

Legal and Accounting Challenges of Underwater Endowment Funds

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The widespread adoption of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) across the country has already been of great help to charities, in part because the financial markets collapsed just months after the uniform act was approved. Most, if not all, endowment funds created in the past six years are “underwater”—a phrase used to indicate that the fair market value of the investments in a particular endowment fund is less than the value of the gift that originally created that fund. Many older funds may also be underwater or approaching that condition. Under laws that had been in effect in many states, the amount a charity could spend from an underwater fund was limited, and, had UPMIFA not been adopted, charities that depended on their endowments to fund a significant portion of their operations would have been severely hampered in their ability to provide services.

Although UPMIFA’s new prudence standard allows charities to continue to spend from underwater endowment funds, the enactment of UPMIFA, when combined with the economic downturn, has caused challenges for charities when reporting the value of the endowment fund in their financial statements. The challenges are threefold:

- Financial statements of charities display equity (referred to as net assets) in three classes that are based on the existence and nature of donor-imposed restrictions: unrestricted, temporarily restricted, and permanently restricted. Because UPMIFA does not have any specific requirement to preserve the purchasing power of an endowment or to set any amount aside permanently, charities will look to their legal counsel to provide direction for the amount that must be held permanently.
- Accounting standards require that the losses associated with underwater endowment funds be displayed in the unrestricted net asset class. The larger the difference between the value of an endowment fund’s investments and the amount that the charity, working with its legal counsel, determines must be held permanently, the larger the deficit that is included in unrestricted net assets. For a charity that did not have substantial operating reserves and that incurred large losses on its endowment investments, the loss included in unrestricted net assets can swallow up the operating reserves and cause a deficit in that class.
- The large losses and the classification of a portion of them in unrestricted net assets have caused some to conclude incorrectly that the charity must restore the value of its endowment fund investments from the operating assets of the charity. Although there is no such requirement in UPMIFA or in accounting standards, the mistaken belief continues.

The Legal Rules—UMIFA and UPMIFA

UPMIFA and the Uniform Management of Institutional Funds Act (UMIFA) that preceded it are uniform acts developed by the Uniform Law Commission (aka the National Conference of Commissioners on Uniform State Laws). Both acts do three things: provide guidance on the management and investment of charitable funds, provide rules on spending from endowment funds, and provide rules on when and how a charity can release or modify a restriction imposed by a donor. The Uniform Law Commission approved UMIFA in 1972; it was adopted in 47 states plus the District of Columbia. The Uniform Law Commission approved UPMIFA in 2006; as of November 1, 2009, 43 states and the District of Columbia had adopted the Act. A copy of UPMIFA, informative articles about UPMIFA, and information about which states have adopted UPMIFA can be found at www.upmifa.org.

When a donor gives money to a charity, the donor may direct how and when the charity will use the gift. Purpose and time restrictions agreed to by the charity and the donor create legal restrictions that govern the use of the funds. A gift to an endowment represents a time restriction—the charity cannot spend the entire gift in the current year and should manage the fund so that the fund retains its value over time. An endowment also can have a purpose restriction—the charity may use the endowment only for the purpose specified by the donor.

When a donor directs a charity to “spend only the income” from a gift or to “hold this gift as an endowment,” the donor has created a restricted gift. Unfortunately, because there is some ambiguity in these terms, the charity needs guidance with the administration of the gift. When a donor and a charity have not reached a specific agreement on the meaning of those terms, then the rules of UMIFA or UPMIFA, depending on which law a state has adopted, will apply.

In the 1960s, most charities assumed that endowment income meant trust accounting income. That meant that income included interest, dividends, rents, and royalties, but not capital gains because the trust accounting rules in force at that time allocated capital gains to principal. Charities invested in bonds to increase their endowment income, but the lack of equities in the portfolios began to affect the long-term strength of the endowments (because the invested funds did not grow over time to preserve the purchasing power of the gifts).

UMIFA changed the interpretation of income for an endowment and permitted the spending of capital gains. It did so by defining the term “historic dollar value” (HDV) to mean the amount of original contributions to the fund, any additional gifts to the fund, and any additions to historic dollar value made under the donor’s gift instrument. UMIFA then authorized a charity to spend the amount above historic dollar value that the charity determined to be prudent, considering the needs of the charity. UMIFA provided that a charity could not spend capital gains if the value of the fund’s investments fell below the fund’s historic dollar value. UMIFA does not discuss the spending of income, and it was thought that a charity could continue to spend interest, dividends, rents, and royalty income, even if the value of the fund fell below historic dollar value.

