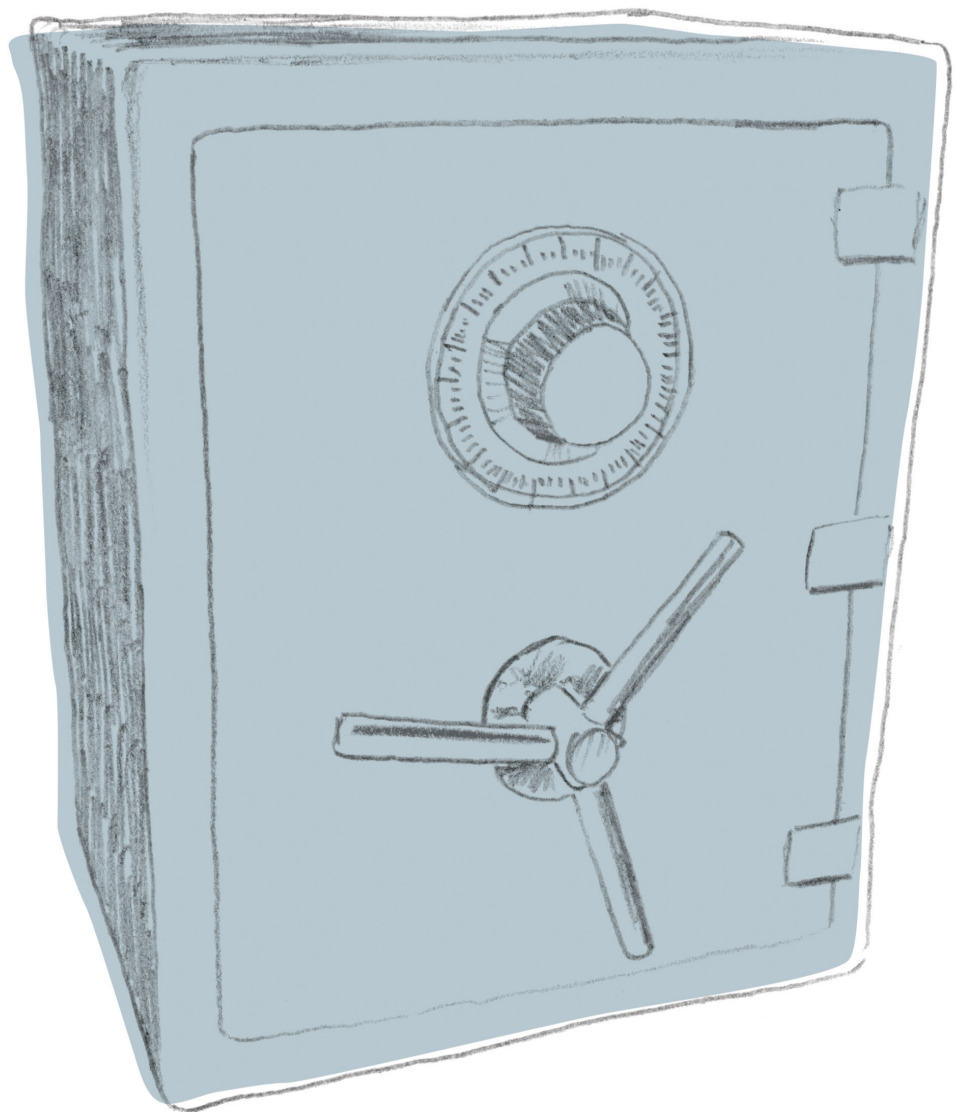


Maintaining sufficient reserves to protect your not-for-profit organization

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Introduction

For not-for-profit organizations — indeed, for all organizations — maintaining adequate reserves is essential to establishing financial stability. These reserves provide a cushion to deal with operating deficits that may arise because of unexpected events, economic uncertainties or lean funding periods. A number of organizations that did not put aside sufficient funds in the past few years to withstand financial shortfalls — and deliver on their missions — no longer exist today.

Maintaining insufficient reserves can put an organization at risk, but maintaining excessive reserves can also be problematic. A number of organizations have been criticized for retaining excessive reserves. So what level of reserves should not-for-profit organizations maintain within their net asset balances? This is an age-old question asked by many not-for-profit organizations and their various constituencies. This paper offers some practical guidance to organizations that wrestle with this issue. As we broaden our discussions, we seek comments from the not-for-profit community on this important topic.

