

To: Members of the FAOG Accounting Practices Committee

From Janne Gallagher

Re: UMIFA, UPMIFA and FASB Staff Position 117-1

Date: December 1, 2008

This memorandum considers whether adoption of the Uniform Prudent Management of Institutional Funds Act (UPMIFA)¹ requires changes to existing guidance regarding the reporting and classification of assets held by community foundations. Current guidance is incorporated in a 1997 memorandum, *Report on Classification of Net Assets by Community Foundations*, prepared jointly by the Legal Advisory Subcommittee of the Committee on Community Foundations and a committee of the Community Foundations Fiscal and Administrative Officers Group (FAOG).²

The 1997 memo considered the reporting consequences that flow from two basic types of donor gift restrictions. These are:

- Purpose restrictions – restrictions included in gift or fund agreements that limit expenditures from the fund to either:
 - a specific charitable purpose, such as protection of the environment (field of interest funds), or
 - a specifically identified charitable organization, such as the Boys and Girls Club (designated funds)
- Endowment restrictions – restrictions that affect the timing and amount of distributions from a fund. Endowments can be permanent or for a term of years³

¹ UPMIFA has been enacted in 25 states and the District of Columbia. For information about enactments see www.upmifa.org.

² http://www.cof.org/files/Documents/Community_Foundations/Professional_Groups/FAOG/AcctAlerts/APCManual.pdf. I discussed the content of this memo with the Community Foundations Legal and Regulatory Standing Committee and its Legal Subcommittee at a meeting on November 17. Members present at the meeting were generally in agreement with the conclusions.

³ This memo uses the terms “principal” or “corpus” to describe the portion of an endowment fund that is not fully expendable under applicable law.

Purpose Restrictions

All community foundations possess the variance power. The classic statement of this power is taken from Treas. Reg. 1.170A-9(f)(11)(v)(B)(1):

To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified charitable purposes or to specified organizations if in the sole judgment of the governing body (without the necessity of the approval of any participating trustee, custodian, or agent), such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served

The 1997 memo concluded that because this power gives a community foundation the unilateral right to change the purpose of a fund, or to redirect funding from the originally designated charity to another, assets in otherwise fully expendable field of interest and designated funds should be reported as unrestricted.⁴

However, the 1997 memorandum also concluded that “for most community foundations, the variance power does not allow them to invade principal.” This is because the standard wording of the power, quoted above, conveys authority only to modify restrictions “for any specified charitable purposes or to specified charitable purposes or to specified organizations.” While this guidance reflected the standard wording of the power, the 1997 memo noted that some community foundations may have a variance power that is broader than the standard. These community foundations should consider whether their power is broad enough to give them authority to fully expend a fund that is otherwise subject to an endowment restriction.⁵

Endowment Restrictions

Power to invade: The 1997 memo cited several bases for community foundations possessing the power to invade corpus. According to the memo, community foundations in trust form often have a power in their trust declarations that is described as “appropriation of corpus,” although the amount that can be expended may be limited to a stated percentage over a period of time, such as 2 percent a year or 20 percent over five years. This authority gives community foundations holding it the power to expend principal up to the stated yearly maximum. Some

⁴ Agency endowments are governed by FASB Statement 136 and are not recorded as assets of the community foundation that holds them.

⁵ For example, a version that omitted the clause, “for any specified charitable purposes or to specified charitable purposes or to specified organizations,” would grant complete powers of modification to the governing board.

versions of this power give community foundations the discretion to change the allowable percentage.

Community foundations in corporate form may have three sources of authority to draw on a fund's corpus:

- Some may have authority in their organizing documents to make:
 - Expenditures from corpus up to a stated percentage (similar to the trust provision for appropriation of corpus)
 - Expenditures from corpus at the discretion of the community foundation, or
 - Expenditures based on a spending rate with discretion in the governing board to establish and change the applicable rate
- Some may have a broader version of the variance power than the one required by the regulations
- Many will have fund agreements that incorporate a reference to the community foundation's spending policy or that authorize distributions from both principal and income⁶

The 1997 memo also cited the Uniform Management of Institutional Funds Act (UMIFA) as authority for expending corpus. However, this was a limited grant of authority since UMIFA permitted only the appropriation for expenditure of the amount by which a fund exceeded its historic dollar value. While technically this authorized spending from corpus since traditional trust accounting required capital appreciation to be added to corpus, UMIFA did not grant the right to expend that portion of corpus that constituted a fund's "historic dollar value."

Impact of UPMIFA

UPMIFA eliminated historic dollar value as a floor on spending from an endowment and replaced it with authority for governing boards to adopt prudent spending policies.⁷ The primary effect of this for community foundations is to provide additional spending authority to those foundations that do not have provisions in their organizing documents or fund agreements that permit them to expend principal.

Both UMIFA and UPMIFA provide that the basic definition of an endowment fund is "an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis."⁸ UPMIFA adds the caveat that assets an institution sets aside for its own use are not endowment funds. UMIFA addressed this point in

⁶ Some care is needed here. Some policies allow only expenditures of a fund's income and net appreciation. Such a policy would not be a basis for expenditures that take a corpus below its historic dollar value.

⁷ The Act enumerates several criteria for the board to consider, including preservation of the purchasing power of an endowment.

⁸ Section 1(3) of UMIFA and section 1(2) of UPMIFA.

a comment, referring to such funds as “quasi-endowment.” Since the basic definition is unchanged, a fund that legally was not an endowment fund under UMIFA will not become an endowment fund under UPMIFA. The converse is also true – if a fund was an endowment fund under UMIFA, it remains one under UPMIFA.

