Endowment Accounting

Session 7D

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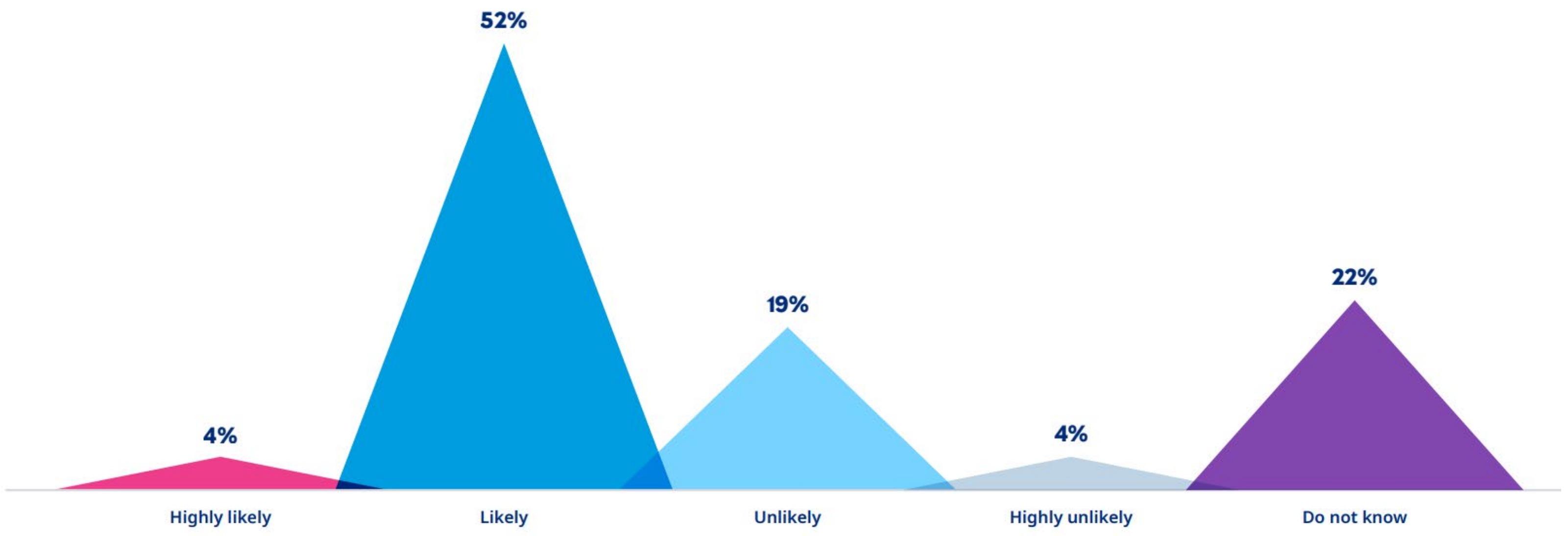
KAPLAN

Endowment Funds- 2023

- NFPs have faced a combination of interconnected challenges, that in some way affect their endowment strategies and endowment investments
    - Geo-political conflicts affecting global investments
    - High inflation- in 2022 half of the respondents to Mercer's survey of foundation and endowment managers responded that inflation was one of their two main investment concerns
    - Market volatility
    - Demand for services and the changing fundraising environment has put pressure on endowment spending

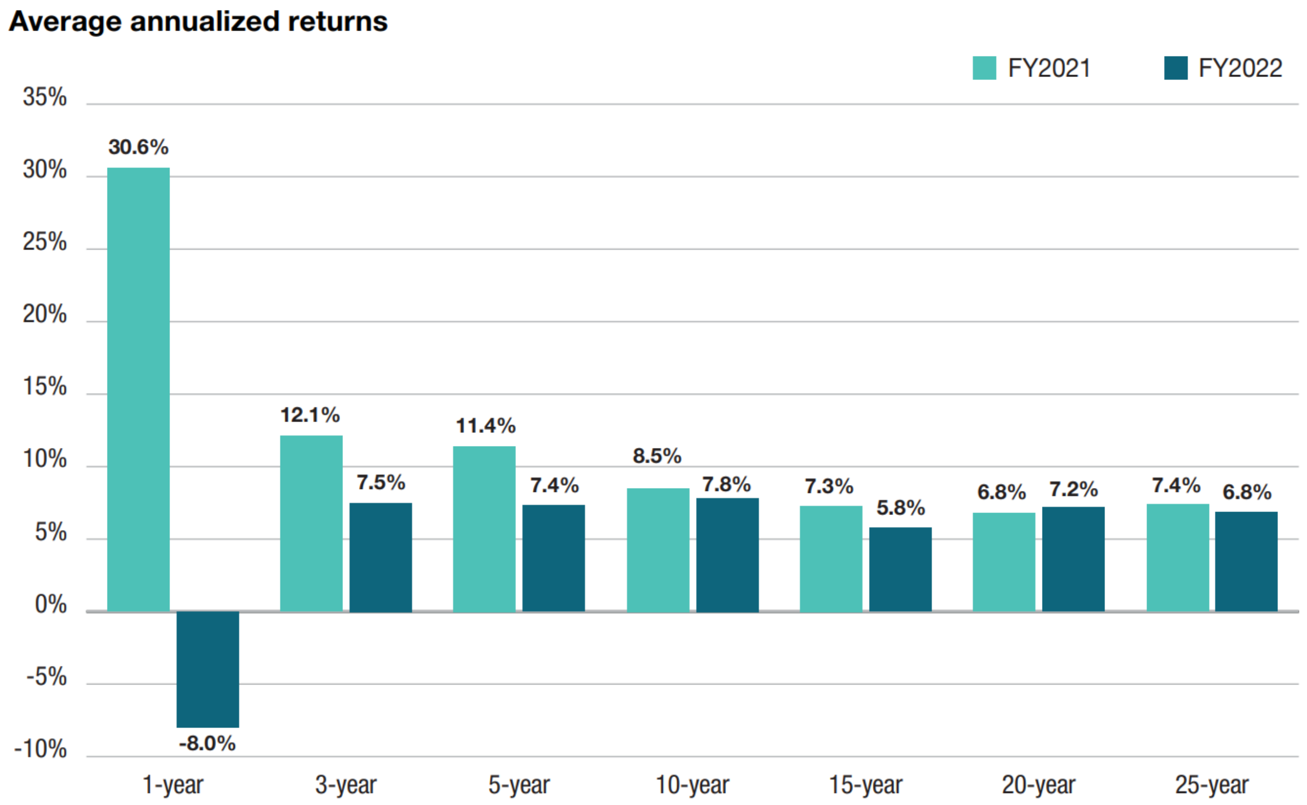
Endowment Funds- 2023



More than half of the respondents believe that it is at least likely that their portfolios will meet stated financial return objectives over the next 3 years.

Source: Mercer 2022 Global Not-for-profit Investment Survey

Endowment Funds- 2023



2022 was not kind to endowments. After experiencing a high annualized return in 2021, endowments faced a significant decline.

Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Funds- 2023

- Interestingly enough, where there was a -8% return on portfolios the overall 4% decrease in endowment size would have been worse had it not been for a surge in giving.

