Endowments – Understanding the Definition and the Accounting Issues

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Objectives

- Understanding what an endowment is
  - Legal understanding
  - Accounting understanding
- Fiduciary duties with respect to these funds and the related accounting implications –
  - Duties associated with managing endowments
  - Endowment agreements
  - Investing
  - Disbursement policy
  - Accounting implications under current and proposed standards

What is an endowment? A legal perspective

- Distinguishing restricted gifts from unrestricted gifts
  - What is the nature of an unrestricted gift?
  - What is the nature of a restricted gift?
- Different types of restricted gifts
  - Restricted charitable purpose trusts
    - long term gifts, including endowments
    - restricted use gifts
    - restricted charitable trust property
    - implied special purpose charitable trust funds
  - Conditional gifts
  - Precatory trusts and donor advised funds

Specific issues concerning endowed funds

- Confusing terminology
- What does "endowment" really mean
- Ability to encroach on capital
- Description of restricted use of income
- Can a charity vary terms of an endowment?
- Minimum contribution thresholds
- Ability to deduct administrative expenses
- Income and capital vs. total return
- Investment power
- Disbursement policy and reinvestment of income

What is an endowment? An accounting perspective

- CICA HB 4410 and PS 4210 - definitions of contributions - including unrestricted, restricted and endowments
- Revenue vs. liability vs. equity
- Trust arrangement or not?
- Types of endowments and differences
  - Externally restricted endowment - income restricted
  - Externally restricted endowment - income unrestricted
  - Internally restricted endowment of restricted funds
  - Internally restricted endowment of unrestricted funds

Legal practical considerations concerning endowed funds

1. Managing existing endowments
   - Locate original restricted gift documentation
   - Determine compliance with applicable restrictions (seek legal advice where there has been non-compliance)
   - Inform board of directors concerning the terms of the restricted gifts
2. Managing new endowments
   - Conduct initial review of gift documentation to determine applicable restrictions
   - Ensuring the ability of the organization to comply with the restrictions
   - Ensure proper deposit of restricted gifts with the correct recipient

Legal practical considerations concerning endowed funds (continued)

3. Commingling
   - Common law rule prohibiting commingling
   - Understanding what the *"Charities Accounting Act"* (Ontario) permits concerning commingling
4. Investing
   - Identify the applicable investment power
   - Co-ordinate with investment policy of the organization
5. Governance issues
   - Board needs to maintain active involvement
   - Board members need to be aware of personal exposure to liability
   - An applicable board committee should have oversight over management of endowments and other restricted funds

Endowment Agreements

- Capital to be held in trust in perpetuity
- Assets forming the trust
- Restricted purpose for income
- Future contributions
- Incorporation by reference of investment policy
- Incorporation by reference of disbursement policy
- Naming rights option
- Donor advised option
- Ability to charge administration fee
- Granting the charity the ability to vary terms of the trust
- Ability to transfer endowment funds
- Reporting responsibilities to donors

Practical considerations for investment policy

1. Determine which investment power applies
   - Look at letters patent or supplementary letters patent (if the letters patent are silent, then by default, *Trustees Act* applies)
2. Requirements for a general investment policy
   - General investment policy needs to reflect the requirement of the organization under the *Trustees Act* as opposed to what a financial institution may propose
   - Need to explain the applicable law concerning investing charitable property as a reference point for board and committee members (i.e. prudent investor standard; ability to invest in mutual funds; seven mandatory investment criteria; need to diversify; commingling requirements)
   - Since each fund will require a different investment approach, there will need to be specific investment plans for each fund that builds on the general investment policy

Practical considerations for investment policy (continued)

3. Requirements for delegation of investment decision making
   - Requires an Agency Agreement under the *Trustees Act*
   - Requires an investment policy in order to reference investment requirements under the *Trustees Act*
   - Choice of investment manager needs to be carefully considered and monitored "with prudence"
   - Investment manager remains responsible for funds invested - ∴ policy needs to require the manager to indemnify the charity
4. Role of finance/investment committee
   - Oversee investments
   - Role can reflect: advise the board on investment decision making; undertake investment decision making on behalf of board; monitor the role of the investment manager (when it has been delegated)
   - Provide regular reports to the full board (because of liability to all)

