Intermediate Accounting and Reporting for Colleges and Universities

Accounting for Investments, Endowments, and Gifts
Learning Objectives

- Introduce relevant law governing endowments and funds functioning as endowments
- Review accounting standards that apply to endowments and funds functioning as endowment
- Describe Annuity Funds, Split Interest Agreements, Pooled Income Funds, and Charitable Remainder Trusts
- Discuss issues related to management of endowment funds

FASB - Key Pronouncements

- SFAS No. 116 Accounting for Contributions Received and Contributions Made
  - ASC 985-605 Revenue Recognition

- SFAS No. 117 Financial Statements of Not for Profit Organizations and FSP FAS 117-1 Endowments of Not-for-Profit Organizations
  - ASC 958-205 Presentation of Financial Statements

- SFAS No. 124 Accounting For Certain Investments Held by Not-for-Profit Organizations
  - ASC 958-320 Investments – Debt and Equity Securities
True or False?

◆ Your institution has a “huge” endowment so you have no budget worries
◆ Need to construct a building...take the $$’ s out of endowment.
◆ You can spend only the income.

ENDOWMENT FUNDS

◆ Governing Law
◆ Fund Types:
  » True
  » Quasi
  » Term
◆ Accounting Entries
◆ Endowment Examples
Endowment Investment Options

- The “spend only the income” tradition of endowment management “Hog Tied” Trustees and Investment Managers”
- Did traditional approach protect against the “ravages of inflation” ??
- Uniform Management of Institutional Funds Act

UMIFA

- Created in 1972
- Purpose: Remove uncertainties about nature and power of governing boards in area of Investment Management
- Act Provides:
  - Prudent use of appreciation
  - Board’s investment authority including permission to invest in stocks
  - Board’s right to delegate investment management
  - Board can act similar to corporate board vs. trustee
  - Can sometimes release donor imposed restrictions
- Historic Dollar Value =
  - Fair value of fund when received
  - Plus subsequent gifts
  - Plus other additions specified by the donor
- Appreciation = Excess of historic dollar value
Uniform Prudent Management of Institutional Funds Act (UPMIFA)

- In 2006, the National Conference of Commissioners on Uniform State Laws approved UPMIFA
- UPMIFA is a revision of the UMIFA
- Applies to all types of not-for profit organizations
- Applies to donor-restricted endowment funds
  - Not to board designated funds

UPMIFA – Key Provisions

- Elimination of the concept of historic dollar value for “prudent” endowment spending
  - More short-term flexibility to handle declining investment markets
  - Emphasis on preservation of the fund

- UPMIFA Section 4(a) states that “Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution.”
**UPMIFA…Accounting Issues**

- In the absence of explicit donor stipulations, does UPMIFA’s elimination of the historic dollar value threshold result in a net asset classification of other than permanently restricted for that portion of donor endowment funds…including an amount that should be “tucked away” to preserve purchasing power?

- Can the reported amount of permanently restricted net assets associated with endowment fall below historical cost?

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**Net Asset Classification in UPMIFA**

- Historic dollar value is in permanently restricted net assets
- +/- amounts a governing board determines that the law requires to be retained permanently are also in permanently restricted net assets
- Remainder of fund is in temporarily unrestricted or unrestricted net assets
- Losses that bring the value of the fund below historic dollar value (or purchasing power maintained historic dollar value in Rhode Island) are charged to temporarily restricted or unrestricted net assets
Net Asset Classification in UPMIFA

◆ Purpose restrictions cannot be released until amounts are appropriated: the “deemed spent” rule will not apply to unappropriated amounts.

◆ Appropriation is considered to occur with approval for expenditure, unless the approval is for a future period.

Endowment Disclosures

- Not-for-profit organization shall disclose information to enable users to understand the net asset classification, net asset composition, changes in net asset composition, spending policy(ies) concerning its endowment funds (both board designated and donor restricted).

- In this era of increased scrutiny on the size and use of endowments, the disclosures help the financial statement users gather more information on an entity’s endowment
Endowment Disclosures

- Minimum requirements:
  - Description of governing board’s interpretation of relevant law underlying net asset classification
  - Description of endowment spending policies
  - Description of endowment investment policies
    - Return objectives and risk parameters
    - How the objectives relate to spending policies
    - Strategies for achieving objectives
  - Composition of endowment by net asset class
  - Endowment roll-forward by net asset class

