WHAT CAN WE SPEND?
THE USE OF APPRECIATION ON ENDOWMENT FUNDS

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Present-day governing boards of not-for-profit organizations have for the most part eagerly embraced the notion of investing for "total return." Now that it is clear that investing for growth is acceptable and boards turn toward more "alternative" investments in order to diversify portfolios, the adoption of a spending or take-down rate from the portfolio has become the norm. These take-down rates, often determined as a percentage of a rolling average of the value of the portfolio over a period of years, in order to smooth out swings in the market, have little to do with the earlier concepts of income and principal whereby, under trust law at least, only income could be expended for current operations. Instead the amount determined to be available for current expenditure under the take-down rate will almost invariably be composed of the items which are normally considered income (*i.e.*, dividends, interest, rent, etc.) and of the appreciation in the portfolio in the form of capital gain income. This flexibility in the expenditure of appreciation is essential to permit boards to invest in a variety of investment vehicles, some of which may yield little or no income in the classic sense of the word.

The ability to expend appreciation is supported by the law governing not-for-profit corporations, in most states through the adoption of the Uniform Management of Institutional Funds Act (UMIFA) in one form or another.[1] However, the determination of how

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[1] UMIFA was issued in 1972 and was adopted in 46 states and the District of Columbia from 1972 to 1998. UMIFA, Table of Jurisdictions Wherein Act Has Been Adopted (July 1999).

much appreciation may be expended by a board under a total return take-down approach or for specific special initiatives by an organization may not be easily ascertainable and is not without restrictions. New York law under the Not-for-Profit Corporation Law (N-PCL) permits the expenditure of realized and unrealized appreciation,[2] but places certain restrictions on a governing board's ability to expend appreciation. While in most cases these restrictions will not impinge on a board's ability to expend appreciation, they must be considered by a board in each authorization to do so.

To further complicate a board's consideration of the expenditure of appreciation of its endowment funds, there are various accounting rules governing not-for-profit corporations which must be adhered to in order to meet Generally Accepted Accounting Principles. Accounting for institutional funds is governed primarily by Statements of Financial Accounting Standards Nos. 116, 117 and 124 (SFAS No. 116, SFAS No. 117 and SFAS No. 124) promulgated by the Financial Accounting Standards Board (FASB). SFAS No. 116 mandates that available funds which donors have specifically restricted as to use be applied toward the restricted uses before general funds can be treated as expended for those uses. SFAS No. 117 classifies all institutional funds in one of three categories: "permanently restricted" or "temporarily restricted" or "unrestricted." SFAS No. 124 elaborates on the rules regarding the treatment of investment gains, losses and income, largely as a follow-up to SFAS No. 117.

Together, and particularly in the case of SFAS No. 117, these rules are somewhat contradictory to the legal framework of the N-PCL. The FASB rules generally result in an institution's balance sheet showing a larger amount of unrestricted funds than may in fact be

[2] N-PCL Section 513(c).

available for expenditure under the N-PCL. As shown below, while these two sets of rules can be parsed through, there is ample room for confusion on the part of a governing board.

Historical Background

Until the late 1960s, there was reluctance on the part of governing boards of not-for-profit institutions to invest in any but traditional investments or to expend any funds other than "income" as generally understood to be interest, dividends, rent, etc. The result was that investments with growth potential but little or no current income were slighted and those with current income were favored. While this reluctance to invest in growth-oriented investments stemmed from trust law principles, under which capital gains were classified as principal, it appears, with the possible exception of two states, not to have been required.[3] A 1969 report commissioned by The Ford Foundation, The Law and Lore of Endowment Funds, dramatically changed this approach. The authors William L. Cary and Craig B. Bright examined the underlying concepts of trust law, corporate law and contract law (as applicable to donative instruments) in light of the desired flexibility in the choice of institutional investments. This report (and a subsequent expansion on it[4]) embraced the concept of total return and contributed importantly to the field.

