

Accounting for Endowment Funds Held at Community Foundations

A Guide for Non Profit Entities and Community Foundations

Introduction

Nonprofits place their endowment funds with community foundations for a variety of reasons, including investment expertise, efficiencies, and access to planned giving advice and services. As nonprofit entities seek to place their assets and partner with the Foundation, questions arise as to the appropriate accounting for this relationship.

The purpose of this document is to provide nonprofits with a possible solution for accounting for their interest in the endowment funds placed with community foundations. As is always the case, each nonprofit entity should consult with its own auditors in determining the best solution for its needs. It should be noted that this paper speaks only to the accounting for endowment funds created at a community foundation by a nonprofit entity with its own endowment dollars. Donor designated funds held by a community foundation, which come directly to the community foundation from a donor and not through the nonprofit, are not covered.

Existing Guidance

In June 1999, The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others (FAS 136)*. This has now been codified within FASB ASC 958-605 principally in sections 15 and 25. FASB ASC 958-605-55-110 provides guidance for accounting in the case where a “resource provider” (nonprofit entity) transfers assets to a community foundation, but specifies itself or its affiliate as the beneficiary of the assets. The transaction is deemed to be reciprocal because at the time of the transfer, the nonprofit entity expects to receive future distributions because it specifies itself as a beneficiary, and by acceptance of the transfer, the community foundation agrees to make distributions to the nonprofit entity. Because the transaction is deemed to be reciprocal, the nonprofit entity should recognize an asset and the community foundation should recognize a liability. The nonprofit is transferring its asset to the community foundation in exchange for future distributions. The community foundation, by its acceptance of the transfer, agrees that at the time of the transfer distributions to the nonprofit are capable of fulfillment and consistent with the foundation’s mission.

Accounting Entries for the Nonprofit Entity

Example #10 in FASB ASC 958-605-55 paragraphs 106-110 demonstrates that upon the transfer of assets to a community foundation, the nonprofit entity would recognize an asset on its books as a beneficial interest in assets held by the community foundation. Therefore, the following entry would be made upon transfer:

Creation of the Fund

Dr. Beneficial Interest in Assets Held by Community Foundation
Cr. Cash

(Assets and net assets are measured at present value based on the expected future cash flows to the nonprofit [generally measured by the fair value of assets transferred to the community foundation, unless facts and circumstances indicate that the fair value of the assets transferred to the community foundation differs from the present value of the expected future cash flows.]

Source of Nonprofit Funds:

If the net assets transferred are from the nonprofit's operating surplus (Unrestricted Net Assets), then the net assets will need to be transferred to Permanently Restricted Net Assets on the nonprofit's books. The nonprofit would show a reclassification of net assets from Unrestricted to Permanently Restricted on the Statement of Activities. If the agreement between the nonprofit and the community foundation provides for the return of its interest at the request of the nonprofit no reclassification would be required.

If the net assets transferred are derived from donor-restricted endowment funds contributed to the nonprofit, the nonprofit should first ensure that the transfer of the net assets will not violate the agreement between the nonprofit and the donor. If the transfer will not violate such agreement and the net assets are already classified as permanently restricted on the nonprofit's books, then no reclassification of net assets will be necessary. If the net assets are classified as temporarily restricted on the nonprofit's books, they should be reclassified as permanently restricted.

Less guidance is given on the proper treatment of changes in value of and distributions from the assets held at the community foundation to the nonprofit throughout the life of the fund agreement.

The nonprofit's interest in the endowment fund at the community foundation is similar in nature to an interest in a perpetual trust in that the nonprofit entity has an interest in a future income stream from the trust. As with a perpetual trust, the nonprofit entity generally does not have access to the principal value of the assets held in the community foundation endowment fund under the terms of the fund agreement.

Based on the premise that a nonprofit endowment fund is like a perpetual trust, the following accounting entries would be made throughout the life of the fund to account for the changes in value and distributions from the assets held at the community foundation:

Income Payments During the Period

As the community foundation makes distributions of income back to the nonprofit organization, the following entries are made on the nonprofit's books.