UPMIFA changed the interpretation of income. UPMIFA removes the concept of historic dollar value and directs the charity to appropriate for expenditure the amount that is prudent, after considering seven factors: “(1) the duration and preservation of the endowment fund; (2) the purposes of the institution 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 institution; (7) and the investment policy of the institution.” UPMIFA § 4(a).

UPMIFA increases flexibility for a charity to maintain spending even in times of market downturn and even if the value of the endowment falls below its initial value. The charity should consider the perpetual nature of an endowment fund and adopt investment policies and spending policies sufficient to maintain the value of the fund over time, but those long-term objectives are considered equally with the purposes of the charity and the other resources available to carry out those purposes (or the lack of those resources). Whether an appropriation for expenditure is prudent is determined at the time the appropriation is made, even though there may be a delay between the time of the appropriation and the actual spending of the resources. If the charity prudently appropriates a portion of an endowment fund, it can expend the appropriated amount even if the value of the endowment is further reduced by market declines before the amount is spent. Likewise, a charity can prudently determine not to spend a previously appropriated but unspent amount and can return that amount to the endowment fund to offset the market decline.

Many charities develop spending rates to help them determine an appropriate amount to spend each year. A charity sets a percentage rate and applies that rate to the overall value of the endowment fund. Four or five percent has been a common rate, at least before the economic troubles began. The charity would invest in a diversified portfolio that would generate, in better economic times, more than the spending rate. The investment return above the spending rate would help the fund maintain its value over time. The use of a spending rate as a way to determine endowment spending has proven successful for many charities. Under UMIFA, if a fund is underwater, the charity must stop applying its spending rate and switch to spending only interest, dividends, rents, and royalty income until the fund has so sufficiently appreciated in value that application of the rate would not invade historic dollar value. Under UPMIFA, a charity may continue to apply its spending rate to an underwater fund, provided that doing so is prudent.

The Accounting Rules

Accountability for Donor-Imposed Restrictions

The equity section of a balance sheet for a charity is presented in three classes that reflect the fact that donor restrictions limit the use of resources and impose special responsibilities on the management of a charity to ensure that it uses contributed assets as stipulated. To properly prepare its financial statements, a charity must be able to track donor restrictions on its resources. A very common method of doing so is by the use of fund accounting. Fund accounting identifies the assets, liabilities, net assets, revenues, and expenses related to a particular agreement with a donor or donors. Although in its common use the term *endowment fund* is sometimes used to refer to a group of individual funds that are held for the long-term support of a charity, this article uses that term to refer to an individual fund (for example, the Smith Family Endowment). Further, although the term *endowment fund* is also commonly used to refer to resources that a governing board has designated to invest for a long but unspecified period, this article uses the term, as UPMIFA and UMIFA do, to refer only to a fund restricted by a gift agreement (that is, a donor-restricted endowment fund).

The three classes of net assets used in a charity’s financial statements are unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. Unrestricted net assets is the portion of equity that is free of donor-imposed restrictions. Similar to the retained earnings of a corporation, the only limits on the use of unre-

stricted net assets are the broad limits resulting from the nature of the charity, the environment in which it operates, the purposes specified in its articles of incorporation or bylaws, and limits imposed by contractual agreements with creditors, suppliers, and others in the normal course of business. Temporarily restricted net assets is the portion of equity that results from contributions and other inflows, such as investment return, whose use is limited by a donor's stipulation that the resources be used during a particular time period or for a particular purpose, or both. Temporary restrictions expire when the time has passed and/or when the required action has been taken by the charity. Permanently restricted net assets also result from contributions and investment returns, but the limitations placed on those resources by donors are permanent—they neither expire by passage of time nor can the charity fulfill them by its actions.

What Amount Is Permanently Restricted?

Under UMIFA, it was relatively easy to determine the amount of permanently restricted net assets. When a charity cannot spend historic dollar value, then at a minimum historic dollar value is permanently restricted. Although accounting standards would have allowed charities to classify a larger amount as permanently restricted, charities and their auditors, working with legal counsel, ultimately decided that because net appreciation of the endowment's investments could be spent under state law, net appreciation would not be reported in permanently restricted net assets. No one wanted to report as permanently restricted an amount greater than historic dollar value.