When the N-PCL was adopted in 1970, it provided that the standard of care for governing boards of not-for-profit corporations was akin to that applicable to boards of for-profit

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3 William L. Cary and Craig B. Bright, The Law and Lore of Endowment Funds, (1969) at 12-13.
4 William L. Cary and Craig B. Bright, The Law and Lore Revisited (1974).

corporations rather than that applicable to trustees under trust law principles.[5] With respect to the expenditure of appreciation, the N-PCL allowed a governing board to expend realized appreciation subject to the standard of care set forth in Section 717(a). Furthermore, the concepts of The Law and Lore of Endowment Funds were embodied in UMIFA, which was adopted in 1972 by the National Conference of Commissioners on Uniform State Laws.

Following the adoption of UMIFA in 1972, the New York legislature again examined the question and in 1978 adopted a modified version of UMIFA. The modified UMIFA provisions were integrated into the existing sections of the N-PCL which govern the expenditure of institutional assets.[6] These provisions govern New York not-for-profit corporations today.

The New York Not-for-Profit Corporation Law

So what can a board decide to expend from its institutional assets under the N-PCL?

The main provisions of the N-PCL governing endowment funds are found in Section 513 – Administration of assets received for specific purposes. First of all, a governing board is bound by the terms of the gift instrument transferring assets to the organization. N-PCL Section 513(b) provides that:

> [T]he governing board shall apply all assets … to the purposes specified in the gift instrument and to the payment of the

[5] N-PCL Section 717(a).
[6] 1978 N.Y. Laws, Ch. 690, March 30, 1978, amending N-PCL Sections 102, 512, 513, 514 and 522.

> reasonable and proper expenses of administration of such assets. The governing board shall cause accurate accounts to be kept of such assets separate and apart from the accounts of other assets of the corporation. Unless the terms of the particular gift instrument provide otherwise, the treasurer shall make an annual report to the members (if there be members) or to the governing board (if there be no members) concerning the assets held under this section and the use made of such assets and of the income thereof.

Thus, if an endowment fund is given to a university, and the terms of the gift instrument provide that principal is to be held intact and the income is to be used for the benefit of the university's library, the board must abide by the terms of the gift, and the income cannot be used for student scholarships. However, unless specifically prohibited by the donor (see below regarding N-PCL Section 513(d)), the board may expend the appreciation as well as the income of this fund. N-PCL Section 513(c) provides that:

> The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized (with respect to all assets) and unrealized (with respect only to readily marketable assets), in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by section 717 (Duty of directors and officers).

This provision is more restrictive than the parallel provision of UMIFA. UMIFA does not restrict the expenditure of unrealized appreciation to the unrealized appreciation on readily marketable assets.[7]

"Endowment fund" and the "historic dollar value" are defined in N-PCL Section 102, as follows:

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[7] UMIFA, § 2.

> "Endowment fund" means an institutional fund, or any part thereof, not wholly expendable by the corporation on a current basis under the specific terms of all applicable gift instruments.[8]
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> "Historic dollar value" means the aggregate fair value in dollars of (i) an endowment fund at the time it became an endowment fund, (ii) each subsequent donation to the fund at the time it is made, and (iii) each accumulation made pursuant to a direction in the applicable gift instrument at the time the accumulation is added to the fund. The determination of historic dollar value made in good faith by the corporation is conclusive.[9]

This authorization to expend appreciation, even when the donor has explicitly stated that "income only" is to be expended for the purposes of the library, is effective unless the donor has explicitly stated that net appreciation may not be expended. N-PCL Section 513(d) provides:

> Paragraph (c) of this section [relating to expenditure of appreciation] does not apply if the applicable gift instrument indicates the donor's intention that net appreciation shall not be expended. A restriction upon the expenditure of net appreciation may not be implied from a designation of a gift as an endowment, or from a direction or authorization in the applicable gift instrument to use only "income," "interest," "dividends," or "rents, issues or profits," or "to preserve the principal intact," or a direction which contains other words of similar import. This rule of construction applies to gift instruments executed or in effect before or after the effective date of said paragraph (c).

