

Uniform Prudent Management of Institutional Funds Act (UPMIFA) Overview

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Introduction

On October 1, 2007, The Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) became a Connecticut law. This statute governs the investment and spending of all charitable endowment funds, including endowments held by churches. It grants force-of-law to best practices for investment and spending. It has been referred to as “probably the least known act involving the most money and the most financial impact of any law in the State of Connecticut.”¹

The governing boards of endowed organizations have significant obligations under UPMIFA with regard to investing endowment assets and appropriating endowment assets for spending. UPMIFA provides guidelines and not clear formulas or rules. The guidelines incline towards maintaining the purchasing power of endowments over time, which is a significant change from the previous statute governing endowments.

In addition, on August 6, 2008 the Financial Accounting Standards Board (FASB), in response to the adoption of UPMIFA generally throughout the United States, issued FASB Staff position Number 117-1 (FSP 117-1) concerning financial statement presentation of net assets in accordance with Generally Accepted Accounting Principles (GAAP). This imposes new reporting and disclosure requirements on organizations issuing GAAP financial statements.

Background – Gift Classification

Long ago, when life was simpler, gifts were easier to understand and account for. There were two basic kinds of gifts, and each of these two basic kinds of gifts had two variations. The gift universe consisted, therefore, of four types of gifts.

The two basic kinds of gifts were gifts to create endowments and gifts that could be used up. If a gift created an endowment, the amount of the original gift was to be preserved and invested to create source of income.

The two variations were gifts that had specified purposes and gifts that could be used for the general purposes of the organization receiving the gift. To summarize the four types of gifts:

1. Specific purpose endowment
2. General purpose endowment
3. Specific purpose gift to use up
4. General purpose gift to use up

¹ Comment from legislative public hearing.

The amount of the original gift was labeled the “principal”. Just to confuse things we stated using the word “restricted” to mean two different things. A restricted gift could mean that the principal was restricted, that is, was for creating an endowment. A restricted gift could also refer to a gift that could be used up, but only for a specific purpose. A careful restatement of the four types of gifts using this restricted terminology would be (numbering corresponds to the above list):

1. Restricted principal, restricted purpose
2. Restricted principal, unrestricted purpose
3. Unrestricted principal, restricted purpose
4. Unrestricted principal, unrestricted purpose

Here are some examples of the four types of gifts (again, keeping the numbering consistent):

1. A gift to establish an endowment fund for scholarships
2. A gift to establish an endowment fund for the general purposes of the organization
3. A gift to a capital campaign
4. An annual gift to support the organization

Classification of Investment Appreciation - UMIFA

Keeping to the past, when life was simpler, restricted principal was invested to produce income. Only income was spent on the purposes for which the endowment was established.

But things are never quite as simple as they appear. Restricted principal, when invested, can increase in value. Should the appreciation be considered an addition to the restricted principal (a permanent addition, not for spending) or income? Should the classification as principal or interest depend on circumstances? If so, how?

In order to help clarify these and other endowment management issues, the Uniform Management of Institutional Funds Act (“UMIFA”) was promulgated in the 1970s and adopted in most states, including Connecticut. (It should be noted that in some states, including Connecticut, case law often trumps statutes if there are conflicts between statutes and case law.)

UMIFA allowed the appreciation of principal to be reclassified as income in certain circumstances, which gave birth to total return investment and spending policies. Principal could be invested for total return (growth and income) and a portion of the growth realized (through the sale of a portion of the appreciated assets) could be spent along with income.

UMIFA also established that the historic dollar value of an endowment gift (the original gift, plus subsequent donor additions) must be maintained by an organization. If, because of investment losses, the value of the gift decreased to be less than the historic dollar value, the organization would have to re-invest income until the historic dollar value was once again achieved.

The historic gift value is determined by the initial and any subsequent donor contributions and is not adjusted for investment appreciation. Organizations could consider spending appreciation in excess of the historic gift value, if it was prudent to do so, *considering the purposes of the organization*.²

The accounting world eventually incorporated many elements of UMIFA and related laws into Generally Accepted Accounting Principles (GAAP.)

Enter UPMIFA

In 2007, Connecticut adopted a new law that replaces UMIFA: the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”). UPMIFA generally provides guidelines, not hard and fast rules. Many things that used to be clear are no longer clear, and it will be some time before everything settles down. UPMIFA eliminates the historic dollar value threshold for assets that must be maintained by an organization in perpetuity. On the one hand, UPMIFA allows that there may be times when it is prudent to spend endowment assets even when the endowment has decreased to less than the historic dollar value³. On the other hand, UPMIFA establishes a different standard for determining whether it is prudent to spend appreciation. Instead of considering the purpose of the *organization*, organizations need to give primary *consideration to the intentions of the donor*. Absent specific directions from a donor, UPMIFA makes it clear that one of the key factors determining what is prudent is maintaining the “fair value” – the inflation adjusted value – of the historic dollar value of the gift.

