

## There's a New Sheriff in Town: UPMIFA Drives Accounting and Reporting Changes for Endowments

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For almost 35 years the Uniform Management of Institutional Funds Act (UMIFA) was the law of the land in 47 states for organizations with institutional funds and permanent endowments. In 2006, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) became the new sheriff in town. As of October 2008, over 30 states had either enacted, or were in the process of introducing legislation to enact UPMIFA, or a version of it. If your organization invests and manages institutional funds in an UPMIFA enacted state, you need to understand and play by the new rules.

### The Big Picture – Who is Affected

As defined under UPMIFA, institutional funds may or may not be subject to donor restrictions; endowments are institutional funds (or portions thereof) that are donor restricted under the terms of the gift instrument. UPMIFA applies to nonprofit charitable entities. It does not apply to trusts managed by non-charitable entities, such as corporations, or to trusts managed by individuals; these are governed by the 1994 Uniform Prudent Investor Act (UPIA). UPMIFA applies to all institutional funds, whether they were created before or after the enactment of the statute. However, it does not govern the management of board designated endowments. UPMIFA sets standards for endowment spending and preservation of the original gift in accordance with donor intent. Management needs to understand the legislative environment they operate in, as it may affect their accounting for institutional funds and permanent endowments.

Whether or not your organization is affected by UPMIFA, it will be impacted by the technical guidance issued by the Financial Accounting Standards Board (FASB) in response to UPMIFA. FASB Statement of Position 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* (FSP FAS 117-1) was issued in August 2008 and is effective for fiscal years ending after Dec. 15, 2008.

Now that is quite a mouthful, so let's break it down. The first part of the title focuses solely on UPMIFA enacted states and jurisdictions; as a result, certain elements of FSP FAS 117-1 apply only where UPMIFA is the law of the land. The latter part of the title, "*Enhanced Disclosures for All Endowment Funds*" (emphasis added), communicates to all organizations with endowment funds (both donor restricted and board designated) that, while you may ignore UPMIFA if you are not in an UPMIFA-enacted state or jurisdiction, you cannot ignore the disclosure requirements of FSP FAS 117-1. If this is your situation, you may want to move ahead to the "Accounting and Disclosure Requirements" section of this white paper, as this information will more closely pertain to your organization.

While UPMIFA was not passed in contemplation of the market crisis that began unfolding in 2008, its expanded guidance on managing and accounting for institutional funds and endowment activity seems particularly on point during this time of market turmoil. Additionally, FSP FAS 117-1's enhanced disclosure requirements will provide financial statement users with more clarity about organizational policies and permanently restricted and board designated endowments in a defined and understandable format.

### Key Changes

UPMIFA brings two key changes to institutional fund management and endowment accounting. The first is the elimination of historic dollar value (HDV) as a benchmark for both endowment spending and the amount identified for accounting purposes as permanently restricted net assets; the second is a change (some would say, a clarification) in the legal classification of earnings. As used in this document, "earnings" refers to both realized and unrealized income. This white paper will focus on these two key changes and also touch on the narrow circumstances under which UPMIFA allows donor restrictions to be modified. Other duties of care in managing institutional funds described in UPMIFA are much the same as under previous requirements.

One of the key duties contemplated by UPMIFA, that was not explicitly included in UMIFA, is "the preservation of the endowment fund."<sup>1</sup> This preservation concept was an underlying principle driving the elimination of historic dollar value as a benchmark in UPMIFA. In some cases, donor intent, as either expressly stated in the gift instrument or implied, would not be honored by historical dollar value. When a donor intends that the restricted portion of their gift maintain its purchasing power, over time the historical dollar value would, assuming accumulated market increases, need to be increased to maintain its value due to inflation, spending policies and fees. If it is determined that the donor intent was to maintain the purchasing power of the original gift, a methodology to measure what that value is should be established and a portion of the earnings retained permanently and/or, if necessary, unrestricted assets added to the donor restricted endowment. If the donor is silent on maintenance of purchasing power, an organization would have to look at whether the version of UPMIFA enacted in that state simply requires preservation of the fund or explicitly requires maintenance of purchasing power. "While the drafters' commentary to the Model Act describes the desirability of not just preserving the fund, but of maintaining the (inflation adjusted) purchasing power of the fund, the Model Act itself does not contain such a requirement," says Mr. Jeff Mechanick, project manager at the FASB for Not-For-Profit Organizations.

