



# Strategies for Managing Endowments in Independent Schools

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# Meet the Presenters



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# Learning Objectives

- Identity the philosophy and purpose behind endowments
- List best practices for policy considerations for endowments
- Recall the proper accounting and disclosure procedures for endowments while avoiding common errors
- Determine the impact of endowment strategies and potential pitfalls through real-world case studies



# Understanding Endowments



# General Types of Endowments

- Perpetual type of endowment
- Term endowment
- Quasi-endowment – Board-designated endowments
- Board-designated (reserves, scholarship, capital campaigns)
  - These are NOT endowments, they are different
  - Therefore, NOT included in the enhanced endowment disclosures
  - But they are required to be considered for the impact to liquidity

# UPMIFA Definition – Endowment Fund

- “**Endowment fund**” – an institutional fund (or part thereof) that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis
  - Does not include board-designated endowments since there is no gift instrument

# Intergenerational Equity

## Perpetual Endowment

“The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations. The trustees of an endowed university like my own assume the institution to be immortal. They want to know, therefore, the rate of consumption from endowment which can be sustained indefinitely. Sustainable consumption is their conception of permanent endowment income. In formal terms, the trustees are supposed to have a zero subjective rate of time preference. Consuming endowment income so defined means in principle that the existing endowment can continue to support the same set of activities that it is now supporting.”

– James Tobin, 1974, What is Permanent Endowment Income?

# Acceptance of Endowment Gifts

- Organizational promise
- Donor expectation
- Gift acceptance policy



# Investment Management & Spending Rate

- Portfolio management protects endowment purchasing power
- Spending rate balances the support across the different generations
- Spending rate dictates the monetary societal impact endowment assets can make in any one year

# Factors in Appropriating or Accumulating Donor-Restricted Endowment Funds

The following are required as part of UPMIFA, & FASB shows it as part of its example disclosure. See 958-205-50-1B & 958-205-55-38

1. The duration & preservation of the fund
2. The purposes of the organization & the donor-restricted endowment fund
3. General economic conditions
4. The possible effect of inflation & deflation
5. The expected total return from income & the appreciation of investments
6. Other resources of the organization
7. The investment policies of NFP

Enacted state versions of UPMIFA could have other requirements.

Consideration of these factors when appropriating, along with the spending rate, should be documented in the board committee minutes

# Investment Management Code of Conduct (CFA Institute)

- Act with loyalty & proper purpose
- Act with skill, competence, prudence, & reasonable care
- Abide by all laws, rules, regulations, & founding documents
- Show respect for all stakeholders
- Review investment strategy & practices regularly

# Endowment Risk Management & Legal Structure





# Donor-Restricted Endowment Fund

When classifying net asset classes, consider the donor's explicit stipulations & the applicable laws that extend donor restrictions



Since there is a requirement to appropriate for expenditure, the funds are time-restricted until that appropriation takes place



If the fund is subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act of 2006 (UPMIFA), it extends a donor's restriction to use of the funds, that includes the corpus & the investment return, until the funds are appropriated for expenditure by the governing board



49 of the 50 states have an enacted version of UPMIFA

# Board-Designated Endowment Fund

Funds without any purpose-type restrictions

The original fund & all investment returns are free of donor restrictions

Reported in net assets without donor restrictions

Are set up by the board

NOT subject to an enacted version of UPMIFA

NOT subject to underwater disclosure requirements

Subject to the disclosure requirements under FASB's ASU 2016-14

- Since both board-designated & donor endowments are typically shown in the notes side by side, no additional disclosures may be necessary
- It is optional to bifurcate this within net asset without donor restrictions on the balance sheet

# Endowment Risk Management

- Endowments impose upon the school
  - Contractual
  - Legal/Fiduciary
  - Ethical
  - Financial
  - Management
  - Reporting responsibilities

# Regulatory/Legal Framework – Restricted Gifts

- General Tips
  - New endowment set up
  - Structure & options for endowments
  - Hurdles & leadership decision-making



# What Can Go Wrong?

- Donor default on payment
- Restrictions or requirements the school cannot handle
- Lack of clarity around provisions
- State regulatory enforcement
- Private donor enforcement (or attempts)
- Charitable pledges
- Reputational risk
- Donor relations
- Change in culture or values over time
- Change in circumstances
- Conflicts of interest
- Donor actions/reputation