Example of Endowment Composition Disclosure

<table>
<thead>
<tr>
<th>Endowment Net Asset Composition by Type of Fund</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>As of June 30, 2008</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unrestricted</td>
<td>Temporarily Restricted</td>
<td>Permanently Restricted</td>
<td>Total</td>
</tr>
<tr>
<td>Donor restricted endowment funds</td>
<td>$</td>
<td>$ - 49,774</td>
<td>$ 97,959</td>
<td>$ 147,733</td>
</tr>
<tr>
<td>Board designated funds</td>
<td>$ 8,247</td>
<td>$ -</td>
<td>$ -</td>
<td>$ 8,247</td>
</tr>
<tr>
<td>Total Funds</td>
<td>$ 8,247</td>
<td>$ 49,774</td>
<td>$ 97,959</td>
<td>$ 155,980</td>
</tr>
</tbody>
</table>
Example of Endowment Roll-forward Disclosure

Changes in Endowment Net Assets

For the Fiscal Year Ended June 30, 2008

<table>
<thead>
<tr>
<th>Net assets, beginning of year</th>
<th>Net assets, beginning of year</th>
<th>6,947</th>
<th>6,947</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment return:</td>
<td>Investment return:</td>
<td>298</td>
<td>298</td>
</tr>
<tr>
<td>Investment Income</td>
<td>Investment Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net appreciation</td>
<td>Net appreciation</td>
<td>865</td>
<td>865</td>
</tr>
<tr>
<td>(realized and unrealized)</td>
<td>(realized and unrealized)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total investment return</td>
<td>Total investment return</td>
<td>1,163</td>
<td>1,163</td>
</tr>
<tr>
<td>New gifts</td>
<td>New gifts</td>
<td>(7,450)</td>
<td>(7,450)</td>
</tr>
<tr>
<td>Appropriation of endowment</td>
<td>Appropriation of endowment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>assets for expenditure</td>
<td>assets for expenditure</td>
<td>(7,077)</td>
<td>(7,077)</td>
</tr>
<tr>
<td>Other changes:</td>
<td>Other changes:</td>
<td>510</td>
<td>510</td>
</tr>
<tr>
<td>Transfers to create board</td>
<td>Transfers to create board</td>
<td></td>
<td></td>
</tr>
<tr>
<td>designated funds</td>
<td>designated funds</td>
<td>(373)</td>
<td>(373)</td>
</tr>
<tr>
<td>Other</td>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(10)</td>
<td>(10)</td>
</tr>
<tr>
<td>Total Other Changes</td>
<td>Total Other Changes</td>
<td>510</td>
<td>510</td>
</tr>
</tbody>
</table>

Net assets, end of year

<table>
<thead>
<tr>
<th>Net assets, end of year</th>
<th>Net assets, end of year</th>
<th>8,247</th>
<th>8,247</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment return:</td>
<td>Investment return:</td>
<td>10,471</td>
<td>10,471</td>
</tr>
<tr>
<td>Net appreciation</td>
<td>Net appreciation</td>
<td>8,940</td>
<td>8,940</td>
</tr>
<tr>
<td>Total investment return</td>
<td>Total investment return</td>
<td>11,920</td>
<td>11,920</td>
</tr>
<tr>
<td>New gifts</td>
<td>New gifts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Appropriation of endowment assets for expenditure</td>
<td>Appropriation of endowment assets for expenditure</td>
<td>(7,450)</td>
<td>(7,450)</td>
</tr>
<tr>
<td>Other changes:</td>
<td>Other changes:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfers to create board designated funds</td>
<td>Transfers to create board designated funds</td>
<td>(7,077)</td>
<td>(7,077)</td>
</tr>
<tr>
<td>Other</td>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(10)</td>
<td>(10)</td>
</tr>
<tr>
<td>Total Other Changes</td>
<td>Total Other Changes</td>
<td>510</td>
<td>510</td>
</tr>
</tbody>
</table>

TRUE ENDOWMENT EXAMPLE

<table>
<thead>
<tr>
<th>Gift</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Later Gift</td>
<td>2,000</td>
</tr>
<tr>
<td>Investment Gains</td>
<td>1,000</td>
</tr>
<tr>
<td>Market Value</td>
<td>15,000</td>
</tr>
</tbody>
</table>

What is the historic $ value?

What is the appreciation?
Funds Functioning Like Endowment

Definition: “Funds which the governing board of an institution, rather than the donor..., has determined are to be retained and invested. Since these funds are internally designated rather than externally restricted, the governing board had the right to decide at any time to expend the principal.”

