



Understanding Underwater Endowment Funds

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Sean P. Riley, Senior Manager, Education & Nonprofit Practice

John H. McCarthy, National Higher Education & Nonprofit Practice Leader

About the Authors

Sean Riley is a senior manager in the Boston office of PricewaterhouseCoopers' Assurance and Business Advisory Services (ABAS) practice. Sean has been a frequent presenter on accounting and financial reporting issues including the topic of Underwater Endowment Funds at various higher education forums. He has also worked with several higher education clients dealing with this issue during the past two years.

Sean works with his co-author, Jack McCarthy, and many other partners on higher education audit engagements throughout the Northeast. He has been heavily involved with the development of and the delivery of training courses for the Firm's professionals serving education and nonprofit clients. Sean holds a B.A. from the University of Vermont, and he is a certified public accountant (CPA).

John H. McCarthy is the National Leader for the Education and Not-for-Profit Practice. Most recently, Jack has been speaking and writing about Underwater Endowments as well as the implications of The Sarbanes-Oxley Act of 2002 for colleges and universities. He is the co-author of the sixth edition to the *Financial and Accounting Guide for Not-for-Profit Organizations* published by John Wiley & Sons, Inc. He also is the co-author of *Understanding Financial Statements: A Strategic Guide for Independent College & University Boards*, published by the Association of Governing Boards of Universities and Colleges (AGB), as well as several other publications.

Jack is a member of the American Institute of Certified Public Accountant's (AICPA) Government and Not-for-Profit Expert Panel, the senior body within the AICPA that oversees the activities in the industry. He currently serves on several nonprofit boards. He is a past president of the Massachusetts Society of CPAs, Inc. (MSCPA) and a two-term member of the Governing Council of the AICPA. He graduated from Boston College and has an M.B.A. from the University of Michigan Business School.

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Executive Summary

As a result of the market declines during the past three years, many not-for-profit institutions have experienced negative investment returns and an overall reduction in the value of their investment portfolios. Because these investment portfolios are directly linked to an institution's endowment funds in a manner similar to how a mutual fund is linked to (owned by) individual investors, a decline in the value of an investment portfolio causes a similar decline in the value of individual endowment funds. A decline in the value of an institution's endowment funds naturally causes a reduction in the amount of overall funds an entity has available to distribute in accordance with its internal spending policy. Individual endowment funds were established at different times over the life of an institution and therefore, the impact of a decrease in market value of an investment portfolio on a particular endowment fund will vary. An institution may hold unrestricted board-designated endowment funds (quasi-endowment funds), temporary endowment funds (funds that function as part of the endowment for a stated period of time) and / or permanently restricted endowment funds (funds contributed by a third-party donor, of which a portion—usually the original gift—is intended to be maintained by the recipient in perpetuity).

An “underwater fund” is an individual endowment fund that has a current market value that has declined below its historic dollar value.

Of particular concern in a declining market is an individual endowment fund that has a current market value that has declined below its “historic dollar value” (i.e., the dollar value of the contribution at the date of the gift), which we refer to as “underwater funds.” In general, the “newer” the endowment fund, the more susceptible it is to falling below its historic dollar value. As such, those entities that have initiated significant fundraising efforts over the past several years to increase their overall endowment are particularly at risk to the impact of underwater funds.

Underwater funds create complexity and require consideration in a number of areas, including:

- The specific financial accounting and reporting requirements related to underwater endowment funds;
- Endowment fund management issues, including the identification and tracking of an institution's underwater endowment funds; and
- Business issues related to underwater endowment funds, since endowment funds support the operations as well as the strategic initiatives of the institution.

There has been a great deal of discussion about how not-for-profit entities should address the accounting and business issues associated with these funds. This paper has been written principally for individuals within accounting and finance organizations, as well as other key financial decision makers, at not-for-profit organizations. It focuses on both the financial accounting and reporting impact of

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underwater endowment funds, and some of the business issues caused by the existence of such funds.

We have structured this paper in a *Question and Interpretative Response* format, starting with the financial accounting and reporting related questions and then progressing to a variety of business-related topics. Finally, we have included in the Appendix an example of the accounting for underwater endowment funds that we hope the reader will find helpful.

Questions and Interpretative Responses— Consideration of Various Issues Associated with Underwater Endowment Funds

Section A: Underwater Funds—Basic Concepts

Question 1. What is an “underwater endowment fund?”

