TOPIC:

SPENDING FROM UNDERWATER ENDOWMENT FUNDS IN TIMES OF ECONOMIC DISTRESS

INTRODUCTION:

Many academic institutions, in addition to facing sharply reduced investment portfolios, have recently encountered the unpleasant phenomenon of "underwater" endowment funds—funds that have current market values that have declined below their original values. While institutions have confronted this situation before, a new model law, the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which has already been enacted in almost all states, provides much greater flexibility than its predecessor, the Uniform Management of Institutional Funds Act (UMIFA), for institutions that wish (or need) to continue to spend from underwater endowment funds. Both statutes define the term "endowment fund" as a fund that is restricted by the donor so that it is not "wholly expendable by the organization on a current basis." Funds designated as an endowment fund by an organization itself (i.e., board-restricted endowment funds) are not endowment funds for purposes of these statutes.

Until recently, most endowments held by charitable institutions were subject to UMIFA, which provides guidelines for spending from endowment funds, as well as for managing and investing charitable funds and releasi f6m- or modifying donor restrictions on gifts to charitable institutions. Approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1972, UMIFA modernized portfolio management for charitable institutions. UMIFA was eventually adopted in some form by 47 states and the District of Columbia and is still in effect in a few states.

In 2006, NCCUSL approved revisions to UMIFA. The revised statute, UPMIFA, has been enacted in 43 states plus the District of Columbia. UPMIFA has been introduced in the legislatures of several other states. Many institutions in the remaining states are interested in encouraging rapid passage of UPMIFA because the statute permits expenditures from underwater endowment funds. Additional nationwide information about the enactment status of UPMIFA is available at http://www.upmifa.org.

This NACUANOTE summarizes the endowment spending provisions of UPMIFA and UMIFA and discusses certain legal considerations for institutions that would like to continue to spend from underwater endowment funds. It also provides a brief explanation of a new Financial Accounting Standards Board (FASB) statement that governs financial statement reporti f6m- of expenditures from underwater endowment funds.

DISCUSSION:

Spending from Underwater Endowment Funds in UPMIFA States

Most importantly for academic institutions located in states that have enacted

required by UPMIFA [7]. However, a fund formed by a gift instrument that states simply that the organization should "hold the fund as an endowment" will be entitled to rely on UPMIFA's expenditure provisions. For greater clarity with respect to future gifts, institutions may want to consider revising their standard gift agreements to state that gifts to the endowment will be governed by the Institution's endowment spending policy.

- Institutions may wish to revise their endowment spending policies to refer to the prudent expenditure factors listed in their state's version of UPMIFA and, where applicable, to any presumption of imprudence on "excessive" endowment fund spending. Institutions in states that have adopted a percentage cap on spending should also confirm that the market values of endowment funds are determined at least quarterly and may wish to amend their spending policies to require such valuations.
- When making the decision to spend funds from an underwater endowment fund, an institution should document in minutes of the meeting of the governing board or relevant committee its consideration of the factors listed in its state's UPMIFA statute.
- In the interest of preserving good donor relations, institutions may want to consider requesting consent from donors for underwater spending, even if such consent is not required by UPMIFA.

Spending from Underwater Endowment Funds in UMIFA States

As explained above, institutions still subject to UMIFA are limited to spending only current income from underwater endowments. Institutions in UMIFA states also should take care to understand any particular state requirements regarding expenditures from underwater funds. For example, the New York Attorney General has taken the position that an organization has an affirmative duty to restore the historic dollar value of a fund that becomes underwater as a result of the organization's spending rate policy rather than as a result of market depreciation. Despite the limitations imposed by UMIFA, at least two steps that institutions can take when evaluating expenditure options are as follows:

- Institutions can review their records and identify which funds treated as permanently restricted endowment funds are, in fact, subject to donor restrictions that do not permit the expenditure of principal. For example, it is not necessary to track and preserve historic dollar value for funds set aside as an endowment fund by the organization's board. Similarly, some funds treated as permanently restricted may, in fact, be subject to gift instruments that do not impose legally binding requirements that the funds be maintained as permanently restricted endowment funds.
- Institutions may want to consider contacting the donor who contributed a fund that is now underwater to request that the donor grant (in writing) permission for the organization to apply its spending rate policy to the fund, even if doing so will cause the fund to fall below historic dollar value. New gift agreements can include a provision specifically allowing spending from the fund if it falls below historic dollar value.

