NACUBO

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What Activity Should be Included in the Endowment Roll-forward?

Situation

Two controllers from independent Institutions are sharing experiences about their recent financial statement preparation and audit and are relaying conversations with new team members who were asking why pledges are included in the endowment rollforward. The controllers had arrived at the same explanation for their new employees but wondered if they were correct.

They had explained that promises to give (pledge receivables) that establish or add to endowments are reported as contributions on the statement of activities. Also reported as endowments are interests in outside perpetual trusts (aka. perpetual trusts held by others, "THBOs") that are irrevocable and will benefit the organization in perpetuity. Although pledges and THBOs are not included in the consolidated investment pool, they are included as net assets with donor restrictions in perpetuity and are considered part of the total endowment. However, were they correct that pledges and THBOs should be included in the required endowment roll forward schedule?

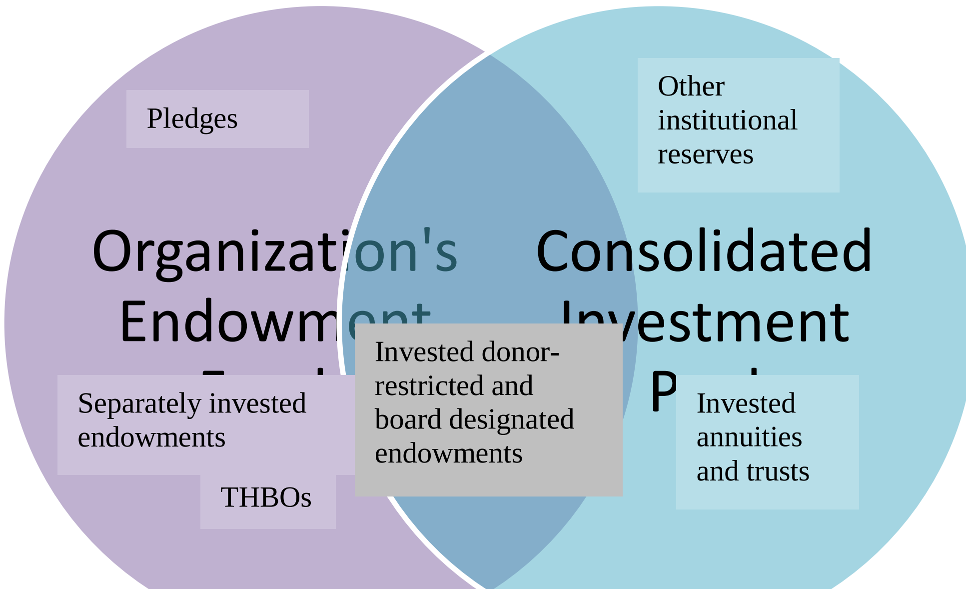
Response

Yes, contributions (including pledges) and the activity in trusts held by others should be included in the endowment rollforward. However, they can be displayed separately. Although pledges cannot be invested by the institution and perpetual trusts held by others are not invested by the institution, both are part of net assets. FASB Accounting Standards Codification (ASC) 958-205-50-1B requires a disclosure of the composition an NFP's endowment by net asset class at the end of the period and a roll-forward of net asset activity from the beginning of the reporting period.

The confusion is caused by a misunderstanding that equates the consolidated investment pool with an institution's endowment. As shown in the diagram below, the consolidated investment pool is not exactly synonymous with the concept of endowments as reported in financial statements. The investment pool will hold most of the endowments, but pledges and THBOs are excluded from the pool. Pledges are excluded because there is no cash to invest until the pledge is paid; THBOs are excluded because the reporting entity does not hold the assets. The institution may also have endowed funds that are separately invested (based on donor directives) or tangible assets (such as income producing real estate, not used in operations) that are not part of the consolidated investment pool.

Although it's not recommended[1], there could be funds invested in the consolidated investment pool that are not endowments. The consolidated investment pool may include operating reserves (that are not board-designated endowments), assets of charitable trusts, or general operating funds.