# Regulatory/Legal Framework – Restricted Gifts

## Federal/IRS

- Completed gift
- Charitable deduction/Quid pro quo rules
- Conditional “get it back” restrictions
- Impact on 501(c)(3) status/Private benefit
- Private foundation rules, *i.e.*, self-dealing

## State

- Donor intent
- UPMIFA
- Attorney General/Charities Bureau
- Other issues
- Private litigation

# Educational Issues

- Acceptance – when & how
- Applicable approval thresholds
- Importance of record-keeping
- Documenting conversations regarding intent, restrictions, & conditions
- Guidelines for communications with donors
- Checklists for potential issues
- Consider print & online solicitations also
- Periodic review & revisit existing restrictions
- Internal tracking of spending/investments

# Endowment Issues

- What do you do if you don't have documentation of the original gift?
- Some endowments go back 50 plus years
- Donors may no longer be alive



# Endowment Policy Considerations



# Endowment Fund Policy

- Policy of the management of endowments
  - Philosophy & attitude
  - Delegation of authority considerations
  - Fiduciary responsibilities – board, committees, reporting
  - Objectives related to growth, targets, goals, & benchmarks
  - Allowable investments, asset allocation
  - Clarity of fund restrictions & interpretations
  - Periodic reviews & updates of the policy

# Fiduciary Responsibility & Delegation of Authority Policy Considerations

- What documents govern activities?
  - Charter
  - Bylaws
  - Laws
  - Trust documents
- What governing body is tasked with managing the endowment?
  - Board of separate 501(c)(3)
  - Finance & investment committee
  - Executive committee
  - Development & public relations committee
    - Outsourced

**Any person serving on the governing committee has a fiduciary responsibility under UPMIFA**

# Gift Acceptance Policy

- Mission requirement
- Types of gifts (liquid, real estate, land, partnerships, alternative investments)
- Restrictions to programs/campaigns
- Administration fees
- Credit risk of the donor
- Donor-advised funds
- Delegation of Authority
- Minimum dollar amount to establish a new endowment



# Investment Policies

- Business plan of the ENTIRE investment portfolio
- Reassures potential donors of investment stewardship
- Required by UPMIFA
- Sets the risk tolerance
- Fiduciary responsibility of the board
- Necessary for GAAP-required disclosures
- Financial advisors/investment managers

# Spending Distribution Policies

- Donor always rules!
- Parameters
- Mission
- Communicates the prudent distribution method
- Sets parameters for spending patterns & distribution uses
- Frequency, percentages & disbursements are made in accordance with the spending policy
- Prevents excessive distributions, promotes good stewardship
- Fiduciary liability required by UPMIFA

# UPMIFA – General Approach

- UPMIFA takes a two-tier approach – its provisions apply to “Institutional Funds” (the duties & factors related to management & investment) & a portion (the expenditure/appropriation/spending rules) only apply to “Endowment Funds”
- So, whether (& how) UPMIFA applies to you depends on **whether you have an institutional fund or endowment fund**
- UPMIFA potentially applies to all charitable entities regardless of form, e.g., nonprofit corporations, nonprofit associations, limited liability companies, trusts

# UPMIFA Presumption of Imprudence

- **Common misconception that this is a safe harbor**, particularly because UPMIFA gave us a bright line rule
- Presumption is rebuttable if facts & circumstances dictate that expenditure from the endowment fund was prudent (for example, a fund for a major construction project may have no expenditures for 3 years & then spend 20% in year 4)

# UPMIFA Protections & Duties

- Delegation of Management & Investment Functions
- Duty of Loyalty
- Duty of Care
- Duty to Diversity
- Duty to Manage Costs & Verify Facts

# Modification & Release – UPMIFA

- Permits release or modification of restrictions by donor, charity, or court in specific instances
- Small/Old Funds – if restriction is unlawful, impracticable, impossible to achieve, or wasteful, an institution may release or modify a restriction without donor consent or court approval if all of these conditions are met
  - Institutional fund < \$25,000
  - Institutional fund is more than 20 years old
  - Will be used consistent with charitable purposes
  - Requires Attorney General notice
- Example – \$15,000 fund set up in 1973 for the cure of polio – with AG notice, can release restriction & use for a purpose consistent with original purpose, *i.e.*, cure of other children's diseases

# Modification of Restrictions – Outside of UPMIFA

- What if the UPMIFA modification provisions don't apply?
- Does the gift agreement address?
- Can donor consent?
- Court Action
- Attorney General Approval



