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Fundamentals

Third Quarter 2009

Ways and means for the public sector

Endowments Experience Accounting and Reporting Changes with UPMIFA

For almost 35 years the Uniform Management of Institutional Funds Act (UMIFA) was the law of the land in 47 states for organizations with institutional funds and permanent endowments. In 2006, the Uniform Prudent Management of Institutional Funds Act (UPMIFA) was created to be responsive to changes in the economy and donor gift instruments. As of October 2008, over 30 states had either enacted, or were in the process of introducing legislation to enact, UPMIFA or a version of it. If your organization invests and manages institutional funds in an UPMIFA enacted state, you need to understand and play by the new rules.

As defined under UPMIFA, institutional funds may or may not be subject to donor restrictions; endowments are institutional funds (or portions thereof) that are donor restricted under the terms of the gift instrument. UPMIFA applies to nonprofit charitable entities. It does not apply to trusts managed by non-charitable entities, such as corporations, or to trusts managed by individuals; these are governed by the 1994 Uniform Prudent Investor Act (UPIA). UPMIFA applies to all institutional funds, whether they were created before or after the enactment of the statute. However, it does not govern the management of board designated endowments. UPMIFA sets standards for endowment spending and preservation of the original gift in accordance with donor intent. Management needs to understand the legislative environment they operate in, as it may affect their accounting for institutional funds and permanent endowments.

Whether or not your organization is affected by UPMIFA, it will be impacted by the technical guidance issued by the Financial Accounting Standards Board (FASB) in response to UPMIFA. FASB Statement of Position 117-1 *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds* (FSP FAS 117-1) was issued in August 2008 and is effective for fiscal years ending after Dec. 15, 2008.

Now that is quite a mouthful, so let's break it down. The first part of the title focuses solely on UPMIFA enacted states and jurisdictions; as a result, certain elements of FSP FAS 117-1 apply only where UPMIFA is the law of the land. The latter part of the title, *"Enhanced Disclosures for **All** Endowment Funds"* (emphasis added), communicates to all organizations

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Final Issue of Fundamentals

This will be the final print edition of *Fundamentals*, as we will be increasing the circulation of another RSM McGladrey publication with an emphasis on tax-exempt organizations, *Muse*.

You may already be a subscriber to *Muse*, or may have received your first issue in late May. Although it could become a print publication in the future, it is currently strictly an electronic newsletter. For those that prefer a print publication, a printable PDF will be available each month at www.rsmmcgladrey.com.

Unlike the quarterly *Fundamentals, Muse* is a monthly publication, so it is better positioned to deliver timely advice and information that is critical to today's Not-for-Profit executives.

With *Muse* being an electronic publication, it is essential that we have your e-mail address. To ensure that you receive *Muse*, or to manage any existing subscriptions, please visit www.rsmmcgladrey.com/Publications/Publication-Subscription.

Please contact Matthew Snellings at matthew.snellings@rsmi.com with any questions.

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Be Prepared for Increased Accountability Requirements Related to the American Recovery and Reinvestment Act

It's not just major corporations that will be benefiting from the American Recovery and Reinvestment Act (ARRA). A large number of not-for-profit organizations will also find that they too will have access to a large portion of the more than $780 billion marked for economic recovery. If you haven't already done so, we suggest you visit the official federal government ARRA web site at www.recovery.gov for more information about the Act.

"The federal government has concluded that the single audit process will be a major component of their plan for determining accountability and evaluating the expenditure of federal awards by not-for-profit organizations."

Of specific importance to us all is the President's promise of accountability. "We cannot overstate the importance of this effort," said President Obama. "We are asking the American people to trust their government with an unprecedented level of funding to address the economic emergency. In return, we must prove to them that their dollars are being invested in initiatives and strategies that make a difference in their communities and across the country. Following through on our commitments for accountability and openness will create a foundation upon which we can build as we continue to tackle the economic crisis and the many other challenges facing our nation."

The federal government has concluded that the single audit process will be a major component of their plan for determining accountability and evaluating the expenditure of federal awards by not-for-profit organizations. Most ARRA programs will bear unique CFDA (Catalog of Federal Domestic Assistance) numbers, specifically identifying them as ARRA awards. However, you should not assume this information will be readily available, especially if you do not receive such funds directly from the federal government. Although the funding source is required to provide this information up-front to you, we suggest you obtain formal representations from them concerning the source and CFDA number for any awards you suspect to be of a federal origin. This should be done before you start to actually receive or expend funds, not after, because, you will also need to obtain relevant information about applicable laws, regulations and award provisions concerning the use and accountability for such funds.

As part of your ability to demonstrate accountability, if your organization has or is planning to participate in any federally funded programs, you will want to take steps as soon as possible to develop or enhance existing internal controls to ensure compliance with all of the many laws, regulations, and award provisions that will apply to the various federal programs, including those under which ARRA awards will be made. To avoid noncompliance and reports of control deficiencies, these controls should be in place before you actually start to expend federal awards.