<sup>1</sup> UPMIFA, Section 4 (a)(1)

Another underlying principle is the move away from short-term barriers to spending (especially in underwater situations) in favor of a long-term approach focusing on the organization's having prudent spending and investment policies. Spending policies affect endowment duration and performance and also the ability to fulfill gift intent. UPMIFA contains an optional section that establishes a safe harbor of 7 percent for endowment spending for states to consider.<sup>2</sup> This is applied to the fair value of the endowment fund, calculated at least quarterly over a minimal period of three years prior to expenditure. For endowments in existence for less than three years, the base is calculated from the date of existence.<sup>3</sup> Donors may specify spending rates in excess of UPMIFA requirements; these should be expressly stated in the gift instrument to document donor intent and protect the organization. Additionally, building or capital campaigns may require higher spending rates, as would endowments of limited duration. These are examples of spending policies that focus on fulfilling the purpose of the endowment, rather than HDV.

Gift instruments, especially for long established endowments, may not be detailed enough to contain sufficient documentation of donor intent for purposes of UPMIFA. Additionally, gift instruments typically use words interchangeably and without clear definition as to use or meaning. As a result, UPMIFA provides "Rules of Construction" that allow the organization to focus on the implied donor intent with regard to spending, the desire to create an endowment of permanent duration, and the ability to react accordingly with respect to investment strategies and spending policies once that determination has been made.<sup>4</sup>

UPMIFA also provides a framework to allow for the modification of restrictions in limited circumstances. When gift instruments are written with too narrow a focus, over time it may become difficult or impossible to fulfill the gift intent as expressly stated. An example is a medical foundation that received a gift targeted at a specific disease that is now substantially cured. How does the organization advance the donor's true underlying intent to further medical science and discovery? UPMIFA clarifies that two key doctrines apply: the doctrines of *cy press* and *deviation*. The deviation doctrine allows a variation from the express terms of the original gift when there have been unforeseen changes that result in the inability to fulfill it without such a change. When exact compliance is not possible, the doctrine of *cy press* allows an interpretation of the gift instrument to carry out the donor's wishes as closely as possible to the express written intent. External oversight is needed to insure that the doctrines of *cy press* and *deviation* are used appropriately in the furtherance of donor wishes. As a result, the courts, and potentially the attorney

general, participate in the process to modify and/or release restrictions.<sup>5</sup>

UPMIFA supports donor intent through its retroactive rules of construction that place the organization in the donor's shoes and charge them with honoring express or implied donor intent. While an organization may modify or release a restriction, they may never convert an endowment into a fund with no endowment. Additionally, UPMIFA allows the restrictions on older, smaller funds (more than 20 years and less than \$25,000) to be removed through notification of the Attorney General, rather than through the courts. There have been high-profile lawsuits related to donor intent; therefore consultation with legal counsel would be appropriate anytime that a restriction modification is being considered.

Under UMIFA, unless the gift instrument indicated otherwise or relevant law required, earnings were not classified explicitly as restricted assets for legal purposes.<sup>6</sup> UPMIFA mandates that earnings, unless otherwise instructed by the gift instrument, be classified as donor restricted for legal purposes until they are appropriated for expenditure. Under UPMIFA and its Rules of Construction, donor intent extends not just to the original gift corpus, but to earnings on the related investments. Therefore, earnings are donor restricted in nature until such time as the board appropriates them to be used in advancing and fulfilling donor intent.<sup>7</sup> Under FSP FAS 117-1, this results in earnings being reported as temporarily restricted net assets until appropriated. For organizations subject to UMIFA, Emerging Issues Task Force Topic No. D-49 (EITF D-49), *Classifying Net Appreciation on Investments of a Donor-Restricted Endowment Fund*, still applies. EITF D-49 states that earnings on such funds will be reflected as unrestricted net assets, unless otherwise donor restricted. This results in substantially different accounting and reporting outcomes based solely on the enactment status of the state in which the organization operates.

### Accounting and Disclosure Requirements

FSP FAS 117-1 changes the accounting requirements to conform to UPMIFA related to maintenance of the purchasing power of the original gift, if donor directed, and the classification of earnings on endowments. Mr. Mechanick states that "UPMIFA requires organizations to focus on preservation of the endowment fund in accordance with donor intent. There may be express or implied guidelines in the gift instrument, or conversations with the donor, that define and clarify the meaning of gift preservation. While the term 'historic dollar value' does not appear in UPMIFA, FSP FAS 117-1 does not preclude the use of historic dollar value as an

<sup>2</sup> UPMIFA, Section 4 [(d)]

<sup>3</sup> UPMIFA, Section 4 (d)

<sup>4</sup> UPMIFA, Section 4, Subsection (c)

<sup>5</sup> UPMIFA, Section 6

<sup>6</sup> Paragraphs 22 of FAS 117 and 11 of FAS 124

<sup>7</sup> UPMIFA, Section 4 (a)

appropriate measure of permanently restricted net assets maintained in accordance with donor intent.”

In the future, the content of gifting instruments may change in order to be responsive to UPMIFA and its focus on endowment preservation. Ms. Tiffani Shaw, COO & CFO for The University of Iowa Foundation, shares that for colleges and universities “under the new law, gift instruments should not only disclose the intentions of the donors, but also the policies as it relates to investments and spending, in addition to how the institution will address endowment preservation.”

