

Endow it?

By James D. Cole, CPA

Anyone who has served on a nonprofit board of directors has heard the talk. Every CPA who has a nonprofit client has also heard the talk. But what does the talk mean?

“Let’s just set up an endowment — our problems will be solved. “

“If donors truly believe in our program, then we can raise money to endow it.”

“Aunt Becky just endowed a building at the university.”

The American Heritage Dictionary defines the magical word “endow” as follows: “To provide with property, income, or a source of income.”

Certainly, an endowment can be a great thing for charities. Every charity should have one, but like every financial tool, it needs to be understood. The concept sounds so simple. It seems so powerful; a wonderful remedy to an ailment suffered by a nonprofit organization. But is it?

CPAs who serve nonprofits as service providers and/or as volunteer board members must beware. The concept of endowments is often misunderstood and ignorance in this case is not blissful, but it certainly can be painful.

An endowment has accounting implications, but it also carries specific legal complications as well.

The basic concept of endowing gifts or creating an endowment simply means that a donor makes a gift to a charity with the understanding that the charity cannot spend the original gift, but is instead only allowed to spend the income or earnings which the gift will produce.

The often missed “downside” of endowments involves the legal definition and its implications. In one of those rare moments in history, CPA accounting standards actually provide descriptive, easily understood language about this concept.

You see, an endowment is referred to as, according to the U.S. Financial Accounting Standards Board (FASB), a permanently restricted fund. What many charities and volunteers overlook is that the “permanently restricted” aspect of the fund is not just based on an accounting standard. It is a matter of law, under the Uniform Management of Institutional Funds Act (UMIFA). This model act, adopted by most states, is found in the Code of Virginia, Section 55.268.1, which states “‘Endowment fund’ means an institutional fund, or any part thereof, which is not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument.”

So, you may ask, “Maybe that law does not cover my small charity?” Unfortunately, the law covers almost all charities. Reading further, UMIFA states “‘Institutional fund’ means a fund held by an institution for its exclusive use, benefit or purposes...”

UMIFA then describes an “institution” as: “...an incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes or a governmental organization to the extent that it holds funds exclusively for any of these purposes.”

So what CPAs refer to as “permanently restricted” appears to mean, under the law, permanently restricted. That means that charities cannot put money into what they call an “endowment” one year when times are good and then spend all of it to repair the roof five years later. Gifts accepted

into an endowment fund are permanently restricted and the original gift amount cannot be spent, unless the charity seeks relief in a court of law or from the original donors.

UMIFA is also consistent with FASB standards and makes it clear that the only party who can determine that an endowment exists is the donor. A board of directors cannot, under accounting standards, endow or permanently restrict funds. Only a donor has that authority, under both the law and the accounting standards.

Because only some portion of the earnings derived from these monies can be expended, endowments create unique budgeting issues. For example, I worked with a charity 10 years ago that initially proclaimed they had a \$50 million endowment. In fact, their auditor reported the money as permanently restricted funds.

During my first meeting, the Board was advised that a \$100,000 bequest had been received. They immediately voted to "send it to the endowment." I inquired as to whether the decedent's will designated the bequest as an endowed gift and a retired judge on the board assured me that the decision to endow monies lay solely with the charity's board. He further advised me that the word "endowment" did not even appear in any law.

After asking a few more questions, I learned that the charity routinely deposited gifts "to the endowment," then every few years, the governing board pulled out large sums of money "from the endowment" to build new facilities or make major renovations.

In truth, the charity had no idea what amount of their investments were legally endowed and what amount were free to use as they desired. After months of discussion, the board agreed to investigate and determined that their true endowment value was less than \$8 million of the \$50 million of investments. By correcting their records, this entity released restrictions on \$42 million, which gave them the legal authority to spend that money in support of their mission, rather than being limited to spending only the earnings from the \$42 million. Of course, this had a long-term impact on the entity's budgeting process.

Endowments can be pictured as the ceramic piggy bank that I had as a child, the one with a slot in its back. I could easily put money in, dropping it in the little slot, but getting money back out was not as easy. The problem is the little piggy bank called "endowment" is legally protected. (That means you cannot "accidentally" drop it on a concrete floor to get your money out.)

The initial moral of the story is that charities must be careful with what they call an endowment. A charity does not necessarily want to lock up all their gifts in an endowment, because they will be limited in how much money they can spend at any point in time. Furthermore, when a charity specifically solicits endowment gifts, any money received in response will likely be considered endowed in a legal sense.

UMIFA is clear that the endowment "agreement" does not have to be written (although the best advice is to have all such agreements in writing, or following written guidelines). Therefore, the organization's communication with its donors can be critical in determining whether an endowment truly exists.

Also, charities need to be careful to not attempt board action to "endow" a gift. Any gift can be temporarily restricted by the governing board and even co-mingled, solely for investment purposes, with endowed funds, as long as the accounting records can differentiate between endowed and non-endowed investments. However, a charity should never legally "tie their hands" by claiming a gift as endowed, when they could just as easily invest it and spend it without future restrictions.

As mentioned previously, endowments can be great for charities, if properly managed. These instruments can support the long-term financial stability of a charity, but they have a unique

investment and budget philosophy. Endowments are forever. That means they must be invested with a very long-range, long-term growth perspective. The methods used in initially establishing the endowment are crucial in determining how the fund is most effectively invested in the future. Why?

Endowments that allow only the use of the income derived from the fund are the most restrictive. The law does include a broader definition, allowing the use of all “earnings,” which includes not only income, but also “so much of the net appreciation, realized and unrealized.... as may be determined by the board.” The initial endowment should be established with written guidelines that allow the broadest possible definition of earnings — thus giving the charity the greatest flexibility in the future.

Endowments, like every tool in the financial arsenal of an organization, can be effective when properly utilized. CPAs can better serve their clients by understanding the impact of both the accounting rules and legal constraints related to these commonly used funds.

Some helpful hints:

- The charity should document major individual endowments with a simple written agreement that allows the broadest definition of earnings.
- Through board resolution/policy, establish guidelines for an endowment fund, to which gifts can be added merely by the donor indicating “for the endowment fund.”
- Through board resolution/policy, establish a temporarily restricted, non-endowed fund that can also be used to accept gifts. Consider naming the fund with an inspiring name as a marketing ploy, such as “New Century Fund.” Then, encourage donors to designate gifts to the New Century Fund. The board of the organization can invest the monies in this fund, but will also be able to tap into the underlying principal, if needed, to support the mission of the organization.
- Endowments established with broader definitions of earnings should be more broadly diversified in their investment, as there is no need to emphasize high-income investments like bonds.
- Endowments established with more narrow definitions of earnings must have more narrowly defined investment allocations, as these endowments need to generate income — interest and dividends rather than appreciation. This means more investments like bonds, with less opportunity to invest in stocks.
- Establish written investment policies, including spending guidelines. Typical spending policies allow a maximum percentage of the market value of the endowment to be spent in any one year. For instance, most major universities, regardless of the total return or earnings produced by their endowments, spend less than 5 percent of the endowment fund's market value each year. Their goal is to reinvest 3 percent or more of the fund's value annually, particularly in good years, so that the reinvested appreciation can be spent in future years if needed. This is allowed under the law and under accounting standards.

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