



Retooling Your Reserves

Moving to a Data-Driven Approach to Financial Reserves

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Landscape scan of the past decade

Evolution of best practice and policy

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The Nature of Reserves

- Represent accumulated surpluses over time.
- Investments represent **a portion** of that reserve.
- Perpetual in nature.
- Ultimate source of internal financing.
- Performance is generally out of management's control.
- In-house and board investment expertise is typically weak.
- Pressure for sound management and governance.



Why Organizations Need Reserves

- Bridge cash flows
- Maintain financial solvency
- Weather economic cycles
- Fund (un)expected opportunities
- Protect against unpredictable political behavior
- Maintain and purchase productive assets
- Reinvest for programmatic relevance and impact
- Generate interest income to support operations
- Drive capacity for new debt to fund major capital needs



State of the Industry

- It's never been more important to find ways to continuously monitor the financial health of your nonprofit organization.
- A 2018 analysis of nonprofit financial health conducted by Oliver Wyman, SeaChange Capital Partners, and GuideStar by Candid concluded that among U.S. nonprofits:
 - ✓ 7-8% are technically insolvent with liabilities exceeding assets
 - ✓ 30% face potential liquidity issues with minimal cash reserves and/or short-term assets less than short-term liabilities
 - ✓ ~50% have less than one month of operating reserves



12 Key Metrics to Monitor the Financial Health of Your Nonprofit

BY NANCY MASTER | JANUARY 13, 2021



Nonprofit finance leaders are responsible for ensuring good stewardship of donor dollars, so the greatest possible percentage of resources can go toward achieving your mission and not operational expenses. Nonprofit leaders want



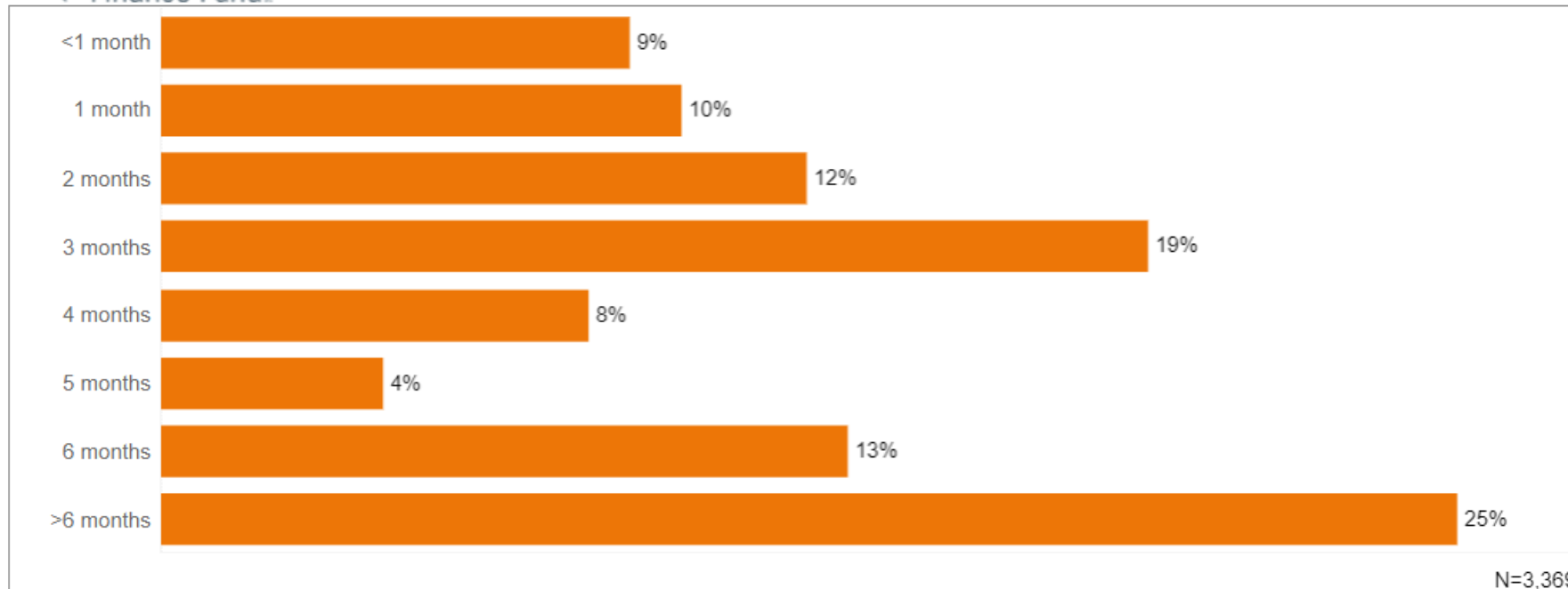
State of the Industry



Nonprofit
Finance Fund.

