Endowments 101 Workshop

Financial and Business Services

Agenda

- **Context for today's presentation**
- **What is an endowment?**
- **What are different kinds of endowments?**
- **Pool accounting**
- **Spending policy & distribution**
- **Regulatory issues**
- **Social Choice Pool**
- **Final thoughts**

What is an endowment?

- **An endowment is created when funds are invested for the purpose of creating present and future income – to be used for a particular purpose**
- **An endowment is perpetual**
- **University of Utah has ~1,400 endowments with a market value of ~$400M**

Historical Cost

- **Original gift (or investment in the case of quasi endowments)**
- **Plus:**
  - **Subsequent gifts adding to historical cost**
  - **Reinvested endowment distributions**
- **Less:**
  - **Withdrawals (ONLY in case of quasi endowments)**
- **Also known as "principal", "corpus", and "book value"**

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Types of Endowments

- **There are three types of endowments:**
  - **True**
  - **Term**
  - **Quasi**

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True Endowments

- ***True endowment funds*** **(also known as permanent endowment funds) are resources with respect to which a** donor has stipulated**, as a condition of the gift (also referred to as a nonexchange transaction), that the gift is to be maintained** inviolate and in perpetuity**. A true endowment is to be** invested for the purpose of producing present and future income **that may, also by donor stipulation, be expended or reinvested with the original gift. The principal or corpus of the true endowment must be maintained intact. Income that may be expended according to the donor's stipulation may be unrestricted or restricted as to the purpose for which it is expended, the time it may be expended, or both. Income that may not be expended but rather added to the principal or corpus in accordance with the donor's stipulation assumes, or takes on, the same restrictions as the original gift.**

Source: NACUBO Accounting Tutorial – Endowment Definitions

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True Endowments (cont'd)

- **A true endowment can only be created by donor stipulation**
- **Evidenced by a gift agreement or by bequest**
- **Invested in the unitized pool (although some older endowments may not be)**

True Endowments (cont'd)

•John Doe, an avid skier, wants to create an endowment to fund scholarships for talented skiers from Utah studying Geology (his late wife's profession). His gift of $50,000 is established as a true endowment.

Term Endowments

- ***Term endowment funds* are similar to true (permanent) endowments, except that,** upon the passage of a stated period (or time) or the occurrence of a particular event, all or part of the donation may be expended. **True and term endowments are collectively referred to as 'donor-restricted' transactions.**

Source: NACUBO Accounting Tutorial – Endowment Definitions

Term Endowments (cont'd)

- **Generally not as common as true and quasi endowments – we have 2**
- **Created by donor intent – evidenced by gift agreement or bequest**

Term Endowments (cont'd)

•John and Mary Wise want to support lab renovations that won't begin for five years. In the meantime, they want to support start-up packages for faculty who will use the new lab facilities. They create a term endowment. The income for five years supports the researchers and then the endowment is liquidated to provide funds for renovations.

Quasi Endowments

- ***Funds functioning as endowments* (often referred to a quasi-endowments) are** used to report resources that the governing board, rather than the donor, has determined are to be retained and managed like an endowment. **Principal and income of these funds may be utilized at the discretion of the governing board. Resources that the governing board sets aside to function as an endowment may be unrestricted or restricted as to the purpose or time of expenditure by an agent outside the institution.**

Source: NACUBO Accounting Tutorial – Endowment Definitions

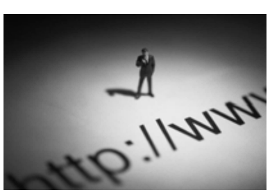
Quasi Endowments (cont'd)

- **Established by the University, not by specific donor intent**
- **Can be liquidated by the institution – in whole or in part**
- **Receive distributions like true and term endowments**
- **Invested in the pool with true and term endowments**

Quasi Endowments (cont'd)

•Elma Jones bequeaths $1M to the Museum of Natural History to support dinosaur research. The Museum creates an endowment from the bequest to fund present and future expeditions. The funds would be established as a quasi endowment.