The determination of whether an endowment fund is considered underwater is made on a fund-by-fund basis.

Interpretive Response: An underwater endowment fund is an individual permanently restricted endowment fund whose market value has decreased below its historic dollar value (the amount required to be accounted for as permanently restricted, usually represented as the value of the original gift adjusted for amounts required to be added to it either by the donor or law). The historic dollar value of the endowment fund should correlate to the balance designated as a permanently restricted net asset for the fund. It is important to note that the determination of whether an endowment fund is considered underwater is made on a fund-by-fund basis rather than for the entire pool of endowment funds in accordance with *Statement of Financial Accounting Standards No. 124, Accounting for Certain Investments Held by Not-for-Profit Organizations* (“SFAS 124”)¹ and the Uniform Management of Institutional Funds Act (“UMIFA”).

Example:

Not-for-Profit Z maintains a pool of investments associated with its endowment with a market value of \$1,000,000 as of June 30, 2002. The endowment is comprised of three permanently restricted endowment funds.

<u>Endowment Fund</u>	<u>Market Value</u>	<u>Original Gift</u>
Fund A	\$400,000	\$320,000
Fund B	\$100,000	\$150,000
Fund C	\$500,000	\$450,000
	<u>\$1,000,000</u>	<u>\$920,000</u>

As is shown from the above example, the total market value of the endowment at June 30, 2002 is \$1,000,000. The original basis of the contributions is \$920,000 (classified as permanently restricted net assets). However, on an individual basis, Fund B is considered “underwater” as the market value of that particular fund has decreased below its historic dollar value.

¹ For a summary of SFAS 124, visit the FASB's web site at www.fasb.org. Look under “FAS Summaries.”

Question 2. What is the Uniform Management of Institutional Funds Act (UMIFA), and how does it impact the treatment of underwater endowment funds?

Interpretive Response: UMIFA governs how a not-for-profit institution may spend the appreciation generated from its endowment funds. Under UMIFA and its equivalents, a prudent portion of the gains generated from an endowment are considered available for expenditure in accordance with the restrictions the external donor placed on the income from the endowment. Different states have adopted varying versions of UMIFA or have retained trust law so that there have been many different requirements as to how such gains should be classified in financial statements. Generally, the classification as “restricted” or “unrestricted net assets” should be made in accordance with the restrictions imposed by the donor and/or those that by law extend donor-imposed restrictions.

In general, we see not-for-profit institutions falling into one of three categories related to classification of net appreciation for endowment funds:

Type	Type of State / Method of Adoption	Classification of Net Appreciation
A	UMIFA adopted without modification	Temporarily restricted until the donor restriction is met; otherwise they are classified as unrestricted.
B	UMIFA adopted with modification	Unrestricted or restricted in accordance with the UMIFA, as modified.
C	Trust law	Generally restricted

Two examples of Type B follow:

- The law requires that the purchasing power of the original endowment be maintained, and accordingly, an inflation adjustment must be reflected annually to retain that portion of the gains as part of the “permanently restricted net assets” of the institution.
- The law imposes some guidelines as to how prudent spending will be viewed by the law (e.g., the law states that there is a rebuttable presumption of prudence if an organization’s spending is limited to 7 percent of the three-year average of

the market value of the fund balance). In Massachusetts, the Attorney General has interpreted that common law extends donor restrictions to the gains and, accordingly, has issued guidance that all gains that have not been appropriated in accordance with the law must be classified as “temporarily-restricted net assets.”

An example of Type C follows:

- Under trust law, the net appreciation must be classified in the same manner as the principal of the original gift, accordingly, all appreciation or depreciation must be added to or deducted from principal (permanently restricted net assets) and only the current income can be spent.

Overall, UMIFA allows an institution to spend the income and a prudent portion of appreciation earned as part of its endowment spending policy. The rules adopted within a particular state determine how the appreciation earned on endowment funds is classified. Appreciation may be categorized as unrestricted, temporarily restricted or permanently restricted, depending on the state in which a not-for-profit organization resides.

Once an institution determines how much of the fund must be classified as permanently restricted in accordance with the applicable accounting (as impacted by local law), that amount is compared to the current market value of the fund. If the current market value is less than the amount so determined, the fund is “underwater.”

How to Find the UMIFA Regulations for Your State

The URL for the State of Massachusetts, for example, is www.state.ma.us. To get the URL for your state, insert in place of the “ma” the two-letter abbreviation of your state. When you find your state’s Web site, look for laws or regulations—you want to find the state’s “general laws.” Then search for such terms as “management of institutional funds” or “appreciation.” By using this process, we believe you will be able to find your state’s UMIFA laws.