Cash on Hand

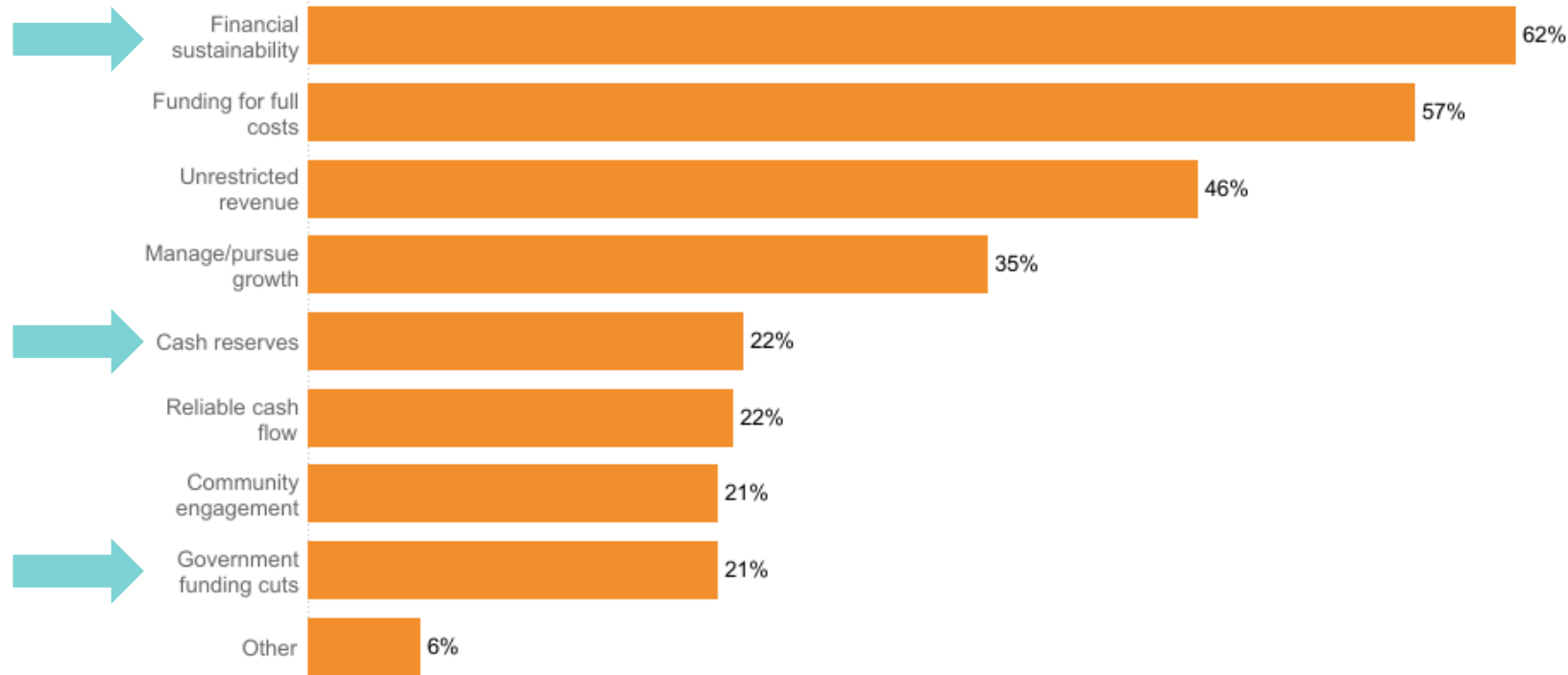
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State of the Industry (cont'd)



Nonprofit Finance Fund **Top operational/financial challenges**
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N=2,694



In the Media: More Pressure Than Ever

The Mercury News

THE CHRONICLE OF PHILANTHROPY

ARTICLE
MARCH 10, 2020



As Coronavirus Threat Continues, Experts Tell Nonprofits to Shore Up Reserves

By Dan Parks, Emily Haynes, and Maria Di Mento

Community News • News

Coronavirus pushing arts and nonprofit groups to the edge: Pizarro

A disaster relief fund will be needed – and it starts with all of us



Accumulating Funds - Avoid accumulating funds that could be used for current program activities. To meet this standard, the charity's unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher.



How Is The Shutdown Affecting America? Let Us Count The Ways

HEALTHCARE FINANCE

MAR 09, 2018 | MORE ON REIMBURSEMENT

Moody's says nonprofits struggle to maintain credit ratings in 2017

Mergers and acquisitions didn't necessarily help providers and labor costs remain a burden as downgrades go up.



Where this Fits

- Today's discussion centers on your financial reserves policy.
- But like any good integrated strategy, it will touch on other elements of a broader sustainability framework...things like your...
 - ...investment policy
 - ...new revenue development
 - ...financial assistance and grantmaking activity
 - ...risks to program margin goals
 - ...industry and financial sustainability



Business Model Components

	Operations		Non-Operating Reserves & Investments	
	Current Business Lines: <i>Ongoing revenue and expenses associated with current business lines</i>	Future Initiatives: <i>Exploratory, aspirational new business lines, offerings, or efforts</i>	Reserves: <i>Short-term holdings</i>	Investment Pool: <i>Long-term investment portfolio</i>
Money In	Church Contributions Apportionment	TBD	Growth	Growth
Transfers	from reserves from investment income from investment pool	TBD	from investment income from investment pool to operations to investment pool	from reserves to reserves to operations
Money out	Expenses	Expenses	--	--
Net	???	???	???	???



Corresponding Questions and Tools

Operations		Non-Operating Reserves & Investments	
Current Programs: <i>Ongoing revenue and expenses associated with current business lines</i>	Future Initiatives: <i>Exploratory, aspirational new business lines, offerings, or efforts</i>	Reserves: <i>Short-term holdings</i>	Investment Pool: <i>Long-term investment portfolio</i>
<p>What economic changes in current business lines are you expecting to see over the next several years?</p>	<p>What are the assumptions about upfront investment, ongoing expense, and expected revenue from these initiatives?</p>	<p>How much of your reserves and investment portfolio (corpus and earnings) should you deploy to fund operations? What amount of expense (and when) are you willing to invest to earn additional revenue?</p>	
<p>Exam Revenue and Margin Goals</p> <p>Pricing Plan</p> <p>Scenario Modeling</p>	<p>Revenue and Margin Goals</p> <p>Pricing Plan</p> <p>Marketing and Sales Plan</p> <p>Portfolio Management Discipline</p>	<p>Reserves Policy</p> <p>Investment Policy</p> <p>Scenario Modeling</p>	



Key Question

What are current best practices or credible frames of thinking to address how reserves are built, accessed, and reinvested?



2008: The Last Wave of “Best Practice”

A WHITEPAPER

BY: *The Nonprofit Operating Reserves Initiative Workgroup*

In spring 2008, a *Nonprofit Operating Reserves Initiative Workgroup* (see member list on page 10) comprising experienced individuals representing multiple facets of the nonprofit sector was convened with the objective of:

1. Defining an “*Operating Reserve Ratio*”
2. Using the ratio to focus attention on the importance of nonprofit financial stability.

