

A NEW STANDARD FOR ENDOWMENTS
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Executive Summary

Effective July 1, 2007, the State of South Dakota adopted a version of UPMIFA (the Uniform Prudent Management of Institutional Funds Act). Consequently, the University of Sioux Falls is subject to the provisions of FASB Staff Position (FSP) FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classifications of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for all Endowment Funds*. The FSP provides guidance on classifying net assets associated with donor-restricted endowment funds held by organizations that are subject to an enacted version of UPMIFA.

While it is commonly overlooked, UPMIFA and FAS 117-1 allow a non-profit to implement a new standard for its endowment accounting. The opportunity comes in the elimination of historical dollar value as a legal or accounting requirement. Historical dollar value is no longer a required benchmark for endowment spending or as a marker to identify the amount of an endowment fund that is permanently restricted for accounting purposes. Endowed funds may now be spent below the value of the original gift (historical dollar value) subject to a standard of prudence and donor intent as expressed in a gift instrument. The FSP also only requires that *a portion* of a donor-restricted endowment fund be classified as permanently restricted net assets and that the amount not classified as permanently restricted net assets be classified as temporarily restricted net assets until appropriated for expenditure. The FSP does not prescribe a specific requirement for how the portion should be determined.

In response to UPMIFA and FAS 117-1, the University of Sioux Falls has taken a position which establishes a spending floor (below historical dollar value) identified by extrapolating expectations for portfolio market risk while including a spending factor. This will allow for some flexibility to honor a donor's intent to provide spending from a fund in spite of short-term market declines. Consequently, the spending floor becomes the new marker for the portion of an endowed fund that is classified as permanently restricted. The adoption of a new marker for permanently restricted net assets results in a reclassification of endowment net assets from permanently restricted to temporarily restricted.

The opportunity to classify the portion of an endowment fund that is permanently restricted as something different than historical dollar value, and even less than historical dollar value, is clearly afforded in the language of UPMIFA and FAS 117-1. Establishing a marker for PRNA that is less than HDV, and based on the premise of a spending floor that takes market risk into consideration, creates endowment accounting and financial reporting that provides a more faithful representation of the value of an endowment as well as the manner in which we expect to manage that endowment. It provides a clear message to donors by attempting to identify the value of a fund that will be truly permanently restricted (and not be offset by losses in other net asset classes) and a firm point at which spending will no longer be deemed prudent. It also aligns endowment accounting and financial reporting with the reality of investment risk that has

developed as a result of investment opportunities afforded to endowments through the passage of UMIFA (the Uniform Management of Institutional Funds Act of 1972).

Organization

The University of Sioux Falls is a Christian university in the liberal arts tradition. Founded in 1883, it is the oldest and second-largest private university in South Dakota. The traditional motto of the University is Culture for Service, that is, we seek to foster academic excellence and the development of mature Christian persons for service to God and humankind in the world. Located in Sioux Falls, an economic hub of southeastern South Dakota USF draws over 60 percent of students from within a 100-mile radius of the city and the remainder from throughout South Dakota and the neighboring states of Iowa, Minnesota, and Nebraska. The reported population of the Sioux Falls MSA was 223,000 residents as of 2009.

The University of Sioux Falls offers 34 major areas of study, 3 degree completion programs, 7 pre-professional programs, master's degrees in business administration and education, and a collaborative doctorate in education with the University of St. Thomas in St. Paul, Minnesota. USF also has strong athletic programs, including a highly competitive football heritage which includes NAIA national championships in 1996, 2006, 2008, and 2009. Enrollment for the fall 2009 term was 981 full-time students. The University has an operating budget of roughly \$20,000,000 and manages an endowment of approximately \$15,000,000.

Problem/Initiative

While it is commonly overlooked and misinterpreted, UPMIFA and FAS 117-1 allow a non-profit to implement a new standard for its endowment accounting. The opportunity comes in the elimination of historical dollar value as a legal or

accounting requirement. Historical dollar value is no longer a required benchmark for endowment spending or as a marker to identify the amount of an endowment fund that is permanently restricted for accounting. Endowed funds may now be spent below the value of the original gift (historical dollar value) subject to a standard of prudence and donor intent as expressed in a gift instrument. Additionally, FAS 117-1 only requires that *a portion* of a donor-restricted endowment fund be classified as permanently restricted net assets and the FSP does not prescribe a specific requirement for how an institution should establish that marker.