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[8] N-PCL Section 102(a)(13).
[9] N-PCL Section 102(a)(16)

Thus, a gift instrument providing that a fund is to be an endowment fund and that only income of the fund is to be expended does not in itself prohibit the expenditure of appreciation, regardless of the date of the gift instrument.

In making a determination of whether to expend appreciation, the board is governed by the general standard of care set forth in N-PCL Section 717(a), that is:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

The board must also take into account factors described in the second sentence of N-PCL Section 717(a), as follows:

> In the administration of the powers to make and retain investments pursuant to section 512 (Investment authority), to appropriate appreciation pursuant to section 513(Administration of assets received for specific purposes), and to delegate investment management of institutional funds pursuant to section 512 (Delegation of investment management), a governing board shall consider among other relevant considerations the long and short term needs of the corporation in carrying out its purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends and general economic conditions.

Read together, these provisions allow a governing board wide latitude with respect to the expenditure of appreciation on its endowment funds. The board may expend realized appreciation and unrealized appreciation on readily marketable securities, so long as the board acts in accordance with the standard of care set forth in the first sentence of N-PCL Section 717(a) and, in each case, considers the factors enumerated in the second sentence of Section 717(a). These factors suggest, if perhaps not require, that a board consider the impact of inflation on the historic dollar value of the fund and thus keep in the fund at least a portion of the appreciation so as to preserve the purchasing power of the fund over time.

Example Illustrating N-PCL Provisions

For example, assume that the historic dollar value of the endowment of the library of a university is $20 million, and the endowment is now worth $50 million. Its total return for the past several years has averaged 12 percent. The endowment is composed of gifts made over the course of the last fifty years. It is all invested in readily marketable securities. It could well seem imprudent for a board to decide to expend the entire $30 million of appreciation, thereby ignoring the effects of inflation in the intervening years. A board could, however, analyze the library's needs, both long and short term; its current and anticipated future needs; the expected total return of the university's investments, of which the library's endowment constitutes a part; and the general state of the economy; and make a decision to expend a portion of the appreciation in the library's endowment. It could accomplish this in a minor fashion by increasing its take-down rate from, say, five percent, to eight percent, or by deciding to expend, say, $5 million for a new technology initiative for the library, or by a combination of both. The eight percent is well within the total return of the library fund. The $5 million would still leave the fund with $45 million, well over the historic dollar value of the fund, and presumably well over the historic dollar value of the fund plus an inflation factor. In making this decision, however, the board should have before it, not only the historic dollar value of the fund, but also figures showing the amount necessary to preserve the fund's purchasing power in light of inflation. This would be particularly important if the board were considering an expenditure of, say, $25 million for the construction of a new wing for the library.

To complicate the example further, suppose, as is the case with some institutional funds, that thirty percent of the fund is held in non-readily marketable securities. The board's decision and ability to expend funds will be more complicated, and may be more restricted. Assume again that the university holds a library endowment fund worth $50 million with a historic dollar value of $20 million. Its assets are composed of the following:

Readily Marketable Assets
(Equities, Fixed Income, Cash Equivalents)

FMV	Historic Dollar Value	Realized Gains – Reinvested	Unrealized Gains
$35 million	$15 million	$15 million	$5 million

Non-readily Marketable Assets
(Alternative Investments, e.g., private equity, hedge funds)

FMV	Historic Dollar Value	Realized Gains – Reinvested	Unrealized Gains
$15 million	$5 million	$3 million	$7 million

The $3 million of realized reinvested gains and $7 million of unrealized gains are all held in non-readily marketable securities.