The *Nonprofit Operating Reserves Initiative Workgroup* reached consensus on definitions for *operating reserves* and the “*Operating Reserve Ratio*.” The workgroup also reached a conclusion on what constitutes adequate *operating reserves*. Workgroup member Richard Larkin had previously concluded and written that the answer is: it

MAINTAINING NONPROFIT OPERATING RESERVES

An Organizational Imperative for Nonprofit Financial Stability

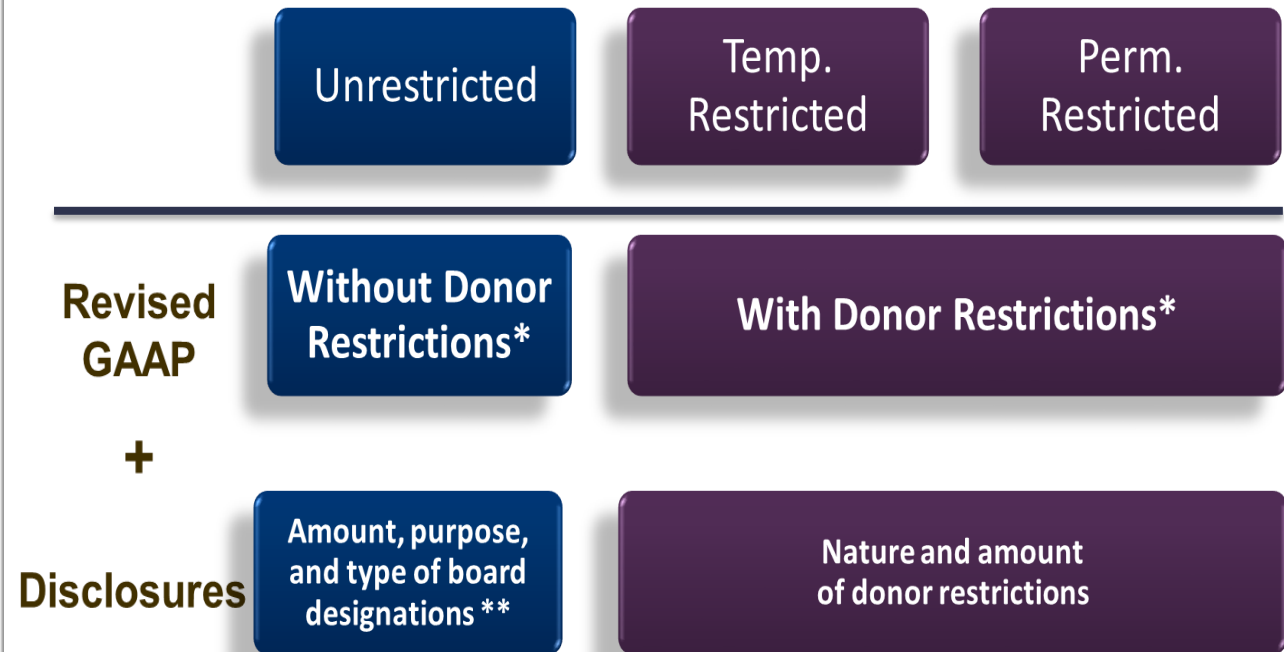
December 2008

A top priority for nonprofit leaders needs to be maintaining *operating reserves* at levels adequate for achieving financial stability. While this may seem obvious, preliminary research indicates that many organizations neglect to put aside funds that will help them preserve their capacity to deliver on their missions in the event of unforeseen financial shortages.

The fact is *numerous nonprofits have negative reserves* and are already at risk. The Work Group (see side bar) recognizes that the current economic crisis threatens the very existence of thousands of nonprofit organizations. At a time when nonprofit organizations may be focused on survival, the thought of building reserves may seem a distant priority. But for organizations currently just hanging on which expect to survive this crisis and those in relatively stable current financial condition which seek to fortify their position, the Work Group encourages including operating reserves in the planning process. Organizations which review their policies closely and devise plans for replenishing their *operating reserves* to an agreed upon adequate level will emerge from this current economic crisis in a stronger financial position, positioned to withstand the next challenge that arises.