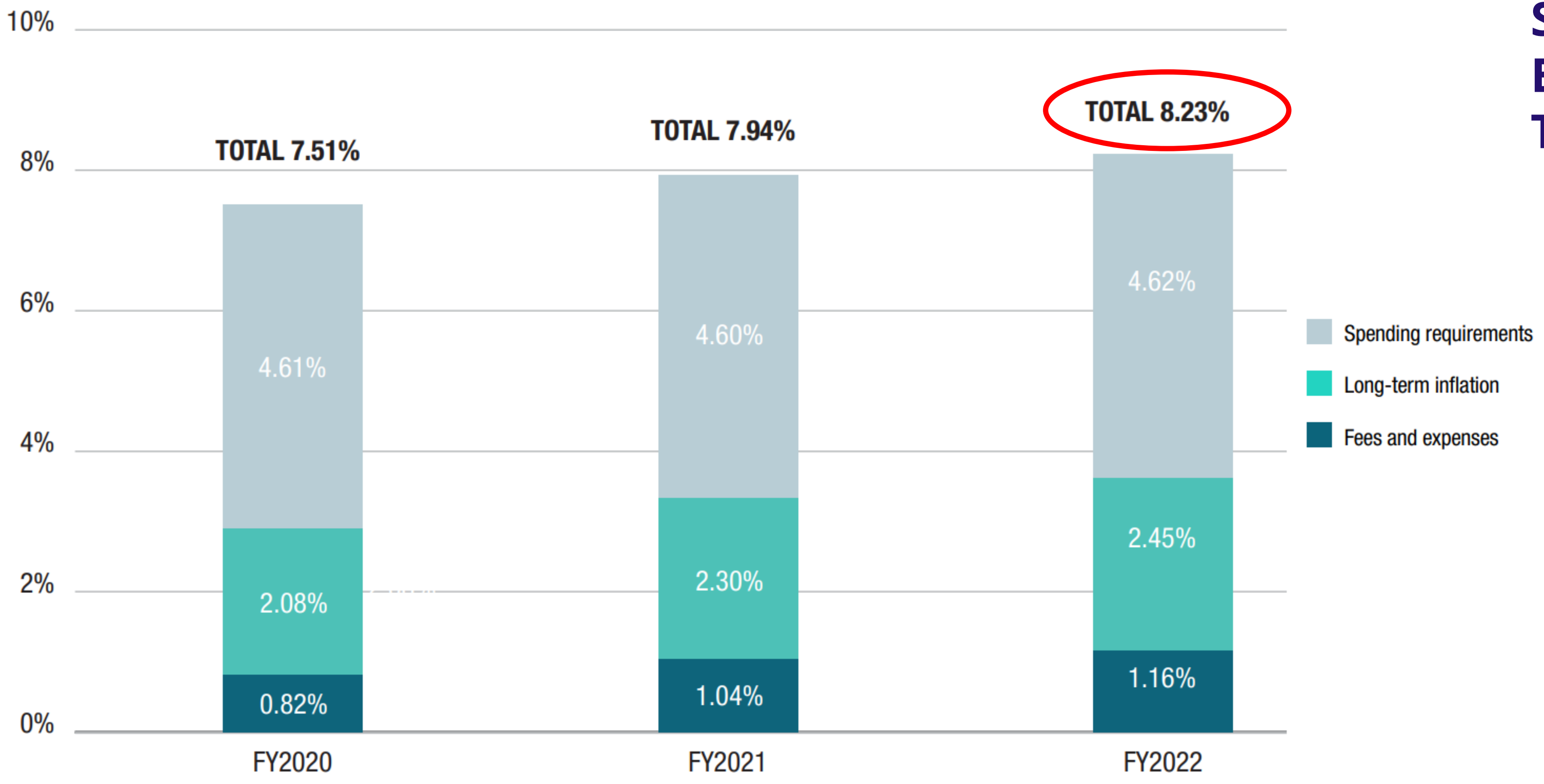
- Endowment gifts generally are made in November and December. The market downturn did not begin until January 2022. NFPs saw a 22% increase in giving during fiscal year 2022 (7/1/21-6/30/22).

- For years the target return for endowments has been 7.5%. In FY 2022 the return rate rose to 8.23% because of inflation expectations and projected fees and expenses.

- This may be difficult to achieve given expectations of investors that investment returns are expected to be modest for the next few years.

Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Funds- 2023



Setting Expectations for Targeted Returns

Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Funds- 2023

- Inflation has been historically low for the 10 years leading up to 2020 (0% to 3%)
- By June 2022 inflation rose to a high of 9.1%. The remainder of 2022 and the beginning of 2023 saw reductions.

Endowment Funds- 2023

- Rise in inflation causes the central bank interest rates and bond yield to rise. This means that debt service costs are higher for borrowers.

- As bond yields rise bond prices decrease.

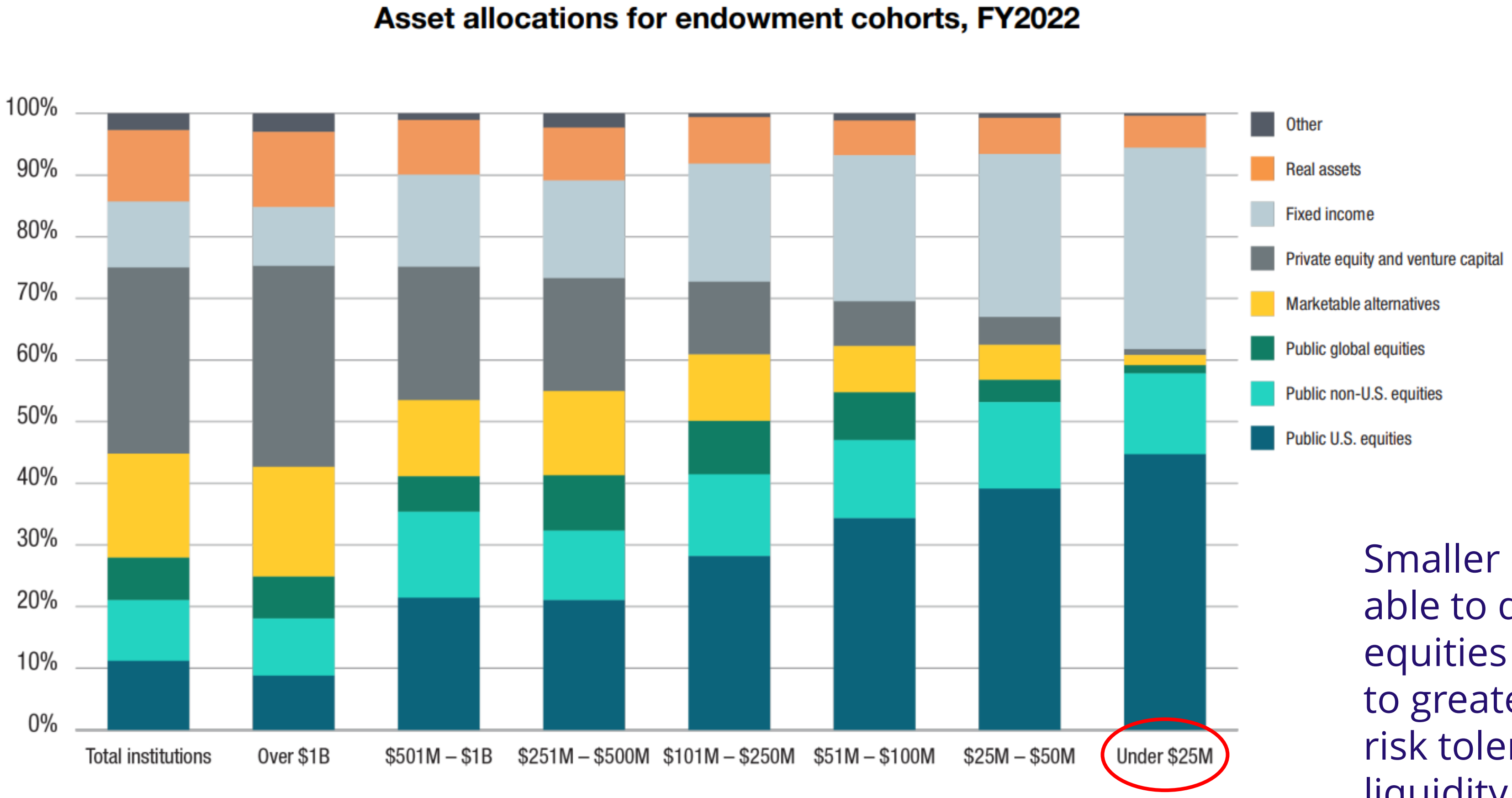
- Public equities and commodities have declined as well causing endowments and foundations (E&F) considerable issues.