In analyzing how much the board has available to expend, it seems clear that $20 million attributable to the readily marketable assets, both the realized and unrealized gains, may be expended. It is not as clear that the $3 million in realized and reinvested gains, but attributable to non-readily marketable assets, may be expended. It is clear that under N-PCL Section 513(c) the $7 million attributable to the unrealized appreciation in non-readily marketable assets is not available for expenditure until those non-readily marketable assets are sold and the appreciation is realized. However, in deciding how much to be expended from these sources, the board must consider all the factors enumerated in the second sentence of N-PCL Section 717(a). In order for a board to make this decision, it needs information about the fund (including its historic dollar value, the inflation factor to be considered, the nature of the assets in which the fund is held). It appears rare that a board will have all this information available despite the requirement of N-PCL Section 513(b) of an annual report on the nature of the institution's endowment funds.

FASB Standards

SFAS 117

With this statutory framework in mind, we can now turn to the FASB rules. SFAS No. 117 was issued in June 1993 and applies to the financial statements of most not-for-profit tax-exempt organizations. The summary accompanying the issuance of the statement says:

> This Statement establishes standards for general-purpose external financial statements provided by a not-for-profit organization. Its objective is to enhance the relevance, understandability, and comparability of financial statements issued by those organizations. It requires that those financial statements provide

> certain basic information that focuses on the entity as a whole and meets the common needs of external users of those statements.[10]

Whether or not SFAS No. 117 achieved this result is an open question. It requires an organization to classify its net assets in the following three categories, based solely on whether there are donor-imposed restrictions or other legal restrictions applicable to the funds:

1. "Permanently restricted net assets" include net assets that result from "contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by the passage of time nor can be fulfilled or otherwise removed by actions of the organization."

2. "Temporarily restricted net assets" include net assets that result from "contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations."

3. "Unrestricted net assets" include net assets that are "neither permanently restricted nor temporarily restricted by donor-imposed stipulations."[11]

The SFAS No. 117 position is that with respect to the reporting of these three classes of net assets, donor restrictions are determinative in classifying any particular fund. If the governing board has any discretion with respect to the expenditure of the fund, then it is not

[10] SFAS No. 117, Summary.
[11] SFAS No. 117, Appendix D, paragraph 168.

"permanently" restricted. This means that all income earned by a general purpose endowment fund and all appreciation, realized and unrealized, on a general purpose endowment fund is customarily classified as "unrestricted," or, if the fund is restricted as to purpose, such as a university's library fund, then the income and the realized and unrealized appreciation on that fund, generally is classified as "temporarily restricted." Each year an institution's balance sheet reflects the following:[12]

Permanently restricted:	historic dollar value of all endowment funds (which includes any income or appreciation specifically designated by the donor as permanently restricted).
Temporarily restricted:	(i) any unexpended income on endowment funds restricted as to purpose;
	(ii) realized and unrealized appreciation on endowment funds restricted as to purpose;
	(iii) gifts available for expenditure for a particular purpose, *e.g.*, $10 million gift for construction of a new wing of the library.
Unrestricted:	(i) any unexpended income on general purpose endowment funds;
	(ii) realized and unrealized appreciation on general purpose endowment funds;
	(iii) all other unrestricted assets such as current operating funds.

At the time of the issuance of SFAS No. 117, there was concern among some members of the non-profit legal community that treating all appreciation, both realized and

[12] See SFAS No. 117, Appendix C, paragraph 156.

unrealized, as unrestricted really misstated an institution's financial position. Mindful of the second sentence of N-PCL Section 717(a), which requires a governing board to consider a variety of specific factors before deciding in the general context of the Section 717(a) standard to expend appreciation, these lawyers believed that all or some portion of the appreciation over the historic dollar value of the fund should be treated as permanently restricted until a board decided otherwise, or failing that, at least as temporarily restricted.[13] FASB did not agree with this interpretation, believing that Section 717(a) did not impose a legal limitation on a governing board's exercise of discretion.[14] The Committee on Nonprofit Organizations of the Association of the Bar of the City of New York also issued a report in May 1997 in which it recommended that FASB revise SFAS No. 117 to provide more categories by which funds could be classified, and that, pending such a change, unappropriated appreciation on a general purpose endowment fund be classified as "temporarily restricted."[15]