Question 3. Are quasi-endowment funds exposed to the same issues that impact temporary and true-endowment funds?

Interpretive Response: In general, no. Quasi-endowment funds (also known as “funds functioning as endowment”) generally refer to those funds that the governing board—rather than donors or other outside agencies—has determined are to be retained and invested. The governing board also has the right to decide at any time to expend any portion of the fund (*College and University Business Administration*, 6th Edition, page 9-8).

Quasi-endowment funds are categorized as unrestricted net assets in accordance with Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-For-Profit Organizations* ("SFAS 117").² The reason is that quasi-endowment funds may be spent in whole or in part at the discretion of an institution and its governing board.

Question 4. Are any particular endowment funds at greater risk for underwater-related issues?

Interpretive Response: Yes. By definition, any individual endowment fund that has a market value less than its historic dollar value (original cost as adjusted for donor restrictions or law) is considered to be underwater. Newer endowment funds (i.e., endowment funds that have been in existence for a relatively short period of time) have not had the opportunity to accumulate appreciation. As a result of recent negative market returns and the impact of annual endowment spending, they are more likely to reach market values that fall below their historic dollar value.

² For a summary of SFAS 117, visit the FASB's web site at www.fasb.org. Look under "FAS Summaries."

Section B: Accounting-Related Issues Associated With Underwater Endowment Funds

Question 5. What is the technical guidance that specifies how to account for underwater endowment funds?

The accounting for underwater endowment funds for private institutions is driven primarily by SFAS 124, paragraphs 12, 13, 73, 74, 76, and 77.

Interpretive Response: The accounting for underwater endowment funds for private institutions is driven primarily by SFAS 124, paragraphs 12, 13, 73, 74, 76 and 77:

12. *In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets 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 unrestricted net assets.*
13. *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 unrestricted net assets.*

Paragraphs 12 and 13 above provide the definitive accounting guidance for the accounting for losses on the investments of a donor-restricted endowment fund. The Financial Accounting Standards Board (FASB) provided its basis for conclusions under Paragraphs 73, 74, 76 and 77 of SFAS 124, clarifying the requirements under paragraphs 12 and 13 as follows:

73. *The Financial Accounting Standards Board (the Board) concluded that, in the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund reduce temporarily restricted or unrestricted net assets. The Board concluded that if a donor requires an endowment fund to be invested in perpetuity, permanently restricted net assets should equal the historic dollar value of the fund. UMIFA says, "Accounting entries recording realization of gains or losses to the fund have no effect upon historic dollar value. No increase or decrease in historic dollar value of the fund results from the sale of an asset held by the fund and the reinvestment of the proceeds in another asset." Unless historic dollar value changes, such as when a donor directs that gains be accumulated in the fund, neither gains nor losses affect permanently restricted net assets.*

Paragraph 73 of SFAS 124 has very specific guidance related to permanently restricted net assets, so it drives the accounting associated with underwater endowment funds. As is stated by the FASB, permanently restricted net assets should equal the historic dollar value of an endowment fund, and neither gains nor losses affect permanently restricted net assets. Therefore, losses on a true

endowment fund may only be recorded as temporarily restricted or unrestricted net assets—as stipulated by paragraph 74 below.

74. Whether a loss reduces temporarily restricted net assets, unrestricted net assets, or both depends on where the net appreciation of the fund is classified at the time the loss occurs. First, to the extent that donor-imposed temporary restrictions on net appreciation have not been met prior to the loss, the loss reduces temporarily restricted net assets. The remaining loss reduces unrestricted net assets, which can be viewed as reducing any net appreciation classified in that net asset class and then reducing unrestricted net assets for any excess loss (that is, the amount by which the fair value of the assets of the fund is less than the historic dollar value). In other words, when losses exceed the net appreciation classified in temporarily restricted and unrestricted net assets, the excess loss reduces unrestricted net assets.

Paragraph 74 provides guidance about how an institution should record the losses on a true endowment fund. Specifically, if an entity records appreciation as temporarily restricted in accordance with donor provisions and/or state law (as described above), and accumulated unspent appreciation exists at the time investment losses are incurred, the losses should be recorded as reductions to temporarily-restricted net assets. When the losses exceed (eliminate) the accumulated appreciation classified as temporarily restricted, the excess losses reduce unrestricted net assets. It is important to note that this accounting is performed on a fund-by-fund, rather than on an aggregated basis. Specifically, once an individual endowment fund becomes underwater, the losses allocated to that fund are ascribed to unrestricted net assets—despite the existence of accumulated unspent appreciation remaining in temporarily restricted net assets associated with other endowment funds.