Dr. Cash
 Cr. Investment Income (Unrestricted)

(Distribution received from assets held at community foundation)

Periodic Valuation

Changes in value of the endowment fund at the community foundation would be captured on the nonprofit's books as follows:

Dr. Beneficial Interest in assets held at Community Foundation
Cr. Gain or Loss (Permanently Restricted)

(To adjust for changes in present value of expected cash flows – debit and credit could be reversed.)

Accounting Entries for the Community Foundation

The community foundation will record a liability on receipt of the cash from the nonprofit entity as follows:

Dr. Cash
Cr. Agency Endowment (A liability account)

All future adjustments resulting from income, expense or distributions to the nonprofit entity will be recorded in this liability account with no impact on the statement of activities of the community foundation.

Presentation and Disclosure by the Nonprofit Entity

As shown above in the Accounting Entries, the nonprofit would show an asset on its balance sheet equal to the interest in the fund held at the community foundation. Because in most cases the fund agreement limits the nonprofit's access to the endowment assets at the community foundation, the net assets related to the interest in the fund would be classified as permanently restricted. In circumstances where the fund is returnable to the nonprofit, the creation of the fund would not result in any change in the classification of related net assets.

In addition, as provided at FASB ASC 958-605-50-6, the nonprofit should disclose the following in its financial statements:

1. The identity of the community foundation,
2. Whether variance power was granted to the community foundation and, if so, a description of the terms of the variance power,
3. The terms under which the community foundation will distribute amounts to the nonprofit, and
4. The aggregate amount reported in the statement of financial position and how that amount is described.

The question arises as to whether or not the nonprofit entity should include assets held at a community foundation as part of its endowment assets disclosed in accordance with FASB ASC 958-205-45 paragraphs 13 – 31. (The former FSP FAS 117-1) An endowment fund is defined in the Accounting Standards Codification as “an established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit entity (NFP).” Funds held at a community foundation are usually held to provide income for the maintenance of the nonprofit, however the disclosure required of endowment investment and spending policies would not generally be relevant as the nonprofit entity does not control these policies, accordingly it would

seem to be acceptable to present only the disclosure required as noted above. Nevertheless, the nonprofit entity should consider the disclosure it would provide for its own endowment assets when describing the terms under which the community foundation will distribute amounts to the nonprofit. If it has other endowment assets it would make sense to include disclosure about community foundation funds in the same note, or at least in close proximity. An example disclosure is as follows:

The Organization has transferred assets to the XX Community Foundation (the “Foundation”) which is holding them as an endowed component fund (“Fund”) for the benefit of the Organization. The Organization has granted the Foundation variance power which gives the Foundation’s Board of Trustees the power to use the Fund for other purposes in certain circumstances. The Fund is subject to the Foundation’s investment and spending policies which currently result in a distribution to the Organization of 5 percent of the average quarterly value over the previous 12 quarters . The Organization reports the fair value of the Fund as Beneficial Interest in Assets Held at the XX Community Foundation in the statement of financial position and reports distributions received as investment income. Changes in the value of the Fund are reported as gains or losses in the statement of activities. Changes in the Fund for the year ended June 30, XX10 are as follows:

Balance at July 1, XX09	\$ 500,452
Additional amounts invested in Fund	50,000
Share of appreciation of fund	10,000
Distributions received	<u>(25,000)</u>
Balance at June 30, XX10	<u>\$ 535,452</u>

Some nonprofit entities have asked whether or not funds held at a community foundation would be subject to UPMIFA. UPMIFA defines an endowment as “an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis.” (UPMIFA, section 2 (2)) The question of whether or not a specific fund meets the UPMIFA definition of an endowment is a legal question that needs to take into account the applicable state law and is beyond the scope of this paper. It would seem difficult, however, to conclude that a fund that has been transferred to a community foundation would remain an institutional fund of the nonprofit unless the nonprofit retained the right to demand that the fund be returned in its entirety to the nonprofit.

As the interest in assets held at the community foundation is carried at fair value, the nonprofit entity also needs to include information in its fair value disclosure in accordance with FASB ASC 820, *Fair Value Measurements and Disclosures*.

