

NFP Endowments in Uncharted Water

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To secure financial strength and viability, not-for-profit (NFP) organizations have long sought financial gifts to invest in perpetuity as endowments. Sizeable, well-managed endowments have provided many NFPs with a stable, continuing source of income and capital appreciation.

In recent years, however, the combination of a series of different economic events has made the journey to financial strength and viability uncertain for many NFPs.

Endowments may get wet

Equity markets have declined for three straight years with no end in sight, and interest rates are at historic lows. As a result, the fair value of many endowments has dropped below required levels (historic dollar value), placing some in, or rather *under*, uncharted water.

Individual endowment funds may fall underwater despite an NFP's conservative spending policy or history of high investment returns. Recently created endowments and endowments heavily invested in equity securities are particularly susceptible.

Understand FASB 124 & UMIFA

Financial Accounting Standards Board (FASB) Statement No. 124, "Accounting for Certain Investments Held by Not-for-Profit Organizations," has been in effect since 1995, though provisions on reporting losses on endowment fund investments, triggered when an NFP has one or more endowment funds underwater, have only recently become widely applicable.

These provisions are based on the Uniform Management of Institutional Funds Act (UMIFA), a model act affecting NFP investment and management of donated assets, enacted in most states with only minor variations.

NFP managers and directors should be familiar with the provisions of FASB 124 and UMIFA, as well as ways to structure endowment gifts to avoid unwanted consequences.

To understand the provisions of FASB 124, begin by studying those of the UMIFA. Basic premises of the UMIFA include:

- No restriction is placed on investment income (dividends, interest, etc.) or on net appreciation or depreciation in fair value of investments (realized and unrealized) unless imposed by a donor or law
- Endowment funds (funds provided by a donor to be held and invested in perpetuity or for a term of years) shall not decrease below their historic dollar value
- Historic dollar value includes the original principal amount, amounts subsequently added by the donor and amounts of net appreciation added by the terms of the donor stipulation or law
- Prudent spending and net appreciation appropriation policies are permitted but do not alter donor-imposed stipulations

FASB 124's accounting model is built on the same premises and applies whether or not the state where the NFP is located has adopted UMIFA or a variation.

Under FASB 124, endowment fund investment income and net investment value appreciation or depreciation are considered changes in unrestricted net assets unless temporarily or permanently restricted by the donor. Therefore, the specialized accounting of FASB 124 must be applied to the fund unless the donor stipulates losses (realized and unrealized) may reduce an endowment fund below its historic dollar value.

Group swimming prohibited

FASB 124 applies individually to each donor-restricted endowment fund. Grouping similar funds or grouping different funds created by the same donor is inconsistent with the standard.

Application to each fund requires maintenance of records to determine the fair value of each fund's assets, eliminating the option to offset an underwater fund with another fund's net appreciation.

This task becomes more difficult when investments are pooled. However, with proper application of unit methodology, the fair value of each individual fund's assets may be determined in a pooled situation.

Scuba diving with FASB

The following examples illustrate how FASB 124's accounting model works.

Example 1 - *Rich donor gives not-for-profit 1 (NFP 1) \$1 million cash to be held and invested in perpetuity as an endowment to support any activity.*

NFP 1 immediately invests the cash in equity securities. The historic dollar value of \$1 million is permanently restricted, but investment income and net appreciation or depreciation in fair value of investments are unrestricted.

In Year 1, the investments produce income of \$50,000 and appreciate in value to \$1.1 million at year end. Under NFP 1's spending policy, an amount equal to 5% of the beginning of year fair value was expended from investment income and appreciation. At Year 1's end, the net assets of this endowment would be classified as \$1 million permanently restricted and \$100,000 unrestricted.

In Year 2, the investments produce income of \$55,000 and depreciate in value at year end to \$900,000. Income of \$55,000 (5% of beginning fair value) was expended pursuant to the spending policy.

At Year 2's end, the net assets of this endowment would be classified as \$1 million permanently restricted and \$(100,000) unrestricted. (Losses below historic dollar values don't decrease permanently restricted net assets.)

In Year 3, the investments produce income of \$40,000 and appreciate in value to \$950,000 at year end. Investments of \$5,000 were sold during the year to provide cash that together with the investment income enabled expenditures of \$45,000 in accordance with the spending policy.

At Year 3's end, the net assets of the endowment would be classified as \$1 million permanently restricted and \$(50,000) unrestricted.

