

Navigating the New Endowment Landscape: A Practical Guide and Compliance Checklist for NC Nonprofits

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By Dianne Chipps Bailey and Ashley C. Hedgecock

In March of 2009, the North Carolina legislature enacted the Uniform Prudent Management of Institutional Funds Act (UPMIFA) to modernize the rules governing endowment fund spending and management. The newly-enacted UPMIFA effects three primary changes to North Carolina law.

- First, UPMIFA updates spending rules to address market volatility and fluctuations in asset balances, in some instances providing institutions greater flexibility in troubled economic times.
- Second, the law provides guidance related to the management of endowment assets and the delegation of such management.
- Finally, UPMIFA makes it easier for nonprofits to release or modify restrictions that a donor has imposed on older, smaller endowment funds.

UPMIFA poses a number of immediate challenges for organizations that hold endowment funds. For example, Nonprofits need to assess existing grant agreements to determine donor intent, review investment and spending policies to ensure they satisfy UPMIFA's requirements, and review and potentially modify the manner in which they account for endowment funds to ensure compliance with accounting rules. This memorandum provides background on the new legal and accounting landscape for North Carolina endowments and offers a checklist for the steps an institution should consider when navigating the new rules.

Scope of UPMIFA

An endowment fund is a fund that, under the terms of a gift instrument, is not wholly expendable by the nonprofit on a current basis. UPMIFA only applies to funds with donor-imposed, rather than board-designated, restrictions.

Spending Prudently Under UPMIFA

Under prior North Carolina law, a charity could spend earnings and appreciation from an endowment fund over the fund's "historic dollar value" – the aggregate value of all contributions to an endowment fund at the time they were made, but the organization could not spend from "underwater" funds that had fallen below historic dollar value. UPMIFA eliminates the concept of historic dollar value and offers governing boards more flexibility by allowing organizations to expend amounts from an endowment based on what is prudent, acting in good faith with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Subject to the specific intent of the donor expressed in a

gift instrument, an organization may expend or accumulate as much of an endowment fund as the institution determines is prudent “for the uses, benefits, purposes, and duration for which the endowment fund is established.”

In determining what is prudent, the organization must consider:

- The duration and preservation of the endowment fund
- The purposes of the institution and the endowment fund
- General economic conditions
- The possible effect of inflation or deflation
- The expected total return from income and the appreciation of investments
- Other resources of the institution
- The investment policy of the institution

To be clear, UPMIFA does not permit a governing board to convert an endowment fund into a totally expendable fund – the duration and preservation of the fund always must be a priority. However, UPMIFA does permit the institution to preserve the purchasing power of the current value of the fund while being responsive to the needs of the organization during short-term value fluctuations. Because UPMIFA lacks a bright-line test for what constitutes a prudent spending level, governing boards should be prepared to thoroughly analyze and weigh each of the above factors pursuant to a board adopted spending policy and document their decision-making process in the meeting minutes.

Investing Prudently Under UPMIFA

UPMIFA requires nonprofits to apply modern portfolio theory and invest on a diversified basis. The standard of care for making such investment decisions is the same prudence standard that applies to spending decisions – the governing board must manage and invest the fund “in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.” In making investment and management decisions, the organization must consider:

- General economic conditions
- Effects of inflation or deflation
- Tax consequences
- How an investment fits within the total portfolio
- Portfolio’s expected total return
- Other resources available to the institution
- Institutional needs and the relationship between distributions and capital preservation
- An asset’s special relationship or value, if any, to the charitable purposes of the institution

In addition, UPMIFA expressly permits nonprofits to delegate the management and investment of an endowment fund as long as the board acts prudently and in good faith in selecting the agent, establishing the scope and terms of the delegation, and monitoring the agent's performance and compliance with the terms of the delegation. Finally, in North Carolina, UPMIFA provides certain protections from personal liability for volunteers overseeing investments for nonprofits.

Releasing or Modifying Donor Restrictions Under UPMIFA

UPMIFA also updates the method for releasing or modifying donor restrictions on the use of certain endowment funds. The traditional methods of release or modification still apply but older, smaller funds can now be released or modified without making a request to the court or the donor as long as the property is used in a manner consistent with the donor's intent.

If the fund is less than \$100,000 and more than 10 years old, a nonprofit may modify or release the fund's restrictions by giving notice to the Attorney General. As a practical matter, of course, it may be in the best interest of nonprofits to communicate with donors when possible before unilaterally releasing or modifying fund restrictions, notwithstanding this change in the law. The modification or release takes effect automatically 60 days after notice barring objection by the Attorney General.

Accounting for UPMIFA

In response to the adoption of UPMIFA by many states and UPMIFA's elimination of the historic dollar value concept, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position FAS No. 117-1 to provide new financial reporting guidelines for donor-restricted endowment funds in states that have enacted UPMIFA. FAS 117-1 directs nonprofit organizations in classifying certain assets and requires certain disclosures for all organizations that hold endowment funds, whether donor-restricted or board-designated. The following rules apply to endowment funds under FAS 117-1.