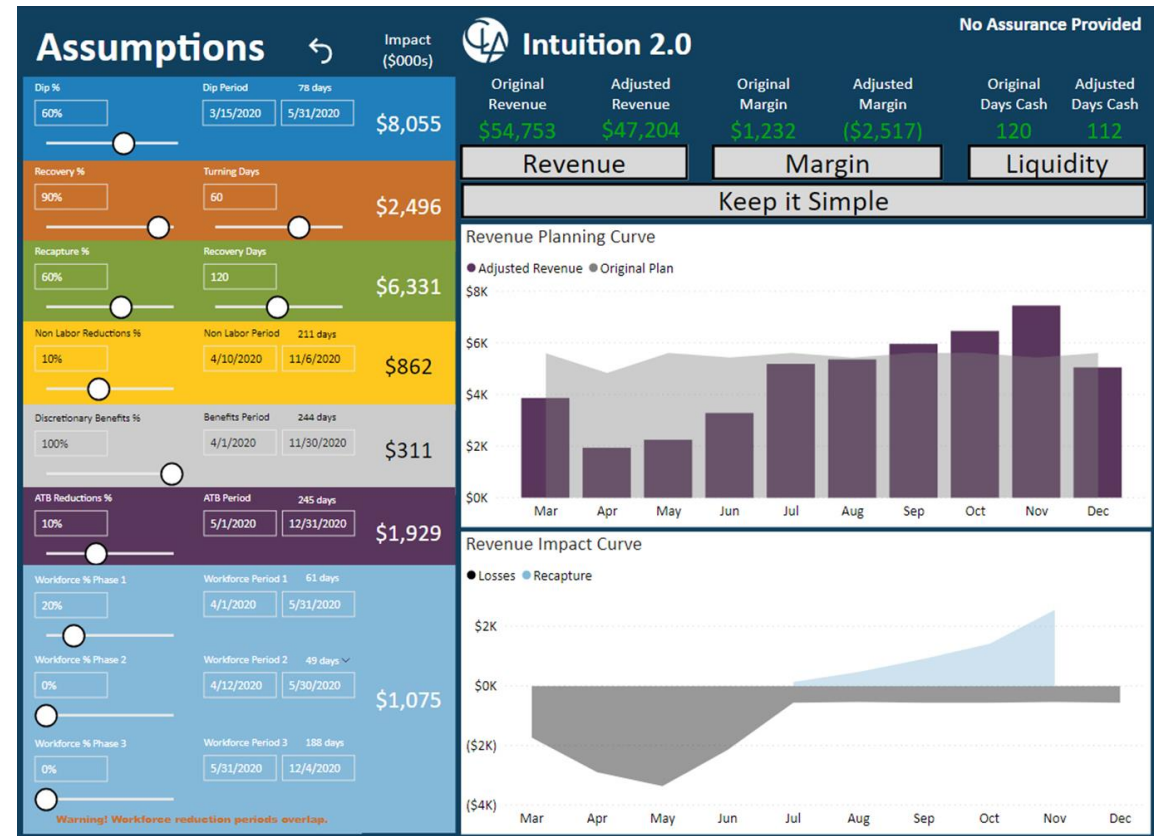
Briefly, *operating reserves* are the portion of “unrestricted net assets” (see Figure 1) that nonprofit boards maintain or designate for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. “Unrestricted net assets” is a required line item in the balance sheets of financial statements prepared in accordance with generally accepted accounting principles (GAAP) and IRS Forms 990 of nonprofit organizations. [See “*Operating Reserve Ratio*” - page 2]

Figure 1 -- Suggested balance sheet net asset terms presented in an illustration that all nonprofit CEOs and boards need to understand.



How Do You Define Sustainability?

“The ability to carry out activities that will achieve your mission while also developing and maintaining capacity for mission relevance into the future.”



Post-Recession Resurgence of ERM + Data

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Developing a robust control environment to manage your risk takes time and resources. Let us help so you can concentrate fully on running your business.

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Together we'll create opportunities

Mitigating business risk requires thorough planning and confidence in your processes, controls, and systems. Our team can help you identify risks and create a cost-effective control environment so you can focus on other strategic initiatives.

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Turn business intelligence into action

Our connected world produces countless data sources. Our data analytics and insights team can help your organization reveal the hidden potential in your data and take steps to improve management and operations, reduce risk, and apply strategic, forward-looking action.

We're committed to addressing what matters most to you:

- Improving enterprise-wide performance, efficiency, and profitability
- Building financial transparency
- Gathering timely business intelligence to better understand the competition