The accounting profession was much quicker to respond to UPMIFA than UMIFA, immediately recognizing a conflict between existing accounting standards and the new law. With regard to donor designated endowment funds, four options were recognized:

- None of an endowment fund could be considered permanently restricted;
- All of an endowment fund could be considered permanently restricted;

² This is the standard under UMIFA. There is case law in Connecticut that may require a higher standard for spending appreciation in excess of the historic gift value.

³ This has led some people to conclude that it is generally acceptable to appropriate funds from an endowment that is below the historic value of the gift. This overstates the flexibility inherent in the new law. A Connecticut Assistant Attorney General provided this example: A donor establishes an endowment for seminary scholarships. Based on a forecast for appropriations, a number of three year scholarships are awarded. The market declines, and the value of the endowment falls below the historic value of the gift. UPMIFA would permit the distribution of funds for scholarships already rewarded, even if it further reduced the value of the endowment below the historic value. Future appropriation decisions would still have to be made in light of UPMIFA’s inclination towards maintaining the historic gift value, even if that meant suspending the scholarship program for a period of time.

- A new classification could be created; or
- Some, but generally not all of an endowment fund could be classified as permanently restricted. The amount classified as permanently restricted should be determined by a governing board in light of their interpretation of state law. The interpretation would be disclosed in the organizations financial statements.

Accountants chose the last option. This means that governing boards need to make determinations about asset classifications. A corollary issue is that boards need to determine a spending policy addressing any endowment fund where the current value is less than the permanent amount determined by the board.

To restate the accounting policy issues as questions:

1. How much of the historic gift value and investment appreciation of endowment gifts should be classified as permanently restricted?
2. What should the spending policy be for endowments whose current balance is less than the permanently restricted amount?

Classification of endowment gifts

Answering the first question is not simple. UPMIFA provides no clear guidance and accounting standards leave the determination up to organizations. It is possible, however, to take a “wait and see” position. The attached resolution was acceptable to the Connecticut Conference’s auditors and was also reviewed by the General Counsel of the United Church of Christ. In plain language, the resolution says:

All investment appreciation of endowment gifts will be classified as temporarily restricted AND none of the investment appreciation so classified will be appropriated for spending unless the Board determines that UPMIFA permits the appropriation.

Or even more simply:

We won’t spend any endowment funds unless permitted by UPMIFA, whether or not the funds are classified as permanently restricted on our financial statements.

The resolution will continue to permit the use of a total return spending policy.

The resolution will require changes to financial statements:

[See next page for table.]

Endowment Asset	Current Classification	New Classification
Original gift – historic dollar value of gift	Permanently Restricted	Permanently Restricted
Appreciation of designated purpose endowment gifts	Temporarily Restricted. Funds can be released from restriction and spent only if it is determined that doing so is consistent <i>with the mission and needs of the organization.</i>	Temporarily Restricted. Funds can be released from restriction and spent only if it is determined that doing so is consistent <i>with the donor’s intention.</i>
Appreciation of general purpose endowment gifts	Currently classified in either of two ways: “Board designated – functioning as endowment” or “unrestricted.” The amount of appreciation necessary to maintain the inflation adjusted value of the original gift classified as “Board designated – functioning as endowment” and any amount in excess of this classified as “unrestricted.”	Temporarily Restricted. Funds can be released from restriction and spent only if it is determined that doing so is consistent <i>with the donor’s intention.</i>

Spending policy be for endowments whose current balance is less than the permanently restricted amount

This is also not an easy issue to address, because we are deferring the definition of permanently restricted.

It is clear that endowment funds whose current value is less than the original gift should be “frozen” and all investment income and appreciation should be retained until the value exceeds the original gift amount. A possible exception to this is spending commitments that have already been made. However, further reductions below the historic gift value may result in a longer delay before new appropriations can be made.

It is also clear that endowment funds whose current value exceeds the fair value (inflation adjusted value) of the original gift can continue to make distributions.