The requirements of paragraph 74 were the subject of much debate among accountants, lawyers, and finance officers of not-for-profit institutions. The view of many was that it was inappropriate to classify such incremental losses as reductions to unrestricted net assets, as the institutions were under no legal obligation to restore an endowment fund for such losses. The individuals making this argument believed an adjustment to permanently restricted net assets was more reflective of the economic substance of the investment declines. However, these arguments were ultimately rejected based on the definitive guidance by the FASB included in paragraphs 73 and 74 noted on page 7.

76. A drawback of that method (described in paragraphs 73 and 74, above) is that excess losses decrease unrestricted net assets even if the organization is not required by a donor-imposed restriction or law to use its unrestricted resources to restore immediately the value of the endowment fund to the level required by donor stipulations or law. Some respondents said that that drawback could be mitigated by requiring organizations to disclose the amount of the deficiency when the fair value of the assets of a donor-restricted endowment fund is less than the level required by the donor's

restriction or law. The Board agreed and added that requirement. However, the field test results indicated that, except in the early years of an endowment fund, incidences of excess losses will be few because organizations generally accumulate net appreciation through policies that preserve and grow their endowment funds.

Many institutions provided for the first time in fiscal 2002 a disclosure of the amount of deficiency that existed as of the date of the Statement of Financial Position and that was subsequently recorded in the financial statements. This deficiency, which represents the difference between the market value of an entity's underwater endowment funds and their related historic dollar value, was an area of focus for many institutions because of its impact on financial ratios, investment ratings, funding of future budgets and other strategic initiatives. Because of the scrutiny this deficiency was receiving, some institutions, on the advice of their legal counsel, included language in their external financial statements that stated in essence that the institution was under no legal obligation to restore the deficiency at a future date.

77. Because unrestricted net assets are reduced for the excess loss when the fair value of the assets of the endowment fund falls below the fund's historic dollar value, this Statement requires that unrestricted net assets be restored from future gains for that reduction. Some respondents said that that classification was confusing and that they would expect those gains to be classified as increases in permanently restricted net assets because they cannot be appropriated for expenditure. However, because the prior loss did not reduce permanently restricted net assets, the classification suggested by respondents would increase the amount of permanently restricted net assets beyond the level required by donor restrictions or law. Thus, gains that restore the fair value of the assets of the endowment fund to the fund's required level (historic dollar value) should be classified as increases to the same class of net assets that was previously reduced for the excess loss-unrestricted net assets. After the fair value of the assets of the endowment fund equals the required level, gains are again available for expenditure, and those gains that are restricted by the donor are classified as increases in temporarily restricted net assets.

Please refer to the Appendix for an example of how to account for underwater endowment funds in accordance with the provisions of SFAS 124 paragraphs 12, 13, 73, 74, 76, and 77.

Question 6. How are public institutions that are subject to the authoritative standards set by the Governmental Accounting Standards Board impacted by underwater funds from an accounting perspective?

Interpretive Response: There is no specific authoritative guidance regarding the accounting treatment of underwater endowments for colleges and universities that follow accounting principles prescribed by the Governmental Accounting Standards Board (GASB). Further, based upon the provisions of GASB Statement No. 20 *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, and Statement No. 29, *The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities*, state and local governments should not apply FASB statements and interpretations whose provisions are limited to not-for-profits issued after November 30, 1989, thereby excluding the provisions of SFAS Statement No. 124.

However, in developing its new financial reporting model, the GASB was specific as to the financial accounting and reporting for true endowments. GASB *Statement No. 34 Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* created new categories of restricted net assets (formerly fund balances) and required that a distinction be drawn between permanent (nonexpendable) and temporary (expendable) restrictions on net assets. Further, nonexpendable net assets (i.e. true endowments) are required to be reported separately from the expendable net assets generated by the true endowments.

The business issues associated with underwater endowment funds will be the same for public and private institutions.