- Returns are not meeting and in many cases are not exceeding the endowment spending policies and expenses so that maintaining purchasing power of the portfolio is challenged in the short term.

- Diversification is important for institutional investors. Mercer's Global Inflation Survey (2022) showed that 61% of respondents plan to add to private equity holdings and 53% are targeting real estate assets which are viewed to be a protection against inflation.

Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Funds- 2023



Smaller endowments are not as able to diversify into private equities and venture capital due to greater fee sensitivity and low risk tolerance as well as different liquidity requirements.

Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Funds- 2023

- The large returns in FY2021 compared to the far lower returns in FY2022 led average effective spending rates to decrease in FY2022 even though withdrawal levels increased.

	2021	2022
Average effective annual spending rate	4.79%	4.17%

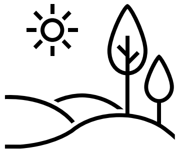
- Spending policy distributions in higher ed institutions for FY 22 were spent mostly on student financial aid (46%), endowed faculty positions (11%), operations and maintenance (10%), academic programs and research (16%), other purposes (17%).

Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Strategic Challenges

1. Adapting to higher inflation rates
2. Balancing investment returns and philanthropic goals- ESG
   - Poor returns in 2022 have prompted investment committee to challenge whether the ESG investments are producing the best outcomes.
   - Political and special interest backlashes a growing. Example- Texas and Florida have moved to ban asset managers from doing business with state entities if they screen out oil and gas investments.
   - "Greenwashing"- some managers are marketing their investment strategies as more green than they actually are.
   - 67% of respondents said they adopted ESG beliefs to align their mission with the portfolios.
   - Over half the respondents noted an intention to support and benefit from emerging clean energy investment opportunities. Climate change is one of the biggest investment opportunities identified in the survey along with diversifying away from traditional asset classes.
   - 72% expressed an intent to increase ESG related investments in the next 12 months.

ESG Investing and NFPs



- ESG investing refers to responsible investing that incorporates environmental, social, and governance factors into the investment process and decision-making.

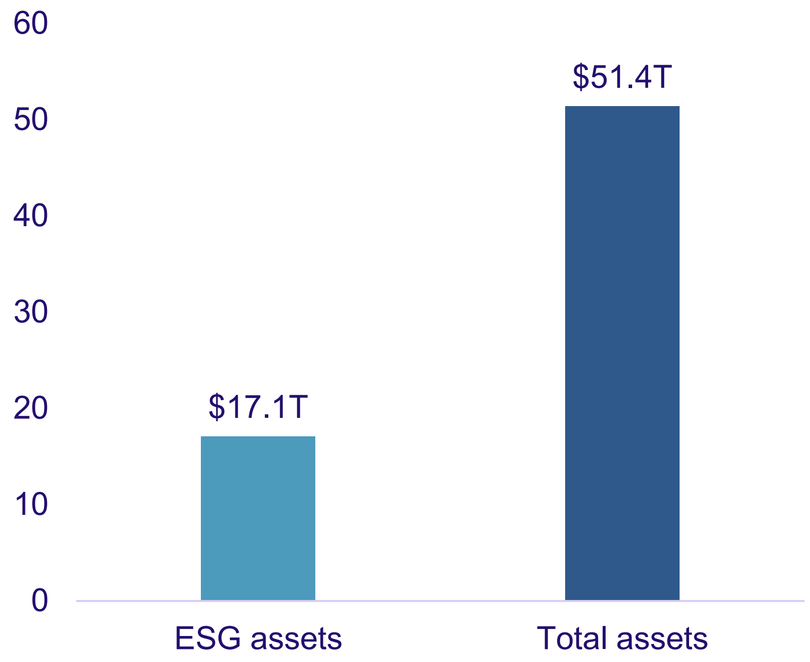
- **Environmental criteria** consider how a company safeguards the environment, including corporate policies addressing climate change, for example.
- **Social criteria** examine how it manages relationships with employees, suppliers, customers, and the communities where it operates.
- **Governance** deals with a company's leadership, executive pay, audits, internal controls and shareholder rights.

- NFPs started out viewing ESG as a tool to enhance the organization's reputation.
- Now it is viewed as a way to meet/enhance financial performance
- Some NFPs have been hesitant to embrace the concept
- ESG matters a lot to certain donors
- Many believe it's not just the NFPs mission that matters but also how they carry it out

Source: Forbes, Morgan Stanley Capital International, US SIF, Politico.

ESG Investing

$17.1 trillion of professionally managed assets at the start of 2020 were under strategies that considered ESG criteria in their investment process and decision-making, compared to **$8.1 trillion** in 2016 and **$2.5 trillion** in 2010



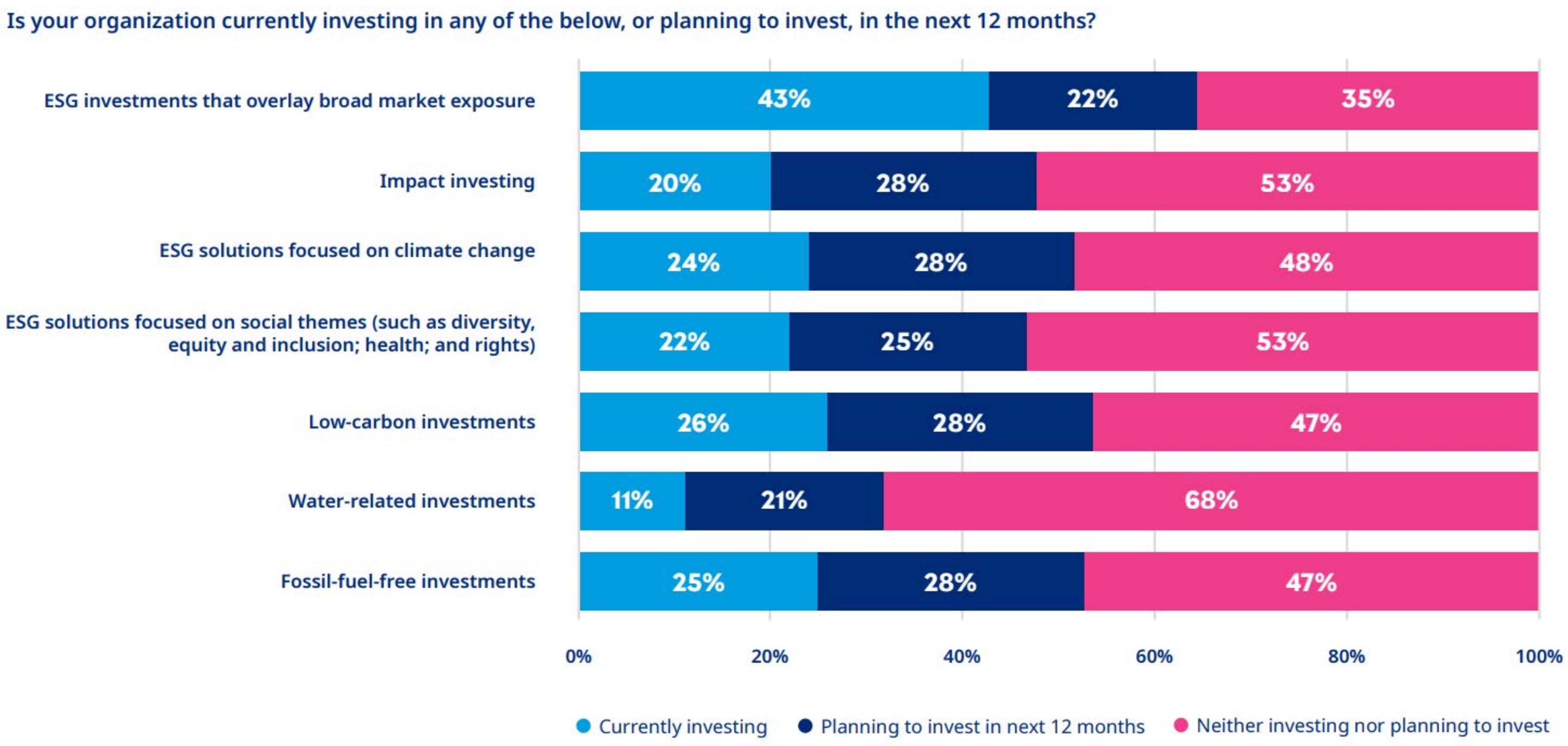
Source: Forbes, Morgan Stanley Capital International, US SIF, Politico.

