



Developing Risk-Based Reserves

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Agenda

- Learning objectives
- Defining reserves
- Current environment and reserves
- Communicating need for reserves
- Developing risk-based reserves
- Developing a reserve policy
- Conclusion



Learning Objectives

- Define reserves and identify common misconceptions
- Recognize importance of reserves
- Understand how to develop a reserve policy
- Articulate importance of reserves to stakeholders





Defining Reserves

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Why Organizations Need Reserves

- Bridge cash flows
- Maintain financial solvency
- Weather economic cycles
- Fund unexpected opportunities
- Protect against unpredictable political behavior
- Maintain and purchase productive assets
- Drive capacity for new debt to fund major capital needs
- Increasing your capacity through investing in people

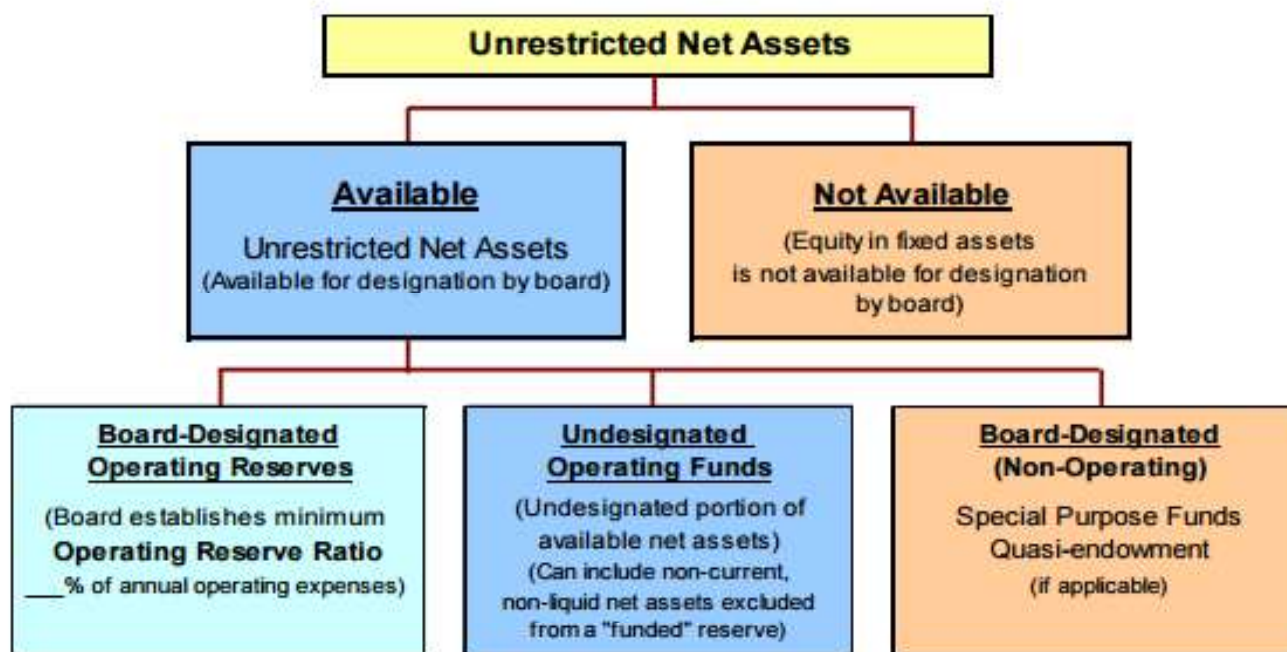


What is a Reserve?

- Excess cash?
 - No
- Restricted cash?
 - No
- An endowment fund?
 - No
- Unrestricted net assets?
 - No



Net Assets Without Restrictions \neq Reserves



Reserves Are:

- Liquid/Available and unrestricted net assets:
 - Liquid/ available: can be converted into cash quickly with minimal impact to price received
 - Unrestricted: not restricted for use by donors or organization



Reserve Calculation

| | |
|---|------------------------|
| Total Unrestricted Net Assets: | 2,500,000 |
| Less Equity in Fixed Assets: | |
| Building: | <1,000,000> |
| Equipment: | <u><250,000></u> |
| Available Unrestricted Net Assets: | 1,250,000 |
| Less Board-Designated Funds | |
| Program Expansion | <u><750,000></u> |
| Cash Available for Undesignated Operating Reserves | 500,000 |





Current Environment and Reserves

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Financial Position of NFPs

- Less than 50% of nonprofits end the year with an operating surplus
- Nearly half operate at break-even point
- A small number operate with deficits or are unsure how each year will end



End game = Sustainability



Ability to carry out activities that will achieve your mission while also developing and maintaining capacity for mission relevance in future.