Management Reports



•Let's take a tour of new information available online…

For Future Reference…

CAMPUS INFORMATION SYSTEM

- **Quarterly Endowments by Org**
  - **Reports Quarterly Endowment Market Value Changes**
  - **Includes Beginning Market Value, Gifts/Transfers, Market Adjustments, Accrual Distribution (4th Qtr only), Ending Market Value, Ending Book Value, and Cumulative Gains/Losses**
  - **Reports Quarterly Reconciliation from Management Reports to Market Value**
  - **Includes Total Assets, Market Value Adjustments, Accrual Distribution (4th Qtr only), and Ending Book Value**
  - **Includes Activity specific attributes**

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For Future Reference…

CAMPUS INFORMATION SYSTEM

- **Quarterly Endowments by Account Executive**
  - **Reports Quarterly Endowment Market Value Changes**
    - **Includes Beginning Market Value, Gifts/Transfers, Market Adjustments, Accrual Distribution (4th Qtr only), Ending Market Value, Ending Book Value, and Cumulative Gains/Losses**
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  - **Includes Activity specific attributes**

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Expendable Accounts

- **Expendable accounts receive income distribution**
  - **Generally matched 1:1 with the endowment**
    - **Although, a true and a quasi endowment can have the same expendable account if for the same purpose**
  - **Funds spent according to the donor's stipulated purpose in the gift agreement**

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Classification Issues

- Funds are received from multiple donors for a particular purpose – one of the larger donors agrees to invest the funds as an endowment
  - A single donor can't speak for the group – the solution would be to create a true endowment for his/her gift and a quasi endowment for the others
- A solicitation is sent to raise endowment funds to honor a faculty member who is retiring – unfortunately, only a small amount is raised
  - Best case – solicitation contains "out" language
  - Worst case – still have to create a true endowment

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Classification Issues (cont'd)

- Bequest is received, but language is not clear whether donor intended for an endowment to be created
  - Consult with University Counsel and Planned Giving Office – certain language (e.g. "fund") gives a clue and helps with classification
- Donor gives large gift. At a future time, the college approaches the donor about investing the funds in an endowment.
  - With a gift agreement documenting the intent, a true endowment can be established with the funds

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Classification Issues (cont'd)

- Donor provides a gift, but stipulates that department or college must provide matching funds
  - Both sources of funds can generally be combined to create a true endowment because there is a third party stipulation restricting internal funds – and it's documented in the gift agreement
- Same situation, but department voluntarily wishes to add to the endowment
  - Here we have two endowments – a true and a quasi

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Why is this important?

NET ASSETS		
Invested in capital assets, net of related debt	828,988	760,338
Restricted for		
Nonexpendable		
Instruction	99,041	92,889
Research	32,944	30,057
Public service	45,205	39,771
Academic support	31,550	29,580
Scholarships	91,010	78,711
Other	5,284	4,033
Expendable		
Instruction		5,768
Research	152,083	123,239
Public service	20,869	25,971
Academic support	52,130	41,651
Institutional support	38,979	29,528
Scholarships		5,765
Loans	35,976	37,048
Debt service	2,504	14,474
Capital additions	52,054	49,228
Other	4,134	6,193
Unrestricted	580,272	488,461
Total net assets	$2,073,023	$1,862,705

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Financial Report Issues

- **Net Asset classifications defined by the Governmental Accounting Standards Board (GASB) Statement No. 34**
- **Restricted Net Assets**
  - **Constraints externally imposed by creditors, grantors, contributors, or laws or regulations of other governments**
  - **Constraints imposed by law through constitutional provisions or enabling legislation**
  - **Reported as “expendable” and “nonexpendable”**

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Financial Report Issues (cont’d)

- **Restricted – Expendable**
  - **Includes market appreciation of all endowment types**
  - **Includes historical cost of quasi endowments established from restricted fund sources**
  - **Also includes other kinds of restricted funds such as gifts, endowment expendable accounts, etc.**
- **Restricted – Nonexpendable**
  - **Includes historical cost of true and term endowments**

