Accounting and reporting for endowment funds

Prepared by:

Junia Perez, *Director*, McGladrey LLP and **Ian Benjamin**, *Partner*, McGladrey LLP

The Uniform Prudent Management of Institutional Funds Act ("UPMIFA") and the FSP FAS 117-1, Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and *Enhanced Disclosures for All Endowment Funds,* have been in existence for some time now, yet confusion and inconsistency in accounting and reporting for endowment funds have continued.

UPMIFA was approved in July 2006 by the National Conference of Commissioners on Uniform State Laws to replace the Uniform Management of Institutional Funds (UMIFA) Act of 1972, and to provide guidance and authority to charitable organizations concerning the management and investment of funds held by those organizations. UPMIFA imposes additional duties on those who manage and invest charitable funds to provide additional protection for charities and protect the interests of donors who want to see their contributions used wisely.[1] To date, 49 states, the District of Columbia and the U.S. Virgin Islands have adopted or enacted a version of UPMIFA. Pennsylvania and Puerto Rico are the only jurisdictions that have not enacted a version of UPMIFA.

UPMIFA also prescribes the standard of conduct in managing and investing endowment funds. It requires investments in good faith and with the care of an ordinarily prudent person in a like position would exercise under similar circumstances. UPMIFA emphasizes that investment decisions must be made in relation to the overall resources of the institution and its charitable purposes, and not be made in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risks and return objectives reasonably suited to the fund and to the institution.[2]

One of the key changes brought about by UPMIFA was the elimination of the historic-dollar-value threshold set by UMIFA. UPMIFA allows not-for-profit organizations, absent explicit donor restrictions, to spend endowment funds below their original dollar amount, subject to the standard of prudence and consideration of the following factors:

1. The duration and preservation of the endowment fund
2. The purposes of the not-for-profit organization and the endowment fund
3. General economic conditions
4. The possible effect of inflation or deflation
5. The expected total return from income and the appreciation of investments
6. Other resources of the not-for-profit organization
7. The investment policy of the organization

FSP FAS 117- 1 was issued in August 2008 to address the accounting and reporting issues brought about by UPMIFA. FSP FAS 117-1 1 (now in the FASB codification at ASC 958-205-45/50) provides guidance on the net asset classification of donor-restricted endowment funds for a not-for-profit organization that is subject to an enacted version of UPMIFA.

The table below summarizes the key provisions in Section 4(a) of UPMIFA that result in an accounting issue for endowment funds and the guidelines provided by FASB ASCS 958-205 to address the issue.

UPMIFA Provision	FASB ASC 958-205-45 Guideline
Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established.[3]	A not-for-profit organization that is subject to an enacted version of UPMIFA shall classify a portion of a donor-restricted endowment fund of perpetual duration as permanently restricted net assets, which shall be the amount of the fund (a) that must be retained permanently in accordance with explicit donor stipulations, or (b) that in the absence of such stipulations, the organization's governing board determines must be retained (preserved) permanently consistent with the relevant laws.[4]
Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution.[5]	For each donor-restricted endowment fund for which the restriction described in subsection 4(a) of UPMIFA is applicable, a not-for-profit organization shall classify the portion of the fund that is not classified as permanently restricted net assets as temporarily restricted net assets (time restricted) until appropriated for expenditure by the organization.[6]

FSP FAS 117-1 (codified as FASB ASC 958-205-50-1B) also requires improved disclosures about a not-for-profit organization's donor-restricted and board-designated endowment funds regardless of whether or not the not-for-profit organization is subject to UPMIFA. The following information about all endowment funds is required to be disclosed for each period for which the organization presents financial statements:

- A description of the governing board's interpretation of the law(s) that underlies the organization's net asset classification of donor-restricted funds.
- A description of the organization's endowment spending policy (ies).
- A description of the organization's endowment investment policies, which shall include the return objectives and risk parameters; how those objectives relate to the organization's endowment spending policies and the strategies employed for achieving those objectives.
- The composition of the organization's endowment by net asset class at the end of the period, in total and by type of endowment fund, showing donor-restricted endowment funds separately from board-designated endowment funds.
- A reconciliation of the beginning and ending balance of the organization's endowment, in total and by net asset class, including, at a minimum, the following items (as applicable): investment return, separated into investment income (i.e., interest, dividends, rents) and net appreciation or depreciation of investments, amounts appropriated for expenditure; reclassifications and other changes.
- The nature and types of permanent or temporary restrictions on the endowment net assets.
- The aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.[7]

The requirement to include reconciliation for board designated and donor-restricted endowments, and to present deficiencies in donor-restricted endowment funds, has resulted in a table being included in most financial statements. While intended to provide clarity to financial statement users; there has been much disparity in practice in its presentation. Let's walk through an example to better understand how it is intended to be prepared.