Absent a donor restriction or a clear legal mandate, FASB, in its effort to bring uniformity to balance sheets, believed that to classify all or any part of the appreciation on a fund as permanently, or even temporarily, restricted, pending action by a board would allow boards and management to manipulate the classification of these funds. Only where UMIFA had been modified by a state to <u>require</u> a board to retain appreciation, did FASB agree that this explicit modification would require that the appreciation be treated as "permanently restricted." For instance, Rhode Island law states that:

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[13] Memorandum dated October 5, 1995 of Milbank, Tweed, Hadley & McCloy; memorandum dated February 1995 of Nixon, Hargrave, Devons and Doyle (Michael J. Cooney); and memorandum dated September 12, 1995 of Patterson, Belknap, Webb & Tyler.

[14] SFAS No. 117, paragraphs 126 and 127.

[15] Classification of Appreciation on Endowment Funds, The Record, The Association of the Bar of the City of New York, vol. 52, No. 7, p. 858 (May 1997).

> The historic dollar value of an endowment fund shall be prudently adjusted from time to time to reflect the change, if any, in the purchasing power of the historic dollar value of the fund.[16]

Paragraph 128 of SFAS No. 117 recognizes that this kind of provision might mandate an adjustment to the historic dollar value of a fund:

> This modification [referring to the Rhode Island provision] is substantive because it requires changes to the measure of the original historic value. Thus, the portion of net appreciation in excess of the original historic dollar value that is necessary to cover the purchasing power adjustments must be retained and, considering past economic history and prospects for continued inflation, interpreting and classifying that amount as permanently restricted would be a fair representation.[17]

Therefore, when the law mandates that the historic dollar value must be adjusted to reflect purchasing power of an endowment fund, SFAS No. 117 would permit the amount of appreciation deemed necessary to reflect this requirement to be classified as "permanently restricted."

Very few other states have imposed any specific legal requirements on the expenditure of appreciation other than the general standard of care and the consideration of various factors, some of which are more elaborate than those specified in UMIFA or New York law. California, for instance, includes as factors to be considered "the appropriateness of a

[16] R.I. Gen. Laws § 18-12-1(d). Rhode Island also set the historic dollar value of existing endowment funds at their fair market value on May 4, 1972, the date of Rhode Island's adoption of UMIFA.
[17] See also January 16, 1996 FASB memorandum from Ronald J. Bossio, Project Manager.

reasonable proportion of higher risk investment with respect to institutional funds as a whole, income, growth, and long-term net appreciation, as well as the probable safety of funds."[18] It does not appear that the added factors would serve to limit a board's discretion in a manner that would persuade FASB to classify any of the appreciation, realized or unrealized, on an endowment fund as permanently restricted.

Massachusetts and New Hampshire both have adopted a variation on the power to appropriate appreciation which has more sting to it. Massachusetts law provides:

> The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized and unrealized, in the fair value of the assets of the endowment fund over the historic dollar value of the fund as is prudent under the standard established by section eight; provided, however, the appropriation of net appreciation for expenditure in any year in an amount greater than seven percent of the fair market value of the institution's endowment funds, calculated on the basis of market values determined at least quarterly and averaged over a period of three or more years, shall create a rebuttable presumption of imprudence on the part of the governing board. This section does not limit the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument, or the charter of the institution.[19]

While this provision leaves a board the flexibility to appropriate all realized and unrealized appreciation, the rebuttable presumption of imprudence is rather daunting, and certainly requires a board to have and articulate good reasons for doing so. Despite this restriction, it is likely that under SFAS No. 117 all appreciation would nevertheless be removed from the permanently restricted category.