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Pool Accounting

- **Gift funds are invested into the endowment pool once the gift agreement is executed**
  - **Investment strategy advised by the Investment Committee of the Board of Trustees and carried out by the Investments Office**
  - **Currently, market value of the pool ~$400M**
- **Endowment "buys" units of the pool**
  - **Number of units received equals investment divided by the pool unit market value**
  - **Number of units does not change over time unless new funds are added to the endowment**

Distribution

- **University spending policy**
  - **Quarterly distributions**
  - **4% annually of the 12 quarter rolling average pool unit market value**
  - **Includes both an income and market appreciation component**
  - **Objective for underlying investment is long term growth and to support the spending policy**

Distribution (cont'd)

- **Distributed funds go to expendable accounts to be used for the purpose defined in gift agreement**

Example

Unitized Pool Example

Endowment	Historical Cost	# of Units	Market Value	Income (Distribution)	Appreciation (Distribution)	Total (Distribution)
Fred & Ethel Mertz Scholarship	$25,000	1,000	$621,118	$3,882	$2,329	$6,211
Utahns for Red Rocks	$2,000,000	50,000	$31,055,901	$194,099	$116,460	$310,559
Skiers for Orthopedics	$5,000,000	100,000	$62,111,801	$388,199	$232,919	$621,118
Frank Sinatra Music Scholarship	$400,000	10,000	$6,211,180	$38,820	$23,292	$62,112
Pool	$7,425,000	161,000	$100,000,000	$625,000	$375,000	$1,000,000
Unit Market Value			$621	62.5%	37.5%	
Spending Policy (4%)				$1,000,000		

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See earlier definition

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1% of the 12 qtr rolling average unit market value per quarter

Example

"Plug" figure = total distribution - income

Unitized Pool Example - Simplified

# of units times pool unit market value

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Unitized Pool Example

# of units times pool unit market value

Amount added to expendable account

Endowment	Historical Cost	# of Units	Market Value	Income	Appreciat[illegible]n	Total
				Distribu[illegible]		
Fred & Ethel Mertz Scholarship	$25,000	1,000	$621,118	$3,882	$2,3[illegible]9	$6,211
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Cautionary notes…

- **In a rising market, the 12 quarter rolling average pool unit market value lags behind the unit market value for most recent quarter**
- **Why is this a problem?**

Example

- John Doe wants to fund a literary prize of $4,000 annually
- He is advised to give $100,000
- Why will there not be enough in the expendable account?

Example (cont'd)

Predicting Endowment Earnings

Gift	# Units	Pool Unit Market Value, Ending Quarter	Hypothetical Distribution	Pool Unit Market Value, 12 Qtr Rolling Average	Actual Per Policy	Difference
$100,000	465	$215	$4,000	$190	$3,535	($465)

Number of units = Gift/Pool Unit Market Value at most recent quarter end

Example (cont'd)

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Distribution is based on 12 quarter rolling average unit market value

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Example (cont'd)

Actual distribution will be less – resulting in a programmatic shortfall

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Example (cont'd)

So if the amount of the distribution is important in deciding the amount of the gift, call Endowment and Investment Accounting!

Actual distribution will be less – resulting in a programmatic shortfall

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Not all endowments are in the pool…

- **Separately Invested**
  - **By donor stipulation, some endowments have specific investment requirements**
    - **This, however, should not be encouraged**
- **Nonpooled Endowments**
  - **By college choice, certain endowments are not invested in the pool and instead receive monthly interest distributions**
    - **Here's an example of why this isn't the best choice**

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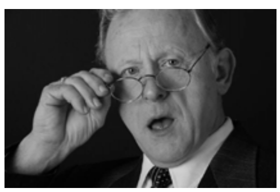
Pool vs. CID