ESG Investing

Most ESG assets are managed by third parties. Institutional investors hold 4 times as many ESG assets than they did in 2005

Source: Forbes, Morgan Stanley Capital International, US SIF, Politico.

ESG Investing and NFPs



Source: Mercer. "Making Waves: A Spotlight on Water Scarcity," *Critical Thinking, Critical Issues*, 2022, available on Apple Podcasts at https://podcasts.apple.com/ie/podcast/making-waves-a-spotlight-on-water-scarcity/id1555223857?i=1000558162219.

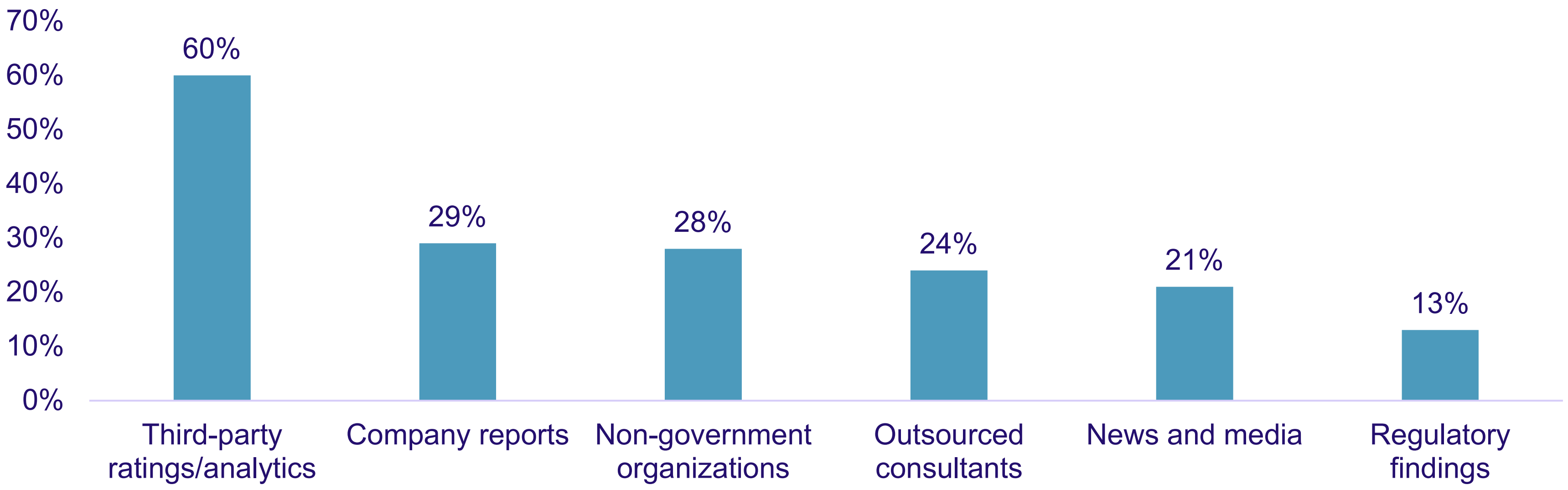
ESG Investing in Climate Change Sector

- A UNPRI (UN investor group) study found that climate change ranked as the top concern for investors in 2019; investors were also found to be concerned about risks around food and agricultural production, as well as deforestation
- In a GMO white paper, investor Jeremy Grantham and portfolio manager Lucas White argue that investors will benefit from the “secular growth tailwinds in the climate change sector”
- They believe a climate change strategy allows investors to invest in growth-focused companies at a discount, while protecting them from climate risk and inflation
- Clean energy solutions serve as potential alternatives for those looking to divest from fossil fuels, given these solutions’ indirect exposure to fossil fuel prices
- A UBS survey of over 600 asset owners across 46 countries found that environmental factors could “outstrip financial analysis” over the coming years

Source: https://www.gmo.com/americas/research-library/

ESG Investing

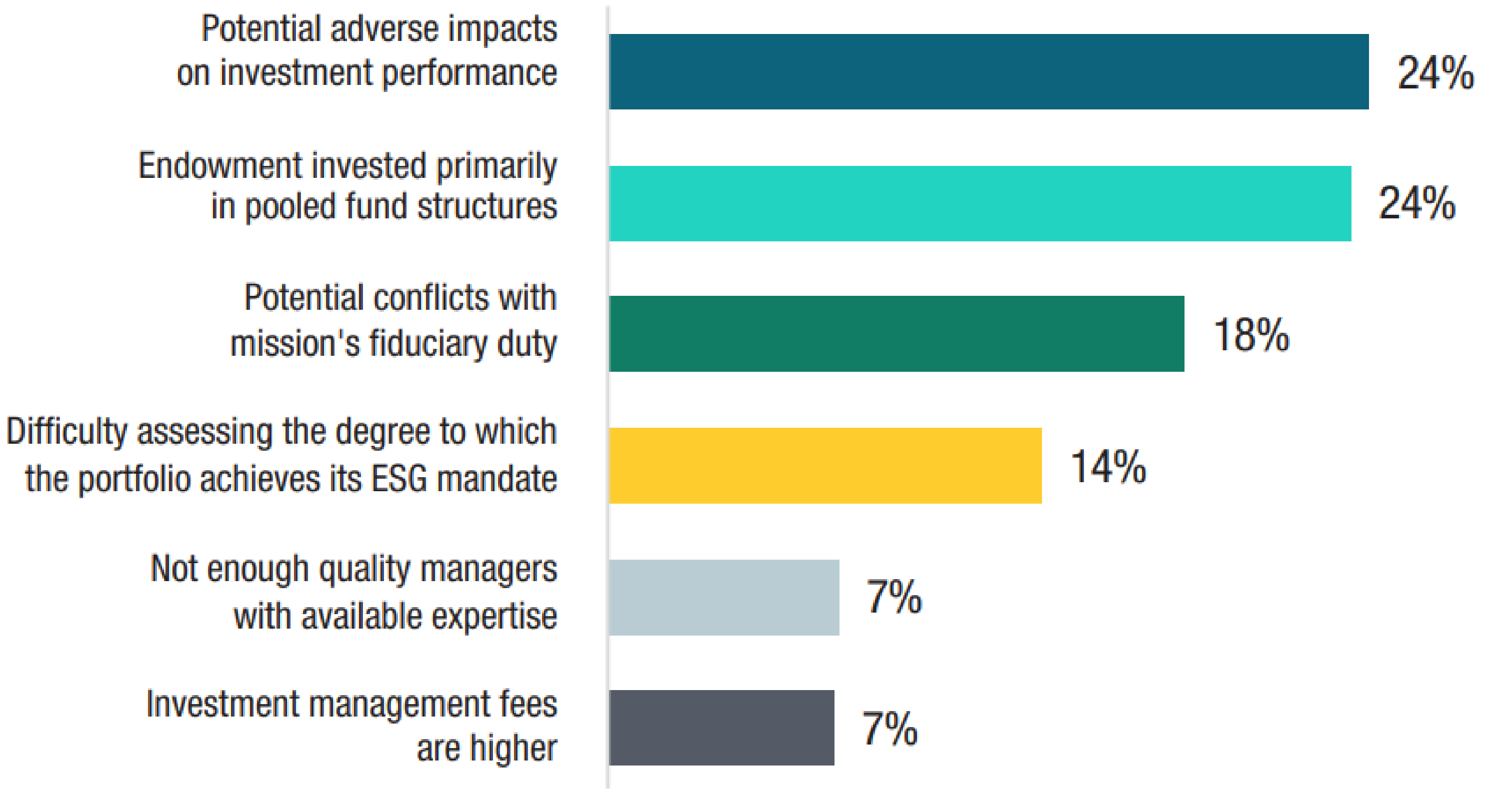
Tools used to measure nonfinancial ESG performance



Source: Forbes, Morgan Stanley Capital International, US SIF, Politico.