Acknowledgements

I would like to thank the more than 50 not-for-profit leaders throughout the United States who read the first draft of this white paper and shared their wisdom and insights as I developed the final version of this document. These individuals included board members, CEOs, COOs and CFOs of not-for-profit organizations, as well as not-for-profit accountants, attorneys, bankers, fundraising specialists and other professionals. I would also like to thank my not-for-profit partners and senior managers at Grant Thornton who shared their experience and feedback with me as I developed this document.

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Defining net asset categories

Not-for-profit organizations maintain net asset balances (assets minus liabilities) based on donor intent or the lack thereof. Net assets typically fall into one of three categories: unrestricted, temporarily restricted or permanently restricted funds.

- Unrestricted net assets are available for the general operations of an organization and have not been restricted by outside donors.
- Temporarily restricted net assets are restricted by donors for certain purposes and/or for future time periods. Once these restrictions have been met, the funds are released as unrestricted net assets.
- Permanently restricted net assets are to be maintained in perpetuity; their income may be used for general operations or specific activities based on donor intent.

Since temporarily and permanently restricted funds can only be spent based on donors' instructions, management and the board typically do not have discretion to spend these donor-restricted monies for purposes other than those the donors intended.

Boards have more flexibility when it comes to unrestricted funds as opposed to restricted assets such as endowment funds. Boards can establish and designate several subcategories within unrestricted net assets. For example, boards can designate their organization's unrestricted net assets into funds for certain program activities or future time periods. Board-designated funds can also include quasi-endowment funds. Quasi-endowment funds, or funds functioning as endowments, are earmarked by the board — rather than by donors or regulators — to act like permanently restricted funds from which income is available for general operations or certain specific purposes. The board can decide to spend the principal of such funds at any time.

Board-designated funds can also include debt reserve/sinking funds, which are often established to accumulate funds for future debt payments, and plant funds. Plant funds typically include the net book value of property, plant and equipment and related assets, less debt and other related liabilities. Plant funds may also include an accumulation of funded depreciation or other amounts for future fixed-asset replacements. Unlike donor-restricted funds, board-designated net assets can be undesignated by the board at any time.

The image shows an open ledger with handwritten entries in blue ink. The ledger is divided into multiple columns and rows. The left page is numbered 54 and the right page is numbered 55. The entries are organized into several columns, with some cells containing numbers and others containing text. The handwriting is in blue ink and appears to be a mix of numbers and letters, possibly representing financial data or accounting entries. The ledger is open to two pages, showing the continuity of the data across the spread.

Key questions

Should temporarily and permanently restricted net assets be included when determining reserve levels?

Many not-for-profit leaders ask whether temporarily and permanently restricted net assets should be included in determining an organization's reserves. Operating reserves — funds that are available to support an organization's day-to-day operations — are the appropriate measure to consider. Temporarily restricted net assets that result in additional expenditures beyond normal day-to-day operations — for example, temporarily restricted contributions received to fund nonrecurring activities — should not be considered part of these operating reserves. However, if temporarily restricted net assets fund expenditures that would normally be supported by unrestricted funds, such temporarily restricted net assets should be considered in determining the operating reserves.

Temporarily restricted pledges should be discounted to their present value in computing the amount of operating reserves. For example, pledges receivable that are reflected as temporarily restricted net assets simply because of a time restriction (e.g., pledges to be paid over multiple years) but can be spent for any purpose once received should be considered part of the operating reserves.

Permanently restricted funds should not be considered part of the operating reserves, since the corpus of these funds must remain intact in perpetuity. However, unspent income generated from permanently restricted net assets which are available for the general operations of an organization should be considered part of the operating reserves.

Are quasi-endowment funds a good idea?

The boards of many midsize and large not-for-profit organizations have designated certain unrestricted net assets as quasi-endowment funds. Many not-for-profit organizations, in fact, have been criticized for maintaining high levels of such designated funds. Often, the income generated from these quasi-endowment funds is desperately needed by those organizations to subsidize their programs. If these organizations were forced to liquidate and spend these funds, it could have a significant impact on their ability to sustain the same level of quality programs and services. Without these board-designated funds, these organizations would no longer exist or would have to restrict their programmatic activities severely, especially during difficult economic times.



Is there an average percentage that constitutes a reasonable reserve?

Over the years, not-for-profit organizations have used a variety of measurements to evaluate the level of reserves that should be maintained. Some organizations believe that they must maintain the equivalent of at least six months of operating expenses in reserves. Other organizations feel that reserves should equal one to two years of operating expenses.