From a legal perspective, “UPMIFA’s framers intended that it provide nonprofits with greater freedom in endowment investment and spending matters, subject to specific factors enumerated in the law and to an overall standard of prudence.¹” Absent explicit donor stipulation to the contrary, UPMIFA clearly allows an institution to spend as much of an endowed fund as its governing Board determines to be appropriate (applied against a standard of prudence), thereby removing the notion that 100% of the original gift amount (historical dollar value) must be classified and maintained on the books as permanently restricted. According to South Dakota statute 55-14A-4(c)(the Act), language in a gift instrument that directs the use of only “income”, “interest”, “dividends”, or “rents, issues, or profits” or “to preserve the principal intact” serve to “**create** an endowment fund”, but “**do not otherwise limit the authority to appropriate for expenditure.**”² The law creates no requirement to classify an endowment asset as temporarily restricted or permanently restricted (only that it be restricted to demonstrate that it is not wholly expendable on a current basis). To the contrary, the notion of

historical dollar value, which in its origin was a legal term and legal requirement under the prior UMIFA statute (Uniform Management of Institutional Funds Act), is now eliminated through UPMIFA.

FASB Staff Position No. 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* 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. Paragraph 5 of the FSP states that an organization “shall classify **a portion** of a donor-restricted endowment fund of perpetual duration as permanently restricted net assets.”

In paragraph 6 of the FSP, the Financial Accounting Standards Board acknowledges that interpretation of UPMIFA will become clearer with the passage of time and it makes the recommendation that an organization investigate other sources which might provide guidance as to the intent of the law in a given state. These sources include but may not be limited to “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 “clarifying court decisions.”³

In Appendix A: Basis For Conclusions (of FAS 117-1) the FASB identifies four views which were evaluated in considering the effect of UPMIFA’s elimination of the historical-dollar-value threshold. Ultimately the Board concluded that View 4 “best reflects the underlying nature of the fund under UPMIFA within the current framework for reporting donor-restricted net assets of not-for-profit organizations.

View 4 states: “**some, but generally not all**, of the fund should be classified as permanently restricted net assets. **The amount** classified as permanently

restricted net assets should be ***the portion*** of the fund that must be retained permanently ***as determined by a governing board's interpretation of the state's version of UPMIFA.***"

Among other factors, the Board very clearly identifies the fact that the position asserted in View 4 "avoids inappropriately providing a definitive legal interpretation" as a primary reason for their preference for View 4.

The observation may be made that the FASB opinion is prefaced with the statement that the short-term spending flexibility allowed through UPMIFA does not change an organization's long-term fiduciary duty to the donor. If historical dollar value was the mark for that long-term fiduciary duty before, why would it be less now? In response, the legal requirement for historical dollar value as a benchmark has been eliminated through UPMIFA. To that end historical dollar value only exists as a concept; a concept that can be utilized as an accounting tool to the degree that users of the financial information find it useful. However, under the current language of FAS 117-1 there is ***no requirement*** that historical dollar value and permanently restricted net assets be one and the same value. Secondly, how a fund is divided between net asset classes does not preclude the expectation for the long-term fiduciary duty of an organization. The long-term fiduciary duty is concerned with an endowment fund as a whole and not one net asset class. Long-term fiduciary duty is exemplified to a greater degree in institutional decisions concerning investment and appropriation than the degree to which an endowment is restricted from an accounting standpoint (temporarily restricted vs. permanently restricted). Additionally, in the case of underwater endowments, it can be argued that historical dollar value is potentially misleading as a financial indicator of the health of an endowed fund.

The argument may also be made that paragraph A7 of FSP FAS 117-1 creates a requirement or recommendation that the permanently restricted portion of an endowment fund include some allocation of investment gains in an effort to maintain purchasing power. While an implied obligation to maintain purchasing power may exist in the language of FAS 117-1, there is no explicit requirement. Secondly, if attempting to associate permanently restricted net assets with original gift value adjusted for inflation, the only way to demonstrate an effort to maintain the purchasing power of an endowment fund would be to move a portion of investment gains from temporarily restricted net assets to permanently restricted net assets. This would result in an even greater disparity between the value of PRNA and the value of a fund as a whole in environments with significant market declines (with no requirement for an institution to restore that disparity). Making this accounting adjustment would undermine expectations for permanently restricted net assets as well as expectations for donor-restricted vs. board restricted net asset classification in the same manner as the position USF has put forth which changes (to some degree) the net asset classification of original gift dollars. This illustrates that historical dollar value, as we know it today, is an equally arbitrary value when it comes to defining what must be classified as permanently restricted.

