

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 releasing 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 reporting 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 UPMIFA, the new statute liberalizes UMIFA's endowment spending rules applicable to underwater endowment funds. Under UMIFA, an institution can spend appreciation from an endowment fund over the fund's "historic dollar value"—the aggregate value of all contributions to an endowment fund at the time they were made—to the extent the institution deems prudent [1]. In other words, the institution may treat some of the endowment appreciation as income that may be distributed currently. But, under UMIFA, an institution with an underwater endowment fund may only distribute current income (e.g., dividends and interest) from the fund; it cannot spend below the fund's historic dollar value. The historic dollar value limitation has proven to be administratively and economically burdensome for institutions, particularly in situations where a new endowment is created shortly before or during a downturn in the economy and then falls below historic dollar value because of investment performance.

Under UPMIFA, institutions are no longer restricted by historic dollar value. Instead, an institution can spend the amount it deems prudent after considering the following factors:

- The duration and preservation of the endowment fund;
- The purposes of the institution and the endowment fund;
- General economic conditions;
- The possible effect of inflation or deflation;
- The expected total return from income and the appreciation of investments;
- Other resources of the institution; and
- The investment policy of the institution [2].

It is interesting to note that the drafters' comments to UPMIFA state that although the Act does not require that a specific amount be set aside as "principal," the Act assumes that the institution will act to maintain the purchasing power of amounts contributed to the fund [3].

In general, if a donor restricts an endowment fund's distributions to "income," a prudent spending rule that exceeds ordinary income—such as dividends and interest—may be adopted. But if the donor specifies the types of income that may be distributed, that specification will control [4].

Several of the 43 states plus the District of Columbia that have enacted UPMIFA to date have elected to include an optional provision that creates a rebuttable presumption of imprudence for spending more than a certain percentage (7 percent in most states) of the value of an endowment fund in one year [5]. The endowment fund's value is calculated by valuing the fund at least quarterly and averaging values over three years. The optional provision does not create a safe harbor presumption of prudence for spending less than the cap (except in Ohio) [6].

Despite the welcome flexibility provided by UPMIFA, boards still need to be careful when deciding to spend from an underwater fund because as yet, few rules or even conventions exist as to how boards are expected to make this decision. UPMIFA provides guidance for spending decisions in the form of the "prudence" factors listed in the statute, but does not answer the question--how much can be spent from an underwater fund? As a general matter, institutions in states that have adopted UPMIFA should consider taking the following steps before spending from underwater endowment funds:

- The board and senior management should be briefed on the key provisions of UPMIFA.
- Institutions should review their gift agreements for any provisions that would override the UPMIFA rule permitting expenditures of more than ordinary income from underwater funds. For example, a fund formed by a gift instrument that provides that the organization can spend only 4 percent per year from the fund will be governed by that restriction and not by the prudent spending analysis

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 fund continue permanently, the purposes of the fund (and not just of the charity as under UMIFA), and relevant economic factors. In addition, in states where the optional provision is included, UPMIFA creates a rebuttable presumption of imprudence for spending more than a statutorily defined percentage of the endowment's value in one year, but does not create a safe harbor for spending under a specified amount. Boards still need to be careful when spending from an underwater fund because the rules for making this decision are uncertain and new FASB accounting rules may affect the way underwater fund expenditures are disclosed for financial statement purposes. Institutions subject to UMIFA, however, are still limited to spending only current income from their underwater endowments, unless otherwise permitted by the terms of the gift.

FOOTNOTES:

- 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."
- FN8.** FSP 117-1 is entitled "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." In addition to new guidance for institutions in states that have enacted UPMIFA, FSP 117-1 requires new disclosures for all organizations with endowment funds (as defined by FASB) whether or not they are subject to UPMIFA. FASB recently codified all authoritative nongovernmental U.S. generally accepted accounting principles. The codification is in effect for annual and interim periods ending on or after September 15, 2009. FSP 117-1 is now codified at sections 958-205-05 through 65 of the Financial Accounting Standards Board Accounting Standards Codification (ASC).
- FN9.** Statement 124 is entitled "Accounting for Certain Investments Held by Not-for-Profit Organizations," and is now codified at various sections of ASC 958-205, 320, and 325.

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RESOURCES:

Uniform Statutes:

- [Uniform Prudent Management of Institutional Funds Act](#)
- [Uniform Management of Institutional Funds Act](#)

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.

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