In the statement of net assets of a public college or university, the principal amount of a true endowment is categorized as a restricted non-expendable net asset. Absent specific instructions by the donor, the appreciation in market value of the true endowment is categorized as a component of restricted expendable net assets due to the existence of either a usage restriction in the case of realized gains, or time requirement in the case of unrealized gains. The GASB has not issued guidance on how to treat accumulated depreciation in the market value of a true endowment. However, it is our opinion that because the GASB requires that the principal of a true endowment to be held in perpetuity, accumulated decreases in the market value of true endowments in excess of the accumulated appreciation are charged to unrestricted net assets.

The business issues associated with underwater endowment funds will be the same for public and private institutions, regardless of the availability of guidance from the GASB. Management of public colleges and universities will need to be aware of the impact that underwater endowment funds have on the endowment distribution, current and future operating budgets, and possibly the strategic plan of the institution.

Question 7. Under what circumstances would an institution reduce its permanently restricted net assets as a result of underwater endowment funds?

Interpretive Response: An institution would be allowed to reduce its permanently restricted net assets under each of the following circumstances:

- (1) Donor Modification of the Restriction on the Funds. The donor who created the permanently restricted fund allows the institution to spend a portion of the original gift (i.e., re-designates the restrictions on the endowment funds).
- (2) Donor Requirement to Hold Restricted Securities. In certain instances, donors make contributions of securities to an institution to create an endowment fund, with the stipulation that the institution hold the securities for a specific period of time. In the situation where a donor places these types of restrictions on contributed securities (restricted securities) that were used to create an endowment fund classified as permanently restricted, when those restricted securities lose value and the market value decreases below the historic dollar value, we believe it is appropriate to reduce the related permanently restricted net assets rather than charge unrestricted net assets. Thus, because the donor directed the institution to hold the restricted securities for a period of time, the classification of the net assets should generally mirror the return on those securities until the donor's restriction related to the sale of the restricted securities has lapsed.
- (3) Split-Interest Agreements. Split-interest agreements, such as charitable lead trusts, charitable remainder trusts, perpetual trusts held by a third party, charitable gift annuities and pooled life income funds, are arrangements whereby a donor makes an initial gift to a trust or directly to a not-for-profit organization, in which the organization is not the sole-beneficiary (AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, Chapter 6). When a donor makes a contribution to an organization in the form of a split-interest arrangement, the net contribution is recorded in the appropriate net asset category consistent with the instructions of the donor. Therefore, when a donor determines that the gift is to be maintained in perpetuity, that contribution is recorded as a permanently restricted net asset. Over the life of the split-interest agreement, adjustments are made to the net asset (fund balance), depending on the nature of the arrangement. Adjustments could be made for payments to third-party beneficiaries, changes in actuarial liabilities, and changes in the market value of the investments held for the split-interest agreement. All of these activities and adjustments are recorded as changes to the related permanently restricted net asset. With respect to split-interest agreements that will ultimately become part of an institution's true endowment, it is generally the donor's intent that the remaining net assets of that fund be transferred to the true endowment of the entity.

- (4) Trust Law. Under trust law all appreciation and depreciation of investments are treated as increases and decreases in the principal of a fund. Only income (e.g., dividends and interest) is available for current expenditure. Accordingly, for those entities that would be required to account for an endowment under trust law, all changes other than income would be reflected as increases or decreases in permanently restricted net assets.

Question 8. What would be considered “best practice” related to disclosure of underwater endowment funds in an institution’s external financial statements?

Interpretive Response: We believe the following points of discussion would be considered best practice with respect to disclosure of underwater endowment funds in an institution’s external financial statements:

Best Practices for Financial Statement Disclosure:

- *Provide full disclosure in footnotes—description, accounting and policy*
 - *Provide more detail on significant underwater funds*
 - *Include affect on liquidity and operations in MD&A*
- Disclosure of the total underwater fund deficiency that exists as of the date of the Statement of Financial Position, as well as a related description of the nature of the deficiency and how it has been accounted for by the institution. In addition, the disclosure of the endowment spending policy should be clarified to describe the institution’s policy related to expenditure from or funding for underwater endowment funds.
 - Depending on the extent of the underwater funds, additional detail should be provided describing the nature of significant underwater funds (e.g., purpose, value) and how the position of such funds has affected the endowment distribution in the current fiscal year.
 - Finally, for those institutions that provide a “Management Discussion and Analysis” along with the financial statements and related notes, a discussion of how the institution’s liquidity and operating needs could be affected in the following year as a result of the underwater funds may be appropriate. The need for such a discussion would depend on the severity of the underwater fund situation.