The governing boards of nonprofits subject to FSP FAS 117-1 have essentially three alternatives when determining how the permanently restricted portion of an endowment fund should be defined. In their article “Legal and Accounting Challenges of Underwater Endowments”, Susan Gary and Susan Budak usefully classify these three alternatives as the following:

- 1) “Set permanently restricted net assets at the amount of the original gift that established the fund, and subsequent gifts to the fund, and any accumulations added to the fund pursuant to the gift instrument (historical dollar value).
- 2) Set permanently restricted net assets at an amount that is indexed in a manner that preserves the purchasing power of the original gift.
- 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.⁴”

DESIGN (APPLYING A NEW STANDARD)

To the extent that it is allowed under law and generally accepted accounting principles, the governing Board of the University of Sioux Falls has elected to adopt UPMIFA and FAS 117-1 in a manner consistent with that expressed in no. 3 (above). The Board has done so in the interest of providing a more faithful representation of the financial reporting of our endowment funds, and in the interest of establishing prudent spending policy that will offer greater clarity and transparency to donors. USF has taken a position that defines the permanently restricted portion of a donor-restricted

endowment fund in connection with a spending floor. The spending floor is determined by extrapolating to the overall fund the principles of short-term market risk inherent in an endowment investment model which, through a diversified asset allocation and long-term investment horizon, strives to outperform inflation and spending rates. This also includes consideration of institutional expectations concerning the ability and intent to authorize appropriation from endowed funds. This must be evaluated within the context of the standards of prudence as prescribed by UPMIFA.

In calculating a spending floor the University of Sioux Falls utilized an analysis of different asset allocation models comparable to the University's target asset allocation as recommended in the University Investment Policy. For the purpose of a spending floor, our interest is in the projected "worst case" scenario one-year returns. Based on the analysis of these models, as well as experiencing the reality of market declines in 2008 and 2001, it is our contention that the one-year market risk of an endowment fund can be extrapolated by taking the average of the high and low one-year "worst case" scenario returns (which is 27% from our analysis). Additionally, in a "worst case" scenario it is our expectation that a donor's intent is to provide an annual, on-going award from their endowment fund, and the University would still make an effort to honor that intent by awarding from endowed funds where feasible and in accordance with policy (and subject to explicit donor stipulation), albeit at a reduced level of perhaps 3-4%. The average of the expected award of 3.5% times two years is 7%; which represents the potential award/spending impact on an endowment fund in the given "worst case" scenario. The average of two years of awards is factored in due to the fact that the (unknown) timing of a potential one year market decline could affect two years

of awards. The market risk of 27% together with the spending factor of 7% represent an endowment funds potential total loss in value (of 34%) in a “worst case” market environment.