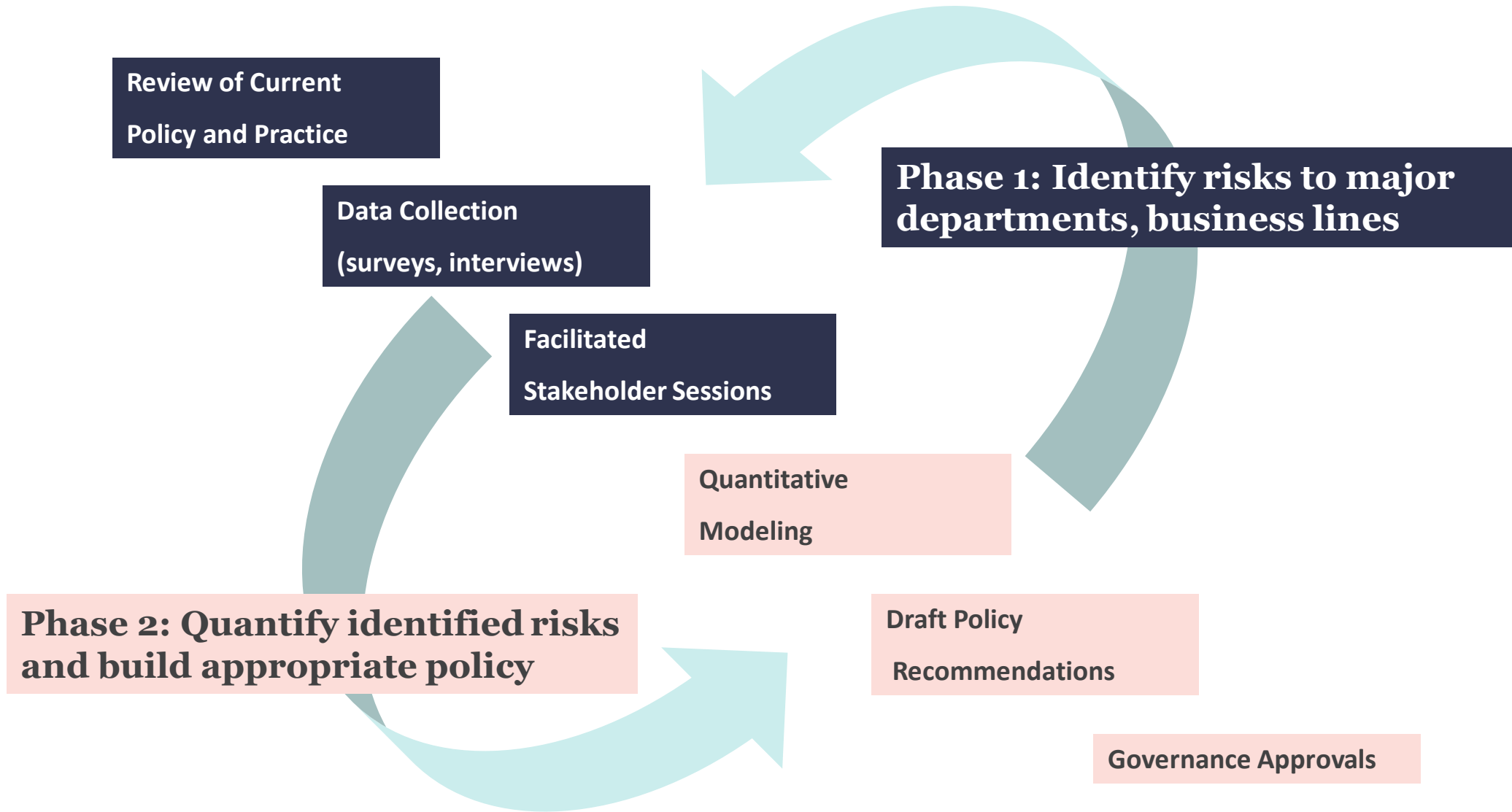
Financial Reserves Maturity Model

Start-up	Formative	Growth	Maturity
Reserves are non-existent; the organization has to carefully manage its balance sheet year to year.	Reserves are growing, but a target level has either not been set or achieved.	Reserves are well-funded, but not consistently considered for re-deployment to spur growth.	The approach to reserves and re-investment allows for thoughtful innovation and calculated risks.

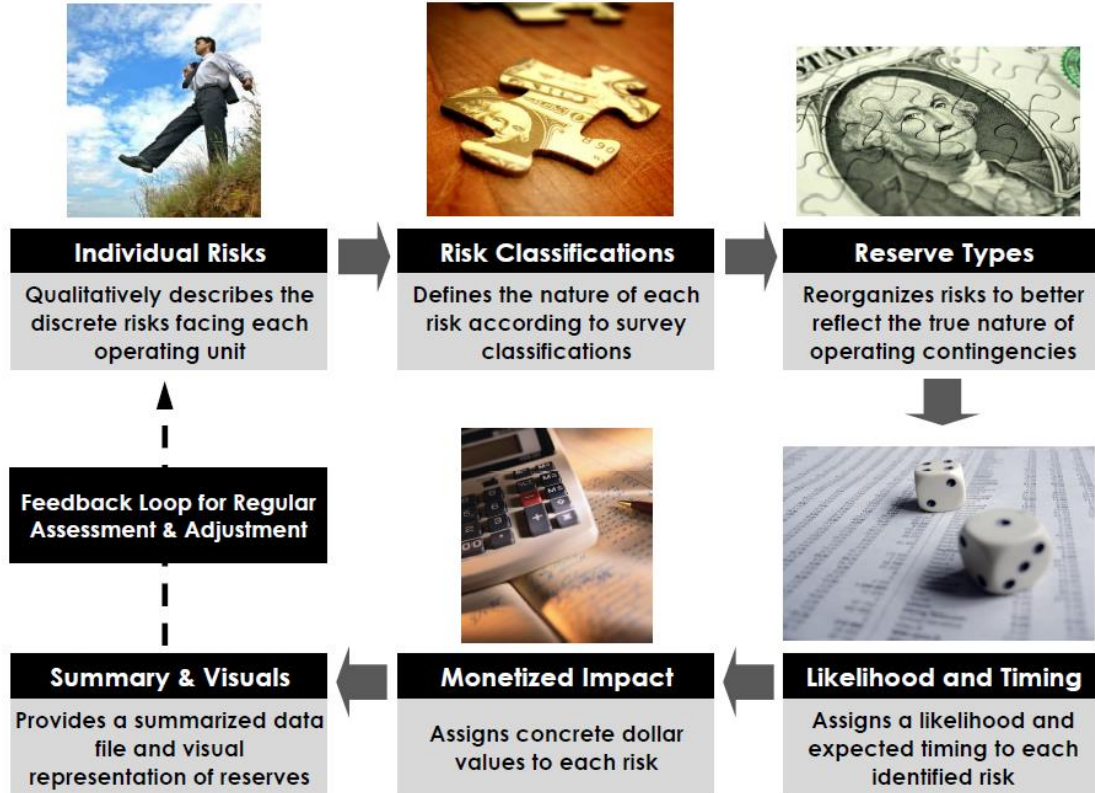
Where does your organization land on the maturity scale?