Practical considerations for a disbursement policy

- If the amount available for disbursement is not clearly articulated in a policy then the trust law definition of income and capital will prevail (interest & dividends = income) – (capital gains & losses = capital)
- Common practice to establish disbursement policies based on a total return approach, i.e. gains and losses become part of income
- Income available for disbursement must factor in 3.5% disbursement quota
- Need to capitalize income in order to keep up with inflation
- Where disbursement is to another charity may need to make it a "designated gift" under the *Income Tax Act*

Accounting for original contribution

Accounting Treatments		
Type of endowments	**PSAS (PS 1201,3100,3200 and PSG – 4)**	**PSAS+4200 (PS 4210) – focus on deferral method only**
Externally restricted endowment – income restricted	Revenue (inconsistency in application of this nationally)	Direct increase to net assets
Externally restricted endowment – income unrestricted	Revenue (inconsistency in application of this nationally)	Direct increase to net assets
Internally restricted endowment of restricted funds	Deferred contribution (not addressed in PSAS)	Deferred contribution – then transfer to endowments through net assets
Internally restricted endowment of unrestricted funds	Revenue	Revenue then transfer from unrestricted to internally restricted net assets

Accounting for income (based on trust law definition of income)- PSAS

Accounting Treatment			
Endowment fund classification	**Interest/ Dividend Income**	**Unrealized gains/losses**	**Realized gains/losses**
Externally restricted endowment – income restricted	Deferred contributions	Statement of remeasurement gains and losses (inconsistency in application)	Revenue (inconsistency in application)
Externally restricted endowment – income unrestricted	Revenue	Statement of remeasurement gains and losses (inconsistency in application)	Revenue (inconsistency in application)
Internally restricted endowment of restricted funds	Deferred contributions	Deferred contributions	Deferred contributions
Internally restricted endowment of unrestricted funds	Revenue	Statement of remeasurement gains and losses	Revenue

Accounting for income (based on trust law definition of income) – PSAS + 4210

Accounting Treatment – deferral method			
Endowment fund classification	**Interest/ Dividend Income**	**Unrealized gains/losses**	**Realized gains/losses**
Externally restricted endowment – income restricted	Deferred contributions	Direct increase to net assets losses (inconsistency in application)	Direct increase to net assets losses (inconsistency in application)
Externally restricted endowment – income unrestricted	Revenue	Direct increase to net assets losses (inconsistency in application)	Direct increase to net assets losses (inconsistency in application)
Internally restricted endowment of restricted funds	Deferred contributions	Deferred contributions	Deferred contributions
Internally restricted endowment of unrestricted funds	Revenue	Statement of remeasurement gains and losses	Revenue

Current standards vs. proposed standards – PSAS

Current standards	Proposed standards

• There is no standalone section for revenue or contributions
• PS1201 – *Financial statement presentation*
• PS3100 – *Restricted assets and revenues*
• PSG – 4 –*Funds and reserves*
• Three options:
  • Trust arrangement
  • Liability
  • Revenue
• Different practices amongst jurisdictions across Canada
	► Endowments are recognized as revenue if it does not meet the definition of a liability
	► No discussion in new proposed standards to have endowments being a direct increase to fund balances

Current standards vs. proposed standards – PSAS + 4200 series

Current standards	Proposed standards
► There are currently two methods to account for endowments – the restricted fund method and the deferral method ► PS 4210 - *Contributions*	► There will be a one method to account for endowments ► Endowments are recognized as revenue if it does not meet the definition of a liability ► The Boards believe that the requirement to retain the principal amount of a contribution permanently is not a condition that creates a liability. While the NFPO is restricted in its ability to dispose of the principal, it controls the asset and is under no obligation to return the endowment to the contributor

Summary

- Endowments are complex
- Understand the donors' intentions and expectations
- Understand your fiduciary responsibility in accepting these contributions
- Ongoing management and record keeping is necessary
- Proposed changes may have significant implications to your statements

Questions ?