# Endowment Disclosure Requirements



# Disclosures

FASB Codification 958-205-50-1B says an NFP should disclose information about the Endowment Fund's Net Asset Classification, Net Asset Composition, Changes in net asset composition, Spending policies, & Related investment policies

## Minimum disclosures

- A description of the governing board's interpretation of the law or laws that underlie the school's net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from underwater endowment funds.
- A description of the School's policy or policies for the appropriation of endowment assets for expenditure (its endowment spending policy or policies), including its policy, & any actions taken during the period, concerning appropriation from underwater endowment funds
- A description of the School's endowment investment policies, including all of the following: Return objectives & risk parameters, how it relates to spending policies, & strategies employed
- The composition of the School's endowment by net asset class at the end of the period, in total & by type of endowment fund, showing donor-restricted endowment funds separately from board-designated endowment funds
- Reconciliation of the beginning & ending balance of the endowment fund, including: Net investment return, contributions, amounts appropriated for expense, other changes

# Disclosure Requirements

- A school shall disclose information to enable users of financial statements to understand all of the following about its endowment funds (both donor-restricted & board-designated)
  - A description of the governing board's interpretation of the law or laws that underlie the school's net asset classification of donor-restricted endowment funds
  - Net asset classification
  - Net asset composition
  - Changes in net asset composition

# Disclosure Requirements

- A school shall disclose information to enable users of financial statements to understand all of the following about its endowment funds (both donor-restricted & board-designated)
  - A description of the school's policy or policies for the appropriation of endowment assets for expenditure (its endowment spending policy or policies)
  - Related investment policies
  - Disclosure of aggregate deficiencies of all donor-restricted endowment funds. Therefore, if one endowment has unrealized gains while another has unrealized losses, the not-for-profit organization **should account for each donor-restricted endowment fund individually rather than netting the gains of one endowment fund with the losses of another endowment**

# Endowment Disclosure

## Description of Law

The [Organization]'s governing body is subject to the State of [ ] Prudent Management of Institutional Funds Act ([ ]PMIFA) **OR [Uniform Prudent Management of Institutional Funds Act (UPMIFA)]**. As a result, the [Organization] classifies amounts in its donor-restricted endowment funds as net assets with donor restrictions because those net assets are time restricted until the governing body appropriates such amounts for expenditures. Most of those net assets also are subject to purpose restrictions that must be met before being reclassified as net assets without donor restrictions.

Additionally, in accordance with [ ]PMIFA [UPMIFA], the [Organization] considers the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

1. Duration and preservation of the fund
2. Purposes of the Organization and the fund
3. General economic conditions
4. Possible effect of inflation and deflation
5. Expected total return from investment income and appreciation or depreciation of investments
6. Other resources of the Organization
7. Investment policies of the Organization

The [Organization]'s endowment consists of approximately [ ] individual funds established for a variety of purposes. The endowment includes both donor-restricted endowment funds and funds designated by the governing body to function as endowments (board-designated endowment funds). As required by accounting principles generally accepted in the United States of America (GAAP), net assets associated with endowment funds, including board-designated endowment funds, are classified and reported based on the existence or absence of donor-imposed restrictions.

# Endowment Disclosure

## Composition of Net Asset

	2022		
	Without Donor Restrictions	With Donor Restrictions	Total
Board-designated endowment funds	\$ -	\$ -	\$ -
Donor-restricted endowment funds			
Original donor-restricted gift amount and amounts required to be maintained in perpetuity by donor	-	-	-
Accumulated investment gains	-	-	-
Term endowment	-	-	-
Total endowment funds	\$ -	\$ -	\$ -

# Endowment Disclosure

## Change in Net Asset

	2022		
	Without Donor Restrictions	With Donor Restrictions	Total
Endowment net assets, beginning of year	\$ -	\$ -	\$ -
Investment return, net	-	-	-
Contributions	-	-	-
Appropriation of endowment assets for expenditures	-	-	-
Other changes			
Transfer to create board-designated endowment	-	-	-
Distribution of board designation of endowment funds	-	-	-
Endowment net assets, end of year	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>



# Investments



# ASU 2016-14

## Investments

- Report investment return net of external and direct internal investment expenses and no longer require disclosure of those netted expenses.
- Direct internal investment expenses involve the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. These include, but are not limited to, both of the following:
  - Salaries, benefits, travel, and other costs associated with the officer and staff responsible for the development and execution of investment strategy.
  - Allocable costs associated with internal investment management and supervising, selecting, and monitoring of external investment management firms.
  - Direct internal investment expenses **do not** include items that are not associated with generating investment return. For example, the costs associated with unitization and other such aspects of endowment management would not be allocated.