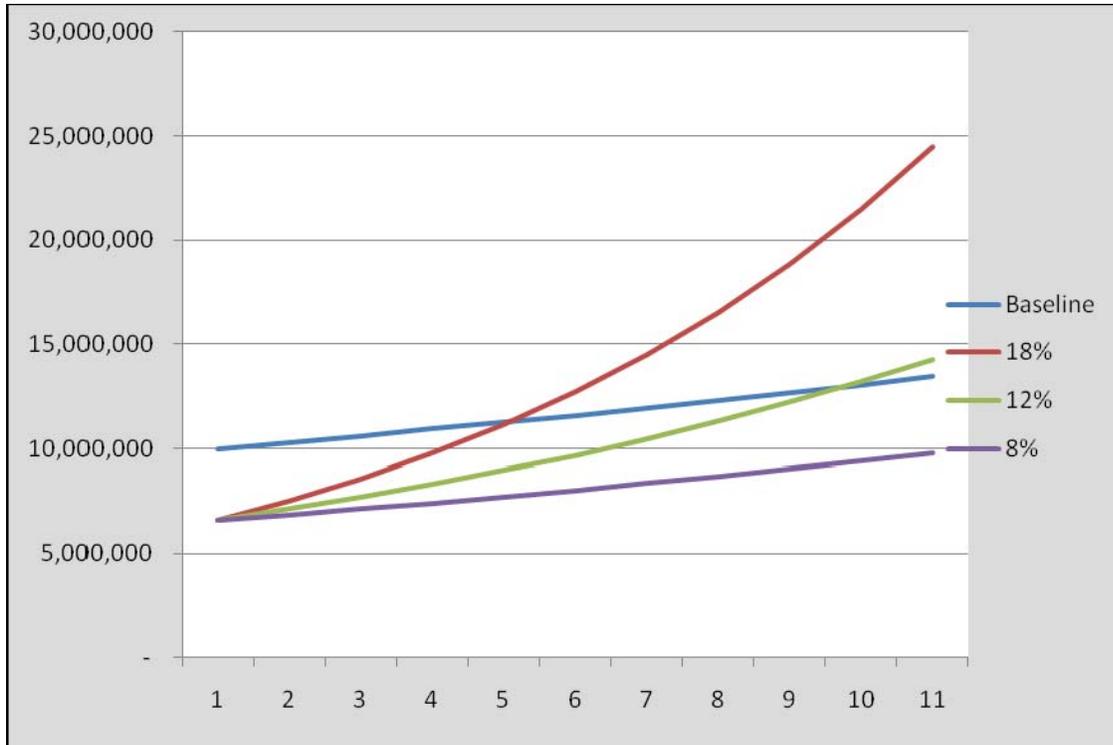
The compliment of this number, 66%, provides an appropriate and prudent spending floor, and consequently a more faithful marker for what portion of an endowment fund should be accounted for in permanently restricted net assets on the books of the University with the excess being classified as temporarily restricted. If the total balance of an endowment fund drops below the spending floor, through any combination of market losses or spending, all spending from the fund will cease until the value of the investments once again exceeds the floor. To this end it is our contention that the portion of an endowment fund classified as permanently restricted will be truly permanently restricted. This action achieves endowment accounting and financial reporting framed within the context of an organization’s investment strategy (considering risk and return objectives and market volatility) and current spending policy.

The new standard is applied to every fund subject to UPMIFA on a fund by fund basis in order to determine proper accounting and appropriation. UPMIFA is a default statute, meaning it only applies in the absence of overriding, explicit donor stipulations as expressed in a gift instrument. For the University of Sioux Falls, gift instruments that contain specific reference to historical dollar value or explicitly require the preservation of a fixed dollar amount as permanent (or to be held in perpetuity) are considered not applicable to the new standard because the donor has made a clear expression of intent which must be honored. However, according to South Dakota statute, language in a gift instrument that directs the use of only “income”, “interest”, “dividends”, or “rents,

issues, or profits” or “to preserve the principal intact” serve to **create** an endowment fund, but **do not otherwise limit the authority to appropriate for expenditure**.

Assessing Fund Integrity & Purchasing Power

The classification of the permanently restricted portion of an endowment fund as something less than HDV, for accounting purposes, does not impair the long term viability of that fund nor does it undermine the fiduciary duty to maintain that fund in perpetuity which is managed to a greater extent through investment and spending decisions. While no one can predict future market returns, the University did evaluate whether a spending floor of this nature would undermine the long-term viability of its endowment funds and impede the ability to maintain purchasing power. Further study of investment portfolio models show that an endowment can move from the floor of 66%, provide an annual payout, and maintain purchasing power (long-term).



This graph provides an illustration of that analysis. The baseline is 100% (original gift value) adjusted for annual inflation of 3%. Three varying returns adjusted for annual appropriation of 4% are plotted against the baseline. The starting point for the graph lines representing rates of return is 66% (\$6,600,000) because our interest lies in probable scenarios subsequent to fund values being taken to the spending floor. The intersection of the baseline with another line is the point at which the fund has recovered from the spending floor, provided annual payouts of 4% and maintained purchasing power against 3% inflation. Pivotal to this analysis is the assumption that there is an increased probability for above average rates of return subsequent to the occurrence of an extreme low probability event (a Black Swan). The compound average annual return on a balanced portfolio (60% stock/40% bonds) for the five year period subsequent to the October 1987 stock market crash was 13.58%. If above

average returns are achieved, the endowment could regain “real value” within 10 years or less.