Illustrative example

ABC Organization has a sizeable donor-restricted endowment, along with a board designated endowment. The net asset classifications of ABC Organization's endowment funds at the end of Year 200X, *prior to UPMIFA* enactment, are as follows:

	Permanently Restricted	Temporarily Restricted	Unrestricted
Donor-restricted endowment funds:			
• With explicit restrictions by donor or law to be held in perpetuity	$ 150,000	$ -	$ -
• With time/term restrictions imposed by donor or law		500	
• Without explicit time or purpose restriction by donor or by law			20,000
• Accumulated income on endowments to support purposes specified by donor		15,000	
• Accumulated income on endowments to support general operations of the organization			1,000
Total donor-restricted endowments	$ 150,000	$ 15,500	$ 21,000
Board designated endowment funds for certain purposes			$ 10,000

In early Year 200Y, ABC Organization became subject to UPMIFA and adopted FSP FAS 117-1/FASB ASC 958-205-45/50.

Below are the activities related to the endowment funds of ABC Organization during Year 200Y and Year 200Z:

	Year 200Y		Year 200Z	
	Donor-Restricted Endowment Funds	Board-Designated Endowment Funds	Donor-Restricted Endowment Funds	Board-Designated Endowment Funds
Pledges received for endowment funds	$ 5,000	$ -	$ 3,000	$ -
Cash contributions received for perpetual endowment funds	2,000	-	1,500	-
Cash collections received on multi-year pledges for perpetual endowment funds	1,500	-	2,500	-
Amounts appropriated for expenditures	(3,000)	(500)	(3,250)	(500)
Transfer from unrestricted general funds to create board-designated endowment funds	-	650	-	250
Investment return:				
Investment income	600	200	650	250
Net appreciation (depreciation)	(350)	125	1,000	500
Investment fees and expenses	(15)	(5)	(25)	(6)

Of the total investment return for donor-restricted endowment funds, $120 must be retained annually and and added to the perpetual funds in accordance with the explicit donor stipulations to maintain the purchasing power of those funds.

Due to the depreciation of investments during Year 200Y, the fair value of certain donor-restricted endowment funds were less than the amount of the original gift by $750. The board deemed it prudent to continue to appropriate $100 from those funds so as not to suspend certain programs.

$500 of the net appreciation for Year 200Z were attributed to investments of donor-restricted endowment funds that have gone underwater in Year 200Y.

Considering the above assumptions and the requirements of UPMIFA and FASB ASC 950-205-45/50, ABC Organization would account for its endowment funds during years 200Y and 200Z, as follows, with note explanations following the table:

Year 200Y

		Donor-Restricted Endowments				Board-Designated Endowments	
		Permanently Restricted	Temporarily Restricted	Unrestricted	Total	Unrestricted	Total Endowments
Balance, beginning of year		$ 150,000	$ 15,500	$ 21,000	$ 186,500	$ 10,000	$ 196,500
Net asset reclassification based on change of law	1	-	21,000	(21,000)	-	-	-
Balance, beginning of year after endowment net asset reclassification		150,000	36,500	-	186,500	10,000	196,500
Changes in endowment funds during the year:							
Investment return:							
Investment income	2	120	465		585	195	780
Net appreciation (depreciation)	3	-	400	(750)	(350)	125	(225)
Total investment return		120	865	(750)	235	320	555
Contributions to endowment funds during the year	4	3,500	-	-	3,500	-	3,500
Transfers from general unrestricted funds to board-designated endowments		-	-	-	-	650	650
Amounts appropriated for expenditures	5	-	(2,900)	(100)	(3,000)	(500)	(3,500)
Total changes		3,620	(2,035)	(850)	735	470	1,205
Balance, end of year		$ 153,620	$ 34,465	$ (850)	$ 187,235	$ 10,470	$ 197,705