In determining whether funds are endowment funds, community foundations will need to examine their authority for spending from a fund to determine whether that authority is sufficiently broad to permit a fund to be fully expended “on a current basis.” Consistent with the guidance in the 1997 memo, funds that are “fully expendable” would include:

- Any fund for which there is blanket authority to invade or expend principal or corpus
- Any fund that is subject to a spending policy if the community foundation may change the policy at its discretion⁹

These funds are not, as a matter of law, endowment funds, although community foundations may administer them as such if donors expressed a hope that the fund would be permanent in character.

The guidance in the 1997 memo was that community foundations with organizing documents that establish a specific percentage by which the community foundation can draw on corpus, but which do not authorize the community foundation to alter that percentage, should classify such funds as temporarily restricted on the theory that such a fund could eventually be spent out even if it took hundreds of years. These funds would be endowment funds within the UMIFA/UPMIFA definition because they cannot be fully expended on a current basis.

Classification of Funds for Accounting Purposes

The Financial Accounting Standards Board’s definition of endowment fund is broader than the legal definition. The FASB definition¹⁰ encompasses all funds established to provide income for the support of an institution, including unrestricted funds set aside by the board of the

⁹ Unless, as noted above, the spending policy itself is limited to expenditures of income and appreciation.

¹⁰ **Endowment fund:** An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor restricted gifts and bequests to provide a permanent endowment, which is to provide a permanent source of income, or a term endowment, which is to provide income for a specified period. The portion of a permanent endowment that must be maintained permanently—not used up, expended, or otherwise exhausted—is classified as permanently restricted net assets. The portion of a term endowment that must be maintained for a specified term is classified as temporarily restricted net assets. An organization’s governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called funds functioning as endowment or quasi-endowment funds) to be invested to provide income for a long but unspecified period. A board-designated endowment, which results from an internal designation, is not donor restricted and is classified as unrestricted net assets. FASB Statement 117, Financial Statements of Not-for-Profit Organizations, Glossary (emphasis supplied).

institution as endowment.¹¹ Thus, a fund that is not an endowment fund legally may nonetheless be an endowment fund for accounting purposes.

Compliance with FASB Statement 117 requires both the identification of funds as endowment funds and the allocation of each such fund to one of three categories: permanently restricted, temporarily restricted or unrestricted. The definition of permanently restricted net assets is:

The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.¹²

Applying this definition, the 1997 memo recommended that funds be classified as permanently restricted only if both the following conditions are met:

- The donor does not allow principal invasions in the gift instrument
- The governing documents of the community foundation do not provide for the invasion of corpus

A recent FAOG survey suggests that most community foundations are classifying most of their assets as unrestricted or temporarily restricted.

FASB Staff Position 117-1

On August 6, 2008, FASB staff issued Position 117-1, which provides guidance on the net asset classification of endowment funds in states that have adopted UPMIFA. FSP 117-1 also provides for increased disclosures with respect to all endowment funds and these requirements apply without regard to whether the state has adopted UPMIFA. The changes in net asset classification primarily affect only permanently restricted endowment funds. To the extent that community foundations are correctly classifying their assets as unrestricted or temporarily restricted, these changes would not affect them.

However, the disclosure requirements apply to all endowment funds, including funds that are board designated as endowment as well as those that are subject to donor restrictions. This will require community foundations to determine whether assets they are correctly reporting

¹¹ The funds that UMIFA/UPMIFA characterize as “quasi-endowment.”

¹² Id.

as unrestricted or temporarily restricted are subject to the disclosure requirements because they are within the accounting definition of an endowment fund.

An interpretation of FASB 117 that determined that these funds are within the accounting definition of an endowment fund would have the impact of requiring that community foundation financial statements include the information required by paragraph 11 of FSP 117-1.

- a. A description of the governing board's interpretation of the law(s) that underlies the organization's net asset classification of donor-restricted endowment funds.
- b. A description of the organization's policy(ies) for the appropriation of endowment assets for expenditure (its endowment spending policy(ies)).
- c. A description of the organization's endowment investment policies. The description shall include the organization's return objectives and risk parameters; how those objectives relate to the organization's endowment spending policy(ies); and the strategies employed for achieving those objectives.
- d. 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.
- e. 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 line items (as applicable): investment return, separated into investment income (for example, interest, dividends, rents) and net appreciation or depreciation of investments; contributions; amounts appropriated for expenditure; reclassifications; and other changes.

Most community foundations describe themselves as institutions that hold endowed or permanent funds for the benefit of their communities. While a power to invade corpus may make the funds they hold not endowment funds in the legal definition, many funds are intended by donors to be permanent and are being managed accordingly. The question of whether funds that are being managed as if they were endowment are within the FASB 117 definition of endowment is an accounting issue rather than a legal one. However, I believe there are benefits to adopting a broad interpretation of the definition.

Making the FSP 117-1 disclosures with respect to funds that are managed with the intent that they be permanent would provide useful information to donors and would let them form a more accurate picture of the community foundation. Disclosure may also be helpful in dealing with regulators, again allowing them to understand an important aspect of the investment and distribution policies of many community foundations. To the extent that there is room for interpretation with respect to what may be required by FSP 117-1, I'd encourage you to

consider interpreting it as allowing community foundations to make appropriate disclosures on their financial statements and in Form 990.

Implications for Form 990

Organizations that hold endowment funds must now report information relating to their endowments on Part V of Schedule D of the revised Form 990. The instructions for Schedule D adopt the definition of endowment from FASB Statement 117 rather than the legal definition. The instructions also adopt the distinctions between funds that are permanently restricted, temporarily restricted, and unrestricted but set aside as endowment by the organization's board. Accordingly, community foundations reporting assets as permanently restricted or temporarily restricted on their balance sheets will need to complete the endowment section of Schedule D. Whether community foundations reporting assets as unrestricted will need to complete Part V will depend on whether those assets, even though unrestricted, fall within the FASB definition of an endowment fund.