In part, the decision about what to report as permanently restricted under UMIFA was probably made so as not to tie the hands of future governing boards. In addition, financial statement considerations influenced the decision. If circumstances changed and the governing board determined that it would spend a portion of the net appreciation that a prior board had represented must be held permanently, the financial statements of that future period would show that a portion of the permanently restricted net assets had been appropriated and spent. The decision to spend would be legal, but because the financial statements of the prior periods represented that the law required the charity to keep those net assets intact in perpetuity and no legislation or case had changed the interpretation of that law, a reader of the financial statements could construe that (at best) the governing board was unwise in fulfilling its fiduciary responsibilities or that (at worst) the governing board had just done something illegal by spending a portion of the permanently restricted net assets.

With the passage of UPMIFA, the determination of permanently restricted net assets is not as easy. Accounting standards require a governing board to make a decision that the law does not require. The law requires that a governing board make a periodic decision to expend prudently, which is not the same as a decision to retain permanently.

The Financial Accounting Standards Board (FASB) issued standards in August 2008 for charities that are subject to an enacted version of UPMIFA. The standards are found in FASB Staff Position 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*, which is codified in FASB *Accounting Standards Codification*TM 958-205. They state that a portion of an endowment fund of perpetual duration should be classified as permanently restricted net assets and that in the absence of an explicit donor stipulation that determines that permanent amount, the governing board determines the amount that must be retained (preserved) permanently consistent with the relevant law. The charity includes in its financial statements a description of the governing board's interpretation of the law that underlies its net asset classification of endowment funds.

The authors believe that governing boards have three options open to them to determine the amount to be classified as permanently restricted for each endowment fund:

1. set permanently restricted net assets at the amount of the original gift that established the fund, any subsequent gifts to the fund, and any accumulations added to the fund under the gift instrument (that is, permanently restricted would continue to be equal to HDV);
2. set permanently restricted net assets at an amount that is indexed in a manner that preserves the purchasing power of the original gift; or
3. set permanently restricted net assets at an amount less than the original gift—an amount that serves as discipline for applying UPMIFA spending provisions. The amount chosen is the amount at which the governing board determines that it will stop appropriating from the endowment, until the value of the investments once again exceeds the chosen amount.

Deciding among these alternatives is not an entirely free choice—the permanently restricted amount should be based on the governing board's understanding of the requirements of the law. The accounting standards state:

How an enacted version of UPMIFA will be interpreted and enforced in a particular state will become clearer

with the passage of time. Because the legislation is newly enacted, no case law currently exists for its interpretation. In the meantime, organizations could look to other sources, such as the discussion that occurred in the legislative committees leading to the law adopted in a particular state, announcements from the state attorney general, a consensus of learned lawyers in the state, or similar information, to help them understand what the law requires. In the absence of new legislation, clarifying court decisions, additional guidance issued by the state attorney general, or similar developments, the governing board's interpretation of the relevant law should be consistent from year to year.

The nature of the legal guidance UPMIFA provides has made the project of figuring out how to report endowment funds a difficult one. To a lawyer, "prudence" conveys a sense of the underlying legal restriction, especially when prudence is defined through the list of factors set forth in UPMIFA. A lawyer can read UPMIFA and advise a charity about how to apply the prudence standard to distributions. The lawyer cannot—and need not—tell the charity what specific dollar amount should be preserved and what amount should be distributed. The charity must determine those amounts, and under UPMIFA the decision required is the amount to be appropriated or accumulated, not the amount to be preserved permanently.

Unlike lawyers, accountants need to be able to put specific dollar amounts into the available net asset classes. Information about permanent restrictions is useful in determining the extent to which a charity's resources are not directly available for payments to present or prospective lenders, suppliers, or employees. The problem is that UPMIFA does not provide a way to determine what specific amount is permanently restricted, even though UPMIFA clearly restricts the spending of an endowment fund. The following discussion sets forth reasons why one option might be better suited to a particular charity than another.

Set Permanently Restricted Equal to Historic Dollar Value. Setting the permanently restricted portion of an endowment fund equal to historic dollar value, as defined under UMIFA, indicates that the governing board believes that the charity has a fiduciary duty to maintain at least the amount of the donor's original gift(s) and any required accumulations. Although the value of the assets of the endowment fund will fluctuate above or below that amount, historic dollar value will serve as the benchmark against which the governing board will judge whether an appropriation from the fund is prudent. Determining the permanently restricted portion of net assets in this manner identifies within the accounting records the original gift amounts.