New Accounting Rules for Endowments

Academic institutions should be aware that in response to the rapid and widespread adoption of UPMIFA, FASB recently issued guidance providing financial statement reporting rules for endowments affected by UPMIFA. The new accounting rules, FASB Staff Position FAS No. 117-1 (FSP 117-1), may significantly affect the way in which expenditures from underwater funds will be disclosed for financial statement purposes and may be important to consider as institutions deliberate regarding endowment spending [8].

For institutions in states that have enacted UPMIFA, the main provisions of FSP 117-1 are as follows:

- The FSP requires institutions to classify a portion of a donor-restricted endowment fund as

permanently restricted net assets. The permanently restricted amount is: (1) the amount that must be permanently retained in accordance with explicit donor stipulations, or (2) in the absence of such stipulations, the amount that the organization's governing board determines must be permanently retained consistent with relevant law. An appendix to the FSP indicates that FASB assumes institutions generally will classify the amount of a fund's historic dollar value (or possibly historic dollar value adjusted for inflation) as permanently restricted net assets. This portion of the FSP has been criticized as inconsistent with UPMIFA, which explicitly eliminated the concept of historic dollar value.

- The FSP retains the controversial requirement of FASB Statement 124 (November 1995) providing that the portion of a donor-restricted endowment fund that is classified as permanently restricted net assets is not reduced by losses on investments of the fund (except to the extent required by the donor) or by an organization's appropriations from the fund [9]. Under Statement 124, losses and appropriations from the permanently restricted portion of a donor-restricted endowment fund are charged first to "temporarily restricted" net assets and then to unrestricted net assets. Thus, despite the fact that no legal requirement exists to restore underwater funds to historic dollar value in UPMIFA states, FSP 117-1 requires institutions to reduce temporarily restricted net assets (if the fund has accumulated unspent appreciation classified as temporarily restricted) or unrestricted net assets (if the fund has no accumulated appreciation or losses have exceeded the amount of appreciation). This accounting requirement means that an institution that classifies its endowment funds' historic dollar values as permanently restricted net assets and then decides to spend from an underwater endowment fund must reduce unrestricted net assets by the amount of the expenditure. As a result, expenditures from underwater endowment funds can result in a substantial negative balance in the unrestricted net assets category.
- Any portion of a donor-restricted endowment fund, including appreciation, that is not classified as permanently restricted should be classified as temporarily restricted until appropriated for expenditure.
- Institutions must identify the portion of an endowment fund that is not permanently restricted and that has not been previously appropriated for expenditure (e.g., unappropriated appreciation on the fund). Any such amounts that were previously classified as unrestricted net assets must be reclassified as temporarily restricted net assets until they have been appropriated for expenditure.

The provisions of FSP 117-1 are effective for fiscal years ending after December 15, 2008.

CONCLUSION:

UPMIFA loosens UMIFA's historic dollar value spending restriction, permitting institutions to spend the amounts they deem prudent, after considering several factors, such as the donor's intent that the endowment

FN1. Model Uniform Management of Institutional Funds Act (UMIFA), Section 2 (1972).

FN2. Model Uniform Prudent Management of Institutional Funds Act (UPMIFA), Section 4(a) (2006).

FN3. UPMIFA, Section 4, Comment.

FN4. UPMIFA, Section 4(b) and (c).

FN5. UPMIFA, Section 4(d). The states that have enacted variations of the optional rebuttable presumption percentage are: California, Maine, Maryland, Montana, Nevada, New Hampshire, North Dakota, Ohio, Oregon, Rhode Island, Tennessee, Texas, Utah, and Wyoming.

FN6. Maine, New Hampshire, and Texas have enacted an additional optional provision for small organizations. Under the provision, an institution with endowment funds valued at less than $2 million would be required to give 60 days notice to the attorney general if the institution's planned spending would bring its endowed funds below the aggregate historic dollar value for all endowment funds.

FN7. UPMIFA permits governing boards to release restrictions imposed on a gift with the written consent of the donor. If a written consent cannot be obtained, the board may apply to court, which may release the restriction in whole or in part if it is "obsolete, inappropriate, or impracticable."

Accounting Guidance:

FASB Staff Position FAS No. 117-1

FASB Statement 124

NACUA Resources:

Endowments and Gifts Resource Page

Additional Resources:

Susan Gary, "UMIFA Becomes UPMIFA"

David Bass, "Management of Underwater Endowments Under UPMIFA," Findings of a Survey of Colleges, Universities, and Institutionally Related Foundations Conducted by the Association of Governing Boards in partnership with Commonfund Institute and NACUBO.

John Griswold and William Jarvis, "Freedom isn't Free," Mission Matters, Spring/Summer 2009.