Colleges and universities are becoming increasingly dependent on their endowed resources to fund their strategic endeavors, as well as institutional scholarships. With discount rates rising, operating margins plunging, and a decreased appetite for borrowing, effective management of investments is a critical component in achieving the college or university’s goals and mission.

At the same time, investment vehicles have become increasingly complex over the years, making it more difficult for all but the most sophisticated investor to make informed investment decisions.

But, what should your college or university be doing to protect your endowed investments?

1. **Make sure that your investment policy is current.** In September of 2010, the New York Prudent Management of Institutional Funds Act (NYPMIFA) became effective and established rules of conduct for managing institutional funds, appropriating funds, and also set standards for delegating management and investment functions to outside agents. If your investment policy has not been updated since 2010, then you are probably not meeting your legal or fiduciary responsibilities.

2. **Ensure that roles and responsibilities for managing investments are well-defined.** Who is responsible for determining asset allocation guidelines, hiring investment managers, investment trading and rebalancing, and reviewing valuations? Some of these things should be outlined in your by-laws and in your investment policy, but you will need to document more detailed processes and procedures to augment your investment policy.

3. **If you outsource your Chief Investment Officer (CIO) function to an independent advisor, ensure that you are performing appropriate Board oversight of the advisor.** Do you evaluate the performance of your advisor on a regular basis? Are you sure that the fees you are paying to your advisor are reasonable? Is a formal Request for Proposal in order?

4. **Review your spending policy on a regular basis to ensure that it is reasonable relative to your risk profile, your expected rate of return, and the rate of inflation.** Be mindful of the fact that NYPMIFA establishes a safe harbor of 7% of a 5-year rolling average market value as the threshold for prudent spending. Spending in excess of this threshold requires robust discussion and documentation by the board to support prudency.
5. Document board appropriations of your endowment spending on an annual basis, even if these appropriations are made in accordance with your spending policy as part of the normal budget process. This formal board appropriation is required by NYPMIFA and will become increasingly important if the Not for Profit Advisory Committee’s proposed changes to the not for profit reporting structure come to fruition. Does your organization have a policy of spending on underwater funds? If so, it is important that this is documented.

6. Ensure that the minutes of your investment committee are sufficiently robust. Based on my personal experience as an auditor, I believe that investment committee minutes are generally too sparse. It is especially important that you document the due diligence of fund managers, valuation assessments, and spending decisions, along with decisions on asset allocations, fund performance, and any changes in advisors or fund managers. Maintaining resumes of investment committee members is also good practice.

7. Perform due diligence on fund managers throughout the year. Set up a schedule for performing due diligence. Fund managers should report to the investment committee on a regular basis, whether by telephone or face-to-face. This is particularly important when you are dealing with alternative investments, such as hedge funds or private equity. Even if you work with an outsourced CIO, periodic meetings with fund managers and equity partners is considered a best practice. Again, these discussions should be documented in the investment committee minutes.

8. Formally approve valuations. Management is ultimately responsible for making fair value measurements, selecting appropriate valuation techniques, and identifying and supporting any assumptions used in determining fair value. Given the complexities of some of today’s investment vehicles, this is no small task. Management cannot outsource this responsibility. It is critical that management and the investment committee have a thorough understanding of how their investments are valued and who is performing the valuation.

9. Obtain “SOC 1 Reports on the Controls of a User Organization” when they are available. Although fund managers don’t typically have a SOC 1 audit performed, custodians and record-keepers, who perform the valuation work, may have them and these reports are an excellent way to ensure that the third parties that you work with have appropriate internal controls in place. Ask for the SOC 1 reports and then document that you have reviewed them.

10. Challenge your investment advisors and your fund managers. Ask questions and document their responses. This is particularly important when your investments lack transparency, which is often the case with hedge funds, certain real estate, and private equity investments. In order to do this, it is essential that the sophistication of your investment committee and your management group is aligned with the sophistication of your portfolio.

11. Finally—Document, document, document! Ensure that your written records adequately reflect the good work that you are doing in managing your college or university’s precious assets.

Jean Close is the Partner that oversees Bonadio’s higher education practice, bringing over 35 years of professional experience. Jean specializes in financial audit services, not-for-profit tax and regulatory compliance, consulting, benchmarking, and assistance with financing.
What Your Tax-Exempt Organization Needs to Know About Schedule K-1

by Heather J. Leggiero

College and universities invest their endowment funds in various vehicles to generate income and to obtain a total asset value which will yield an inflation-adjusted principal amount. Some of these investment vehicles, typically those investments in limited partnerships, may generate a Schedule K-1. What does your organization need to know about the Schedule K-1 and how it will affect your federal filing requirements?