FAS 117-1 Accounting Requirements for donor- FAS 117-1 Disclosure Requirements for all donor restricted endowments governed by UPMIFA restricted and board-designated endowments

The provisions of FAS 117-1 are effective for fiscal years ending after December 15, 2008. Organizations must classify a portion of a donor restricted endowment fund of perpetual duration as permanently restricted net assets. The permanently restricted amount is: (a) the amount that must be permanently retained according to the donor's restriction, or (b) in the absence of such restrictions, the amount the organization's governing board determines must be permanently maintained in accordance with relevant law.

The portion of an endowment fund that is not classified as permanently restricted now must be classified as temporarily restricted until appropriated for expenditure.

Consistent with FAS 124, "Accounting for Certain Investments Held by Not-for-Profit Corporations," for financial statement purposes, the portion of a donor-restricted endowment fund that is classified as permanently restricted net assets generally is not reduced by investment losses or an organization's appropriation from a fund. Rather, losses and appropriations from the permanently restricted portion of a donor restricted endowment fund are charged first to "temporarily restricted" net assets and then to unrestricted net assets unless one of the following limited exceptions applies:

- o The donor controls the investment;
- o For perpetual trusts; or
- o The donor grants permission to charge losses to the fund

Organizations must identify the portion of an endowment fund that is not permanently restricted and that has not been previously appropriated for expenditure (e.g., unappropriated appreciation on the fund). Any such amounts that were previously classified as unrestricted net assets must be reclassified as temporarily restricted until they have been appropriated for expenditure.

All organizations, whether or not subject to UPMIFA, must make new disclosures about the management of their endowment funds on their financial statements, including:

- A description of the governing board's interpretation of the laws underlying the organization's net asset classification of donor restricted endowment funds
- A description of the organization's endowment spending policy
- A description of the organization's investment policy, including:

o Return objectives,

o Risk parameters,

o The relationship of return objectives and risk parameters to spending policies, and

o Strategies employed to achieve such objectives

- The composition of the organization's net asset class at the end of the period, in total and by type of endowment fund, showing donor restricted funds separately from board designated funds, and
- A reconciliation of beginning and ending balances of the endowment in total and by net asset class including:

o Investment income,

o Net appreciation or depreciation,

o Contributions, and

o Amounts allotted for expenditure changes and reclassifications

□ The FASB has provided examples of these disclosures in an appendix attached to FAS 117-1. See www.fasb.org/pdf/fsp_fas117-1.pdf

Next Steps for North Carolina Nonprofits Holding Endowment Funds

In light of the newly-enacted rules under UPMIFA and FAS 117-1, North Carolina nonprofits with endowment funds should consider taking the following actions:

1. □ Train your governing board and finance/investment committee on the new legal and accounting rules.
2. Make a list of questions or issues to resolve with your legal counsel or accountant.
3. □ Review all institutional endowment funds and determine whether they are donor-restricted or board restricted. Recall that only donor-restricted funds are subject to UPMIFA, but all endowment funds are subject to the disclosure rules under FAS 117-1.
4. □ Review existing gift instruments for donor-restricted funds to determine whether they impose specific donor restrictions regarding expenditures. If a gift instrument contains a specific provision for expenditures, the gift instrument trumps UPMIFA.
5. □ Review the organization's spending policy to determine whether it complies with UPMIFA's prudence standards. Consider revising the policy to track the language of the prudence factors listed in the North Carolina statute.
6. □ Review the organization's investment policy and the terms of any delegation of investment authority to determine whether they satisfy UPMIFA. Consider revising the policy to show consideration of the prudence factors listed in the North Carolina statute.
7. □ Document the governing board's decisions with respect to the spending and investment policies and terms of delegation in the board meeting minutes. Be sure the governing board discusses and analyzes all of the applicable prudence factors when making decisions about the organization's spending and investment policies, and when delegating management and investment functions to third parties.
8. □ Organizations that have standard endowment agreements for use with potential donors should review the agreements to make sure they appropriately reference or incorporate the organization's new expenditure policy and allow for future changes. Consider whether to avoid the requirements of UPMIFA by giving the governing board discretion.
9. □ Determine what portion of each donor-restricted fund's assets should be classified as permanently restricted. Recall that the permanently restricted amount is: (a) the amount that must be permanently retained according to the donor's restriction, or (b) in the absence of such restrictions, the amount the organization's governing board determines

- must be permanently maintained in accordance with relevant law (i.e., the North Carolina UPMIFA statute).
10. Classify the portion of each fund that is not classified as permanently restricted until appropriated for expenditure. Reclassify any assets previously classified as unrestricted to temporarily restricted if they have not been appropriated for expenditure.
 11. Identify any debt covenants issues with lending institutions and obtain amendments to debt covenants where necessary. The reclassification of assets from unrestricted to temporarily or permanently restricted may cause the organization to violate its debt covenants in certain credit agreements, so the organization will want to address these issues with its lenders.
 12. Draft disclosure footnotes for financial statements, including a description of the 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 endowment spending policy and investment policy, and the composition of the organization's endowment by net asset class.

Questions?

Please do not hesitate to contact Dianne Bailey at (704) 377-8323 or dbailey@rbh.com or Ashley Hedgecock at (704) 377-8163 or ahedgecock@rbh.com.