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[18] CA Probate Code § 18506. Until January 1, 1994 California also limited the appropriation of appreciation attributable to real property to realized appreciation. CA Probate Code § 19502.5

[19] MA Gen. Laws ch. 180A, § 2. See also NH Rev. Stat. Ann. § 292-B:6.

One of the interesting aspects of this historical review of the FASB rules was that little attention was given to the inability under N-PCL Section 513(c) of a governing board to expend the unrealized appreciation on non-readily marketable securities. There is a real statutory impediment to expending these funds. Despite this, when SFAS No. 117 was first applicable and organizations reviewed their endowment funds to ascertain the historic dollar value of those funds, they do not appear to have included as permanently restricted the unrealized appreciation attributable to the non-readily marketable assets held in those funds. It appears that the unrealized appreciation on these assets (to the extent that they can be marked to market) is regularly classified on financial statements as unrestricted (or temporarily restricted if the unrealized appreciation is attributable to specific use funds). The FASB position would likely be that, because it is within the discretion of a governing board to liquidate these assets and convert them to cash or readily marketable securities, the unrealized appreciation is not permanently restricted. However, the board may not be able easily to liquidate these assets, at least on a short-term basis, which is presumably why the restriction exists in the statute. The absence of focus on this issue at the time of the adoption of SFAS No. 117 was undoubtedly twofold – first, because the use of the alternative investment vehicles, which are so common today, only composed a small fraction of most investment portfolios at that time; but second and more importantly, because for most of these assets there was no accounting requirement that they be marked to market. The appearance of SFAS No. 124, issued in November 1995, did not significantly change this situation. It requires that all equity securities that have readily determinable fair values and all investments in debt securities must be shown at their current fair value on an organization's balance sheet.[20]

All in all, SFAS No. 117 created arbitrary classifications into which institutional assets are put. It can be safely said that most boards do not understand these classifications or the legal restrictions on the expenditure of what look like freely usable assets – the "unrestricted assets" on the financial statement.

SFAS 116

Another FASB rule, SFAS No. 116, probably adds to this confusion. SFAS No. 116 requires that once an institution has classified its assets and each gift received from a donor as "permanently restricted," "temporarily restricted" or "unrestricted," the institution must expend the use-restricted assets, whether it be the income or appreciation attributed to permanently restricted assets or the income, appreciation or principal of temporarily restricted assets, for the specific purpose of the fund or gift before it applies its general funds for those purposes.[21]

A brief example illustrates this rule. A library endowment fund at a university has a fair market value of $50 million, of which $20 million is the historic dollar value. The appreciation of $30 million is classified under SFAS No. 117 as temporarily restricted. The university has a four percent take-down rate and decides to expend $5 million toward the

[20] SFAS No. 124, paragraphs 3-7.
[21] SFAS No. 116, paragraph 17.

renovation of the library. This $5 million is to come from two sources: $2 million from the library fund (four percent times $50 million) and $3 million from the university's general operating funds. Under SFAS No. 116, the $3 million attributable to general operating funds will be treated as coming from the $30 million of appreciation classified as temporarily restricted for the library and will thereby free $3 million of the temporarily restricted funds so that they can be reclassified as unrestricted. At that point, they can be used for any purpose by the university.

Again, this may have an internal logic and was meant to prevent the accumulation of use-restricted funds by an institution. Moreover, it serves to free up what would otherwise be use-restricted assets and makes them unrestricted, presumably giving more flexibility to an institution. It is not, however, to the extent a board considers these matters at all, the way a board generally thinks.

While this rule of SFAS No. 116 seems to comport with legal requirements, it may be counter intuitive to a governing board which genuinely meant to expend current operating funds for, in our case, library purposes. In the above example, $3 million was spent for library purposes from general operating funds and, as a result, $3 million in the library endowment fund is now, pursuant to SFAS No. 116, classified as unrestricted and may be spent for any purpose. When the University's treasurer makes the annual report to the governing board required by N-PCL Section 513(b) regarding the university's library fund, however, is this $3 million shown as part of the library fund?