Sometimes Called “QUASI”

Usually Established for a Minimum Period of Time

Sample Policy

Introduction - Board authorization to establish an endowment fund is required whenever the donor’s written instructions concerning the use of funds as endowment are unclear or absent. Each year the University receives requests from the various schools and divisions, or the Development Office, to create new funds functioning as endowment in amounts ranging from $10,000 (the minimum threshold to establish an endowed fund) to several hundreds of thousands of dollars.

Purpose - To establish procedures to create new funds functioning as endowment.

Policy

1. The minimum threshold to establish a new fund functioning as endowment is $25,000. Moneys used to create a new fund functioning as endowment account, or moneys added to existing fund functioning as endowment account must be held for a minimum of ten years.

2. The Vice President for Business and Finance is authorized to approve individual requests for the new funds functioning as endowment or additions to existing funds functioning as endowment as they are received through the year.

3. An upper limit of $1 million per request is the limit of this authority. Any request to establish a fund functioning as endowment in excess of $1 million requires Board of Trustees approval.

4. Each June, the Vice President for Business and Finance will report on new funds functioning as endowments established in the past year, and obtain ratification from the Executive Committee of the Board of Trustees for funds that have been created during the previous twelve months.

5. While the Executive Committee retains its traditional oversight of the creation of new funds functioning as endowment, this policy allows for the more timely establishment of endowment funds throughout the year.
TERM ENDOWMENT

- DEFINITION: “Funds similar to (true) endowment funds except that, upon the passage of a stated period of time or the happening of a particular event, all or part of the principal may be expended.”

- Active Management Required

- Popular in the 1960’s (Ford Foundation)

TYPICAL ACCOUNTING ENTRIES

- Entry to record receipt of true endowment gift:
  - DR. Cash
  - CR. PR Contribution Revenue

- Entry to record receipt of term endowment gift:
  - DR. Cash
  - CR. TR Contribution Revenue
ACCOUNTING ENTRIES
(CONTINUED)

- Entry to record receipt of gift that is subsequently designated to function as endowment:
  - DR.
  - CR.
  - DR.
  - CR.

ENDOWMENT EXAMPLES

- The School of Business Administration receives a large bequest to be invested for the general benefit of the School.
- How would you classify ??
**ENDOWMENT EXAMPLES**

- Mount Vernon College has received an unexpected bequest of $200,000 from Melinda R. Farrow who graduated from the College in 1928. The College’s Trustees voted to place 70% in the endowment with the balance to be used to upgrade academic programs and student services.

- How would you classify the gift?

- The chairman of the English Department requests an endowment fund be established with the income to be restricted to support lectures in Creative Writing. The funds came from the sale of publications, principally a creative writing magazine the Department has authored for many years.

- How would you classify this?
ENDOWMENT EXAMPLES

- You have received a bequest containing the following provision: “I direct my residuary estate be paid to the Veterinary College to be used for research and the study of **equine** diseases. The funds of this trust shall be used for direct scientific **equine** research and shall be known as the Jones Equine Research Foundation.” How would you classify ????

ENDOWMENT EXAMPLES

- The University received a generous endowed scholarship of $500,000 in fiscal 2010 expected to produce enough in annual payout to underwrite one full undergraduate “named” scholarship each year.
- The market value of the endowment at June 30, 2011 is $400,000 and the calculated formula payout from the endowment is $25,000.
- **Do you allow for continued payout from an “underwater” endowment?**
“UNDERWATER” Endowments

SFAS 124…”In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce TRNA to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce UNA. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in UNA.”

“UNDERWATER” Endowments

- Year 1...$10,000 endowment for library books established. $700 investment gain.
- Year 2: $800 investment loss
- Year 3: $500 investment gain
- Accounting ???

<table>
<thead>
<tr>
<th></th>
<th>UNA</th>
<th>TRNA</th>
<th>PRNA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1-gift</td>
<td>700</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Year 2-gain</td>
<td>(100)</td>
<td>(700)</td>
<td></td>
</tr>
<tr>
<td>Year 3-loss</td>
<td>100</td>
<td>400</td>
<td></td>
</tr>
</tbody>
</table>
“UNDERWATER” Endowments

To pay or not to pay??

- Things to consider:
  - Pay yield only
  - What does your State law say
  - Do you have the unrestricted resources to back up the payment
  - Trustee concerns…prudence
  - Are there donor concerns
  - Do you need to go through the accounting “mumbo-jumbo”

ANNUITY FUNDS

- Definition
- Examples
- Accounting Considerations
- Tax Considerations
ANNUITY DEFINITION

◆ AICPA:
- “Funds acquired by an institution subject to agreements whereby assets are made available to the institution on the condition that the institution bind itself to pay stipulated amounts periodically to designated individuals. Payments of such amounts terminate at a time specified in the agreements.”
- “Upon termination, the principal of annuity funds is transferred to the fund group designated by the grant or, in the absence of such a designation, to unrestricted current funds revenue and accorded the same treatment as unrestricted expired term endowments.”