ESG Investing and NFPs

Reasons why NFPs are hesitant to embrace ESG Investing



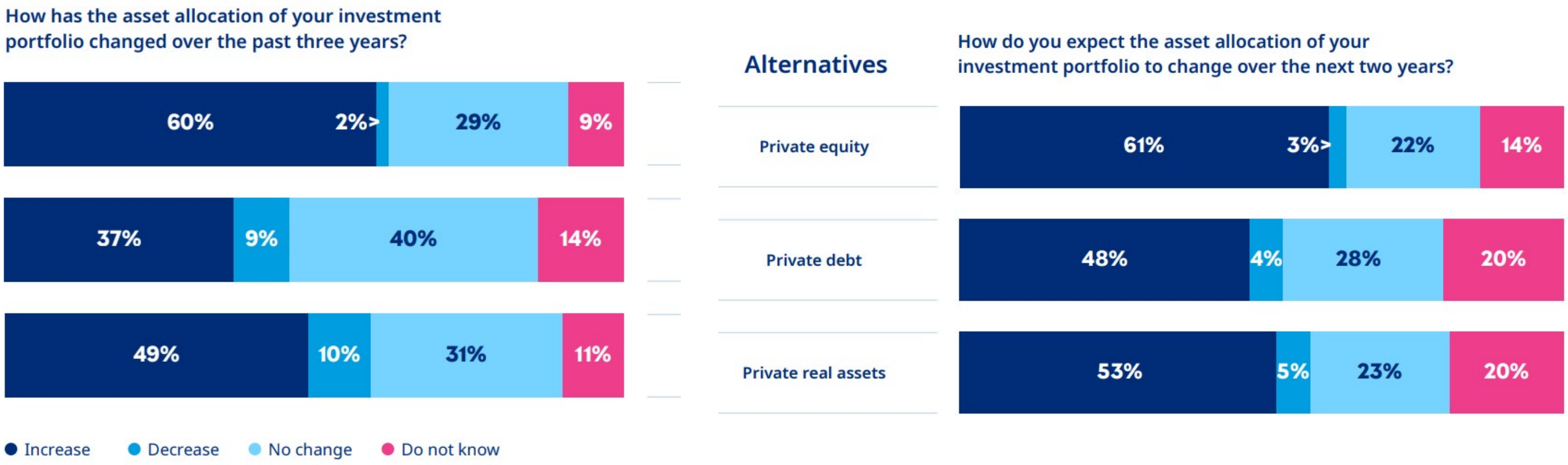
Source: https://www.nacubo.org/Research/2022/NACUBO-TIAA-Study-of-Endowments

Endowment Strategic Challenges

3. Look for opportunities emerging in private markets to invest in private market managers. They are looking for capital to make investments especially due to the markets which are in a state of volatility
    - Private investment managers can offer a variety of assets such as floating rate private debt which can hedge against inflation
    - Evaluate the investment time horizons in years or decades to determine if the institutional investment policy and liquidity requirements can handle them
    - 65% of respondents intend to diversify out of traditional assets over the next two years.

Source: Mercer 2022 Global Not-for-profit investment Survey

Change in Asset Allocation to Private Assets



Source: Mercer 2022 Global Not-for-profit investment Survey

Change in Asset Allocation to Private Assets

Two main reasons for investments in private markets	Percent of respondents
Searching for better yields or enhanced returns	75%
Reduce portfolio risk or downside mitigation	48%
Protect against inflation	29%
Way to implement ESG or impact investing strategy	23%
Align investments with the mission	16%

Source: Mercer 2022 Global Not-for-profit investment Survey

Endowment Strategic Challenges

4. Capture long-term trends in public markets
   - Post pandemic world is very different
   - US is bringing manufacturing back from Asian countries and Asian countries are experiencing higher domestic demand from an affluent middle-class population.
     - Global equity investors should consider the international vs. US mix. (global includes US where international does not)
   - China is home to almost 20% of the world's population. This is a large market that is harder to access by global allocations but provides diversification potential through "A shares".
     - NFPs should consider the risk involved (geopolitical and market)

Endowment Strategic Challenges

Main investment opportunities over the next 3 years	Percent
Diversifying portfolios away from traditional asset classes (fixed income and equities)	65%
Climate change (clean energy)	56%
Demographic shifts (aging, healthcare, consumer spending habits)	26%
Technology (robotics and cyber security)	22%
ESG	10%
Investing in China	5%
Digital Assets (blockchain and cyber currencies)	4%

Source: Mercer 2022 Global Not-for-profit investment Survey

Endowment Portfolio Considerations

- **Stress Test the Portfolio** Evaluate the portfolio to explore the impact of different interest rate and inflation scenarios to see the impact on the portfolio
- **Reassess bond allocation** and the role bonds play in the portfolio. Prices are down and yields are up. Determine at what point the allocation could be increased (government and corporate)
- **Explore inflation protection options** such as index-linked bonds to hedge against rising prices, real estate, private debt
- **Review spending plans** to determine if spending should be reduced. Is there a way to increase donations, provide products or services for fees to reduce the pressure on the endowment.
- **Evaluate liquidity needs** and see if some excess cash could be put to a more productive use. If liquidity is not necessary in the short term determine if there are alternative investments.
- **Engage with investment managers** to understand the ESG approach they use. Third party approaches tend to have less impact. Tie mission goals to tangible outcomes and then hold outside managers accountable for them.

Endowment Portfolio Considerations

- **Capture long term opportunities** by looking for investment opportunities in smaller companies that are growing. They are willing to pay a premium for investment and many are more innovative than larger companies.
- **Perform scenario modeling** to provide an idea of different scenarios and the impact they could have on the portfolio.

Endowment Funds

- The Uniform Prudent Management of Institutional Funds Act (UPMIFA 2006) is a uniform state law that provides fundamental rules for the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments." Those rules support two general principles:

    1. assets would be invested prudently in diversified investments that sought growth as well as income, and

    2. appreciation of assets could prudently be spent for the purposes of any endowment fund held by a charitable institution.

- At this time only Pennsylvania and Puerto Rico have not adopted UPMIFA.

