Endowment Fund Spending Policy and Practice

Not-for-Profit Services Group

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The KLR white paper is one in a series of white paper discussions dealing with endowment fund policy, accounting and practice. The guidance provided in this white paper is derived from the Uniform Prudent Management of Institutional Funds Act (UPMIFA) which replaced the Uniform Management of Institutional Funds Act (UMIFA). These two Acts are called “uniform” because they were created by The National Conference of Commissioners on Uniform State Laws (NCCUSL). After drafting an Act, the Conference sends it to the states for approval and implementation as a state law.

The Conference approved UMIFA in 1972, and 47 jurisdictions enacted the Act. UPMIFA was approved in 2006 and it has been enacted by almost every state. This white paper will discuss the provisions for the uniform Act passed by the NCCUSL which is most likely what your state has implemented, however, you are urged to consult the specific legislation enacted in your state for any unique or unusual provisions that your state may have included in their law.

When the NCCUSL refers to endowment funds, they mean donor permanently-restricted funds. These are funds established by donors where the donor has specified that the fund is to be maintained in perpetuity and annual income from the fund is to be used for annual support of the beneficiary.

Not-for-Profit boards have, over the years, established what were called “funds-functioning-as-endowments” which were generally comprised of unrestricted funds set aside by the board for long-term endowment-like purposes. The FASB has determined that both donor-restricted and board-designated endowment funds should both be called simply “endowment funds.”

While the guidance in this white paper applies under law only to donor-restricted endowment funds, the practices described herein should also apply to board-designated “funds-functioning-as-endowments” because if those funds are not managed in the same manner as the donor-restricted endowment funds, then they are not truly “functioning as an endowment” and should not be referred to as part of the organization’s endowment. However, the force of (the UPMIFA) law does not apply to board-designated endowment funds.

This white paper will address the following endowment spending policy questions:

1. What is a spending policy?
2. Can an organization spend all of its endowment?
3. Can an organization spend nothing from its endowment if none is needed?
4. Can an organization change its spending policy?
5. What is the risk of penalty?

One of the biggest changes between UMIFA and UPMIFA is the impact of a number of expressly enumerated prudence standards in UPMIFA, the central one of which is the preservation of the endowment fund. This means that an endowment fund is supposed to last in perpetuity, providing annual income to the beneficiary organization. It also means that the endowment fund should retain
its relevance; meaning, the fund should be as valuable to the beneficiary organization in the future as it was on the date of the initial gift.

The Act noted that the endowment donor’s intent is to provide current benefits to the charity. Therefore, the primary focus of a fund should be on the needs of the charity rather than on the purposes and perpetual nature of the fund. UPMIFA provides clearly articulated guidance on the prudence rule for spending from an endowment fund, with emphasis on the permanent nature of the fund and a goal of protecting the purchasing power of endowment funds.

Included in the UMIFA law, was a presumption of imprudence if a charity were to spend more than 7% of an endowment fund in any one year. Many NCCUSL representatives believed that this was a good provision in the UMIFA laws and lobbied to include such a provision in UPMIFA. However, ultimately the NCCUSL concluded that such a statutory provision is unresponsive to changes in the rate of inflation or deflation and left the inclusion of a presumption of imprudence as an optional provision in UPMIFA. Some states have indeed opted to include such a provision in their UPMIFA law – another reason to check your particular state law.

**Spending Policy**

Section 4 of the UPMIFA document is the section regarding *Appropriation for Expenditure or Accumulation of Endowment Fund(s)*. Since most of the states have followed the UMPIFA template, these appropriation rules will likely also appear in Section 4 of your particular state’s law.

UPMIFA begins this section with the phrase “subject to the intent of the donor”. This phrase appears in numerous places within UPMIFA. It is there to remind us that a donor has the ability to ask the recipient charity to do anything the donor wishes with their donation. Once the charity accepts the donation, it is bound by all of the donor’s directives. Thus, a donor who provides $5 million to a college scholarship endowment with the directive to “spend 15% of the funds balance annually on undergraduate scholarships for as long as the fund remains” is establishing their own rules for appropriation for expenditure and accumulation of the fund. However, absent such explicit instructions, the Section 4 guidance on appropriations must prevail. Also, inexplicit directions, such as “spend the income and retain the principal” are not viewed as specific donor intents that take precedence over Section 4 guidance. Obviously there is a great deal of gray area in between these two extreme examples and it is incumbent upon the recipient charity to obtain clarity at the time of the gift.

UPMIFA indicates that endowment funds are donor-restricted until they are appropriated. Therefore, all un-appropriated funds are donor-restricted. The Financial Accounting Standards Board (FASB) has provided guidance on how those funds are reported, but that is not part of the content of this white paper.