Set Permanently Restricted to Preserve Purchasing Power. UPMIFA does not have any specific requirement to preserve the purchasing power or to set any amount aside permanently. The comments to UPMIFA § 4 state:

Although the Act does not require that a specific amount be set aside as "principal," the Act assumes that the charity will act to preserve "principal" (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending "income" (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions). Thus, an institution should monitor principal in an accounting sense, identifying the original value of the fund (the historic dollar value) and the increases in value necessary to maintain the purchasing power of the fund.

Nonetheless, charities often represent to their donors that they will reinvest to grow the endowment fund over time or to maintain the real value of the endowment fund (adjusted for inflation). The accounting standards state that if the governing board interprets the law as requiring the maintenance of purchasing power for endowment funds, then the charity should periodically adjust the amount in permanently restricted net assets to reflect that interpretation. Under those circumstances, the charity uses the inflation (deflation) index (or indices) that it deems most relevant for adjusting the permanently restricted net assets of the funds (for example, the Consumer Price Index or the Higher Education Price Index).

Set Permanently Restricted to an Amount That Disciplines Future Appropriations. Having the discipline to stop appropriating from an endowment is difficult to do if the charity is in the midst of financial straits. Yet all recognize that at some point it becomes no longer prudent to appropriate from an endowment if the charity is to maintain a fund of permanent duration. A governing board that adopts a policy that it will stop spending if the value of the fund falls a specified percentage below the original gift could use that floor amount as the amount of permanently restricted net assets for the fund. If a charity chooses to classify net assets in this manner, however, it must comply with its policy to stop appropriating if the value falls to that floor. To continue to appropriate would call into question the governing board's representation regarding the remainder of the endowments classified as permanently restricted. If a governing board represents that it will stop appropriating in order to retain an amount permanently and then spends a portion of that amount, the charity's auditor may not believe the governing board's representation that it holds permanently the remainder of the endowment.

Classification of Losses on Underwater Endowment Funds

The accounting standards state that the portion of an endowment fund that is classified as permanently restricted net assets is not reduced by appropriations or by losses on the investments of the fund (unless the donor so directed—for example, by requiring that a specific investment be held in perpetuity). If losses or spending reduce the value of an endowment below the amount that the governing board determined must be preserved permanently, the difference between the value of the fund's assets and the permanent amount is reflected in another net asset class of that fund. In some ways, it is similar to the common stock and additional paid-in capital accounts of a corporation. Those amounts are reflected in financial statements and change only in very limited circumstances, but the fact that they do not change does not mean that the corporation cannot spend the resources that created those equity classes. Instead, it only means that when the resources are spent, the spending is reported in a different class of equity (retained earnings in the corporate case; unrestricted net assets in the charity case).

Because accounting standards require that the losses associated with underwater endowment funds be displayed in the unrestricted net asset class, the amount at which a charity defines its fiduciary duty to retain permanently affects the amount that will be reported in unrestricted net assets when an endowment fund is underwater. A governing board's determination that the law requires the preservation of purchasing power will result in a larger loss being classified in unrestricted net assets than will a determination that the law requires HDV or an amount less than HDV be permanently retained.

For example, if the investments of an endowment fund are worth \$90,000 and the governing board determines that the original gift of \$100,000 is the amount required to be preserved permanently, the \$10,000 deficit is charged to the unrestricted net asset class. If the governing board had instead determined that the law required preservation of purchasing power, and the indexed value of the original gift was \$125,000, the deficit that would be charged to the unrestricted net asset class is \$35,000.

Although the effect of a particular policy on the amount of the losses in unrestricted net assets should not affect a governing board's determination of its fiduciary responsibility to maintain a portion of an endowment permanently, it might be hard for the governing board to ignore that effect, particularly if the cumulative deficit of all underwater endowments is large. This occurs most frequently in charities that began growing their endowment in the past decade, because the economic downturn has erased most of the gains accumulated in that period. In some cases, the losses of the underwater endowment funds may be larger than the charity's unrestricted operating reserves.

Reclassification of Assets Classified as Unrestricted Under UMIFA

In addition to the severity of the economic downturn, another reason that the losses of the underwater endowments may exceed the balance in the unrestricted net assets is that charities will reclassify net assets from unrestricted to temporarily restricted when UPMIFA is adopted. That reclassification reflects the effect of UPMIFA's more carefully articulated prudence standard.

UPMIFA requires a governing board to carefully weigh the factors provided in the statute before it appropriates an amount for expenditure. In the absence of donor restrictions to the contrary, financial statements reflect this more specific standard of prudence as a time restriction on the portion of an endowment fund that is not classified in permanently restricted net assets. That time restriction expires when the net assets are appropriated for expenditure, at which time they become available for the purpose for which the endowment was created.