It is not clear what we should do with endowment funds whose current value exceeds the original gift amount but is less than the fair value of the original gift amount. Many old endowments will be in this category. For most of these funds’ history, investment was guided by the twin objectives of preservation of principal and generating income. Therefore, the funds were usually invested in fixed income securities or what were

known as “widows and orphans” stocks – stocks that reliably maintained their value and paid dividends. It was not an investment objective to maintain fair value and generally these funds did not do so. For example, the Connecticut Conference has an endowment fund that was established with an original gift of \$25,000 in 1876. As of December 31, 2008, this endowment was worth \$194,306. This is an impressive amount, especially considering all of the distributions of the years, but the inflation adjusted value of the original gift is \$500,000. I think it would be unreasonable to freeze this fund until it reached \$500,000 and equally unreasonable to distribute all of the funds except for the original gift amount. However, the interpretation of the new law has not been established. I think it would be difficult to criticize the stewardship of this fund and that it is appropriate to continue to make distributions until clear guidance is available.⁴

For most of older endowments it seems reasonable to continue distributions until clearer guidelines are established. For relatively recent endowment gifts where the current value is less than the inflation adjusted value of the original gift, it seems prudent to freeze distributions. For the time being, the Connecticut Conference is considering endowment gifts received since 1990 to be relatively recent.

Possible Board Actions

A possible board resolution follows. Except for the last “resolved” the language was provided by the Connecticut Conference’s auditors and reviewed by the UCC’s general counsel. The last “resolved” paragraph addresses the second issue discussed in this memo, the spending policy when endowments are less than the permanently restricted amounts.

Resolution to reflect UPMIFA and FAS 117-1

WHEREAS, Effective October 1, 2007 Connecticut adopted the Uniform Prudent Management of Institutional Funds Act (**UPMIFA**);

WHEREAS, on August 6, 2008 the Financial Accounting Standards Board (**FASB**), in response to the adoption of UPMIFA generally throughout the United States, issued FASB Staff position Number 117-1 (**FSP 117-1**) concerning financial statement presentation of net assets in accordance with Generally Accepted Accounting Principles (**GAAP**); and

WHEREAS, the governing board of the corporation desires to maintain and to follow best current principles and practices in connection with the investment, spending, and financial statement presentation of the corporation’s funds.

NOW, THEREFORE, IT IS HEREBY

⁴ I discussed this specific example with a Connecticut Assistant Attorney General and she agreed with my assessment.

- RESOLVED: That the corporation shall adhere to standards of care and prudence articulated in UPMIFA in connection with the investment and expenditure of donor restricted endowment funds;
- RESOLVED: That the corporation shall continue to present (under GAAP) as “*permanently restricted*” net assets on its financial statements the dollar value of donor restricted endowment funds at the time of the donation; *provided, however*, that such characterization shall not be in derogation of the corporation’s obligation to preserve the spending power of such funds in accordance with the standards set forth in UPMIFA; and *provided further*, that such financial statement presentation shall not be in derogation of any protections, restrictions, or other applicable principles or rules applicable under Connecticut law to monies attributable or allocable to the obligation to preserve spending power.
- RESOLVED: That in accordance with FSP 117-1 donor restricted endowment funds of the corporation not presented in *permanently restricted* net assets shall be presented in *temporarily restricted* net assets until appropriated for expenditure by the governing board, at which time they shall be presented as unrestricted net assets. For this purpose funds shall be deemed to be appropriated (i) upon the first day of the taxable year of the corporation contemplated by the annual budget for such year as finally approved by the governing board, or (ii) a specific resolution of appropriation of the governing board which identifies the funds so appropriated and the reason for such appropriation. Notwithstanding the foregoing, donor restricted funds subject to a donor specified time or purpose restriction shall continue to be presented as *temporarily restricted* net assets until the expiration of the time period or the satisfaction of the purpose, as applicable.

Additional Resolution regarding “underwater” funds

- Resolved: In accordance with the obligation to preserve spending power, no temporarily restricted nets assets shall be appropriated for spending whenever the current value of an endowment gift is less than the historic gift amount. In addition, all investment income earned on such endowment gifts shall be reinvested until such time as the value of the endowment gift exceeds the historic gift amount. In addition, for endowment gifts received after January 1, 1990, no temporarily restricted nets assets shall be appropriated for spending whenever the current value of an endowment gift is less than the fair value of the historic gift amount. In addition, all investment income earned on such endowment gifts shall be reinvested until such time as the value of the endowment gift exceeds the fair value of the historic gift amount.

Resources:

Text of the Act (Note: UPMIFA is sections 28 through 37 of an act addressing other matters):

www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&bill_num=1143&which_year=2007

General Information: www.upmifa.org

Commentary from Commonfund Institute:

www.commonfund.org/Common/RESOURCE_REQUEST/target.pdf?RES_GUID=6E26298C-9A11-4273-995C-1E526561706F

Commentary from Reid & Riege, PC http://leasing-lawyers.net/content/news_detail/177

Commentary from Wiggin and Dana, LLP

www.wiggin.com/db30/cgi-bin/pubs/Alert-TE-Feb07.pdf