In making the determination to either appropriate for spending or accumulate funds, the institution is to consider the following 7 factors:

1. the duration and preservation of the endowment fund;
2. the purposes of the institution and the endowment fund;
3. general economic conditions;
4. the possible effect of inflation or deflation;
Prior to the promulgation of UMIFA, “income” for trust accounting purposes meant interest and dividends but not capital gains, whether or not realized. Many institutions assumed that trust accounting principles applied to charities organized as nonprofit corporations, but such rules limited the institutions’ ability to invest their endowment funds effectively. UMIFA addressed this problem by construing “income” in gift instruments to include a prudent amount of capital gains, both realized and unrealized.

Under UMIFA an institution could spend appreciation in addition to spending income determined under trust accounting rules. This rule of construction is more likely to carry out the intent of the donor (for annual support) better than a rule limiting spending to trust accounting income, while also permitting the charity to invest in a manner that could generate better returns for the fund.

UPMIFA also applies a rule of construction to terms like “income” or “endowment.” The assumption in the Act is that a donor who uses one of these terms intends to create a fund that will generate sufficient gains to be able to make ongoing distributions from the fund while at the same time preserving the purchasing power of the fund. UPMIFA directs the institution to determine spending based on the total assets of the endowment fund and also consider the long-term nature of the fund and the need to preserve purchasing power.

**Question 1 – What is a spending policy?**

Since UMIFA (and UPMIFA) have adopted a rule of construction and said that appropriated spending is not determined by the type of income earned (interest, dividends, or capital gains), then it must be determined by some other means. The law indicates that spending is determined by appropriating a percentage of total endowment assets. An appropriate spending policy is “we will spend 4% of the market value of the endowment fund each year.” The application of this policy will provide you with an annual amount to appropriate for spending.

Some important aspects of the above sample policy: it is a specific number, not a range of numbers. One cannot implement a spending policy of between 2% and 5% because no one knows how to perform the math. It may be appropriate to form a policy that indicates that the spending policy each year will be determined with regard to the 7 factors in the law and that the spending rate must be between 2% and 5%. Such a policy (actually a policy for the formation of a policy!) still requires the organization to determine an annual spending policy specifying a specific percentage within the range.

The simple spending policy noted two paragraphs above can be improved. We suggest applying the spending policy amount to an average of endowment market values over a long period of time in order to smooth the annual appropriation amount as market values raise and fall. Thus, a spending policy that indicates “we will spend 4% of the average market value of the endowment fund over the previous 12 quarters” provides an annual spending appropriation amount that should not vary widely from year to year while still moving in the direction of the total endowment fund assets.
A further improvement in the spending policy can be made for budgetary reasons. Since organizations would benefit from knowing what amount is available for appropriation from the endowment during its budget process, the spending policy could indicate “we will spend 4% of the average market value of the endowment fund over the previous 12 quarters ending 9 months prior to the beginning of the year.” Such a policy would enable a calendar-year organization to calculate the endowment appropriation for the year beginning on January 1 in April of the previous year.

It follows, therefore, that if this were an organization that establishes a spending policy number each year from one that is within a specified range, that figure must be determined by April of the year before the year in which the appropriation will take place.

UPMIFA also indicates that an institution should monitor principal in an accounting sense, identifying the original value of the fund and the increases in value necessary to maintain the purchasing power of the fund. The spending policy number should be below the anticipated total investment return of the fund. The difference between the spending policy percentage and the total anticipated investment return is the amount that will be added to the endowment fund to maintain the fund’s purchasing power.

**Question 2 – Can an organization spend all of its endowment?**

It is important to note that none of the above 7 factors mentions the initial amount of the gift. Therefore if market declines cause a fund to dip below the value of the original gift (what is called an “underwater fund”), there is nothing in the UPMIFA law prohibiting the appropriation of an amount for spending from that fund. UPMIFA applies a more carefully articulated prudence standard to the process of making decisions about the amount of expenditures from an endowment fund.

The organization needs to prudently balance its need for annual support with its need to maintain the fund’s purchasing power.

At this point, let’s shift from the law to the accounting aspects of endowments. The Financial Accounting Standards (FAS) indicate that the initial donor-restricted endowment must be included in the permanently restricted class of assets. This amount will never change unless additional donor-restricted funds are directed to be added to it.

Therefore, while the UPMIFA law(s) allow for spending appropriations to be made from underwater funds, those funds will continue to be reflected on the charity’s books as permanently-restricted net assets in amounts that are equal to their original donation amounts. As the physical funds representing permanently-restricted net assets decline below the net asset balances, this sets up a deficit or a receivable of the permanently-restricted net asset class from the unrestricted net asset class.

In some states where charities holding endowments have filed for bankruptcy and endowment assets, at the time of bankruptcy filing, were below the permanently-restricted net asset balance, the state attorney general has held the officers and directors liable for the dissipation of the permanently-restricted gift(s).