- UPMIFA abolishes the historic dollar value limitation on expenditures that was in UMIFA

- States may adopt an optional rule that presumes expenditure exceeding 7% of fair market value of a fund is imprudent (not addressed in UMIFA). **NC did not do this.**

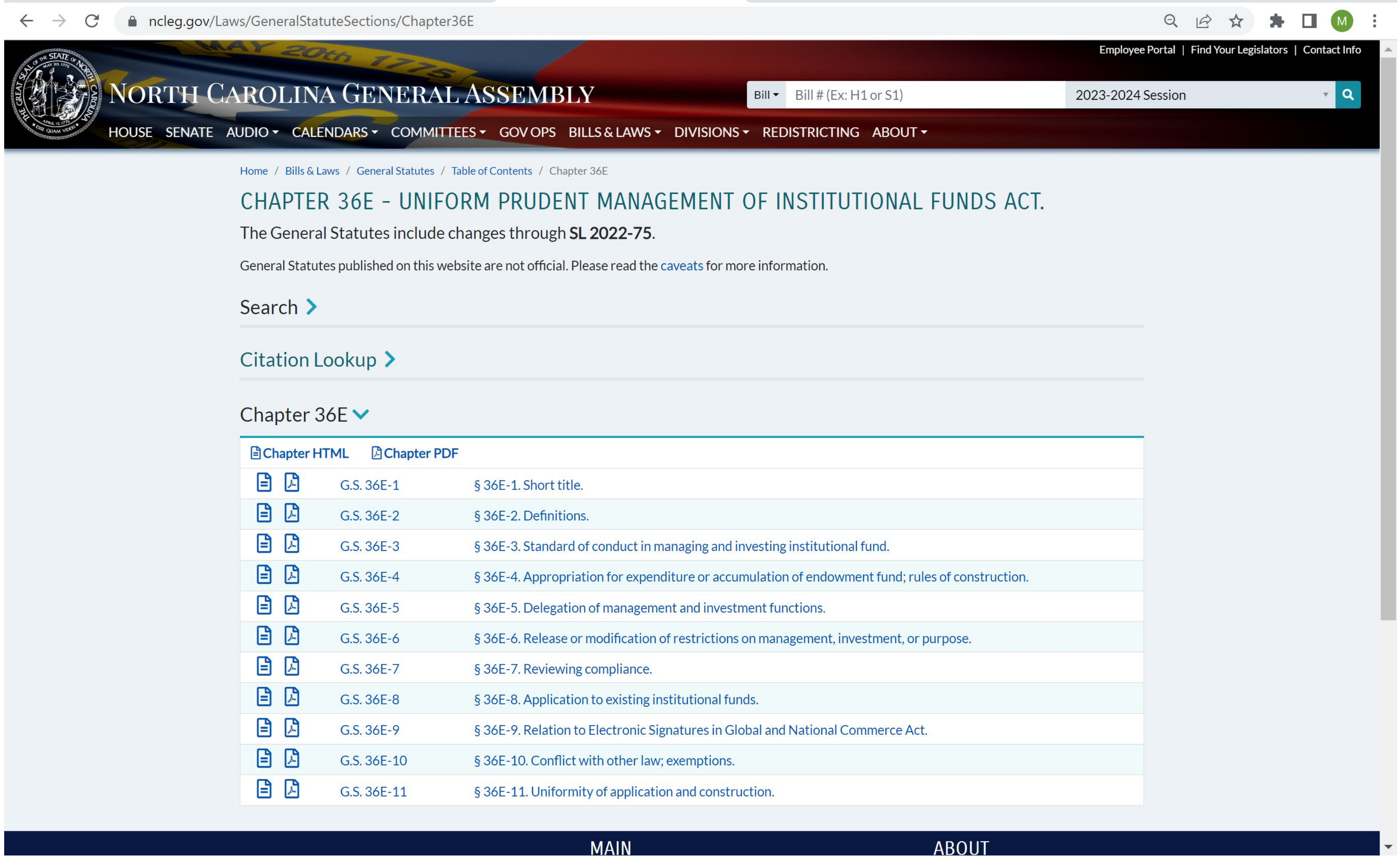
Endowment Funds

- UPMIFA establishes a new procedure for releasing restrictions on small institutional funds (less than $25,000) held for a long period of time (20 years), requiring only notice to the Attorney General 60 days in advance of the release (not addressed in UMIFA). **NC law specifies 10 years and $100,000**
- UPMIFA extends a donor's restriction to use of the funds, including the investment return until the funds are appropriated for expenditure by the board.
- If the donor or state law imposes a restriction on the investment return it is reported in the donor restricted net asset class until appropriated.
- Just because funds are appropriated for expenditure does not mean they must be spent right away. They will be reported in the endowment as "without donor restriction" until spent.
- Although this doesn't happen often, sometimes a board-designated or quasi-endowment fund will include a portion of net assets with donor restrictions.

Endowment Funds

- Institutional funds are those that are held by an institution exclusively for charitable purposes.
- Term does not include program related assets or assets held by a trustee that is not charitable institution or a fund where a beneficiary that is not an institution has an interest.
- A perpetual fund, although an endowment, would not be considered an endowment subject to UPMIFA. It should be noted that UPMIFA is a model law. Each state in the United States has now adopted a version of UPMIFA.
- Quasi-endowment funds- set aside by the governing board, generally to provide a stream of funding for an activity or for some other purpose.
  - These funds come from the organization’s assets that are without donor restriction.

North Carolina and UPMIFA



North Carolina and UPMIFA

§ 36E-4. Appropriation for expenditure or accumulation of endowment fund; rules of construction.

(a) Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following 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;
(5) The expected total return from income and the appreciation of investments;
(6) Other resources of the institution; and
(7) The investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subsection (a) of this section, a gift instrument must specifically state the limitation.

(c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only "income," "interest," "dividends," or "rents, issues, or profits," or "to preserve the principal intact," or words of similar import:

(1) Create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund; and
(2) Do not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (a) of this section. (1985, c. 98, s. 1; 2009-8, s. 2.)

https://www.ncleg.net/EnactedLegislation/Statutes/PDF/ByChapter/Chapter_36E.pdf

Endowment Fund Accounting & Disclosure

- **Relevant Literature:** ASC 958-205
- Established fund of cash, securities, or other assets to provide income for the maintenance of a NFP
- May be with or without donor-imposed restrictions.
- Endowment funds generally are established by donor-restricted gifts and bequests to provide either of the following:
    - A permanent endowment to provide a permanent source of income.
    - A term endowment, which is to provide income for a specified period.
- Donors may or may not stipulate the use of any return on their endowment funds.
    - added to the endowment fund to preserve the purchasing power subject to the donor's spending stipulations
    - used for specific programs or purposes.
    - No stipulations -NFP will spend according to its established spending policy.

Endowment Funds- Example

Example Policy

Introduction - Board authorization to establish an endowment fund is required whenever the donor's written instructions concerning the use of funds as endowment are unclear or absent. Each year the University receives requests from the various schools and divisions, or the Development Office, to create new funds functioning as endowment in amounts ranging from $10,000 (the minimum threshold to establish an endowed fund) to several hundreds of thousands of dollars.

Purpose - To establish procedures to create new funds functioning as endowment.

Policy

1. The **minimum threshold** to establish a new fund functioning as endowment is **$25,000**. Moneys used to create a new fund functioning as endowment account, or moneys added to existing fund functioning as endowment account **must be held for a minimum of ten years.**

2. **The Vice President for Business and Finance is authorized to approve** individual requests for the new funds functioning as endowment or additions to existing funds functioning as endowment as they are received through the year.

3. An **upper limit of $1 million per request** is the limit of this authority. Any request to establish a fund functioning as endowment in excess of $1 million requires Board of Trustees approval.

3. Each June, the Vice President for Business and Finance will report on new funds functioning as endowments established in the past year, and obtain ratification from the Executive Committee of the Board of Trustees for funds that have been created during the previous twelve months.

4. While the Executive Committee retains its traditional oversight of the creation of new funds functioning as endowment, this policy allows for the more timely establishment of endowment funds throughout the year.

Practice Point:
Consider whether first year spending is a good idea.

Endowment Funds- Example

Example

A large disease related foundation has an endowment subject to the terms of UPMIFA and its spending policy. In years where donations to the organization are higher the board does not feel the need to spend the return that is appropriated for expenditure according to the organization's spending policy. Instead of leaving it in the donor restricted endowment, the board moved the amounts to its quasi-endowment fund for long-term investment.