[1] Reserves, annuities and trusts, or operating funds have a different investment objective (and different asset allocations) than what is common for endowment funds that must preserve inter-generational equity and must last in perpetuity. Consequently, investing reserves, annuities and trusts, or operating funds in a consolidated investment pool may result in a loss of principal that will not have been fully recovered at the time the funds are needed.



Pledges to create an endowment are recorded as contributions in the non-operating section of the statement of activities in net assets with donor restrictions. Item e. in ASC 958-205-50-1B (shown below) describes the elements that are required to include in the roll-forward schedule, with the second item listed as “contributions” not “payments”. Excluding pledges from the roll-forward schedule would be very confusing for readers of financial statements who would compare the contributions reported on the statement of activities to the contributions in the endowment roll forward schedule. However, to provide clarity for the financial statement reader, the pledge activity can be shown in a separate column, separate row, or both of the roll-forward, or the amount of pledges included in the endowment’s ending balance can be disclosed within the text of the note.

Trusts held by others in perpetuity meet the definition of an endowment and should also be included in the roll-forward. If the activity is material it can be shown in a separate column, reporting the investment returns and spending distribution resulting from the assets held by the institution separately from the returns and spending policies of the trusts held by others. This helps the financial statement reader connect the qualitative descriptions of the organization’s investment and spending policies with the actual results. Alternatively, the investment returns, and spending could be reported in total, and the amounts associated with the trusts held by others could be disclosed within the text of the note.

Therefore, based on the reasoning above, there can be more components of endowment net assets than what’s held in the consolidated investment pool, those components – separately invested endowments, real estate, pledges and (perpetual) THBOs – should be included in the endowment roll-forward.

Authoritative Reference

From FASB’s Master Glossary:

Endowment funds are “an established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP). The use of the assets of the fund may be with or without donor-imposed restrictions. Endowment funds generally are established by donor-restricted gifts and bequests to provide a source of income in perpetuity or for a specified period.”

Donor-restricted endowment funds are "an endowment fund that is created by a donor stipulation (donors include other types of contributors, including makers of certain grants) requiring investment of the gift in perpetuity or for a specified term. Some donors or laws may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions."

Note that donor-restricted endowment funds may be established directly with the not-for-profit entity or by setting up an irrevocable trust with a third-party for which the income will benefit an organization in perpetuity, i.e. a trust held by others. Therefore, THBOs in perpetuity are included in the concept of endowment funds.

Board-designated endowment funds are "an endowment fund created by a not-for-profit entity's (NFP's) governing board by designating a portion of its net assets without donor restrictions to be invested to provide income for a long but not necessarily specified period (sometimes called funds functioning as endowment or quasi-endowment funds). In rare circumstances, a board-designated endowment fund also can include a portion of net assets with donor restrictions. For example, if an NFP is unable to spend donor-restricted contributions in the near term, then the board sometimes considers the long-term investment of these funds."

FASB Accounting Standards Codification (ASC) paragraphs 958-205-50-1B
This paragraph specifies the information that must be included in the disclosures related to endowment funds. Item e. lists the elements to include in the endowment roll forward.
"At a minimum, an NFP shall disclose all of the following information for each period for which it presents financial statements:

a. A description of the governing board's interpretation of the law or laws that underlie the NFP's net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from underwater endowment funds.
b. A description of the NFP's policy or policies for the appropriation of endowment assets for expenditure (its endowment spending policy or policies), including its policy, and any actions taken during the period, concerning appropriation from underwater endowment funds.
c. A description of the NFP's endowment investment policies, including all of the following:
    1. Return objectives and risk parameters
    2. How return objectives relate to the NFP's endowment spending policy or policies
    3. The strategies employed for achieving return objectives.
d. The composition of the NFP'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.
e. A reconciliation of the beginning and ending balance of the NFP's endowment, in total and by net asset class, including, at a minimum, all of the following line items that apply:
    1. Investment return, net
    2. Contributions
    3. Amounts appropriated for expenditure
    4. Subparagraph superseded by Accounting Standards Update No. 2016-14.
    5. Other changes."

Related FARM Chapters:
452 Endowment Funds
506.4 Endowment Funds