Earnings on endowments are to be reflected as temporarily restricted until appropriated, absent other donor or purpose restrictions, for organizations subject to UPMIFA. Appropriation may be achieved in various ways, including the approval of a formal annual budget and approval at board meetings of a special/emergency needs project. “When budgets are approved annually,” says Mr. Mechanick, “gifts whose earnings are restricted for ongoing operations may be considered by organizations to have been appropriated. Earnings on such endowments may be released from restrictions to the extent of that appropriation.” If the expenditure is for a future period, assets are released when the future period is reached. Upon appropriation, the time restriction expires and the amount should be reclassified to unrestricted net assets. If there is also a purpose restriction, then the expiration would not occur until the intention is met by expenditure of the appropriated amount for the expressed purpose.

Additionally, the FSP requires certain disclosures to be included for *all* donor restricted and board designated endowments, whether or not they are subject to UPMIFA or UMIFA.

The first such disclosure is a description of the governing board’s interpretation of applicable law governing net asset classification for donor restricted endowments, endowment spending policies and investment policies. Investment policy disclosures will include return objectives and risk parameters, how those objectives relate to spending policies and the related strategies to achieve the stated objectives.

Also required is the composition of endowment types at the reporting date, by net asset class, with separate disclosure of board designated and donor restricted endowment funds.

Lastly, the organization will include a reconciliation of endowments, in total and by class, including investment income, net appreciation or depreciation, contributions, appropriations for expenditures and other changes.<sup>8</sup>

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<sup>8</sup> FSP FAS 117-1, paragraph 11

These disclosures will be reflected, in most cases, through a tabular presentation in the notes to the financial statements. Through this tabular presentation, the existence of underwater endowments will be clearly communicated to financial users. “While this initial adoption will require additional reporting requirements for organizations,” comments Ms. Shaw, “it is an opportunity to educate readers about endowments and clearly communicate the priority and importance placed on complying with, and honoring, donor intent.”

## Underwater Endowments

In light of 2008 financial market activity, and the possibility of continued poor overall financial performance in many sectors, underwater endowments may be a reality for many organizations in the near future. Underwater investments are those for which the current market value is less than the amount required to be maintained as donor restricted net assets. UPMIFA allows for the possibility of continuing to appropriate expenditures in an underwater endowment; this was not possible under UMIFA. An underlying presumption is that the organization has prudent policies in place and management and the board have properly considered and supported their course of action. “UPMIFA allows organizations to establish spending policies that are responsive to short-term market conditions, allowing institutions to develop prudent policies that emphasize both endowment preservation and purpose,” says Mr. Mechanick.

In this situation, FSP FAS 117-1 requires the investment loss to be recorded as temporarily or unrestricted activity and not as a decrease in the permanently restricted endowment. Previous accounting guidance required a disclosure for investments that were significantly underwater, but it did not require a specific disclosure format. The tabular presentation required by FSP FAS 117-1 clearly communicates the existence underwater endowments for financial statement users.

## Transition Rules

Due to the retrospective nature of UPMIFA, funds that have not been appropriated for expenditure by the governing board will need to be reclassified under the requirements of FSP FAS 117-1 from unrestricted to temporarily restricted net assets. In some instances, such reclassifications may impact debt covenants. As a reminder, FSP FAS 117-1 is applicable to all fiscal periods ending after Dec. 15, 2008.

In adopting the requirements of FSP FAS 117-1, any resultant net asset reclassifications will be shown as a separate line item, outside of any performance indicator or other measure of operations. If FSP FAS 117-1 is adopted subsequent to the effective date of UPMIFA, the reclassification will be shown in the earliest comparative period for which UPMIFA applies, otherwise it will be reported retrospectively in the earliest period presented.

## Summary

UPMIFA, the new sheriff in town, and its deputy FSP FAS 117-1, require organizations to account and report for donor restricted and board designated endowments in ways that are substantially different from previous guidance. Boards, finance and accounting departments and investment managers need to understand both their applicable legislative environment and the new accounting, reporting and disclosure requirements. Donor relationships grow when they are properly fed and nourished. This includes not only recognizing a donor's passion, desire and objectives in providing significant assets for use in your organization, but providing transparency and clarity in the reporting and disclosure of endowments.

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## Sources:

UPMIFA website, <http://www.upmifa.org/>

Uniform Prudent Management of Institutional Funds Act drafted by the National Conference of Commissioners on Uniform State Laws in July 2006

FAS 117 *Financial Statements of Not-for-Profit Organizations*

FAS 124 *Accounting for Certain Investments Held by Not-for-Profit Organizations*

FSP 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*

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