Applying a general percentage (e.g., one year of operating expenses) as a yardstick to all not-for-profit organizations would be a mistake. Not-for-profits should assess the reasonableness of their reserves based on factors pertinent to their individual situations and the subsectors in which they operate. For example, higher education institutions often rely on significant net asset balances to provide student scholarships, whereas membership organizations may be pressured by their members to maintain a low dues structure and not accumulate significant net asset balances. In addition, some organizations have extensive physical plants, are self-insured, have complex corporate or debt structures, or manage a large labor force. These factors have an impact on the size of the reserves these organizations should accumulate.



What factors should be considered when determining reserve levels?

While some watchdog agencies have developed their own standards for determining appropriate reserve amounts — and many of these standards are very good — there has not been a national standard established that takes into account the full range of factors that can affect reserves. These factors include, but are not limited to, the following:

- Mission and long-term plans or strategies
- Type of organization — e.g., higher education, religious, social services, museum, cultural, association, foundation or other
- Corporate structure — e.g., sole entity, parent/subsidiary entities, brother/sister entities, loosely affiliated groups, etc.
- Investment in the physical plant — e.g., the facilities owned and/or leased
- Complexities of the debt structure
- Current and future commitments
- Funding sources, including fundraising activities
- Types of programs provided
- Self-insurance
- Workforce compensation and benefits issues

(For more details on these considerations and how they affect reserves, see “Calculating what’s right for your organization” on page 8.)

A “prudent-person” measurement should be considered in assessing the appropriateness of reserves: Would a prudent person, exercising due care and proper stewardship over the organization’s resources, set aside such a level of reserves? The organization should also use an independent and competent board of directors or advisory committee as a safe harbor in determining whether the prudent-person rule has been followed.

What constitutes excessive reserves?

Over the past several years, many religious organizations have been criticized for maintaining large net asset balances. While at times the criticism has been justified, often it has not taken into account the needs and circumstances of these organizations. Simply applying a measure such as one year of operating expenditures as a yardstick for determining operating reserves lacks understanding of the complexities these organizations face. For example, many religious and higher education institutions are heavily invested in aged facilities, which are reflected at little or no book value on the institution's statement of financial position. In these cases, the accumulation of reserves in a board-designated plant fund to cover future replacement costs, pay for extensive repairs and renovations, or fund depreciation is a wise business decision to ensure that operations continue effectively and without interruption.

In addition, many sophisticated not-for-profit organizations partially or fully insure for certain risks, such as casualty losses or workers' compensation claims. This may require setting aside additional reserves depending on the nature of the self-insured risks. Organizations may also set aside funds in a board-designated sinking fund in order to pay off debt. All of these types of board-designated funds are prudent set-asides that should not be viewed as part of operating reserves. Establishing reasonable reserves which can be supported by management is an appropriate and necessary business decision. However, board-designated net assets should not be used to hide excess reserves. For example, designating unrestricted net assets "for future programs" without having a specific plan for those funds could be considered by some to be an attempt to hide excess reserves. Such excess reserves should be included as part of the unrestricted undesignated net assets.

Is a surplus problematic?

Many of the factors used by analysts in evaluating public companies should be considered in evaluating not-for-profit organizations as well. Among them is the reality that surpluses should and must be generated in order to support current program activities and plan adequately for the future. A solid foundation and adequate reserves are necessary to ensure the long-term viability of the organization. While public companies are rewarded by rising stock prices and earnings per share when their companies are well-managed, not-for-profit organizations with strong balance sheets are often criticized.

There are two myths that influence the thinking of many individuals. The first myth is that not-for-profit organizations should not generate a surplus, that somehow this is a bad thing. On the contrary, surpluses are needed to sustain the long-term viability of an organization and fund its future programs. Well-managed not-for-profit organizations should be generating surpluses.

The second myth is that not-for-profit organizations should not accumulate significant assets and net assets. We all know that not-for-profit organizations are mission-driven and not profit-driven. However, to sustain their missions and execute their programmatic activities effectively, organizations must also:

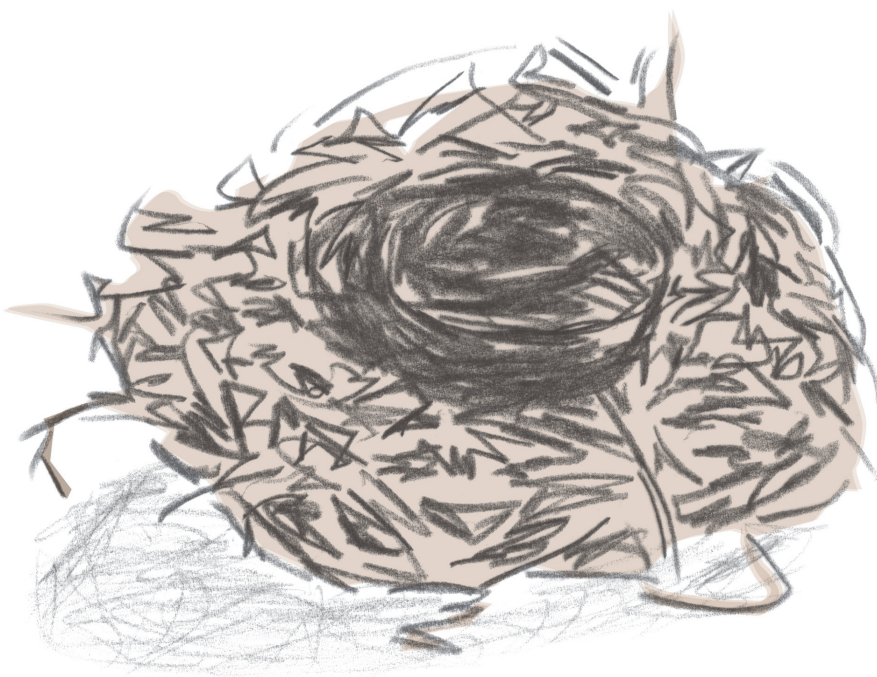
- ensure that adequate financial resources are raised and sustained in order for organizations to fund their programs,
- closely monitor operating and capital budgets and take steps to ensure that organizations operate within those budgets,
- ensure adequate liquidity to avoid a cash crunch and disruption in operations, and
- maintain strong internal control systems.

Establishing a formal reserves policy

Boards and management teams should apply the same principle when investing a not-for-profit organization's operating reserves that they apply to their personal retirement accounts: The shorter the period until retirement, the more conservative the investments. Accordingly, to the extent that a portion of the operating reserves will be needed in the short term, that portion should be invested in more conservative investments. Reserves that are expected to be invested over the long term can be invested in a more diversified portfolio.

Many not-for-profit organizations have not established a formal reserves policy. They should. This policy should clearly articulate and link to the mission and activities of the organization. It should also be discussed with and approved by the governing board. In addition, management should consider establishing a comprehensive reserves plan linked to the strategic plan and annual operating and capital budgeting processes. The plan should be monitored by the organization's finance or audit committee on an ongoing basis and discussed periodically with the full board.

Once the reserves plan is finalized, it should be publicized to both internal and external constituencies. This plan can help development personnel and board members more clearly articulate why their organizations are "not rich" and why specific funds have been placed in reserves or other set-aside funds.



Conclusion

The importance of maintaining adequate reserves cannot be overstated. With so many constituencies relying on the work of not-for-profit organizations, it would be fiscally irresponsible not to accumulate and maintain an adequate level of reserves. The recent protracted recession further demonstrates the importance of maintaining sufficient reserves to survive and sustain operations through turbulent times.

But many not-for-profit organizations have never asked themselves, “What level of reserves is adequate?” Boards and management that have not already done so need to assess what levels of reserves their organizations require given their missions and plans, facilities, structures, funding sources, and a number of other considerations. By looking carefully at their needs and establishing a business case for reserves that may be larger than typical, organizations can avoid accumulating unduly excessive reserves, which may damage the organization’s reputation. The ultimate objective of maintaining appropriate reserves, of course, is to ensure the long-term viability of the organization and the sustainability of the programs it provides.

Where we go from here

Our plan is to build upon this initial document based on the collective wisdom and experience of not-for-profit board members and senior executives throughout the country. The next phase of our effort will be to develop a template to assist not-for-profit organizations in formally documenting both their reserve policies and their reserve plans. We will then work with the not-for-profit community to create a flexible tool that organizations can use in determining their necessary level of reserves.

Once the tool is finalized, we will be able to develop benchmarks regarding how not-for-profit organizations in different subsectors with different characteristics measure their reserve levels compared with peer and aspirant organizations. We hope that our work in this area will be a major contribution to the not-for-profit sector as organizations plan for the future.



Appendix: Calculating what's right for your organization

Mission

In determining the adequacy of reserves, one must first consider the mission of the organization as well as its long-term plans and strategies. The mission and long-term plans and strategies should serve as the foundation in assessing whether reserves are adequate but not excessive.