A Data-Driven, Risk-Based Method



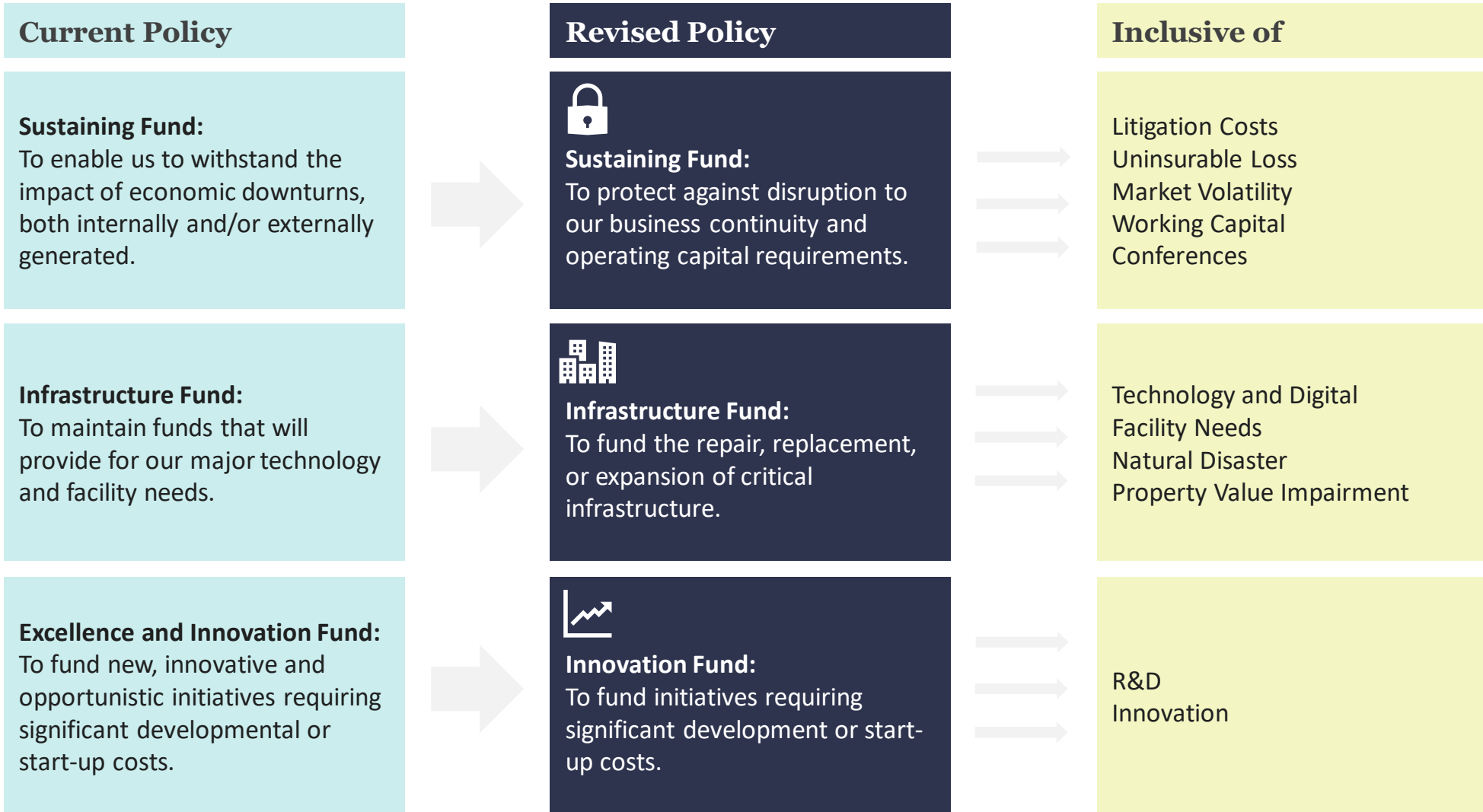
Data-Driven Reserve Model Schematic



Reserve Category	Reserve Sub-Category	Identified Risk/ Opportunity Area	Estimated Reserve Requirement	Estimated Likelihood % per Survey	Estimated Time Horizon per Survey	Reserve Levels at 12/31/2020			CLA Notes
						At Full Value	Recommendation	Policy	
Sustaining Fund	Working Capital / Operating Reserve	To provide internal working capital to finance minimum operating cash flow and debt service needs	\$ 12,810,000	Medium	Within the next 12 months	12,810,000	12,810,000	N/A	Calculation = 3 months FY 2022 budgeted expenses (\$12,211,243) per NORI recommendation + FY 2022 budgeted debt service (\$596,000)
Sustaining Fund	Uninsurable Loss	To protect us in the event of uninsurable loss	\$ 7,500,000	Low (25% or less)	1 – 3 years	7,500,000	1,875,000	N/A	Discounted to 25% reflect low likelihood and prospective overlap with other categories.
Sustaining Fund	Market Volatility	To fund a loss of investment interest income caused by market volatility	\$ 10,000,000	High (75% or higher)	Within the next 12 months	10,000,000	10,000,000	N/A	Reasonable assumption proposed by Controller, CFO, and CEO, validated by CIA.
Sustaining Fund	Litigation Costs	To protect us in the event of litigation	\$ 7,500,000	Low (25% or less)	1 – 3 years	7,500,000	1,875,000	N/A	Discounted to reflect low likelihood and prospective overlap with other categories. Covers potential chapter exposure.
Sustaining Fund	Lease Revenue Impairment	To offset a loss of revenue from facility leases	\$ 300,000	High (75% or higher)	Within the next 12 months	300,000	300,000	N/A	Parsed this apart from "Property Value Impairment" given its focus on sustaining a revenue stream. See calculation below.
Sustaining Fund	Conferences	To offset a loss of revenue from conference activities	\$ 8,000,000	Low (25% or less)	Within the next 12 months	8,000,000	6,000,000	N/A	Set at \$6M given unknowns of current environment.
Sustaining Fund Subtotal						\$ 46,110,000	\$ 32,860,000	\$ 58,393,000	
Infrastructure Fund	Technology and Digital	To fund the repair, replacement, or expansion of critical technology infrastructure	\$ 5,000,000	High (75% or higher)	1 – 3 years	5,000,000	5,000,000	N/A	Fully fund at \$5M.
Infrastructure Fund	Facility Needs	To fund the repair, replacement, or expansion of critical facility infrastructure	\$ 2,500,000	Low (25% or less)	1 – 3 years	2,500,000	2,500,000	N/A	Fully fund at \$2.5M.
Infrastructure Fund	Natural Disaster	To offset the negative financial impact of natural disaster	\$ 5,000,000	Low (25% or less)	5 – 10 years	5,000,000	2,500,000	N/A	Discounted to 50% reflect low likelihood and prospective overlap with other categories.
Infrastructure Fund Subtotal						\$ 12,500,000	\$ 10,000,000	\$ 10,000,000	
Excellence and Innovation Fund	Innovation	To fund initiatives requiring significant development or start-up costs	\$ 10,000,000	100%	Within the next 12 months	10,000,000	10,000,000	N/A	Fully fund at \$10M.
Excellence and Innovation Fund Subtotal						\$ 10,000,000	\$ 10,000,000	\$ 2,000,000	
Scholarship Fund	Scholarships	To provide self-sustaining financial support for our scholarship program	\$ 2,000,000	100%	Within the next 12 months	2,000,000	2,000,000	N/A	No change proposed.
Scholarship Fund Subtotal						\$ 2,000,000	\$ 2,000,000	\$ 2,000,000	
Total Reserve Amount - All Categories						\$ 70,610,000	\$ 54,860,000	\$ 72,393,000	



Sample Reserve Categories: Data-Driven Revisions



Higher Education and Intergenerational Neutrality

The benefits of the endowment should be spread equally across all generations (neither over- nor under-spend on the current and future generations of students and scholars).