Section C: Business-Related Issues Associated with Underwater Endowment Funds

Question 9. Must an underwater fund be restored to its original value?

Interpretive Response: No. Based on discussions with attorneys in several states, we are unaware of any legal requirement to restore funds to their original value.

Question 10. Should an institution fund the shortfall in an endowment distribution caused by underwater funds?

Interpretive Response: This is a management decision that is completely separate from the accounting for underwater funds. In funding a distribution shortfall caused by the existence of underwater funds, an institution is making a decision to use unrestricted net assets for the purposes for which the underwater endowment funds were established.

In determining to use unrestricted net assets to cover a shortfall, an institution should evaluate its current financial position and ability to cover a distribution deficit in the short- or medium-term. The analysis also should consider the affect on credit ratings and financial ratios. Finally, we have observed that many institutions are deciding to reduce their operating budgets, rather than cover a shortfall by using unrestricted net assets.

Question 11. Can an institution spend from an underwater fund as part of its endowment distribution?

Interpretive Response: Generally, an institution can spend only the current income generated by an underwater endowment. UMIFA permits an institution to spend a prudent portion of the accumulated gains from a fund. If there are no gains, then there is nothing available to be spent other than the income that is currently being generated by the endowment fund.

Question 12. Can an institution spend incremental dollars from a fund with accumulated gains to make up for a shortfall in its endowment distribution caused by the existence of underwater funds?

Interpretive Response: Technically speaking, yes, as long as the expenditures meet the prudence standard as well as any donor-imposed restrictions and are approved by the Board as part of the institution's spending policy for that period. We believe an institution could spend incremental dollars from a fund with accumulated gains to make up for a shortfall in its endowment distribution caused by the existence of underwater funds.

However, from a practical perspective, we believe it may be difficult for an institution to justify internally and externally (with its donors) spending from endowment funds in this manner. Also, if an institution were to use funds available from above water endowment funds to cover a shortfall created by underwater funds, the expenditures would have to comply with the restrictions of the above water funds. If the purposes of the above water funds are not aligned with those of the underwater funds, the institution's budget shortfall may not be rectified. Therefore, to the extent a portion of an institution's endowment distribution is covered by accumulated appreciation and the institution has certain endowment funds that are underwater, we would expect the institution's total endowment distribution for the year to be reduced below the board-approved level. The reason for this expectation is the lack of accumulated gains in the underwater funds.

Question 13. What are the key issues that an institution should discuss with its Board of Trustees with respect to underwater funds?

Discussions with Board of Trustees:

- *Provide information and analysis*
- *Discuss funding any shortfall*
- *Advise about control structure or system issues*
- *Review financial ratios*

Interpretive Response: Based on our recent interaction with trustees of not-for-profit institutions in 2002 and 2003, we believe there are numerous issues and areas of interest that financial officers and other members of senior management should address with their boards:

- Trustees should be aware of how underwater endowment funds have reduced the current year's endowment distribution, and they should be informed about how underwater funds could affect the institution prospectively. A prospective evaluation could include providing trustees with a sensitivity analysis indicating the amount of funds that will drop below water based on different levels of total investment return (i.e., losses). We believe a sensitivity analysis could be a useful tool for informing boards of the impact and correlation between market return (losses) and endowment spending. Ultimately, this analysis should tie into a discussion of an institution's budget process for future fiscal years, as well as how such funds could potentially affect the strategic plans of the institution.
- Management should also engage the board with respect to the issue of funding an endowment distribution shortfall from quasi-endowment funds or from other unrestricted net assets. We believe the board should be advised about funding decisions, especially as it relates to the use of quasi-endowment funds. The board should also be advised about the estimated impact on the institution's financial position if the institution used incremental unrestricted funds for budget relieving purposes.
- Depending on the significance of the underwater issue at a particular institution, we believe that management should advise the board about any control structure or system issues that must be addressed as a result of the existence of underwater funds. We are aware that many endowment management

systems are not flexible enough to allow administrators or managers to fully assess and manage their underwater funds. Ideally, all underwater funds should be identified and maintained in an appropriate and equitable manner. Therefore, a discussion with the board is preferable when such weaknesses in the systems of the institution are identified. Management should describe how it will address the situation and ensure that its underwater funds are accurately and completely accounted.