Year 200Z

		Donor-Restricted Endowments				Board-Designated Endowments	
		Permanently Restricted	Temporarily Restricted	Unrestricted	Total	Unrestricted	Total Endowments
Balance, beginning of year		$ 153,620	$ 34,465	$ (850)	$ 187,235	$ 10,470	$ 197,705
Changes in endowment funds during the year:							
Investment return:							
Investment income	2	120	505	-	625	244	869
Net appreciation (depreciation)	3	-	500	500	1,000	500	1,500
Total investment return		120	1,005	500	1,625	744	2,369
Contributions to endowment funds during the year	4	4,000	-	-	4,000	-	4,000
Transfers from general unrestricted funds to board-designated endowments		-	-	-	-	250	250
Amounts appropriated for expenditures	5	-	(3,250)	-	(3,250)	(500)	(3,750)
Total changes		4,120	(2,245)	500	2,375	494	2,869
Balance, end of year		$ 157,740	$ 32,220	$ (350)	$ 189,610	$ 10,964	$ 200,574

1. The reclassification of the net asset restrictions of endowment funds is made in the year of adoption to conform with the requirements of Section 4(a) of UPMIFA that "the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution" and FASB ASC 958-205-45-30 that "for each of the restricted endowment fund for which the restriction described in subsection 4(a) of UPMIFA is applicable, a not-for-profit organization shall classify the portion of the fund that is not classified as permanently restricted net assets as temporarily restricted net assets (time restricted) until appropriated for expenditure by the organization."

2. Investment income, net of fees and expenses. $120 of total investment income added to permanently restricted endowment funds pursuant to explicit donor requirements.

3. The portion of a donor-restricted endowment fund that is classified as permanently restricted net assets is not reduced by losses on the investments of the fund, except to the extent required by the donor, including the losses related to specific investments that the donor requires the organization to hold in perpetuity.[8] In the absence of donor stipulations or laws to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before a loss occurs. Any remaining loss shall reduce unrestricted net assets. Gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets. After the fair value of the assets of the endowment fund equals the required level, gains that restricted by the donor or by law should be classified as temporarily restricted net assets or permanently restricted net assets, depending on the restrictions on the endowment fund.[9]

4. Cash contributions and cash collection on multi-year pledges for perpetual endowment funds. Pledges receivable, although intended for endowments in perpetuity, are not considered contributions to endowment fund until realized and added to the investment pool.

5. Appropriations for expenditure is deemed to occur upon approval for expenditure, unless approval is for a future period, in which case approval is deemed to occur when that period is reached.[10] Generally, approval of appropriations for expenditure is made when a decision is made by the governing board to release a portion of the endowment fund from donor restrictions for spending in accordance with the terms of gift instrument. Actual spending of the appropriated amount may occur at a later date or over a period of time. The amount of permanently restricted net assets is not reduced by appropriations for expenditures.[11] If appropriations reduce the assets of a donor-restricted endowment fund below the level required by donor stipulations or low, the

appropriations shall be classified as unrestricted net assets. Gains that restore the fair value of the endowment fund to the required level shall be classified as increases in unrestricted net assets.

In its notes to financial statements for Years 200Y and 200Z, ABC Organization would show a roll-forward reconciliation of all endowment funds similar to the one shown in this example and the other information required by FASB ASC 958-205-50, such as the governing board's interpretation of the laws underlying the net asset classifications of donor-restricted endowment funds, the investing and spending policies, the nature and type of permanent or temporary donor restrictions, and the amount of deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date have gone below the level required by donor stipulations or law.

Common challenges in accounting and reporting of endowment Funds

- ***Difficulty in determining the assets and the investment earnings, gains and losses attributable to the endowment funds as the assets of endowment funds are commingled in investment pools of the organization for portfolio management purposes.***

  - Review the composition of funds in the investment pool and assign ownership interests (typically through unitization) to the various funds held in the pool (sometimes referred to as participants) based on the market value of the cash and securities placed in the pool by each participant. Use current market value to determine the number of units allocated to the additional assets placed in the pool and to value withdrawals from the pool. Allocate investment income and realized unrealized gains and losses equitably based on the number of units assigned to each participant.

- ***When to classify and report an endowment fund as permanently restricted, temporarily restricted, unrestricted or unrestricted or board designated net assets.***

  Pursuant to FASB ASC 958-205-45-14, each source – original gift, gains and losses, interest and dividends – must be evaluated separately when classifying an endowment fund.