One must also keep in mind that establishing a spending floor does not remove or diminish the fiduciary duty of the Board. The Board must still review the long-term prospects for the endowment according to the standards of prudence prescribed in UPMIFA on an annual basis. This essentially means that every year there is a reset on fiduciary duty before decisions for appropriation can be made despite the methodology utilized in creating a spending floor. The graphs investment return lines include annual appropriation of 4%. This obviously impacts the ability of a fund to regain a point of sustaining purchasing power. Decisions for appropriation must still be made on an annual and fund by fund basis and any decisions to reduce appropriation will increase the probability of sustaining purchasing power.

IMPLEMENTATION

In implementing such a policy, there are several steps to navigate:

- 1) Determine whether FSP FAS 117-1 applies to the organization. For any state that has not adopted UPMIFA, historical dollar value remains the required marker for net asset classification and endowment spending.
- 2) Consider having an attorney review the organization’s governing documents to determine whether the organization has the power to expend the principal of endowed funds on a current basis which is a fundamental consideration in determining the applicability of UPMIFA.
- 3) As recommended by the FASB in paragraph 7 of the FSP, an organization should research “discussion that occurred in legislative committees”, “case law”,

“announcements from the state attorney general”, or “a consensus of learned lawyers in the state” to help understand what the law requires in a specific state.

- 4) Review gift instruments for every endowment fund to determine whether a new marker for expenditure and classification, under the standard of prudence, can be applied. For the University of Sioux Falls, gift instruments that contain specific reference to historical dollar value or explicitly require the preservation of a fixed dollar amount as permanent (or to be held in perpetuity) are considered not applicable to the new standard because the donor has made a clear expression of intent which must be honored. However, according to the formulation set forth in UPMIFA, language in a gift instrument that directs the use of only “income”, “interest”, “dividends”, or “rents, issues, or profits” or “to preserve the principal intact” serve to **create** an endowment fund, but **do not otherwise limit the authority to appropriate for expenditure**.
- 5) Define a spending floor or classification marker. For the University of Sioux Falls, this included a factor for potential market losses as well as a spending factor that will allow for the possibility of appropriation in the face of short terms market losses.
- 6) Obtain a legal opinion. According to Susan Gary, “a legal opinion is not required, (but) because the Board is being asked to make a legal determination many Boards will want to get a legal opinion as to the correct legal answer. The amount that should be considered permanently restricted...depends on the Board's answer to a legal question. Getting a legal opinion is an appropriate thing to do.⁵”

- 7) If necessary, change other internal governing documents (investment and spending policies, gift agreements) to ensure they are consistent with the position you adopt on UPMIFA. If you are eliminating the use of historical dollar value, make sure these documents don't contradict directly or implicitly. Although the statutory language will override conflicting internal rules, it is best practice to conform one's governance rules to the requirements of current statutory law. There are exceptions to this rule where the statute provides "unless otherwise provided by the governance documents," but in the absence of such a provision the statute trumps the governance documents.
- 8) Draft a formal resolution to be approved by the governing board, which implements the policy and, if needed, changes the conflicting governance standards which no longer apply under UPMIFA.

BENEFITS

The benefits of adopting such a position will vary for different organizations. As identified in the Implementation section above, there are various issues (legal and organizational) that might mitigate any benefit or even eliminate this position as an alternative. Organizations that will derive the greatest benefit are those with relatively new endowments or endowments that have been grown significantly over recent years. These endowment funds will have less accumulated earnings to absorb sharp market declines. Non-profits that are relatively new (and have little equity built up) will benefit greatly by protecting unrestricted net assets from potential endowment losses. Specific areas of benefit are the following:

Donor Perception and Transparency

FSP FAS 117-1 requires expanded financial statement disclosure on endowments; however additional disclosure will only offer greater clarity to donors to the extent endowment accounting reflects how an endowment is managed (through investment and appropriation policies). Under the concept of historical dollar value an organization essentially represents to a donor that the value of their fund will never go below the value of original gifts and subsequent gifts (in general). In an underwater endowment situation the value of the endowment as a whole *is* below the value of the original gift and there is no requirement for the organization to return the fund value to that marker. Although it is a common accounting problem, for many organizations this inconsistency will now be highlighted in the newly required disclosures. This contradiction could be further exacerbated if an organization, in accordance with what UPMIFA allows, continues to spend from an underwater endowment while disclosing that historical dollar value is permanently restricted. It could be argued that this situation could expose the organization to potential litigation. If there is only X-number of dollars they can't be spent and permanently restricted simultaneously. Our position considers worst-case market risk in determining the permanently restricted portion of an endowment which also serves as an absolute spending marker. In this manner we are attempting to identify (and represent to donors) the value of a fund that will truly be permanently restricted (and not be offset by losses in other net asset classes).

Underwater Endowments

Endowments are considered underwater to the extent spending and losses have taken the balance of the fund as a whole below the value of the portion that is

permanently restricted (traditionally historical dollar value). These losses are required to be reported as reductions to unrestricted net assets. By reducing the portion of the endowment that is permanently restricted, the range of spending and losses that an endowment can withstand before it is considered underwater is increased. The University of Sioux Falls reported no underwater endowment losses in the unrestricted column of the Statement of Activities for the 2008-2009 fiscal year. This was in the face of a 26% decline in endowment value (including payouts) and the fact that a sizable portion of its endowment was relatively new.

Institutional Financial Statements and Benchmarks

The resulting accounting reclassification from adopting this position decreases permanently restricted net assets and increases temporarily restricted net assets. This action enhances financial statement liquidity which appropriately reflects the increased financial flexibility/liquidity afforded nonprofits through UPMIFA. As mentioned previously, losses from underwater endowments might otherwise (or to a greater extent) flow to the unrestricted column on the Statement of Activities. To the extent that these losses can be mitigated, an organization can improve measures of the *Change in Unrestricted Net Assets*.

To the extent a reclassification reduces permanently restricted net assets, an organization will improve certain balance sheet markers like a Primary Reserve Ratio. The impact on a balance sheet benchmark goes beyond a one-year benefit. The reclassification alone could offer a significant benefit that would impact ratios for years. Plus year after year as new endowment dollars are added, temporarily restricted net assets will be increased along with permanently restricted net assets.

At the University of Sioux Falls mid-year projections were made as to the potential Department of Education Composite Score. Increased fixed assets combined with a sharp endowment decline created concern for the resulting score. In the end, the accounting benefits of adopting FAS 117-1 as well as other efforts taken by management, allowed the University to achieve a final Composite Score of 3 (the highest possible).

I would like to acknowledge that several individuals were instrumental in providing feedback or professional services as the University of Sioux Falls worked towards adopting UPMIFA and FSP FAS 117-1. In some cases invaluable feedback specific to this paper has been provided. These individuals include Jon Schulte, CPA and Partner of McGladrey & Pullen, LLP, Miles Schumacher of Lynn, Jackson, Shultz & Lebrun, P.C., Barry Hawkins, Partner at Shipman & Goodwin, LLP (served as Chairman of the ULC national drafting committee for UPMIFA), Susan Gary, Orlando J. and Marian H. Hollis Professor of Law at the University of Oregon School of Law (served as Reporter of the ULC national drafting committee for UPMIFA), John Griswold and William Jarvis of The Commonfund Institute, and Susan Budak, a former project manager of the FASB who now works as a consultant and author specialized in accounting issues of interest to not-for-profit entities.

¹ *Freedom isn't Free* by John Griswold and William Jarvis, Commonfund Chronicle, Spring/Summer 2009.

² South Dakota Uniform Prudent Management of Institutional Funds Act, Senate Bill No. 89 enacted as SDCL Chapter 55-14A with an effective date of July 1, 2007.

³ FASB Staff Position (FSP) FAS 117-1, *Endowments of Not-for-Profit Organizations: Net Asset Classifications of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for all Endowment Funds*

⁴ *Legal and Accounting Challenges of Underwater Endowments* by Susan Budak and Susan Gary, Probate and Property, Volume 24, Number 1, January/February 2010.

⁵ Susan Gary is the Orlando J. and Marian H. Hollis Professor of Law at the University of Oregon School of Law and served as Reporter for the Drafting Committee to revise the Uniform Management of Institutional Funds Act, a project of the Uniform Law Commission.