- Finally, it may be necessary, depending on the significance of the underwater endowment issue, for management to review the institution's financial ratios with its board. Management should identify those ratios that have been and could be further impacted by underwater funds. Management and the board should assess these ratios to determine the significance of any decline (or anticipated deterioration) in those ratios, and what impact such a decline might have with respect to credit or other rating agencies that track the institution.

Question 14. For institutions that do not adjust endowment shares (units) as a result of their distribution, what is the affect on shares when certain funds shift to an “underwater” position?

Interpretive Response: We are aware that there is varied practice in the not-for-profit industry with respect to the management of endowment funds, stemming from differences in philosophy, nature of endowment funds on an entity-by-entity basis, and perhaps most importantly, due to the differences in systems used to track the activity of such funds on a periodic (monthly, quarterly, or annual) basis. With respect to the endowment distribution(s) made by institutions on an annual basis, some entities do not adjust shares within their funds after completing the endowment distribution—under the assumption that all funds are treated in an equitable and consistent manner and therefore an adjustment to shares is unnecessary.

However, the existence of underwater funds within an endowment adds complexity to the calculation and maintenance of shares on a fund-by-fund basis. Generally, given the asset allocation strategies employed by not-for-profit institutions, current endowment distributions include expenditures of interest and dividend income as well as realized gains. Because underwater funds, by definition, do not have accumulated appreciation available for expenditure within the current period, an endowment with both above-water and underwater funds is unable to make its endowment distribution in a pro-rated, equitable manner across all funds. Consequently, in years in which certain endowment funds fall underwater, we believe that an institution must adjust endowment shares to accommodate the different levels of expenditure between above and underwater funds.

Appendix: Accounting for Underwater Endowment Funds— A Basic Example

The following example provides a simple illustration of how to account for underwater endowment funds in accordance with the requirements of SFAS 124. The example begins with the creation of a true endowment fund, and traces the activity of the fund over a two-year period.

The Smith family contributed \$1 million on July 1, 2001 to College X. (Note that College X is located in Massachusetts, a modified-UMIFA state and has a fiscal year-end of June 30). In accordance with donor specifications, the gift must be maintained in perpetuity, with the return (income and appreciation) generated by the fund to be used for funding for the Economics Department. The specific amount available for expenditure each year will be determined in accordance with the College's endowment spending policy. The gift is to be invested as part of the College's pooled endowment fund.

FISCAL 2002 ACCOUNTING:

Refer to the relevant portions of the Statement of Activities on the next page for a full presentation of the entries described below for the fiscal year ended June 30, 2002.

Entry One

The original entry to record this \$1,000,000 gift (permanently restricted endowment fund) on July 1, 2002 is as follows:

Dr. Cash	\$1,000,000	
Cr. Contribution Revenue – Permanently Restricted		\$1,000,000

Entry Two

Assume that at the end of fiscal 2002, College X's pooled endowment fund generates a net loss for the year. Based on the allocation by College X on a per unit basis, the Smith Fund is allocated \$10,000 in interest and dividend income, and \$(90,000) in depreciation. The entries to record this allocation are as follows:

Dr. Cash	\$10,000	
Cr. Investment income – Temporarily Restricted (See Note A)		\$10,000
Dr. Realized / Unrealized Loss – Unrestricted (See Note B)	\$90,000	
Cr. Investments		\$90,000

Note A: The investment income earned is classified as “temporarily restricted” based on the restrictions of the donor as to how the College may spend the available funds. Upon actual expenditure, these funds are released and transferred to “unrestricted net assets” through the Statement of Activities line “released from restriction” (see Entry Three).

Note B: Massachusetts Law requires that appreciation on true endowment funds be classified as “temporarily restricted” until such funds are appropriated for expenditure and expended in accorded with the College's spending policy. However, in the case of the Smith Fund where there are no accumulated gains, all depreciation allocated to the Fund must be classified as “unrestricted” in accordance with paragraphs 12 and 74 of SFAS 124.