Most colleges and universities are required to file the Form 990 with the IRS every year. In addition, if the college or university generates unrelated business income (UBI) it is also required to file a Form 990-T. Some states require a separate filing to report UBI. What organizations may not know is that the Schedule K-1 includes information about your investments in foreign companies that may trigger additional tax filings.

What should your organization look for on the Schedule K-1 to properly report UBI?

1. Make sure the organization is properly reported as a tax-exempt organization in Box 1. This will ensure that the reporting organization knows that the owner is tax-exempt and that UBI is properly reported.

2. Box 20, Code V reports UBI. This amount is usually disclosed in a footnote or in a supplemental schedule, so it is necessary to look through the entire K-1. This amount should be reported on the Form 990-T.

3. Supplemental schedules and footnotes to the Schedule K-1 are very informative. Take the time to read through these pages. Items of importance relative to UBI include: the amount and detail of the UBI, Foreign Tax Credits that may be claimed to offset unrelated business income tax, if any, and state income tax information.

4. State UBI tax obligations may arise from unrelated business income generated in various states. Each state is different and threshold amounts may apply before income is subject to state tax or filing requirements. The K-1 footnotes or supplemental schedules will disclose income earned, (as well as UBI earned), in each state.

What other items should I review on the Schedule K-1?

1. Foreign investments can lead to additional filing requirements. If your college or university holds foreign investments, Schedule F of the 990 should be prepared and the questions on page 4 of Schedule F should be answered. Other forms that may be required to be filed include: Form 8621, Form 8865, Form 5471, and Form 926.

2. As an owner in a partnership, the college or university is treated as a direct owner of the investments of the partnership. Form 8621 is an informational form that reports ownership and contributions to a foreign corporation. Form 8865 is an informational form that reports ownership in and contributions to a foreign partnership. Ownership and contribution minimums apply; therefore it is important to make sure that there is a filing requirement even though the partnership invests in these foreign entities.

3. Form 5471 is an informational form for US residents, including tax-exempt organizations that are officers, directors or shareholders in certain foreign corporations. Again, many exceptions and thresholds apply.

4. Form 926 reports certain transfers to a foreign corporation. Typically transfers of $100,000 or more in the aggregate or at least 10% of voting power or value of the stock will trigger a filing requirement.

5. Lastly, some partnerships may have to report certain transactions that are deemed “Reportable Transactions” on the K-1. These transactions must be disclosed on Form 8886, Reportable Transaction Disclosure Statement.

6. As with any filing requirement, it is prudent to contact your tax advisor.

As illustrated above, owning a partnership that reports its income on a Schedule K-1 may subject the investor to several additional filing requirements. Reviewing the entire Schedule K-1, its footnotes, and the supplemental schedule is vital to ensure compliance with these requirements.

Heather is a partner in The Bonadio Group’s Tax Division and heads the Tax Division operations in the Albany Office. She also heads up tax services for The Bonadio Group’s tax-exempt services.
Current Events: Proposed Accounting Standards Update—Presentation of Financial Statements of Not-for-Profit Entities

On April 22, 2015, the Financial Accounting Standards Board (FASB) issued a proposed accounting standards update (ASU) that will dramatically impact the financial reporting for not-for-profit (NFP) entities. The proposed update aims to improve information that is presented in a NFP entity’s financial statements to provide better information to the financial statement users and to reduce complexities and inconsistencies in NFP financial statements. These changes focus on net asset classification, liquidity, financial performance, and cash flows. The key changes set forth in the proposed ASU include:

• Elimination of the existing three net asset classifications: unrestricted, temporarily restricted and permanently restricted. The ASU requires two new net asset classifications: without donor restrictions and with donor restrictions.

• The distinction between operating and non-operating activities

• Standardization in the presentation of operating expenses, by function and by nature

• Revision in the methodology for presenting cash flows from the indirect method to the direct method. The amendments in the proposed ASU would change several sections of the existing code, specifically in FASB Accounting Standards Codification (ASC) 958 (Not-for-Profit Entities) and ASC 954 (Health Care Entities).

Net Asset Classification Changes

The three categories of net asset classification currently prescribed by generally accepted accounting principles (GAAP) will be eliminated. This is a result of the reduced relevancy of the term “permanently restricted” post-NYMPIFA, the general lack of transparency in accounting for certain temporary restrictions, and the increased focus on board designations within unrestricted net assets.