# Expenses Versus Losses

- Expenses are outflows of assets or incurrences of liabilities that result from an NFP's ongoing major or central operations & activities
- Losses are decreases in net assets from an NFP's peripheral or incidental transactions & other events & circumstances affecting the NFP other than those that result from expenses
- Gains & losses result from holding assets or liabilities while their values change

# UPMIFA Factors to Consider for Investments

- General economic condition
- The possible effect of inflation or deflation
- The expected tax consequences, if any, of investment decisions or strategies
- The role that each investment or course of action plays within the overall investment portfolio of the fund
- The expected total return from income & the appreciation of investments
- Other resources of the institution
- The need of the institution & of the fund to make distributions & preserve capital
- An asset's special relationship or special value, if any, to the charitable purposes of the institution
- Diversification!!

# Investment Policies Disclosures

- Requirement
  - A description of the school's endowment investment policies, including all of the following:
    - Return objectives and risk parameters
    - How return objectives relate to the school's endowment spending policy (often included in the spending policy)
    - The strategies employed for achieving return objectives

# Endowment Disclosures

## Investment Policy

### ***Investment and Spending Policies***

The [Organization] has adopted investment and spending policies for endowment assets that attempt to provide a predictable stream of funding to programs and other items supported by its endowment while seeking to maintain the purchasing power of the endowment. Endowment assets include those assets of donor-restricted endowment funds the Organization must hold in perpetuity or for donor-specified periods, as well as those of board-designated endowment funds. Under the [Organization]'s policies, endowment assets are invested in a manner that is intended to produce results that exceed *[insert description of results benchmark]* while assuming a *[higher OR moderate OR lower]* level of investment risk. The [Organization] expects its endowment funds to provide an average rate of return of approximately [ ] percent annually over time. Actual returns in any given year may vary from this amount.

To satisfy its long-term rate of return objectives, the [Organization] relies on a total return strategy in which investment returns are achieved through both current yield (investment income such as dividends and interest) and capital appreciation (both realized and unrealized). The [Organization] targets a diversified asset allocation that places a greater emphasis on equity-based investments to achieve its long-term return objectives within prudent risk constraints.

## Example Disclosure

### Investment/Spending

- Laws & regulations allow the governing board to appropriate so much of an endowment fund as is prudent considering the following relevant factors: the duration & preservation of the endowment fund, the purposes of School A & the endowment fund, general economic conditions, the possible effect of inflation or deflation, the expected total return from income & the appreciation of investments, School A's other resources, & School A's investment policy
- Under School A's endowment spending policy, 5% of the average of the fair value at the end of the previous five years is appropriated, which was \$7,500 for the year ended June 30, 20X1

# Endowment Disclosures

## Spending Policy

The [Organization] has a spending policy of appropriating for expenditure each year [ ] percent of its endowment fund's average fair value over the prior [ ] quarters through the year end preceding the year in which expenditure is planned. In establishing this policy, the Organization considered the long-term expected return on its endowment. Accordingly, over the long term, the Organization expects the current spending policy to allow its endowment to grow at an average of [ ] percent annually. This is consistent with the Organization's objective to maintain the purchasing power of endowment assets held in perpetuity or for a specified term, as well as to provide additional real growth through new gifts and investment return.



# Underwater Endowment Fund Changes



# ASU 2016-14

## Underwater Endowment

- What is an underwater endowment fund?
- Accounting change of underwater endowment funds and classifications
- Provide the following enhanced disclosures about
  - Underwater endowment funds, which include required disclosures of
    - A School's policy & any actions taken during the period, concerning appropriation from underwater endowment funds
    - Aggregate fair value of such funds
    - Aggregate of the original gift amounts (or level required by donor or law) to be maintained
    - Aggregate amount by which funds are underwater (deficiencies), which are to be classified as part of net assets with donor restrictions

# Deficiencies

## Requirement

For each period for which a statement of financial position is presented, a school shall disclose the aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.

# Endowment Disclosures

## Underwater Endowments Disclosure

The governing body of the [Organization] has interpreted [ ]PMIFA [UPMIFA] as not requiring the maintenance of purchasing power of the original gift amount contributed to an endowment fund, unless a donor stipulates the contrary. As a result of this interpretation, when reviewing its donor-restricted endowment funds, the Organization considers a fund to be underwater if the fair value of the fund is less than the sum of

- a) the original value of initial and subsequent gift amounts donated to the fund and
- b) any accumulations to the fund that are required to be maintained in perpetuity in accordance with the direction of the applicable donor gift instrument.