Entry Three

Finally, assume that based on its approved spending policy for 2002, College X is allowed to spend \$50,000 from the Smith Fund. Due to the fact that only \$10,000 in income was allocated to the Smith Fund in 2002, and no accumulated gains are available from the current or prior periods, College X is able to release only \$10,000 from temporarily restricted net assets to unrestricted net assets. (Assume that the College satisfied the restrictions of the Smith Fund in an amount at least equal to \$10,000 in 2002.) The accounting entry is as follows:

Dr. Release from restriction – Temporarily Restricted Net Assets	\$10,000
Cr. Release from Restriction – Unrestricted Net Assets	\$10,000

Relevant Portions of Statement of Activities for College X for Fiscal 2002³

Financial Statement Line Item	Unrestricted Net Assets	Temporarily Restricted Net Assets	Permanently Restricted Net Assets	Total Smith Family Fund Balance	Entry Reference
Contribution Revenue			\$1,000,000	\$1,000,000	<i>One</i>
Investment Income		\$10,000		\$1,010,000	<i>Two</i>
Realized / Unrealized Loss	\$(90,000)			\$920,000	<i>Two</i>
Release from Restriction	\$10,000	\$(10,000)		\$920,000	<i>Three</i>
Academic Expense ⁴	\$(10,000)			\$910,000	<i>Three</i>
Totals change in net assets:	\$(90,000)	\$0	\$1,000,000		

³ Note that positive amounts are revenue and negative amounts are expense.

⁴ Represents the amount of expenses satisfying the restrictions of the Smith Fund.

The following table presents the position of the Smith Fund as of June 30, 2002, following one year of activity at College X:

Smith Fund Balance as of June 30, 2002

Component	Unrestricted Net Assets	Temporarily Restricted Net Assets	Permanently Restricted Net Assets	Total
Fund Market Value (Total and Individual Net Asset Balances)	\$(90,000)	\$0	\$1,000,000	\$910,000

FISCAL 2003 ACCOUNTING:

Refer to the relevant portions of the Statement of Activities on the next page for a full presentation of the entries described below for the fiscal year ended June 30, 2003.

Entry Four

Assume in fiscal 2003, the College's pooled endowment fund generates a significant positive return for the year. Based on the allocation by College X on a per unit basis, the Smith Fund is allocated \$40,000 in interest and dividend income, and \$200,000 in appreciation. The entries to record this allocation are as follows:

Dr. Cash	\$40,000
Cr. Investment income – Temporarily Restricted	\$40,000
Dr. Investments	\$200,000
Cr. Appreciation—Unrestricted Net Assets (See Note C)	\$90,000
Cr. Appreciation—Temporarily Restricted Net Assets (See Note C)	\$110,000

Note C: As was shown in entry two and in the year-end analysis of the Smith Fund, there is \$90,000 of depreciation that has been classified as unrestricted in accordance with paragraphs 12 and 74 of SFAS 124 as of June 30, 2002. Because the College's investments generated a positive return for the year, paragraphs 13 and 77 of SFAS 124 require the College to first replenish the losses recorded in the unrestricted net asset class. Once the deficit in the fund has been eliminated, any remaining accumulated gains are required to be recorded as "temporarily restricted" in accordance with Massachusetts Law (as described above).

Entry Five

Finally, assume that based on the approved spending policy for 2003, the College is allowed to spend \$52,000 from the Smith Fund. As income and gains are available for spending in 2003 based on the allocated return for the year, the College will release the entire \$52,000 from temporarily restricted to unrestricted. (Assume that the College satisfied the restrictions of the Smith Fund in an amount at least equal to \$52,000 in 2003.) The reclassification entry is as follows:

Dr. Release from restriction – Temporarily Restriction	\$52,000
Cr. Release from Restriction – Unrestricted	\$52,000

Relevant Portions of Statement of Activities for College X for Fiscal 2003⁵

Financial Statement Line Item	Unrestricted Net Assets	Temporarily Restricted Net Assets	Permanently Restricted Net Assets	Total Smith Family Fund Balance	Entry Reference
Investment Income		\$40,000		\$950,000	<i>Four</i>
Realized / Unrealized Loss	\$90,000	\$110,000		\$1,150,000	<i>Four</i>
Release from Restriction	\$52,000	\$(52,000)		\$1,150,000	<i>Five</i>
Academic Expense ⁶	\$(52,000)			\$1,098,000	<i>Five</i>
Totals change in net assets:	\$90,000	\$98,000			

⁵ Note that positive amounts are revenue and negative amounts are expense.

⁶ Represents the amount of expenses satisfying the restrictions of the Smith Fund.

The following table presents the position of the Smith Fund as of June 30, 2003, following two years of activity at College X.

Smith Fund
Balance as of June 30, 2003

Component	Unrestricted Net Assets	Temporarily Restricted Net Assets	Permanently Restricted Net Assets	Total
Fund Market Value (Total and Individual Net Asset Balances)	\$0	\$98,000	\$1,000,000	\$1,098,000

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