To date, key provisions of the Single Audit Act and OMB Circular A-133 have not changed as a result of the ARRA. However, because of the President's pledge for accountability, it is likely that many not-for-profit organizations participating in federal awards that were not previously subject to a single audit will be required to have one. Other not-for-profit organizations that have had single audits in the past may find that they have a number of new programs, or they are participating in new clusters, that will need to be audited as major.

Under provisions of the ARRA, single audit information, which includes the entities financial statements and auditor's reports, including those on internal control and compliance, will be made readily available to the public. While this is clearly in line with the President's mandate for accountability, this could be especially embarrassing for organizations if their single audit reports are other than unqualified and/or findings are reported. Additionally, members of the Federal Inspectors General community have indicated their plans to closely monitor single audit quality and the results of single audits.

If you have or are planning to participate in ARRA awards, we recommend you obtain as much information as possible about the proposed awards before you agree to participate; the organization is prepared for any additional cost and effort associated with the potential design/re-design and implementation of effective internal controls; and you prepare for the impact and cost of any additional single audit requirements.

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with endowment funds (both donor restricted and board designated) that, while you may ignore UPMIFA if you are not in an UPMIFA-enacted state or jurisdiction, you cannot ignore the disclosure requirements of FSP FAS 117-1.

Key Changes

UPMIFA brings two key changes to institutional fund management and endowment accounting. The first is the elimination of historic dollar value (HDV) as a benchmark for both endowment spending and the amount identified for accounting purposes as permanently restricted net assets; the second is a change (some would say, a clarification) in the legal classification of earnings.

One of the key duties contemplated by UPMIFA, that was not explicitly included in UMIFA, is "the preservation of the endowment fund." This preservation concept was an underlying principle driving the elimination of historic dollar value as a benchmark in UPMIFA.

Another underlying principle is the move away from short-term barriers to spending (especially in underwater situations) in favor of a long-term approach focusing on the organization's having prudent spending and investment policies.

Gift instruments, especially for long established endowments, may not be detailed enough to contain sufficient documentation of donor intent for purposes of UPMIFA. Additionally, gift instruments typically use words interchangeably and without clear definition as to use or meaning. As a result, UPMIFA provides "Rules of Construction" that allow the organization to focus on the implied donor intent with regard to spending, the desire to create an endowment of permanent duration, and the ability to react accordingly with respect to investment strategies and spending policies once that determination has been made.

UPMIFA also provides a framework to allow for the modification of restrictions in limited circumstances. When gift instruments are written with too narrow a focus, over time it may become difficult or impossible to fulfill the gift intent as expressly stated. An example is a medical foundation that received a gift targeted at a specific disease that is now substantially cured. How does the organization advance the donor's true underlying intent to further medical science and discovery? UPMIFA offers two key doctrines for guidance in such a situation.

UPMIFA supports donor intent through its retroactive rules of construction that place the organization in the donor's shoes and charge them with honoring express or implied donor intent. While an organization may modify or release a restriction, they may never convert an endowment into a fund with no endowment.

Additionally, UPMIFA allows the restrictions on older, smaller funds (more than 20 years and less than $25,000) to be removed through notification of the Attorney General, rather than through the courts.

Under UMIFA, unless the gift instrument indicated otherwise or relevant law required, earnings were not classified explicitly as restricted assets for legal purposes. UPMIFA mandates that earnings, unless otherwise instructed by the gift instrument, be classified as donor restricted for legal purposes until they are appropriated for expenditure. Under UPMIFA and its Rules of Construction, donor intent extends not just to the original gift corpus, but to earnings on the related investments. Therefore, earnings are donor restricted in nature until such time as the board appropriates them to be used in advancing and fulfilling donor intent. Under FSP FAS 117-1, this results in earnings being reported as temporarily restricted net assets until appropriated. For organizations subject to UMIFA, Emerging Issues Task Force Topic No. D-49 (EITF D-49), *Classifying Net Appreciation on Investments of a Donor-Restricted Endowment Fund,* still applies. EITF D-49 states that earnings on such funds will be reflected as unrestricted net assets, unless otherwise donor restricted. This results in substantially different accounting and reporting outcomes based solely on the enactment status of the state in which the organization operates.

Organizations should also be aware that UPMIFA and FSP FAS 117-1 also present changes and additions accounting and disclosure requirements for funds and endowments as well as modifications to regulations for endowments that are considered underwater.

Summary

UPMIFA and FSP FAS 117-1 require organizations to account and report for donor-restricted and board designated endowments in ways that are substantially different from previous guidance. Boards, finance and accounting departments, and investment managers need to understand both their applicable legislative environment and the new accounting, reporting and disclosure requirements. Donor relationships grow when they are properly fed and nourished. This includes not only recognizing a donor's passion, desire and objectives in providing significant assets for use in your organization, but providing transparency and clarity in the reporting and disclosure of endowments.

Download our whitepaper *"There's a New Sheriff in Town: UPMIFA Drives Accounting and Reporting Changes for Endowments"* at www.rsmmcgladrey.com for a more detailed analysis of how this new regulation and the related accounting guidance may impact your organization.

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Third Quarter 2009

Printed in U.S.A.