The appreciation partially offsets the losses charged to unrestricted net assets in Year 2, but permanently restricted net assets remain at the historic dollar value.

Example 2 - *Using the same facts as Example 1, rich donor specifies all investment income and appreciation must only support NFP 1's Program X; 5% of fair value at the first of the year must be spent on this program. That is, rich donor has placed temporary restrictions on the time and purpose of all investment income and appreciation.*

At Year 1's end, net assets of the endowment would be classified as \$1 million permanently restricted and \$100,000 temporarily restricted.

At Year 2's end, net assets of the endowment would be classified as \$1 million permanently restricted and \$(100,000) unrestricted. (Losses decrease temporarily restricted net assets to \$0 and then reduce unrestricted net assets; permanently restricted net assets remain at the historic dollar value.)

At Year 3's end, net assets of the endowment would be classified as \$1 million permanently restricted and \$(50,000) unrestricted. Losses previously charged to unrestricted net assets would be partially restored by the appreciation in Year 3.

Subsequent appreciation would continue to increase in unrestricted net assets until the previously charged losses were offset in full. Only then should additional appreciation be classified as temporarily restricted.

Prudence can be a nightmare

Recently, a popular development strategy and hedge against inflation has been to advise donors to annually add a portion of appreciation to endowment principal to preserve its value.

This strategy seems prudent and works well when investments increase in value. It even works well when investment value increases significantly outdistance decreases over a long period.

However, market conditions over the last few years reveal prudence can be a nightmare under FASB 124.

Consider another example.

Example 3 - *Assume richer donor gives not-for-profit 2 \$1 million cash to invest in perpetuity with the stipulation the endowment principal is to be increased at the beginning of each year by 5% of the then current historic dollar value as a hedge against inflation. Any investment income and appreciation remaining after increasing the fund by 5% are unrestricted.*

In Year 1, the investments produce income of \$100,000, all of which is expended, and appreciate in value by \$200,000. Net assets of the endowment fund at Year 1's end would be classified as \$1,050,000 permanently restricted and \$150,000 unrestricted.

In Year 2, the investments produce income of \$75,000, all of which is expended, and depreciate in value by \$150,000. Net assets of the endowment fund at Year 2's end would be classified as \$1,102,500 permanently restricted and \$(52,500) unrestricted. The prudence provision restricts the entire net assets and reduces unrestricted net assets.

In Year 3, the investments produce income of \$75,000, all of which is expended, with no change in fair value. Net assets of the endowment fund at Year 3's end would be classified as \$1,157,625 permanently restricted and \$(107,625) unrestricted. The prudence provision strikes again.

Unintended results

Example 3 shows what can happen when market conditions decline *or* hold steady; what seems prudent may become disastrous. Periods of significant decline have even more dramatic results.

Under FASB 124, adding to principal increases the historic dollar value that must be preserved. Unrestricted net assets become permanently restricted, potentially resulting in insufficient resources to support normal NFP activities.

NFPs should fully understand and accept the possible consequences before advocating or

accepting prudence provisions in endowments. Many NFPs are asking donors to remove existing prudence clauses and are planning to avoid them in the future. Others are simply refusing to accept donations containing prudence clauses.

Other NFPs accept donations only when donors limit prudence increases to the fullest possible amount of appreciation occurring in a particular year, resulting in no increase in historic dollar value in years of depreciation.

Disclosure shark lurking

As if the accounting provisions of FASB 124 are not onerous enough, a disclosure shark also lurks within that standard.

Each time a statement of financial position is presented, an NFP must disclose the aggregate amount of the deficiencies for all donor-restricted endowment funds. Included are funds for which the fair value of assets at the reporting date is less than the level required by donor stipulation or law.

In other words, the aggregate amount by which underwater endowment funds are underwater must be disclosed. It cannot be offset by net appreciation in endowment funds not underwater.

Summary

NFP management must be aware of the waters into which endowments are sailing. They should understand how the provisions of FASB 124 and UMIFA apply to each endowment.

Records must be maintained in sufficient detail to allow assessment of the impact of provisions on each endowment and to permit accounting and disclosure in accordance with FASB 124.

Tailor development policies and strategies to address the provisions and avoid the prudence nightmare. Development personnel must communicate with and educate donors on structuring endowment contributions to achieve the donor's objectives without tying the hands of the NFP.

Consider requesting living donors to help the NFP avoid prudence complications and the unintended consequences of FASB 124 and UMIFA by modifying existing endowment agreements.