HAHN LOESER

New Accounting Standards for Endowments

Executive Summary

Ohio's version of the Uniform Prudent Management of Institutional Funds Act became effective June 1, 2009, changing the law applicable to the management and expenditure of charitable endowments. The Financial Accounting Standards Board issued FASB Staff Position FAS 117-1 to provide guidance as to the proper accounting treatment for endowments at not-for-profit organizations in states that adopted the new law. FAS 117-1 provides guidance on the net asset classification of donor-restricted endowment funds for an organization that is subject to the new law, and improves disclosures about an organization's endowment funds, whether or not the organization is subject to the new law. Organizations with donor-restricted endowment funds need to account for these funds in accordance with FAS 117-1.

The Act and FAS 117-1 present significant changes in endowment management and accounting. Not-for-profit organizations need to carefully review all gift instruments, reclassify the net assets of donor-restricted endowment funds where necessary, and amend their existing spending policies in light of these new accounting and disclosure requirements.

Introduction

Ohio's version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) was signed by the Governor on January 6, 2009 and became effective June 1, 2009. The Act changes the law applicable to the management and expenditure of charitable endowments. For a detailed summary of Ohio's version of UPMIFA, see http://www.hahnloeser.com/references/900/pdf.

UPMIFA amended what had been Ohio's version of the Uniform Management of Institutional Funds Act. (UMIFA). Under UMIFA, an institution could establish a spending rate with respect to the endowment even if the rate resulted in income exceeding the traditional concepts of income such as interest and dividends, but only if the amount used did not result in the endowment fund being reduced below the "historic dollar value." Historic dollar value was essentially the amount originally donated plus any additional donations. UPMIFA's most important change to UMIFA was to remove the concept of historic dollar value and instead provide that an organization may set a spending rate as the organization determines is prudent.

When UPMIFA was first introduced, the Financial Accounting Standards Board (FASB) issued FASB Staff Position FAS 117-1 in order to provide guidance as to the proper accounting treatment for endowments at institutions in states that adopted the new law. In issuing FAS 117-1, FASB announced that the two primary goals were:

- To provide guidance on the net asset classification of donor-restricted endowment funds (i.e., permanently restricted, temporarily restricted or unrestricted) for a not-for-profit organization that is subject to UPMIFA; and

- To improve disclosures about an organization's endowment funds (both donor-restricted endowment funds and board-designated endowment funds), whether or not the organization is subject to UPMIFA.

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Classifying Permanently Restricted Net Assets

Under UMIFA, the historic dollar value of endowment funds was classified as permanently restricted net assets. With the adoption of UPMIFA, the question arose as to whether the entire endowment should be classified as temporarily restricted net assets because theoretically the only issue was how much of the fund the institution would determine it was prudent to spend. FAS 117-1 addresses this issue.

For donor-restricted endowment funds of perpetual duration, FAS 117-1 provides that organizations must classify a portion of these funds as permanently restricted net assets. Although UPMIFA did away with the concept of historic dollar value, FAS 117-1 in effect retains this concept. The amount classified as permanently restricted is the amount of the fund (a) that must be retained permanently according to the donor's restrictions, or (b) in the absence of such restrictions, that the board determines must be permanently retained, consistent with the relevant law. The portion of a donor-restricted endowment fund that is classified as permanently restricted net assets is not reduced by investment losses or by an organization's appropriations from the fund.

In order to comply with this provision of FAS 117-1, organizations should do the following:

- Review donor agreements to determine what portion of the endowment fund must be classified as permanently restricted net assets in accordance with the donor's restrictions;
- Where no donor restrictions exist, the board must act to determine the amount to be permanently retained;
- In making its determination, the board should understand the relevant law and be able to explain its determination as to what portion of the fund was classified as permanently restricted net assets; and
- Accurately report any net asset reclassification in the organization's financial report.

Classifying Temporarily Restricted Net Assets

After the institution has determined the amount of a restricted endowment fund that will be classified as permanently restricted net assets, FAS 117-1 provides that the portion of the fund not permanently restricted must be classified as temporarily restricted net assets (i.e., time restricted) until appropriated for expenditure. This provision differs from previous accounting guidance that considered earnings on donor-restricted endowment funds unrestricted, whether or not appropriated for expenditure by the organization.

Appropriation for expenditure is deemed to occur upon board approval for expenditure, unless approval is for a future period, in which case appropriation is deemed to occur when that period is reached. Upon appropriation for expenditure, the time restriction expires to the extent of the amount appropriated and, in the absence of any purpose restrictions, results in a reclassification of that amount to unrestricted net assets.[1]

[1] If the endowment fund is also subject to a purpose restriction, the reclassification of the appropriate amount to unrestricted net assets would not occur until that purpose restriction has also been met.

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Perhaps the most dramatic effect of FAS 117-1 for Ohio institutions will be to reclassify a significant portion of endowment assets from unrestricted to temporarily restricted net assets. This result can have far reaching consequences and organizations should consider the following steps:

- Identify and reclassify assets that are not otherwise permanently restricted net assets as temporarily restricted net assets; and

- Review existing loan and bond documents to determine the impact, if any, of the reclassification of unrestricted net assets to permanently and temporarily restricted net assets.

Enhanced Disclosures for all Endowment Funds

In order to enable users of financial statements to understand amongst other things the net asset classification, spending policies and investment policies of an organization's endowment funds, FAS 117-1 requires all not-for-profit organizations, whether or not they are subject to UPMIFA, to disclose certain information on their financial statements. This requirement applies to both donor-restricted and board-designated endowment funds.

An organization should disclose the information for each period for which the organization presents financial statements, including:

- A description of the governing board's interpretation of the laws that underlie the organization's net asset classification of donor-restricted endowment funds;

- A description of the organization's policies for the appropriation of endowment assets for expenditure (i.e., its spending policies);

- A description of the organization's endowment investment policies;

- The composition of the organization's endowment by net asset class at the end of the period, in total and by type of endowment fund, showing donor-restricted endowment funds separately from board-designated endowment funds; and

- A reconciliation of the endowment, in total and by net asset class, including, investment returns, net appreciation or depreciation of investments, amounts appropriated for expenditure and other changes.

In addition, an organization should provide information about the net assets of its endowment funds, including:

- The nature and types of permanent restrictions or temporary restrictions; and

- The amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the amount required by donor restrictions or applicable law.

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Effective Date and Transition

The provisions of FAS 117-1 are effective for fiscal years ending after December 15, 2008 and FAS 117-1 contains transition rules for implementing its guidance for the first time.

Conclusion

As a result of the enactment of Ohio's version of UPMIFA, not-for-profit organizations with donor-restricted endowment funds will have to account for these funds in accordance with FAS 117-1. UPMIFA and FAS 117-1 present significant changes in endowment management and accounting. Not-for-profit organizations will need to review and amend their existing spending policies and carefully review all gift instruments in light of these accounting and disclosure requirements and take the necessary steps in order to comply.