Endowment Funds- Example

- If there are further restrictions on how the return can be spent, over and above those required by the enacted version of UPMIFA, the amount would be considered donor restricted until such time as the restrictions have been met, even though appropriated for expenditure.
- Approval for expenditure may occur through different means. (Approved as part of a formal annual budget or could be approved during the year as unexpected needs arise).
- Since donor stipulations and laws vary, NFPs should assess the facts and circumstances related to their endowments and applicable laws to determine the classification of endowment funds
- Investment return includes the dividends and interest, as well as the appreciation/depreciation.

Endowment Funds- Example

- When returns on the endowment investments are negative or the spending policy of the organization permits a level of appropriation for expenditure that exceeds the return in the current year, an endowment fund may go “underwater”. The amount that declines past the amount of the original gift is classified as **donor restricted.**
- Presentation & Disclosure
  - Endowments are reported based on the existence or absence of donor-imposed restrictions.
  - Board-designated endowment funds generally arise from an internal designation of net assets without donor restrictions
  - There are rare circumstances where a board-designated endowment fund also can include a portion of net assets with donor restrictions.

Endowment Funds- Example

Presentation & Disclosure Requirements

- Net asset classification
- Net asset composition by type (board-designated endowment funds or donor-restricted endowment funds)
- Changes in net asset composition
- Spending policies
- Related investment policies.
- Description of the governing board's interpretation of the law or laws that govern the entity's net asset classification of donor-restricted endowment funds, including its interpretation of the ability to spend from **underwater endowment funds**.

Endowment Funds- Example

Presentation & Disclosure Requirements

- Description of the entity's policy or policies for the appropriation of endowment assets for expenditure
- Spending policies including its policy, and any actions taken during the period, concerning appropriation from underwater endowment funds
- Description of the NFP's endowment investment policies, including all of the following:
    - Return objectives and risk parameters.
    - How return objectives relate to the entity's spending policy or policies
    - The strategies employed for achieving return objectives.

Endowment Funds- Example

Presentation & Disclosure Requirements

- A reconciliation of the beginning and ending balance of the entity's endowment, in total and by net asset class, including, at a minimum, all that apply:
  - Investment return (net)
  - Contributions
  - Amounts appropriated for expenditure that contain no purpose restriction
  - Other changes

Endowment Funds- Example

Presentation & Disclosure Requirements

- The entity must disclose each of the following, in the aggregate, for all underwater endowment funds:
  - The fair value of the underwater endowment funds
  - The original endowment gift amount or level required to be maintained by donor stipulations or by law that extends donor restrictions
  - The amount of the deficiencies of the underwater endowment funds

Endowment Disclosure- Example

Note I: Endowment

Caring for Children's endowment (the Endowment) consists of approximately 45 individual funds established by donors to provide annual funding for specific activities and general operations. The Endowment also includes certain net assets without donor restrictions that have been designated for endowment by the Board of Directors.

The Board of Directors has interpreted the Georgia Uniform Prudent Management of Institutional Funds Act (UPMIFA) as requiring the preservation of the fair value of the original gift as of the date of the donor-restricted endowment funds, unless there are explicit donor stipulations to the contrary. At December 31, 20X1 there were no such donor stipulations. As a result of this interpretation, we retain in perpetuity (a) the original value of initial and subsequent gift amounts (including promises to give net of discount and allowance for doubtful accounts donated to the Endowment and (b) any accumulations to the endowment made in accordance with the direction of the applicable donor gift instrument at the time the accumulation is added. Donor-restricted amounts not retained in perpetuity are subject to appropriation for expenditure by us in a manner consistent with the standard of prudence prescribed by UPMIFA.

We consider the following factors in making a determination to appropriate or accumulate donor-restricted endowment funds:

- The duration and preservation of the fund
- The purposes of the organization and the donor-restricted endowment fund
- General economic conditions
- The possible effect of inflation and deflation
- The expected total return from income and the appreciation of investments
- Other resources of the organization
- The investment policies of the organization

Endowment Disclosure- Example (con't)

As of December 31, 20X1, Caring for Children had the following endowment net asset composition by type of fund:

	Without Donor Restriction	With Donor Restriction	Total
Board-designated endowment funds	$ 6,511,186	$ -	$ 6,511,186
			-
Donor-restricted endowment funds			-
Original donor-restricted gift amount			-
and amounts required to be maintained			-
in perpetuity by donor	-	19,864,750	19,864,750
Accumulated investment gains	-	988,194	988,194
	$ 6,511,186	$ 20,852,944	$ 27,364,130

Endowment Disclosure- Example (con't)

From time to time, certain donor-restricted endowment funds may have fair values less than the amount required to be maintained by donors or by law (underwater endowments). We have interpreted UPMIFA to permit spending from underwater endowments in accordance with prudent measures required under law. At June 30, 20X3, funds with original gift values of $19,883,738, fair values of $19,841,061, and deficiencies of $42,677 were reported in net assets with donor restrictions.

Investment and Spending Policies

We have adopted investment and spending policies for the endowment that attempt to provide a predictable stream of funding for operations while seeking to maintain the purchasing power of the endowment assets. Over time, long-term rates of return should be equal to an amount sufficient to maintain the purchasing power of the Endowment assets, to provide the necessary capital to fund the spending policy, and to cover the costs of managing the endowment investments. The target minimum rate of return is the Consumer Price Index plus 5% on an annual basis. Actual returns in any given year may vary from this amount. To satisfy this long-term rate-of-return objective, the investment portfolio is structured on a total-return approach through which investment returns are achieved through both capital appreciation (realized and unrealized) and current yield (interest and dividends). A significant portion of the funds are invested to seek growth of principal over time.

Endowment Disclosure- Example (con't)

We use an endowment spending-rate formula to determine the maximum amount to spend from the Endowment, including those endowments deemed to be underwater, each year. The rate, determined and adjusted from time to time by the Board of Directors, is applied to the average fair value of the endowment investments for the prior 12 quarters at June 30 of each year to determine the spending amount for the upcoming year. During 20X3, the spending rate maximum was 4.5%. In establishing this policy, we considered the long-term expected return on the endowment and set the rate with the objective of maintaining the purchasing power of the endowment over time.

Changes in endowment net assets for the year ended December 31, 20X1 are as follows:

	Without Donor Restriction	With Donor Restriction	Total
Endowment net assets, beginning of year	$ 5,912,222	$ 19,839,035	$ 25,751,257
Investment return, net	1,143,669	1,412,392	2,556,061
Contributions	-	330,409	330,409
Appropriation of endowment assets pursuant to spending-rate policy	-	(728,892)	(728,892)
Other changes:			-
Distribution from board-designated endowment pursuant to distribution policy	(544,705)	-	(544,705)
Endowment net assets, end of year	$ 6,511,186	$ 20,852,944	$ 27,364,130

Endowment – Spending Policy

- State’s version of UPMIFA
- Understand the time horizon the organization has- when is the money likely to be needed
- Downturns happen every 8 or so years. 2008/2009 and not significant until 2021 so this is not always accurate.
- Component to preserve purchasing power of investments
- What returns are expected? What level of spending can be sustained?
- How predictable are revenues and expenses?
- Is it a good idea to build up returns if the organization expects prospective returns won’t be as robust as historical returns?

Endowment – Spending Policy

- Some NFPs are dependent on one or two sources of revenue. (private foundations)
- Most have additional sources- tuition, donations, community foundations
- Some are dependent on fees for service (museums and other arts organizations)
- Healthcare organizations may derive 90% of their revenue from patient care
- Some organizations choose to focus on their annual funds and not on their donor restricted endowment
- On the other side of the equation, NFPs differ in the investment returns they are able to achieve. Risk tolerance, skill of investment professionals and size of portfolio
- Is the purpose or the endowment to sustain or expand the NFPs mission?