In contrast, the accounting standards did not interpret the prudence standard under UMIFA as creating a time restriction. Because there was no time restriction, the net appreciation was immediately available for the donor's purpose. Therefore, unless the donor specified a purpose restriction, the net appreciation of an endowment's investments (the amount above historic dollar value) was classified in unrestricted net assets. In addition, if the donor specified a purpose restriction, the accounting standards required the reclassification of the net assets to unrestricted when the donor's purpose was met by incurring a satisfying expenditure, even if the governing board had not appropriated those assets for use. For many, this classification for accounting purposes was confusing because from a legal standpoint, assets held in an endowment under UMIFA were still part of the endowment and thus were legally restricted. The clearer language under UPMIFA and the new accounting standards will result in a closer correlation between the legal and accounting definitions of "restricted" assets but will require a one-time reclassification.

When UPMIFA becomes effective, a charity must reclassify to temporarily restricted net assets any amounts within an endowment fund that are classified as unrestricted net assets if those net assets had never been appropriated for expenditure.

How Financial Statements Can Inform Readers About Underwater Endowments

The combination of several factors—the economic downturn, the governing board’s determination of the amount that must be retained permanently, and the reclassification of net assets to reflect the new prudence standards—will cause a significant drop in the unrestricted net assets of most charities that have endowments. When this occurs, it may appear that a charity has insufficient resources to continue its work.

Luckily, the format of financial statements can be adapted to ensure that this misunderstanding of the charity’s financial condition will not occur. There are two easy ways to do so. The first is to show separately the endowment amount within the unrestricted net assets section in the financial statements, as follows:

Unrestricted net assets:	
For operating purposes	\$ 500,000
Deficit of endowment assets	(1,500,000)
Total	(\$1,000,000)

The second method is to produce a balance sheet that has three columns: an operating column, an endowment and other long-term investments column, and a total column. Here is a highly simplified version:

	Operating	Endowment and Long-term Investments	Total
Assets:			
Cash	\$ 25,000	\$ 100,000	\$ 125,000
Investments	300,000	3,000,000	3,300,000
Property and equipment	<u>550,000</u>	<u> </u>	<u>550,000</u>
Total assets	<u>\$875,000</u>	<u>\$3,100,000</u>	<u>\$3,975,000</u>
Liabilities:			
Accounts payable	\$ 10,000		\$ 10,000
Long-term debt	<u>175,000</u>		<u>175,000</u>
Total liabilities	<u>\$185,000</u>		<u>\$185,000</u>
Net assets:			
Unrestricted	\$500,000	(\$1,500,000)	(\$1,000,000)
Temporarily restricted	190,000	600,000	790,000
Permanently restricted		<u>4,000,000</u>	<u>4,000,000</u>
Total net assets	<u>\$690,000</u>	<u>\$3,100,000</u>	<u>\$3,790,000</u>

Either of those two methods clearly shows the operating resources available as well as the size of the deficit for the underwater endowment funds.

No Responsibility to Restore the Value of Endowment from Operating Assets

There is no requirement in UPMIFA or in the accounting standards to restore the value of its endowment fund investments from the operating assets of the charity. Under UMIFA, the accounting standards stated that the value of the investments purchased may occasionally fall below HDV and that future appreciation of the investments generally restores the value to the required level. The same holds true for UPMIFA.

Conclusion

The drafters of UPMIFA, the legislatures that adopted it, and the drafters of the new accounting standards had no idea how quickly and dramatically their labors would be tested in the charitable community. The severity of the market decline could have crippled the programs at many charities had UPMIFA not been adopted in their states. The predicted duration of the economic downturn may encourage other states to adopt the act. The new accounting standards go a long way to reconciling the legal and the accounting views of restrictions on endowment funds, which had been widely divergent under UMIFA. Together, the actions of the men and women working on UPMIFA and the FASB guidance unwittingly averted what could have been a perfect storm for many charities’ operations.

Readers can follow the “Enactment Status” link at www.upmifa.org to see whether a particular state has adopted UPMIFA and to link to a particular state’s version. The accounting standards for classification of endowment funds subject to UPMIFA (FSP FAS 117-1) are available at www.fasb.org/pdf/fsp_fas117-1.pdf. The accounting standards apply to financial statements for fiscal years ending after December 15, 2008, and include new disclosure require-

ments, which apply in all states, including states that have not adopted UPMIFA.