Therefore, it appears that the answer to the second question – Can an organization spend all of its endowment? – is clearly “no”. As a matter of fact, boards should proceed with caution when spending causes an endowment fund’s balance to dip below the amount of the permanently-restricted
initial gift amount. However, the UPMIFA laws clearly give the board the ability to continue some amount of annual support for the institution even from an “underwater endowment.”

In such a situation, it would appear that the board needs to be looking at the resources of the organization and its need for funds (factor #6 above) as well as its belief that future earnings (factor #5 above) will bring the fund back to a reasonable inflation-adjusted balance. While the answer to the first question is clearly “no” – an organization cannot spend all of its endowment – this does not mean that the organization has an artificial stopping point below which it can no longer appropriate annual spending dollars from an endowment fund.

Question 3 - Can an organization spend nothing from its endowment if no funds are needed?

Occasionally, organizations have sufficient current income from normal operations to completely finance current operations. When this occurs, they sometimes decide that they do not want to withdraw from the endowment fund and would prefer to let those assets grow and accumulate to benefit the future. This is an admirable position in which to find oneself and growing the endowment is an admirable objective. However, both the law and Financial Accounting Standards have something to say in this regard.

Throughout the NCCUSL’s UPMIFA document, they speak about the donor’s intention to benefit both the long and short-term needs of the organization. Both the law and Financial Accounting Standards have incorporated this concept into their regulations. The law indicates that a spending policy is to be created and implemented on an annual basis to determine the amount of spending available to the institution annually. Even when speaking about underwater funds, the law provides that some amount of endowment income may be made available for current operations. So the law does not contemplate that endowment funds will not provide for some support to be available to the institution.

Notice that the emphasis in the above paragraph is on funds being made available for current spending. Actually withdrawing those funds from the endowment investment account is a different matter entirely. Due to economic conditions, whether they be sufficient operating funds without the need for an endowment earnings, or depressed market values in the endowment investment account, the organization may decide not to withdraw funds from endowment assets. Not withdrawing funds is permissible.

However, regardless of whether an organization withdraws funds from endowment assets or not, the organization must use its spending policy to calculate an amount of available funding from endowments. In the organization’s financial statements, this amount of available funding will appear as operating income and will therefore be a factor in the calculation of the change in net assets from operations.

If the funds are not withdrawn from the endowment assets, those available, but unused funds now represent non-endowment funds commingled with the endowment investments. These funds represent unrestricted (or temporarily restricted) funds-functioning-as-endowment that have been commingled with the permanently restricted endowment funds.

So the answer to Question 3 - Can an organization spend nothing from its endowment if no funds are needed? – is a “yes”. However, one has to recognize the difference between withdrawing and
spending endowment assets vs. **recognizing** the income provided from endowment assets via the spending policy. An organization may choose not to withdraw endowment funds to spend, but it cannot choose not to recognize some annual endowment funding as available for spending.

**Question 4 - Can an organization change its spending policy?**

The simple answer to this is “yes”. As discussed above, some organizations have a policy that their spending policy shall fall within a range and each year they select a spending policy number within that range. What is not allowable, however, is the changing of the spending policy during the year to which it applies.

For example, if the spending policy is established at 4% and midway through the year, the organization is experiencing positive variances such that it no longer needs that much endowment income for operations, the spending policy cannot be reduced to, say 1%. As noted above, the organization is free to stop withdrawals of appropriated spending policy funds from the endowment assets. But, endowment income of 4% will still be reflected within operating income in the organization’s year-end financial statements.

Conversely, if the organization is experiencing unfavorable variances midway through the year, the spending policy cannot be increased. What if an organization withdraws more from endowment assets than the amount of appropriated funds made available via the spending policy? Those additional drawings constitute a loan from the endowment fund to the operating fund. Such a loan must be repaid and should accrue interest at the market rates for similar loans. If a loan such as this exists at year-end, it should be evident in the financial statements or disclosed in the footnotes to the financial statements.

**Question 5 - What is the risk of penalty?**

This white paper has spoken about the UPMIFA act that has been codified into law in every state. Noncompliance with the law carries the same risk of penalty as the violation of any law. However, the penalty for noncompliance is not spelled out within the law.

We noted above how the attorney general of some states have charged officers and directors with a violation of their fiduciary duty when endowment assets have been dissipated by organizations going out of business. In addition, there are numerous legal actions that have been brought by donors against the institutions to whom they have given endowment funding when the donor has disagreed with how the institution has administered their endowment funds. So there are risks associated with not acting prudently when you are one of the fiduciaries administering funds under the Uniform Prudent Management of Institutional Funds Act.

The creation and implementation of a spending policy is only one of the challenges facing the not-for-profit organization with an endowment fund. If you have questions or would like additional guidance relative to your spending policy issues, **please contact us**.
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