We are the stewards for all future generations.

In practice, equates to a target spending rate of 5.25%.

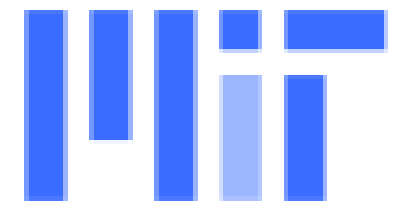
3% inflation, requires annual endowment returns of 8.25% just to stand still.

The Yale logo, featuring the word "Yale" in a blue, serif font.

Recognizing that MIT's mission of education, research and service will be as important and relevant over the long term as it is today, MIT seeks a spending policy that will offer the same support to tomorrow's students as it does to today's.

Two goals: significant + stable flow of funds today + maintain long-term purchasing power.

The ideal spending policy acts as a shock absorber keeping short-term spending relatively stable but gradually allow changing endowment values to filter into changes into spending.



Analogy to Personal Financial Planning



Smaller dollar amounts with a shorter time horizon

Short Term Savings

Student Loans

Vacations

Gifts

Long-Term Savings

Major Renovations

College Tuition

Retirement

Larger dollar amounts with a longer time horizon



These Should Match

Mission + Strategy + Business Model

- Geographic presence
- Growth and expansion
- Business line diversification
- Renovation/replacement
- Affiliations/partnerships
- Capital deployment
- Infrastructure

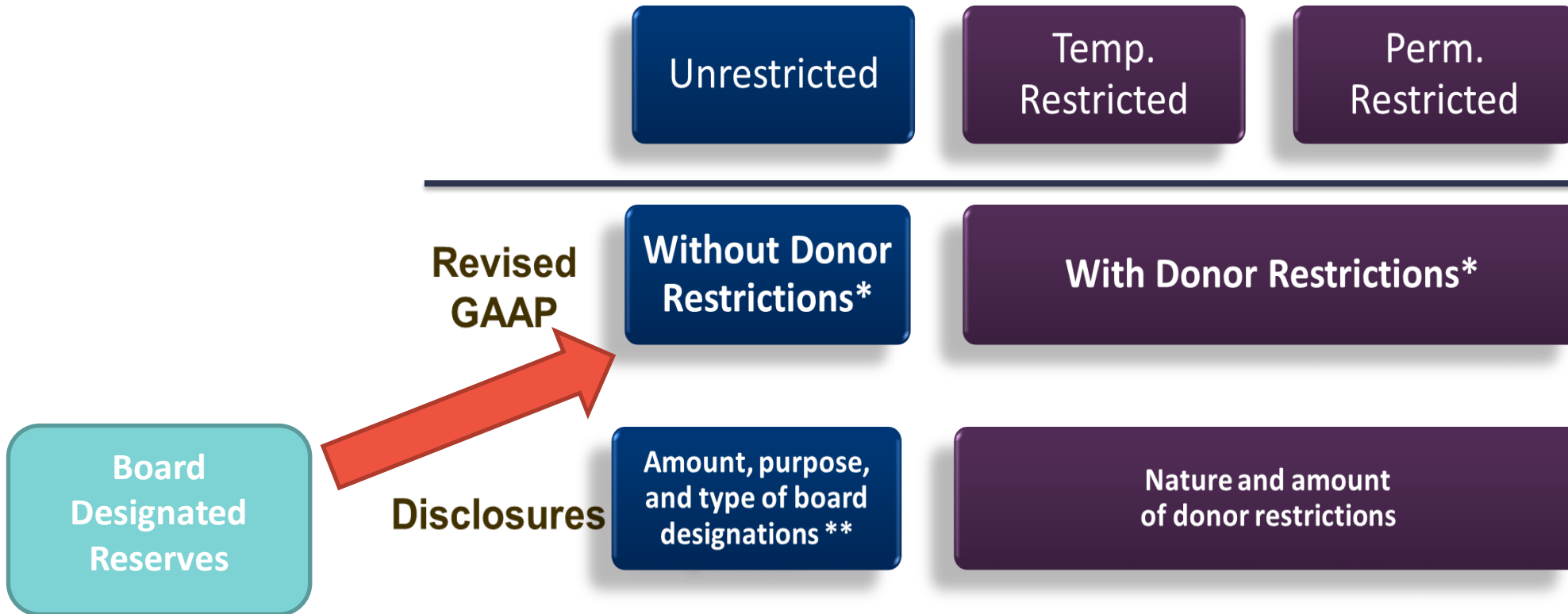


Reserve + Investment Policies

- Business costs and cycles
- Liquidity targets
- Level of risk tolerance
- Acceptable level of return
- Portfolio diversification
- Access mechanisms
- Governance agility



Financial Statement Presentation



* NFPs may choose to disaggregate further

** New disclosure requirement



Financial Statement Presentation

	As of June 30, 2020			
	Existing Policy	Recommended New Policy	Difference	Difference %
NET ASSETS				
FUNDS WITH DONOR RESTRICTIONS				
Scholarship Fund	2,000,000	2,000,000		0%
Other Donor Restricted Funds	1,536,303	1,536,303		0%
Total Funds with Donor Restrictions	3,536,303	3,356,303		0%
FUNDS WITHOUT DONOR RESTRICTIONS				
Sustaining Fund	58,393,096	32,860,000	(25,533,096)	-44%
Infrastructure Fund	10,000,000	10,000,000		0%
Innovation Fund	2,000,000	10,000,000	8,000,000	400%
Undesignated Funds	54,825,646	72,358,742	17,533,096	32%
TOTAL NET ASSETS	128,755,045	128,755,045	-	0%