Moreover, if the example were different – say the library's endowment fund of $50 million consisted of gifts made over the last thirty years with an historic dollar value of

$45 million and the appreciation was only $5 million, all or a substantial part of the $5 million of appreciation, which is shown on the organization's balance sheet as "temporarily restricted" (for library purposes) and ostensibly freely expendable for those purposes, could well be required in order to maintain the purchasing power of the library fund. Expending even the $2 million from that fund which the governing board decided to spend might be seen as imprudent under the factors enumerated in N-PCL Section 717(a); and almost certainly, absent extraordinary circumstances, treating the entire $5 million as freeing up all the temporarily restricted assets of the library fund could be deemed to be imprudent.

<u>SFAS 124</u>

SFAS No. 124 also elaborated on the rules regarding the treatment of investment gains, losses and income on an organization's balance sheet.[22] Referring to SFAS No. 117, it confirmed that gains and losses on donor-restricted endowment funds would be categorized as gains and losses of temporarily restricted assets (for use-restricted endowment funds) and unrestricted assets (for general purpose endowment funds).[23] Thus, under SFAS No. 124, the historic dollar value of an endowment fund would be set forth as permanently restricted, and any gain (appreciation) in that fund would be classified and shown as "temporarily restricted" (for a use-restricted endowment fund) or unrestricted (for a general purpose endowment fund).[24] Losses which may reduce the value of the gift from when it was received (*i.e.*, the historic dollar value) do not do so under SFAS No. 124. The historic dollar value remains the same on the

[22] SFAS No. 133, paragraph 43, specifically addresses the recognition of gain or loss on a hedging or derivative instrument.
[23] SFAS No. 124, paragraphs 8 – 13.
[24] SFAS No. 125, paragraph 11.

balance sheet as permanently restricted, and any loss is shown as a reduction in temporarily restricted assets (for use-restricted endowment funds) or in unrestricted assets (for general purpose endowment funds).[25] This determination was again made in an effort to bring uniformity to the reporting of an organization's funds, and to prevent any different interpretation by governing boards of how to treat gains and losses to influence their classification of the three categories of assets on an organization's balance sheet.

SFAS No. 124 thus treats the classification of losses in endowment assets as follows:

> 73. . . . [L]osses on the investments of a donor-restricted endowment fund reduce temporarily restricted or unrestricted net assets. The Board [FASB] 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. . . . 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.
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> 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 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.[26]

[25] SFAS No. 124, paragraphs 12-13, 65-77.
[26] SFAS No. 124, paragraphs 73-74.

While all of this may have some internal logic, and treats monies as fungible, it may not reflect the legal realities of a board's duties in deciding how much appreciation is available for expenditure. When a board is considering an expenditure from a particular endowment fund, it should not take comfort from the fact that on its balance sheet the historic dollar value of the fund remains unchanged despite losses in the portfolio. Those losses have to be examined for the impact on the particular endowment fund, and presumably should be revealed in the treasurer's annual report to the governing board pursuant to N-PCL Section 513(b).

Notes to the Financial Statements

All the FASB Statements of Financial Accounting Standards state that explanations of the nature of the assets held in each of the three classes of an institution's assets should be set forth in the notes to the organization's financial statements. A review of recently issued financial statements for different organizations, however, indicates that the notes are generally cursory in nature and do not provide much clarity as to the nature of these assets.