  - A donor's stipulation that requires a gift to be invested in perpetuity creates an endowment under UPMIFA. The board must determine the portion that is to be classified as permanently restricted net assets in accordance with the donor's wishes or relevant state law, any remaining balance would be classified as temporarily restricted. Most organizations have interpreted state law as requiring the preservation of the original gift corpus and, therefore, classify the original gift as permanently restricted, absent other donor instructions. A donor's stipulation that requires a gift to be invested for a specified term or period creates temporarily restricted net assets.

- If a donor stipulates that interest and dividends and net gains be added to the principal of the gift until that endowed gift increases to a specified dollar level, then the accumulated earnings and gains are usually classified as permanently restricted. If a donor states that a specific investment security must be held in perpetuity, the gains and losses on that security are subject to the same permanent restrictions, unless the donor specifies otherwise.
- Funds earmarked by the governing board from an organization's unrestricted net assets to be invested to provide income for a long or unspecified period create a board-designated endowment fund that is classified as unrestricted net assets.
- Absent explicit donor stipulations or law to the contrary, interest and dividends and gains on permanently restricted endowment funds are classified as temporarily restricted net assets until appropriated for expenditure by the organization.
- Investment losses on donor-restricted endowment funds shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on the net appreciation of the fund have not been met before the loss occurs. Any remaining losses, or losses that reduce the value of the endowment assets below the level required by donor stipulations or law, are reported as reductions to unrestricted net assets. As a result endowment net assets would include a negative balance in unrestricted net assets equal to the sum of all such 'under water' funds. Gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.
- Interest and dividends, and gains and losses on board designated endowment funds are classified as changes in unrestricted net assets.

- ***When to release the temporary restriction on endowment funds classified as temporarily restricted net assets:***
  - When the funds are appropriated after the period or term specified by the donor has been met by the organization.
  - Upon appropriation or approval for expenditure by the governing board, unless approval is for a future period, in which case approval is deemed to occur when that period is reached. For instance, in FY 200Y the governing board appropriated a certain portion of the temporarily restricted endowment funds to fund FY 200Z budget. The appropriation for expenditures (i.e., "release from temporary restrictions") is deemed to have occurred in FY 200Z when the appropriated amount is available for spending.

- If the temporarily restricted endowment has a purpose restriction, the release occurs when amounts are spent, or deemed spent, for that purpose, although they would cease to be classified as endowment on appropriation.

- ***When to reduce the fund balances of endowments classified as temporarily restricted or unrestricted (board designated) net assets for amounts appropriated for expenditure.***
  - Endowment fund balances and net assets are reduced upon appropriation for expenditure even if cash and assets are not yet transferred. In effect, the appropriated (but not transferred) amount is due to the non-endowment funds (i.e., general operating fund, plant fund, etc.) of the organization. This requirement may be met through the approval of an annual budget that includes such spending.

- ***When to consider permanently restricted pledges receivable as endowment.***
  - Unconditional promises to give that are restricted by donors for investment in perpetuity are not considered *endowment* net assets until the proceeds have been received and added to the investments held for endowments. Therefore, these pledges are not included in the reconciliation of the beginning and ending endowment net asset balances required under FASB ASC 958-205-50-1B. They would still be classified as permanently restricted net assets.

- ***Are assets or investments held for split-interest agreements considered endowments?***
  - Investments held for split-interest agreements are not considered endowments. These investments may not be subject to the same investing and spending policies of the organization. Different states have varying laws or regulations for administering investments held for split-interest agreements.

For further information, contact Junia Perez, Director, McGladrey LLP, or Ian Benjamin, Partner, McGladrey LLP.

---

[1]UPMIFA, Prefatory Note
[2]UPMIFA, Section 3
[3]UPMIFA, Section 4(a)
[4]FASB ASC 958-205-45-28
[5]UPMIFA, Section 4(a)
[6]FASB ASC 958-205-45-30
[7]FASB ASC 958-205-50-2
[8]FASB ASC 958-205-45-29
[9]FASB ASC 958-205-45-22, FASB ASC 958-205-5-24, and AAG-NPO, par. 8.29 and 8.30
[10]FASB ASC 958-205-45-31
[11]FASB ASC 958-205-45-29

800.274.3978
www.mcgladrey.com