- **History**
  - **Pool started in May 1991 – distribution was 5%**
  - **CID at the same time was paying 8%**
  - **Colleges were not forced to move existing endowments to the pool**
- **Now**
  - **CID paying 2% on endowments and 1.5% on expendable accounts**
  - **Pool paying 4% on endowments**



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Pool vs. CID (cont'd)

- **CID**
  - **Works like a savings account or certificate of deposit**
  - **Balance deposited never changes – no market appreciation (or depreciation)**
  - **Interest payout subject to market swings – short term fluctuations can have a significant impact**
  - **Spending power is eroded over time since there is no growth**
- **Pool**
  - **Endowments appreciate as the underlying investments appreciate**
  - **Distributions grow with the unit market value even if there are no additions to the original gift**
  - **Long term view better matches and endowment's perpetual aspects**
  - **Use of the rolling average smoothes short term market fluctuations and allows for more consistent budgeting**

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Pool vs. CID Example

XYZ Scholarship Endowment

Year End Date	Balance on Expendable	Balance on Endowment	Interest on Endowment	% on Endowment	% on Expendable	Expendable Interest	Total Cash Avail.
Jun-98	$92,211	$355,479	$20,581	5.8%	5.2%	$4,787	$25,367
Jun-99	$104,718	$355,479	$20,112	5.7%	5.0%	$5,195	$25,307
Jun-00	$117,141	$355,579	$20,664	5.8%	4.9%	$5,759	$26,423
Jun-01	$130,259	$355,579	$21,425	6.0%	5.1%	$6,693	$28,119
Jun-02	$109,280	$355,579	$13,143	3.7%	3.7%	$4,004	$17,147
Jun-03	$77,042	$355,666	$8,064	2.3%	2.0%	$1,572	$9,636
Jun-04	$54,820	$355,714	$4,522	1.3%	0.9%	$507	$5,028
Jun-05	$31,769	$355,764	$5,140	1.4%	1.0%	$309	$5,449
Jun-06	$17,550	$355,814	$7,116	2.0%	1.2%	$205	$7,321
Feb-07	$3,987	$383,892	$6,351	1.7%	2.2%	$86	$6,437

Note: Approximately July 2006, endowment was invested in the endowment pool. Expected distributions per policy are ~$12,700

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Pool vs. CID Example (cont'd)

XYZ Scholarship Endowment

	CID Scenario		Pool Scenario			
Year End Date	Endowment Balance	Interest on Endowment	Market Value of Endowment	Distributions on Endowment	Cumulative Growth (MV)	Difference in Earnings
Jun-91			$355,000			
Jun-98	$355,479	$20,581	$669,279	$23,967	88.5%	$3,386
Jun-99	$355,479	$20,112	$700,562	$26,710	97.3%	$6,598
Jun-00	$355,579	$20,664	$774,072	$28,989	118.0%	$8,325
Jun-01	$355,579	$21,425	$669,823	$32,522	88.7%	$11,097
Jun-02	$355,579	$13,143	$578,526	$27,644	63.0%	$14,501
Jun-03	$355,666	$8,064	$566,717	$26,017	59.6%	$17,953
Jun-04	$355,714	$4,522	$632,283	$26,111	78.1%	$21,589
Jun-05	$355,764	$5,140	$669,264	$23,605	88.5%	$18,465
Jun-06	$355,814	$7,116	$708,695	$23,767	99.6%	$16,651
Cumulative Earnings		$120,766		$239,331		$118,565

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Regulatory Issues

- **Uniform Management of Institutional Funds Act (UMIFA)**
  - **First promulgated in 1972 and adopted by 46 states including Utah**
  - **Provided concept of historic dollar value held inviolate and in perpetuity**
  - **Market downturn in 2000+ created challenges and uncertainties for endowments that had historical cost greater than their market value**

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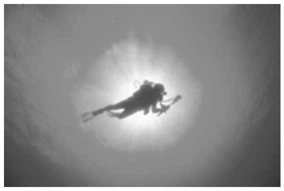
Regulatory Issues (cont'd)

–New terminology at the time – "underwater endowments"