The proposed ASU will require two net asset classifications, “without donor restrictions” and “with donor restrictions.”

A new disclosure requirement is added for net assets without donor restriction that have self-imposed limitations (board-designated).

Liquidity and Availability

By adding additional disclosures about a NFP’s liquidity, FASB hopes to increase the transparency and usefulness of the financial statements and to decrease misunderstandings and confusion about a NFP’s liquidity. The proposed ASU will require the NFP to define the time horizon upon which liquidity is measured, and will require that certain quantitative and qualitative information be disclosed.

Underwater endowment funds will also be affected by the proposed ASU. These underwater funds are currently reported in the unrestricted category. Under this proposal, the funds would be classified in the “with donor restrictions” category. In addition to the current requirement to disclose the aggregate amount of underwater funds, NFPs will also be required to disclose the aggregate amount of original gifts required by donor or law for these underwater funds, the fair value of underwater funds, and the NFP’s policies regarding the spending of these funds while underwater.

Operating Measures

Outside of the healthcare industry, there is currently no clearly defined “performance indicator” for NFPs. The proposed ASU would require intermediate measures of operational performance, based on the source and use of the funds. Amounts will be included in operating activities if they are mission-based (derived from, or used for, the NFP’s mission), and available (resources are available for current period activities). Any operational activities that do not meet these definitions will be classified as non-operating in the statement of activities.

The new presentation of the statement of activities introduces the concept of “transfers.” Transfers result from internal decisions to designate or undesignate funds. Details of each transfer in and out should be disclosed in the notes, if not shown in the statement of activities. A separate transfer section will be included in the operating section of the statement of activities, and subtotals for operating income before transfers and operating income after transfers, will be required.
Current Events: Proposed Accounting Standards Update—Presentation of Financial Statements of Not-for-Profit Entities (cont.)

Reporting of Expenses

The proposed ASU requires expenses to be reported both by natural and functional classification, in one place in the financial statements. This can be in the statement of activities, in a separate statement, or contained in the notes to the financial statements. A disclosure of the NFP’s cost allocation methods, if used, will also be required.

Cash Flow Statement

Another significant change to the financial statements is in the statement of cash flows. The proposed ASU would require the use of the direct method for presenting operating cash flows, versus the indirect method currently in use. The purpose of the change is to more closely align cash activities with the information presented on the statement of activities, in an effort to increase utilization of this statement. Certain items will also be re-categorized within the statement itself, including capital asset activity (purchases, sale proceeds, and contributions restricted for capital purchases), which would move from investing cash flows to operating cash flows. Cash received from interest and dividends would move from operating cash flows to investing cash flows, and interest paid on long term debt would move from operating cash flows to financing cash flows.

Public Comments

Comments from the public on this proposed ASU are due by August 20, 2015. The FASB will consider these comments, re-deliberate, and issue the final ASU. There is currently no timetable for the final issuance of the ASU. Once adopted, the guidance will be applied on a retrospective basis, with disclosure required on the nature of any reclassifications or restatements and the effects on each year presented in the financial statements.

What does your organization need to do to prepare for this new ASU?

We recommend that you discuss the impact of these proposed changes with your auditor. Although this ASU is still in the comment stage, the final version will have a significant impact on the financial statements of your NFP. Keeping your organization informed of the status of the proposed ASU, along with any revisions that may come after the comment period, is critical to ensuring that your organization is prepared for the changes that will be required once the ASU is implemented.
Our Team