FASB ASC 820 requires fair value to be determined using appropriate inputs. The nonprofit does not have a direct interest in the underlying assets so the inputs it considers in determining fair value are related to the value of its right to receive future distributions from the community foundation. GAAP permits, as a practical expedient, use of the net asset value of the underlying

interest provided that value is calculated consistent with the measurement principles used by investment companies. (FASB ASC 820-10-35-59) As community foundations usually carry all their investments at fair value that value will likely be consistent with the measurement principles used by investment companies. GAAP further addresses the categorization of this type of investment at FASB ASC 820-10-35-58 *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*:

“Classification within the fair value hierarchy of a fair value measurement of an investment within the scope of paragraphs 820-10-15-4 through 15-5 that is measured at net asset value per share (or its equivalent, for example member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed) requires judgment, considering the following:

- a. If a reporting entity has the ability to redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date, the fair value measurement of the investment shall be categorized as a Level 2 fair value measurement.
- b. If a reporting entity will never have the ability to redeem its investment with the investee at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a Level 3 fair value measurement.
- c. If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity shall consider the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment shall be categorized as a Level 2 or a Level 3 fair value measurement. For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a Level 3 fair value measurement.”

An interest in assets held by a community foundation is analogous to an ownership interest in which a proportionate share of net assets is attributed and the nonprofit entity does not usually have the ability to redeem its investment. In situations where it may be able to request a return of net assets the nonprofit entity would need to consider how soon it might be redeemable as noted in sub-paragraph c. In the more usual situation where the nonprofit has given its funds to the community foundation as a completed gift with variance power and the nonprofit will never be able to redeem its investment, Level 3 is likely to be the correct category for fair value disclosure. This categorization brings with it other requirements detailed in FASB ASC 820-10-50. The following example provides the required disclosure likely to pertain for most nonprofit entities. Fair value disclosure of other assets or liabilities carried at fair value would also need to be disclosed.

The following is a summary of assets held at fair value:
At June 30, XX10:

Description	Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Beneficial Interest in Assets Held at the XX Community Foundation	\$ 535,452	\$ -	\$ -	\$ 535,452

At June 30, XX09:

Description	Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Beneficial Interest in Assets Held at the XX Community Foundation	\$ 500,452	\$ -	\$ -	\$ 500,452

The beneficial interest in assets held at the XX Community Foundation has been valued, as a practical expedient, at the fair value of the Organization's share of the Foundation's investment pool as of the measurement date. The Foundation values securities and other financial instruments on a fair value basis of accounting. The estimated fair values of certain investments of the Foundation, which includes private placements and other securities for which prices are not readily available, are determined by the management of the Foundation and may not reflect amounts that could be realized upon immediate sale, nor amounts that ultimately may be realized. Accordingly, the estimated fair values may differ significantly from the values that would have been used had a ready market existed for these investments. The Foundation's investments are composed approximately of 35 percent domestic equities, 30 percent foreign stocks, 25 percent bonds and 10 percent alternative investments including hedge funds, real estate and private equity funds. The beneficial interest in assets held at the XX Community Foundation is not redeemable by the Organization as described in note X.

Financial instruments classified as Level 3 in the fair value hierarchy represent the Organization's investments in financial instruments in which management has used at least one significant unobservable input in the valuation model. The following table represents a reconciliation of the activities for Level 3 financial instruments:

Balance at July 1, XX08	\$ 555,000
Additional amounts invested in fund	10,000
Share of depreciation of fund	(39,548)
Distributions received	<u>(25,000)</u>
Balance at July 1, XX09	500,452
Additional amounts invested in fund	50,000
Share of appreciation of fund	10,000
Distributions received	<u>(25,000)</u>
Balance at June 30, XX10	\$ <u>535,452</u>

The components of the net return (loss) on investments, including Level 3 investments, as reported in the accompanying consolidated statements of activities are as follows for the years ended June 30, XX10 and XX09:

	XX09	XX08
Investment income	\$25,000	\$25,000
Gains (losses) on beneficial interest in assets held at XX Community Foundation, net of investment income recorded	(15,000)	(64,548)
	<u>\$10,000</u>	<u>\$(39,548)</u>

Presentation and Disclosure by the Community Foundation

The Community Foundation will include the related assets in its fair value disclosure and will separately identify agency funds as a liability in its financial statements. Information as to the arrangements under which agency funds are held will need to be disclosed, if material, similar to the disclosure provided by the nonprofit entity.