreements
 - The seven factors of prudence

Modification of Restrictions

Additional provision enabling institutions to make better use of older and smaller endowments whose original restrictions may have become impracticable, impossible to achieve, or wasteful

- Under both UMIFA and UPMIFA, donors may release restrictions imposed on their gifts
- Institutions cannot renegotiate gift agreements in cases where the donor has died or many donors have contributed to an individual fund

Modification of Restrictions

- Under UMIFA, institutions were required to go to court to release or modify restrictions
- Under UPMIFA, institutions can release or modify restrictions that are:
 - Old – 20 years or more
 - Below \$25,000
 - by notifying the state’s attorney general and waiting 60 days.
 - If no objections by the AG, the institution can use the fund for an alternative purpose in keeping with the donor’s original intent

Net Asset Classification of Funds (UPMIFA)

- An institution subject to UPMIFA must classify a portion of the donor-restricted fund of perpetual duration as permanently restricted nets assets
- The amount classified should be the amount of the fund that:
 - Must be retained permanently in accordance with the explicit donor stipulations, or
 - In the absence of such stipulations, the NFP's governing board determines must be retained permanently consistent with the relevant law (quasi-endowment)
- For each donor-restricted endowment fund, the NFP must classify the portion not classified as permanently restricted as temporarily restricted until appropriated for expenditure

Enhanced Disclosures

- NFPs (*whether or not subject to UPMIFA*) must disclose information to enable users of financial statements to understand:
 - Net asset classifications
 - Net asset composition
 - Changes in net asset composition
 - Spending policies
 - Related investment policies of endowment funds

Enhanced Disclosures (Continued)

- At a minimum, the following must be disclosed in the financial statements for each period:
 - Description of the Board's interpretation of laws that support the NFP's net asset classifications
 - Endowment spending policies
 - Endowment investment policies, including:
 - Return objectives and risk parameters
 - How those objectives relate to spending policies
 - Strategies employed for achieving those objectives
 - Composition of endowment by net asset class at period-end, in total and by type, showing donor-restricted funds separately from board-designated funds

Enhanced Disclosures (Continued)

- Reconciliation of beginning and ending balance of the endowment, in total and by net asset class
- Must follow SFAS 117 and 124 and provide information about the net assets of endowment funds, including:
 - Nature and type of permanent or temporary restrictions
 - Aggregate amount of deficiencies for donor-restricted funds where the fair value of assets at the reporting date is less than the level required by donor stipulations or law

Auditor Considerations

- Credit Effects – At adoption of UPMIFA, unrestricted portion of a donor-restricted fund is reclassified to temporarily restricted net assets
 - May lead to violation of one or more debt covenants in the NFP's loan agreements or bond indentures
- How enacted version of UPMIFA will be interpreted in a particular state
 - will become clearer with the passage of time
- Enhanced disclosures - whether or not subject to an enacted version of UPMIFA

UPMIFA Summary

- **Investment freedom:** no limits to the kinds of assets that may be included in the portfolio
- **Costs:** costs must be managed prudently
- **Expenditure of funds:** the entire economic situation can and must be considered by management
- **Historic dollar value is abolished**
- **Release of restrictions:** For small funds (<\$25K) the charity can release with notification to the attorney general

FSP 117-1

- Triggered by UPMIFA
- Additional disclosures not included in the original FAS 117
- Charities with endowment funds must reconsider classifications of net assets and draft new disclosures for financial statement presentation

This was effective for years ending after December 15, 2008!

FSP 117-1 “Who Has to Worry About It?”

- If your institution has an endowment fund or a quasi-endowment (board designated endowment) fund this applies to you...

Even if your state has NOT enacted UPMIFA!

(Florida has introduced UPMIFA into 2011 legislation)

FSP 117-1

Endowment may be more than you think:

UPMIFA:

- Definition is limited to funds created by the donor –
- “An institutional fund or part thereof that, under the terms of the gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.”

GAAP:

- Much broader definition, includes board designated endowment funds
- “An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization.”

FSP 117-1 (Continued)

Okay, so you have endowment or board designated funds that resemble endowments. What should you do now?

- If UPMIFA applies to you, you may have to reclassify certain funds as temporarily or permanently restricted that were classified as unrestricted in the past
- If UPMIFA does not apply, then there will be no change in account classifications, but...

Either way, there will be additional footnote disclosures for all financial statements that include endowments

FSP 117-1 (Continued)

Additional provision enabling institutions to make better use of older and smaller endowments whose original restrictions may have become impracticable, impossible to achieve, or wasteful

- Under both UMIFA and UPMIFA, donors may release restrictions imposed on their gifts
- Institutions cannot renegotiate gift agreements in cases where the donor has died or many donors have contributed to an individual fund

FSP 117-1, “*What should you be doing?*”

- Consult with legal counsel to determine which law applies
- Have the Board document in the minutes:
 - Interpretation the relevant law for donor restrictions
 - Establish an investment policy with regard to endowment funds
 - Establish an endowment spending policy
 - Determine what, if any, portion of UPMIFA funds are permanently restricted

FSP 117-1, “*What should you be doing?*”

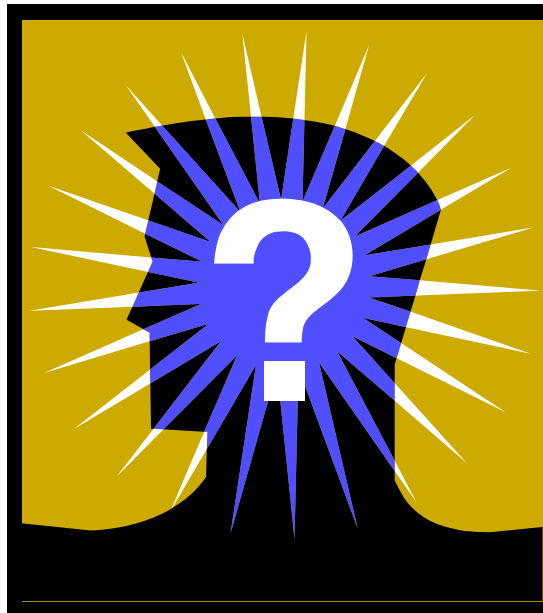
Management should:

- Review supporting documentation for all donations for appropriate treatment
- Obtain legal determination to determine if funds are considered endowments under UPMIFA

Resources

- **UPMIFA.org** (<http://upmifa.org>)
 - Provides information about what states have enacted UPMIFA
 - Gives comparison to UMIFA
 - Provides information regarding the law
- **American Institute of Certified Public Accountants**
(<http://www.aahotline@aicpa.com>)
 - Technical assistance on financial statement preparation

Questions



Thank you!

Robert J. Lane, CPA

Kerkering, Barberio & Co.

1990 Main Street, Suite 801

Sarasota, FL 34236

rlane@kbgrp.com

(941) 365-4617 • www.kbgrp.com