◆ Also Known as Charitable Gift Annuity Contracts

ACCOUNTING CONSIDERATIONS

◆ Assets become Institutions when received.
◆ Income payments usually based on:
  - Life of beneficiary
  - Earnings rate promised
  - Administrative expense
  - Residual of 50%
◆ Accounting:
  - Assets at fair value
  - Liability for PV of expected payments
  - Difference is Fund Balance or Net Asset
  - Changes in Liability:
    » Income on assets
    » Payments
  - Amortization of discount and changes in life are reflected in income.
  - Upon termination, balance goes to fund specified
TAX CONSIDERATIONS

- Portion of Asset Given Considered Gift By IRS
- Gift Portion Based on Age and Payment Rate
- Only Portion of Income Payment Received By Donor Taxable Based on Calculation Made at Date of Gift Contract Per IRS Tables
- 1099 Issued to Beneficiary
- Be Careful...Get Tax Advice When Have Questions!!

SPLIT INTEREST AGREEMENTS

- Definitions
- Examples
DEFINITIONS

◆ **AICPA:** “Funds contributed to an institution subject to the requirement that the institution periodically pay the income earned on the assets to designated beneficiaries. Such payments terminate at a time specified in the agreements, usually upon death of a designated individual.”

◆ **Types:**
  - Pooled Income Contracts
  - Perpetual Trusts (Section IV)
  - Charitable Lead Trusts
  - Charitable Remainder Annuity Trusts
  - Charitable Remainder Unitrusts

◆ **Warning.....Tax “stuff can be tricky. Be sure you know what you are doing.**

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Split-Interest Gifts

◆ **Assets...** Contributions measured at fair value

◆ **Liabilities and Net Assets:**
  - *Charitable Lead Agreement...* PV of estimated future distributions = gift
  - *Remainder Interest Agreement...* value of the assets contributed less PV of the payments to be made to beneficiaries = gift
  - *Pooled Life Income Agreement...* value of the assets contributed, discounted for the estimated time period until the donor’s death = gift

◆ **EXAMPLES...**
Charitable Lead Trust Example

- Mr. Crabb has given the University a $100,000 charitable lead trust that calls for the University to receive $5,000 per year for the next 10 years. At the end of this period the remainder of the trust goes to his favorite nephew John. Assuming a 7% return on Trust assets, the present value of the payments to be received over the next 10 years is $35,000.
- What should be recorded as contribution??

Over the next 10 years how will the $15,000 discount be treated??

Pooled (Life) Income Example

- On June 30, 2005 Ms. Ingrid contributes $10,000 to the School’s pooled income fund. She expects to receive $650 per year for the rest of her life. Based on the donor’s age, the accountants figure the discounted present value of the eventual receipt of the $10,000 life income fund to be $6,000. Upon the death of Ms Ingrid, the residual value of the fund is to be used by the School for general program related purposes.
- What should be recorded as contribution??
- What will you call the difference??
- In subsequent years will you increase the value of the gift??
FUNDS HELD IN TRUST BY OTHERS/PERPETUAL TRUSTS

◆ AICPA Not-for-Profit Audit Guide:
  – “A perpetual trust held by a third party is an arrangement in which a donor establishes and funds a perpetual trust administered by an individual or organization other than the not-for-profit beneficiary. Under the terms of the trust, the not-for-profit organization has the irrevocable right to receive the income earned on the trust assets in perpetuity, but never receives the assets held in trust...”

◆ GAAP Accounting and Reporting Different for GASB and FASB Schools !!!

FASB ACCOUNTING

◆ The fair value of the contribution should be measured at the present value of the estimated future cash receipts from the trust’s assets. Annual distributions from the trust are reported as investment income.
GASB ACCOUNTING

- The Institution
  - Is Trustee:
    » Accounting same as FASB
  - Is not Trustee:
    » Record receipt of distributions as contribution revenue
    » Footnote disclosure of of Trust value

HELPFUL HINT

- NACUBO’s Financial Accounting Reporting Manual and the AICPA Not For Profit Audit Guide are great resources for
  - Explanation of the different gift arrangements
  - Example journal entries to record original gift and subsequent valuation adjustments
MANAGING GIFTS