Bridging Practice to Policy

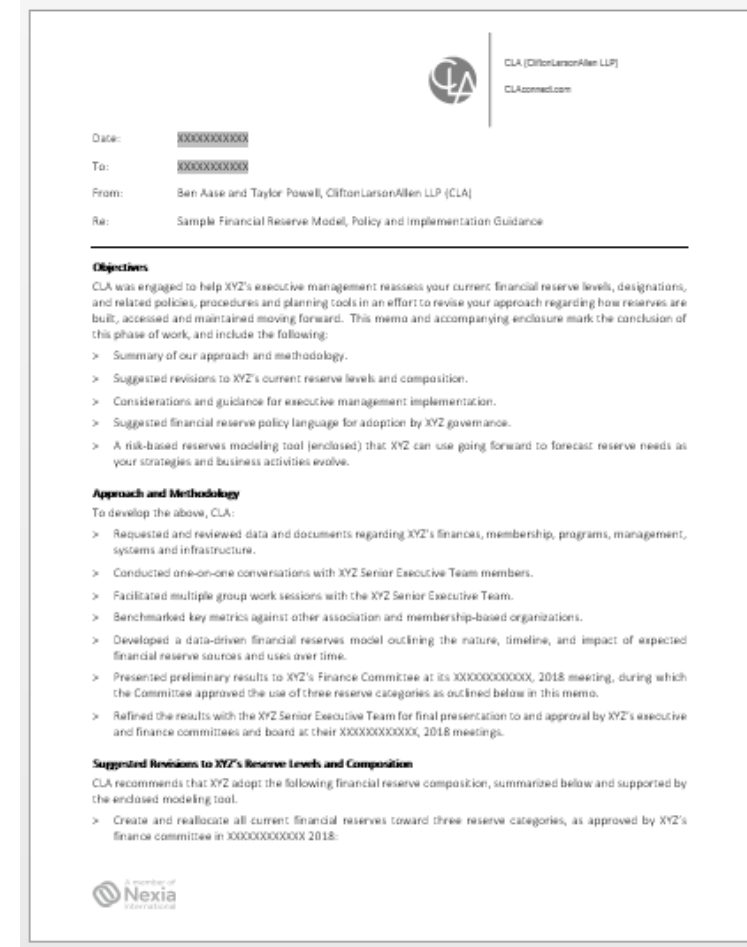
Essential elements and policy intersections

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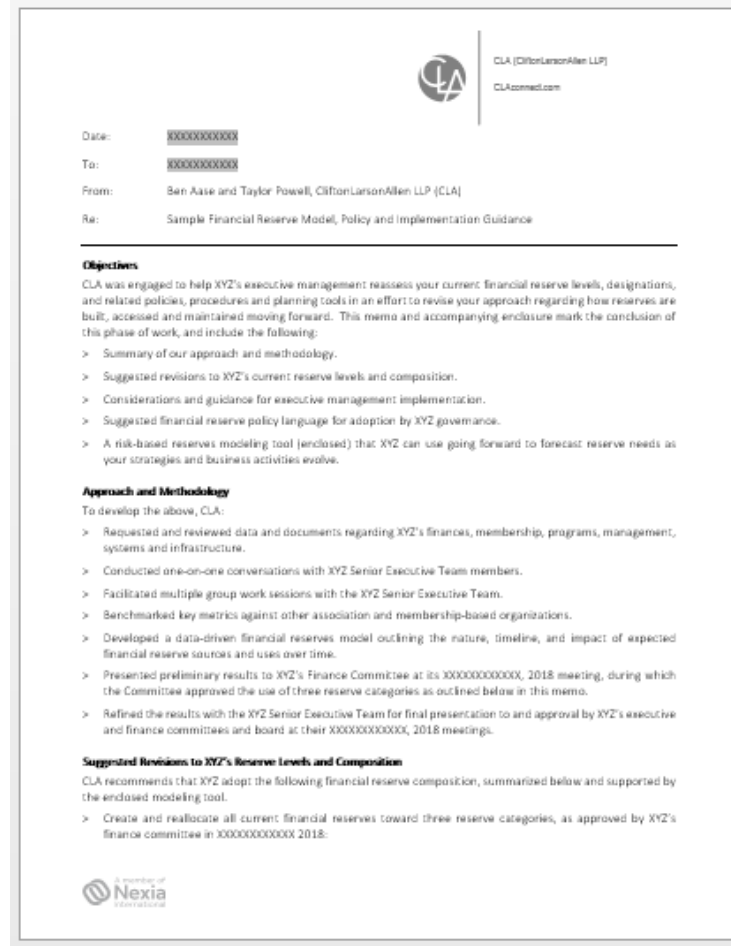
Policy and Practice Considerations: Best Practice

- We would expect your reserve categories to change over time as your environment and strategies change.
- Consider flexible levels of approval and authority between governance and management.
- Reserve targets can be adjusted in conjunction with your annual budgeting process, to understand the reserve requirements and impacts on reserve levels for planned and budgeted activities.
- A revised policy should also speak to how reserves are accounted for, reported, and monitored.



Essential Elements of a Reserves Policy

- Purpose
- Definition and Goals
- Accounting of the Fund
- Funding of the Fund
- Authority to Use the Fund
- Reporting and Monitoring
- Relationship to Other Policies
- Review of Policy



Additional Investment Policy Statement elements often include:

- Asset Allocation
- Risk Tolerance
- Time Horizon
- Prohibited Investments



Complementary Policies

- Investment policy
- Spending policy (key question: how big is big enough to be self-sustaining?)
- Risk management policies and plans (e.g., contingency/disaster recovery)
- Operating and capital budgeting policies
- Pricing policies



Thank you!

Ben Aase

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