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<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jean Close</td>
<td>Partner</td>
<td><a href="mailto:jclose@bonadio.com">jclose@bonadio.com</a></td>
</tr>
<tr>
<td>Mario Urso</td>
<td>Partner</td>
<td><a href="mailto:murso@bonadio.com">murso@bonadio.com</a></td>
</tr>
<tr>
<td>Craig Stevens</td>
<td>Partner</td>
<td><a href="mailto:cstevens@bonadio.com">cstevens@bonadio.com</a></td>
</tr>
<tr>
<td>Bettina Lipphardt</td>
<td>Partner</td>
<td><a href="mailto:blipphardt@bonadio.com">blipphardt@bonadio.com</a></td>
</tr>
<tr>
<td>Timothy Doyle</td>
<td>Partner</td>
<td><a href="mailto:tdoyle@bonadio.com">tdoyle@bonadio.com</a></td>
</tr>
<tr>
<td>Joseph Peplin</td>
<td>Principal</td>
<td><a href="mailto:jpeplin@bonadio.com">jpeplin@bonadio.com</a></td>
</tr>
<tr>
<td>Jonathan Miller</td>
<td>Principal</td>
<td><a href="mailto:jmiller@bonadio.com">jmiller@bonadio.com</a></td>
</tr>
<tr>
<td>Robert Urban</td>
<td>Principal</td>
<td><a href="mailto:rurban@bonadio.com">rurban@bonadio.com</a></td>
</tr>
<tr>
<td>Kevin Testo</td>
<td>Principal</td>
<td><a href="mailto:ktesto@bonadio.com">ktesto@bonadio.com</a></td>
</tr>
<tr>
<td>Michelle Mundy</td>
<td>Principal</td>
<td><a href="mailto:mmundy@bonadio.com">mmundy@bonadio.com</a></td>
</tr>
<tr>
<td>Karen Hignett</td>
<td>Manager</td>
<td><a href="mailto:khignett@bonadio.com">khignett@bonadio.com</a></td>
</tr>
<tr>
<td>Aimee Jozic</td>
<td>Manager</td>
<td><a href="mailto:ajozic@bonadio.com">ajozic@bonadio.com</a></td>
</tr>
<tr>
<td>Richard Leicht</td>
<td>Manager</td>
<td><a href="mailto:rleicht@bonadio.com">rleicht@bonadio.com</a></td>
</tr>
<tr>
<td>Michelle Pyzik</td>
<td>Manager</td>
<td><a href="mailto:mpyzik@bonadio.com">mpyzik@bonadio.com</a></td>
</tr>
<tr>
<td>Grace Gonzalez</td>
<td>Manager</td>
<td><a href="mailto:ggonzalez@bonadio.com">ggonzalez@bonadio.com</a></td>
</tr>
<tr>
<td>Heather Mowat</td>
<td>Manager</td>
<td><a href="mailto:hmowat@bonadio.com">hmowat@bonadio.com</a></td>
</tr>
<tr>
<td>Jessica Pegler</td>
<td>Manager</td>
<td><a href="mailto:jpegler@bonadio.com">jpegler@bonadio.com</a></td>
</tr>
<tr>
<td>Tyler Standish</td>
<td>Manager</td>
<td><a href="mailto:tstandish@bonadio.com">tstandish@bonadio.com</a></td>
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Bonadio's Higher Education Division

The Bonadio Group currently serves as the financial statement auditors for over 20 colleges and universities. We also perform audit and consulting services for over 30 colleges and universities. Our team consists of 18 partners, principals and managers who have significant experience within the higher education industry. We leverage The Bonadio Group’s expertise with enterprise risk management, tax consulting services, “& more” to provide comprehensive value above and beyond traditional audit services. Through our Moore Stephens affiliation, combined with our own international tax expertise, we are able to provide international tax and compliance consulting services. We take pride in being a trusted partner of our higher education clients.

TBG Spotlight: Mario Urso

Mario Urso is the Partner in Charge of The Bonadio Group’s Tax-Exempt/Healthcare Division, and has played an integral role in the development of TBG’s higher education practice. He joined TBG in 1990 after spending 12 years at a big-eight firm. Mario received his B.S. degree from the State University of New York at Buffalo. He is active in local civic organizations as a board member and treasurer of the Rochester Oratorio Society and is a Convener of the ROC the Future Initiative to improve the Rochester City School District performance. Mario and his wife Linda live in Pittsford with their two children. Their daughter will be attending medical school in the fall, and their son is following in his father’s footsteps and pursuing an accounting degree. Mario looks forward to his family’s annual vacation trip, and enjoys spending quality time with his family. When he’s not working, Mario really enjoys spending time outside, golfing, or riding his bicycle. Mario is normally a nocturnal rider. He can be found traversing the Rochester region before sunrise most mornings on his 20–30 mile rides. Mario exercises not only for the health benefits it provides, but also for the ability it affords to eat his favorite thing, desserts.

What’s new at Bonadio

For the third year in a row, The Bonadio Group was named one of 10 CPA firms in the nation to be a 2015 Best Public Accounting Firm for Women. This designation is awarded by the Accounting & Financial Women’s Alliance and the American Women’s Society of Certified Public Accountants. Firms were selected based on proven programs that retain and advance women, and that show evidence that the firm’s advancement of women is essential to its growth and succession goals.

Breakfast Series

We hope you were able to attend our June breakfast series where Jean Close, Mario Urso, and Kelly Thompson from The Bonadio Group discussed the proposed changes to the reporting requirements of not-for-profit organizations. We hope you will join us for our next event in Albany later this summer and in Rochester this fall.