- Gift Stipulations
- Gifts: Restricted or Unrestricted
- Examples

GIFT STIPULATIONS

- Donor Seldom Uses Precise Wording
- Precatory: "Making a Wish"
- Cornell Policy on Precatory Declaration:
  - “Where the donor has expressed a wish or desire as to the use of income or principal, but the expression is precatory and not legally binding, the University will honor the precatory declaration.”
- Cy Pres: "As Near as Possible”
  - If a trust for charity is or becomes illegal, or impossible or impracticable of fulfillment, and if the settler, or testator, manifested a general intention to devote the property to charity, (a court of equity) may, on application of any trustee, or any interested party, or the Attorney General of State, order an administration of the trust, devise or bequest as nearly as possible to fulfill the general charitable intention of the settler or testator.” (UMIFA)
**GIFT STIPULATIONS**

- **Changing Conditions Language:**
  - “Should this purpose (for which the gift is made) ever become incapable of fulfillment because of unforeseeable circumstances or otherwise, in the sole judgment of the Board of Trustees, then this fund can be used for such one or more of the University’s educational purposes as its Board of Trustees shall from time to time determine.”

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**RESTRICTED OR UNRESTRICTED**

- **Questions to Ask:**
  - Spend same amount w/o gift ??
  - Are you spending $ for the same purpose with unrestricted funds ??

- **Who Decides ??**
  - Development
  - Controller
  - Budget Office

- **Best Practice:**
  - Active Management
  - High Level Committee for review
EXAMPLES

- The Chemistry Department has an endowed prize fund which has been yielding $1,500 each year. They have been awarding prizes totaling $1,000 annually and ask that the excess income accumulated, about $4,500, be added to principal. What do you do???

EXAMPLES

- You have received an unrestricted bequest of $40,000 from the estate of James Thompson. Mr. Thompson’s nephew tells you his Uncle wanted this to be a scholarship fund to honor the donor. Would you honor this request???
EXAMPLES

The Development Office says they have a potential donor who wants to make a significant gift to the University but is bothered when told that a new endowment would earn only 4.5 percent in the first year. They indicate they would like to propose that the funds be invested in the Short Term Investment Pool which is earning 8.5 percent. What would you advise???

ACCOUNTING FOR INVESTMENTS

Why Pool???
Investment Objectives
Accounting for Investment Pools
WHY POOL ???

- Spread Risk
- Easier to Manage..More Flexibility
- Minimizes Uninvested Cash
- Easier to Liquidate - No Forced Sales
- Simplifies Accounting
- REASONS MAY NOT WANT TO/ BE ABLE TO POOL ???
- Funds...Held Separately? Separately Invested?

INVESTMENT OBJECTIVES

- Different Pools for Different Objectives
- Investment Objectives:
  - Income Production
  - Capital Growth
  - Balance of Income/Growth
  - Mix Between Stocks and Bonds
  - Alternative Investments
ACCOUNTING FOR INVESTMENT POOLS

- Composition of Investment Pools
- Basic Principles:
  - Identity of each fund maintained at book value
  - Participation in pool identified by number of units
  - Market value of pool determined periodically
  - Additions/Withdrawals made at CURRENT market
  - Income distributed based on units
  - Realized gains and losses accumulated in separate account.
  - Withdrawals based on unit Market value at time of withdrawal.

TOTAL RETURN

- Total Return Approach
- Spending Rules
- Accounting
- Examples
TOTAL RETURN APPROACH

- Uniform Management of Institutional Funds Act Opened Door…Gains Not Akin to Principal
- Total Return = Yield (Interest, dividends) PLUS Gains/Losses
- Real Return = ???

TOTAL RETURN APPROACH
(Continued)

1. Total Return = 11%
   Inflation = 4%
   Real Return = ?? %

2. Total Return = 3%
   Inflation = 4%
   Real Return = ?? %
Typical Spending Formula

“The University utilizes the total return concept in allocating endowment income. In accordance with the University's total return objective, 5% of a twelve-quarter moving average of the market value of endowment investments is available each year for expenditure in the form of endowment payout.”

SPENDING RULES

- Balance Current Income Vs. Protection of Purchasing Power
- Estimate Expected Long-Term Real (Inflation Adjusted) Return
  - Total return 14% - inflation 3% = Real Return of 11%..Spending Rule 5%..Impact ??
  - Total return 9% - inflation 3% = Real Return of 6%...Spending Rule 5%..Impact ??
  - Total return 7% less inflation 3% = Real Return of 4%...Spending Rule 5%..Impact ??
- Types:
  - All Income
  - % of Moving Market Value
  - % Increase Over Prior Year
  - Establish Rate Each Year