Long-term plans

Organizations with plans that include the acquisition or maintenance of a significant number of facilities typically require higher levels of reserves. If the plan is to save up over a period of time to acquire a building, such an accumulation of funds would typically be considered normal and reasonable. If the plan is to erect a Taj Mahal-type facility, this may not be prudent and could be considered excessive. If the plan is to acquire a facility to operate programs effectively, the accumulation of funds for such a purpose would typically be considered prudent and reasonable. Another question to consider is how donors would react to what you are doing. This is a good yardstick in assessing the appropriateness of the accumulation of reserves.

Type of organization

In assessing the adequacy of reserves, consider the type of organization. Certain types of entities, by their very nature, require higher levels of reserves than others. In general, the more complex the organization, the higher the level of reserves. For example, multinational not-for-profit organizations often require higher levels of reserves than similar organizations that are located in only one country.

Corporate structure

Corporate structure also affects the level of reserves. Typically, the more complex the corporate structure, the higher the level of reserves that are needed. “Parent” entities that have a number of subsidiaries or affiliates often hold reserves for their “children” at the parent level. The parent uses these reserves to provide operating, capital and special purpose (often nonrecurring) subsidies to these subsidiaries and affiliates. In assessing reserves in this case, one needs to evaluate the reserve amounts that are needed for the entire group of affiliated entities, not just the parent entity. Loosely affiliated groups of organizations sometimes support each other’s needs. This may also affect the level of reserves.

Investment in physical plant

Many not-for-profit organizations have large investments in physical plants and/or extensive leased facilities. The need to replace, renovate or repair such facilities places a significant burden on these organizations and requires the maintenance of significant reserves. The establishment of reserves to replace or renovate aging facilities is proper and prudent. One cannot just hope that there will be funds available many years into the future; rather, it is important to plan for and accumulate such funds now for when they are needed.

Complexities of the debt structure

Organizations often have complex debt structures. Many organizations have public debt outstanding as well as lines of credit, mortgages and other types of debt. The amount of debt that organizations carry has significantly increased over the past 20 years. As a result, higher percentages of operating budgets are being spent to make principal and interest payments on outstanding debt, which takes away from a not-for-profit organization's ability to fund other program expenditures. The establishment of reserves to fund future principal and/or interest payments is a prudent way to manage. The recent illiquidity in the marketplace — and the impact of that illiquidity on not-for-profit organizations in the auction-rate securities market and other markets — further demonstrates the need to maintain adequate reserves and permit flexibility in working through such problems.

Current and future commitments

Current and future commitments may affect reserves as well. The need to fund commitments — be they contractual obligations, banking requirements or other commitments — may necessitate additional reserves. Banks often require that certain funds be set aside to secure debt, maintain loan covenants or support loan guarantees.

Funding sources, including fundraising activities

The type of funding an organization receives also has an impact on the level of reserves that are necessary. Organizations that have stable revenue streams typically require less in reserves than those whose revenue streams are subject to significant fluctuation. Organizations that operate in a competitive environment with other not-for-profit organizations — and possibly with commercial companies — typically require higher levels of reserves. Not-for-profit organizations that are reliant on only one source of funding, such as fundraising or government contracts, may require additional reserves to protect against a drastic reduction in such funding.

Types of programs provided

The types of programs provided may also affect the level of reserves. Multiple-location operations may require more extensive reserves than single-site programs. Programs that require significant up-front investment or require the organization to match government funding or foundation grants may also require higher levels of reserves to sustain programs.

Self-insurance

Certain sophisticated organizations self-insure for medical, casualty and workers' compensation claims. Such organizations require the establishment of liabilities to cover known claims as well as "incurred but not reported claims." In addition, it is often prudent for such organizations to set aside additional reserves in order to manage any significant deterioration in claims experience or increases in reinsurance premiums.

Workforce compensation and benefits issues

The size and complexity of an organization's workforce may also have an impact on the level of reserves that are required. Organizations that are considering workforce reductions or retraining/redeployment actions may need to maintain specific reserves to subsidize such efforts, especially in difficult times. These organizations may also want to consider maintaining additional reserves to cover unfunded pension and postretirement liabilities.

For more information



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This paper is meant to encourage not-for-profit board members, management and other individuals to consider the matters I have raised. I would appreciate any and all comments on this document and any suggestions you might have on developing appropriate yardsticks for determining the adequacy of reserves. We will incorporate many of the suggestions received in response to this document in our future publications. Please feel free to send your comments and recommendations directly to me at Frank.Kurre@gt.com



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