- •Because distributions include both income and market appreciation components, most colleges and universities chose to distribute only income on underwater endowments
  - –Decreased distribution by about half for these endowments
  - –Made planning and budgeting difficult



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Regulatory Issues (cont'd)

- Uniform Prudent Management of Institutional Funds Act (UPMIFA)
  - – Approved by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in July 2006
  - – Adopted by six states so far: UT, IN, SD, ID, MT, and NE
  - – Effective in Utah April 30, 2007
  - – Effective for the University of Utah with the June 30 distribution

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UPMIFA

- Major provisions
  - – Portfolio managers are not limited in the kinds of assets that may be sought for the portfolio (a more flexible rule than UMIFA)
  - – Investment expenses must be managed prudently in relationship to the assets, the purposes of the institution and the skills available to the institution (not addressed in UMIFA)
  - – Total return expenditure is expressly authorized under comprehensive prudence standards relating to the whole economic situation of the charitable institution (UMIFA does not address this standard)

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UPMIFA (cont'd)

- 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)
- 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)

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UPMIFA (cont'd)

- UPMIFA applies to funds held in any form, including nonprofit corporate form, except charitable trusts, with a commercial or individual trustee (UMIFA applies only to endowments held by a charitable institution for its own account)

Source: NACUBO, www.nacubo.org

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UPMIFA (cont'd)

- Changes for the University of Utah
  - Underwater endowments will receive full distribution – only 11 underwater at end of March
  - Financial reporting issues are still murky, but won't result in changes this fiscal year
- What won't change
  - Spending policy is not expected to change
- UPMIFA does not apply to quasi endowments

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Social Choice Pool

- **Created to facilitate donors' interests in socially responsible investing**
- **…but there are important differences between it and the Endowment Pool**

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Social Choice Pool vs. Endowment Pool

	Endowment Pool	Social Choice Pool
Year established	May 1991	October 2007
Unitized	Yes	Yes
Gift agreement required	Yes	Yes
Addendum required	No	Yes
Distribution policy	4% of 12 Qtr rolling average unit market value	Actual income earned
Spending rule	Total return	Income
Distribution frequency	Quarterly	Quarterly
Includes quasi endowments	Yes	No
Minimum gift	$25,000 ($50,000 for quasi endowments)	$25,000
New endowments enter the pool…	Next quarter opening	Next quarter opening
Investment strategy	Diversified investment portfolio	60% Social Choice Fund and 40% Bond Fund (both through TIAA-CREF)

Final Thoughts

- **Endowments, like diamonds, are forever**
  - **Expendable accounts can only be spent on the stipulated purpose**
    - **What happens if a program goes away? Funds can't be spent and unspent funds do not benefit the University in any way**
    - **How can flexibility be built in for the long term and still meet the donor's objectives?**
      - **Balancing number and extent of restrictions with ability to spend funds**
      - **Including alternate purposes – if funds can't be spent on primary purpose, then what other purpose might the donor support?**

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Final Thoughts (cont'd)

- Growth for the long term is the objective – short term market fluctuations shouldn't affect participation in the pool
- Conditions that require special handling for an endowment increase administrative costs and increase the likelihood that something will be overlooked
  - Example: reinvestment up to a specific dollar amount
- University has to decide whether an endowment's conditions are too restrictive (or illegal) for it to accept
  - This is where Counsel's Office and Planned Giving provide expertise
- All endowments have a story to tell – and they are an important part of the institution's history

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Resources

- Jeff Paoletti, Central Development 581-3726
  - Questions regarding potential gift agreements
- Dave Heaps, Endowment and Investment Accounting 581-5054
  - Questions regarding spending policy, distribution, endowment administration
- Steve Allen, General Accounting 581-8826
  - Questions regarding expendable accounts and restrictions
- Theresa Ashman, Controller 581-5077

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Feedback

- Please share any comments or feedback on this session
- Please share your thoughts on ways we can address your concerns about quasi's
- Please share your thoughts on ways endowment policy could be improved

- Thank you!

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