While it is questionable whether these rules have brought uniformity and clarification to the financial statements of nonprofits, it is quite clear that a governing board trying to decide what is prudent to expend has to look elsewhere. The legal statutory framework and the FASB requirements should be regarded as entirely separate. The classification of assets under the FASB rules as temporarily restricted or unrestricted on an organization's balance sheets will generally overstate the amount of assets which are available for expenditure by a board under the standards of N-PCL Section 717(a). That this is a concern in New York is evidenced by a recent statement issued by the New York State Attorney General. The statement quotes N-PCL Section 513(c) and the second sentence of Section 717(a), and then continues:

> General-purpose financial statements of not-for-profit organizations, prepared in accordance with Generally Accepted Accounting Principles, account for endowment appreciation as unrestricted net assets (or temporarily restricted net assets if the fund is for specific purposes). Officers, directors and managers might assume incorrectly from such financial statements that endowment fund appreciation is available for expenditure without further action or consideration by the governing board.
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> A governing board considering the appropriation of endowment appreciation should not rely solely on general-purpose financial statements. Pursuant to Section 513(b) of the Not-for-Profit Corporation Law the treasurer is required to make an annual report to the governing board concerning the administration and use of all assets held for specific purposes and the income from such assets. The governing board should review all relevant information on the endowment funds including the treasurer's annual report. The governing board should also deliberate and vote on whether to and to what extent to appropriate endowment appreciation for expenditure. Deliberations and decisions of the governing board should be thoroughly documented in resolutions in the minutes.[27]

The reference to the annual report of the treasurer required by N-PCL Section 513(b) is important because it clearly reflects the requirement that separate and careful accounts must be kept of an institution's endowment funds to enable a board, when considering the expenditure of funds to be drawn from appreciation on its investment assets, to understand the source of that

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[27] New York State Attorney General Eliot Spitzer Advises Not-for-Profit Corporations on the Appropriation of Endowment Fund Appreciation, News from the Charities Bureau (May 24, 2000).

appreciation and then to make a decision regarding its expenditure under all the factors required by N-PCL Section 717(a).

The accounting rules have not altered the legal requirements to which a governing board is subject. The flexibility in investment management which stems from The Law and Lore of Endowment and is supported through the adoption of UMIFA in most states and that allows the total return concept to flourish and boards to expend appreciation is a vast improvement in the governance of nonprofit institutions. This flexibility allows boards to diversify their investments, to adopt a specific take-down rate regardless of traditional income earned and to allocate their resources to meet extraordinary needs, as long as the decisions can be justified within the criteria and standards of Section 717(a). The decisions, however, to expend appreciation for specific projects or to adopt a high take-down rate, must not be made in a vacuum. Boards generally are unaware of the legal restrictions governing their operations, and the FASB rules, while intended to bring uniformity of reporting, almost certainly have not helped boards in understanding what is available for appropriation.

Conclusions and Recommendations

A governing board should regard the accounting treatment of the organization's funds under the FASB rules as separate and apart from its analysis of the organization's endowment funds under the N-PCL. The board should adhere to the requirement of N-PCL Section 513(b) to conduct an annual analysis of the organization's endowment funds which would show for each fund (i) the historic dollar value, (ii) any donor restriction on the use of income or appreciation and the effect of that restriction, (iii) the amount of the fund's appreciation held in non-readily marketable securities, and (iv) the amount of appreciation in the fund attributable to an inflation factor since the inception of the fund.

Many organizations have this information readily available but do not look at it systematically or update it annually. For many organizations which have long-term endowments with very low historic dollar values, the review of their endowment funds will make clear that the funds have a significant amount of appreciation available for appropriation, even if portions of the appreciation are set aside to preserve the purchasing power of the funds based on an inflation factor and to account for appreciation held in non-readily marketable securities. Absent such an examination, a board cannot make an informed decision regarding the amount of appreciation which may be expended.

The release from the straight jacket of the concept of principal and income has been highly salutary. The only advantage of that concept was simplicity – traditional income could be spent; principal (including appreciation) could not be spent. The much more flexible total return approach of the N-PCL is definitely an improvement. But this improvement comes with obligations to gather, review and update information regarding the nature and holdings of an organization's institutional funds which must not be ignored.