The Organization has interpreted [ ]PMIFA [UPMIFA] to permit [spending/not spending] from underwater funds in accordance with the prudent measures required under the law.

At December 31, 2022 and 2021, funds with original gift values of \$[ ] and \$[ ]; fair values of \$[ ] and \$[ ]; and deficiencies of \$[ ] and \$[ ], respectively, were reported in net assets with donor restrictions. These deficiencies resulted from unfavorable market fluctuations that occurred shortly after investment of new restricted contributions and continued appropriation for certain purposes that was deemed prudent by the governing body.

The [Organization] has a policy that permits spending from underwater endowment funds depending on the degree to which the fund is underwater, unless otherwise precluded by donor stipulations or laws and regulations. The governing board appropriated for expenditure \$[ ] from underwater endowment funds during the year, which represents [ ] percent of the [ ] quarter moving average, not the [ ] percent it generally draws from the endowment.



# Board & Management Designations/ Appropriations & Enhanced Disclosure Requirements



# ASU 2016-14: Board & Management Designations

- Provide the following enhanced disclosures about
  - Amounts & purposes of governing board designations that result in self-imposed limits on the use of resources
    - Examples
      - Earmarked for future programs
      - Investment
      - Contingencies
      - Purchase or construction of fixed assets
      - Other uses
    - Some governing boards delegate the designation to internal management, which are required to be considered & included in board-designated net assets



# Provide Enhanced Disclosures – Board Designations/Appropriations

- Governing board designations, appropriations & similar transfers that result in the addition or removal of **self-imposed limits** on the use of resources without donor-imposed restrictions
- Those disclosures would include
  - A **description** of the purpose, if not clear on the statement of financial position
  - **Amounts**
  - **Types** of transfers, *e.g.*, those done because of standing board policies, as one-time decisions, or for other reasons
  - **Qualitative &**
  - **Quantitative** information about any period-end balances of board designations of net assets without donor restrictions

# Net Asset Requirements for Presentation & Enhanced Disclosure Requirements





# Classification of Net Assets

- Example net assets classification
  - Assets, such as land or works of art, donated with stipulations that they be used for a specified purpose, be preserved & **not be sold**
  - Assets **donated with stipulations** that they be invested to provide a **permanent** source of income. These result from gifts & bequests that create a donor-restricted endowment that is **perpetual** in nature
  - Support of particular operating activities — should use the top three programs
  - **Investment** for a specified term
  - **Use** in a specified future period
  - **Acquisition** of long-lived assets

# Donor-Designated Restriction Disclosure

	<u>2016</u>
With donor restrictions:	
Specific future periods	
Unconditional Promises to Give – Not received	\$ 80,000
Unconditional Promises to Give – Program A	2,138,114
Allowance for Uncollected Promises	(42,000)
Specific program and support activities – Endowment	
Endowment A	147,350
Endowment B	422,467
Endowment C	32,213
Other	147,905
Endowment – Perpetual	
Endowment A	534,122
Endowment B	<u>875,512</u>
Total net assets with donor restrictions	<u>\$ 4,335,683</u>

# ASU 2016-14 Format A Net Assets Released From Restrictions

- ASU 2016-14 Format A provides the following disclosure on the face of the SOA related to Net Assets released from restrictions
  - Satisfaction of program restrictions
  - Satisfaction of equipment acquisition restrictions
  - Expiration of time restrictions
  - Changes in unconditional promises to give
  - Appropriation from donor endowment & subsequent satisfaction of any related donor restrictions

# Release of Restrictions Footnote Example

Purpose restrictions accomplished:	
Program A expenses	<del>\$5,800</del> <u>\$4,350</u>
Program B expenses	<del>4,600</del> <u>3,450</u>
Program C expenses	<del>1,590</del> <u>1,190</u>
	<del>11,990</del> <u>8,990</u>
Program A equipment acquired and placed in service	<u>1,500</u>
Time restrictions expired:	
Passage of specified time	850
Death of annuity beneficiary	<u>400</u>
	1,250
<u>Release of appropriated endowment amounts without purpose restrictions</u>	<u>4,500</u>
<u>Release of appropriated endowment amounts with purpose restrictions</u>	<u>3,000</u>
Total restrictions released	<u><u>\$14,740</u></u> <u><u>\$19,240</u></u>

# Questions?



# Thank You!

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