Source: https://institutional.vanguard.com/assets/pdf/np-key-topics/ITRFEMDT-spending-policy.pdf

Endowment – Spending Policy

- Vanguard prepared chart using GuideStar data

	Food pantry	Hospital	Private research university with hospital	Museum	Community charity	Private research university without hospital	Private four-year college	Community foundation	State university foundation	Private foundation
Amount derived from investment returns	0%	6%	10%	14%	25%	45%	53%	59%	69%	100%
Sources of revenue	0% from investment returns; 4% from release of assets from restrictions; 72% from donations of foods; 20% from grants and contributions	6% from investment returns; 94% from inflows from net patient revenues	10% from investment returns; 56% from net patient revenues; 9% from net tuition; 25% from other sources	14% from investment returns; 25% of inflows from admissions; 16% from membership; 45% from other sources	25% from investment returns; 75% from other revenues	45% from investment returns; 25% from net assets released from restrictions; 15% from grants and contracts; 4% from net tuition; 11% from other sources	53% from investment returns; 47% from net tuition and room and board	59% from investment returns; 28% from gifts, grants, and bequests; 13% from expiration of restrictions	69% from investment returns; 31% from rents and other activities	100% from investment returns

Source: https://institutional.vanguard.com/assets/pdf/np-key-topics/ITRFEMDT-spending-policy.pdf

Endowment – Spending Policy

Reasons endowment is used to sustain the mission

- Shortfalls are covered by board designated reserves but if there was a downturn an endowment would help
- Substantial amount of revenue from government contracts which are not necessarily long term
- Grant funding is plentiful but additional funding is needed to pay overhead
- Organization provides grants and scholarships and wants a dedicated funding source
- A major donor wants to give a restricted gift that is not to be spent all at once

Reasons endowment is used to expand the mission

- Major donor wants to give a restricted gift for a program or fund future operating costs
- Income can be a useful source of risk capital to permit expansion into new programs before a secured source of funding is developed
- Future plans require significant levels of funding and organization does not want to stage recurring capital campaigns

Source: https://institutional.vanguard.com/assets/pdf/np-key-topics/ITRFEMDT-spending-policy.pdf

Endowment – Spending Policy Models

Inflation based | **Hybrid** | **Smoothed** | **Simple**

Least variable ← → More variable

Starts with prior year spending and applies an inflation factor

Starts with CY beginning market value of investments and applies a fixed spending percentage which will differ depending on the market value of the portfolio

Recent payout rates range from 3% to 7% with the most typical being 4.5% averaged over 3 years. Private Foundations are required by the IRS to spend no less than 5% of endowment assets on grants and charitable overhead.

Endowment – Spending Policy Examples

Scenario 1- A difficult choice

- Private foundation has minimum spending requirements mandated by IRS. Endowment has a corpus of $50 million. It outsources the management of the endowment and has 4 people on staff. These costs plus, occupancy and other costs are $1 million. 5% of charitable use assets is $2,500,000. After expenses this leaves $1.5 million available for grants. If the value of the value of the endowment declines the Foundation will either need to cut staff, reduce grant budgets or eat into the endowment. Generally, Foundations try to maintain grant budgets.

Scenario 2- Private college is 53% dependent on the endowment

- Private college is 53% dependent on the endowment to supplement the tuition it can charge. The CFO in collaboration with the board will need to assess the future growth rate of gifts as well as how many gifts will have donor restrictions (capital campaigns vs. annual fund and other gifts without donor restrictions. They use a hybrid spending rule with more weight given to the portion derived from PY spending adjusted for inflation and less to the portion derived from the value of the endowment. Yale university reduced the likelihood of a spending drop by changing the weight on PY giving from 70% to 80%.

Endowment – Spending Policy Examples

Scenario 3- Museum is 20% dependent on endowment

- Museum has a diverse stream of funding. It generates an increase in net assets w/o donor restriction every year without any endowment funding. In 2008 it had to take the draw from the endowment to avoid a deficit. It generally uses the endowment funds for upgrades and expansion of facilities and to purchase collection items. The museum can tolerate more variability in its spending policy and a fixed policy is easy for them.

Scenario 4- Religious Organization

- Organization has significant annual, recurring support and has consistent surpluses before endowment draws. It uses the draws from its spending policy for discretionary projects. Its members are aging, and many are dying. The board is concerned that in a few years annual giving will not be at the same rate. It might decide that a low base rate (2%) plus a discretionary rate (80%/20%) will allow them to increase the endowment and maximize the amount of the endowment for the future.

Endowment – Spending Policy Example

A NFP used a total return formula to separate the endowment's investment return into operating and non-operating amounts. The concept of total return takes the components of investment return – net appreciation (depreciation) and investment income and breaks it down into spendable and nonspendable components. The Board appropriates the spendable portion for expenditure.

The finance committee chair advised that the spendable portion should be designed so that it is less than the actual return on investment considered over a 5-year period would be. This means that in years with higher returns accumulation would result in the endowment and in years with poor or negative returns this excess would be available for spending. The finance committee believes that was also the intent of UPMIFA. He suggested a 7% spending cap even when returns were higher for an extended period of time. At June 30, 20X3 the following was calculated and $20,250 was appropriated for expenditure by the board.

Endowment – Spending Policy Example (Con't)

Total expected return per year over the life of the assets (debt and equities)	-	Anticipated inflation per year over the life of the assets	=	Spending rate
6.50%		2.50%		4.50%

5 Year Average Investment Balance:	450,000	
	4.50%	
	20,250	**Spendable portion**
Investment return, YE 6/30/X3:		
Interest	5,000	
Appreciation	22,750	
Total return	27,750	
	7,500	**Nonspendable portion**

Investment Return Allocation

- NFPs may pool investments in order to manage the investment portfolios of their endowments (both donor restricted and quasi endowment).
- When a pool is established, the value of the investments in the pool is divided into units and each pool category or participant endowment fund is given an initial number of units.
- The pool is marked to fair value and a new unit value is established each time additional assets are added to the pool or when there are withdrawals. Investment income is allocated to each pool category or participant based on the number of units held.
- The income is reported in net assets with or without donor restrictions depending on the stipulations of the donor.
- Since some investment pools may hold term endowments and quasi endowments in addition to donor restricted endowment funds.
- Accordingly, it is important to address how not only the gains but also the losses on the investment pool should be classified.

Investment Return Allocation

- With endowment accounting it is important to remember that the application is fund by fund.

- Although it is likely that the donors permit spending of the return at the discretion of the NFP, it is possible that some donors may have different instructions about the amount of return that must be retained for purchasing power or must be used for specific purposes.

Endowment Accounting

Endowment Value July 1, 20X1	12,500,000						
Dividends/Interest	75,330						
Appreciation (net)	468,420						
Total return	543,750	0.04	437,500	Spending allocation			
Endowment value June 30, 20X2	13,043,750						
Less spending	(437,500)						
Total fund at June 30, 20X2	12,606,250						
Fund Name	**OB Sanchez**	**Ferguson**	**Grissom**	**Legg**	**Reeves**	**Amos**	**Total**
Fund at July 1, 20X1	1,000,000	2,000,000	7,500,000	650,000	500,000	850,000	12,500,000
Number of units by fund	4,000	8,000	30,000	2,600	2,000	3,400	50,000
	43,500	87,000	326,250	28,275	21,750	36,975	543,750
Spending formula- 3.5%	(35,000)	(70,000)	(262,500)	(22,750)	(17,500)	(29,750)	(437,500)
Fund at June 30, 20X2	1,008,500	2,017,000	7,563,750	655,525	504,250	857,225	12,606,250
Proportion	0.08	0.16	0.60	0.05	0.04	0.07	1.00
Original gift	**$950,000**	**$1,750,000**	**$7,250,000**	**$650,000**	**$450,000**	**$800,000**	

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