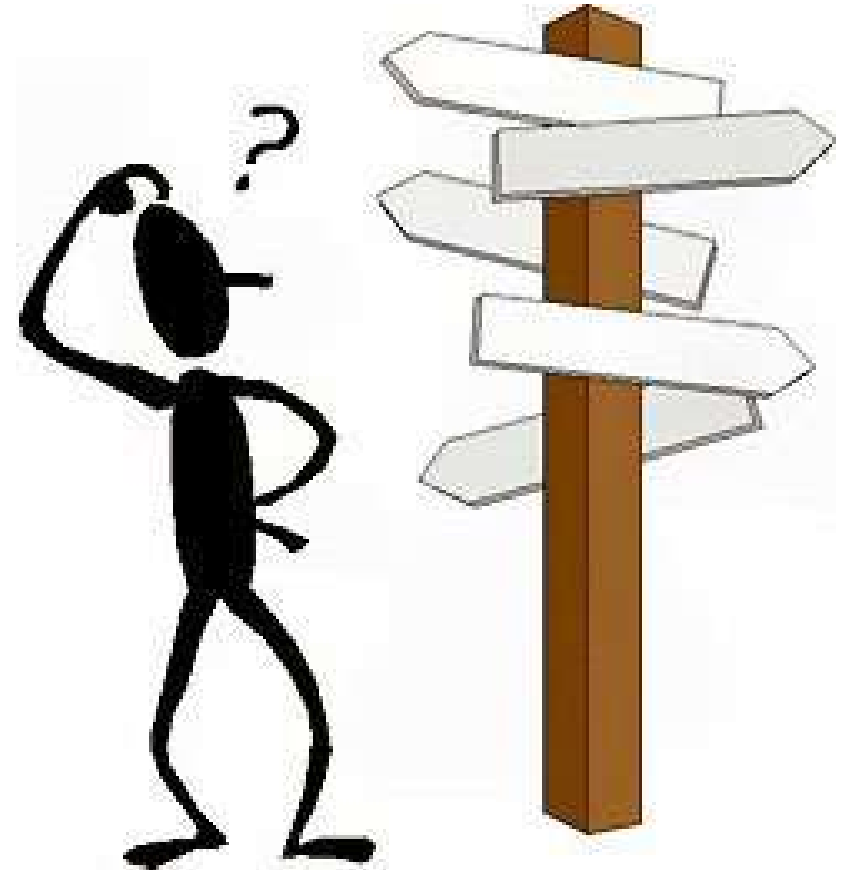
Discussion 1

1. Does your organization have a reserve?
2. How are reserves talked about at your organization?
3. How are reserves talked about among your organization's board?



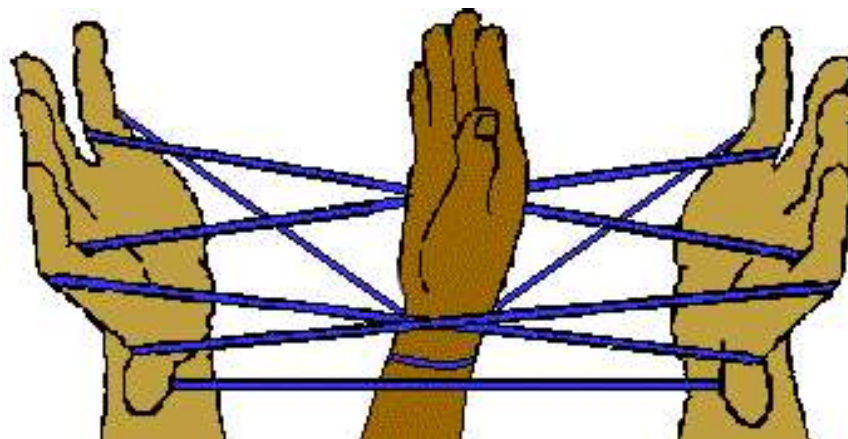
Misconceptions: Nonprofit Reserves

- We are a nonprofit; we can't have a profit (surplus) by IRS definition.
- Nonprofits with large reserves are hoarding donated funds.
- Nonprofits with large reserves don't need more funds.



Reserves: Caught in the Middle

- Nonprofits are discouraged from maintaining large reserves
- Nonprofits with small or no reserve should not receive donated funds because they do not have sound fiscal management and may not exist in the near future.



Discussion 2

- Has your organization been critiqued on its level of reserves?





Communicating Need for Reserves

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Reserves are Needed

- Reserves directly relate to carrying out mission of organization in near-term and long-term.
- How do we communicate the need for reserves to board and external stakeholders?
 - Tell the story



Reserves: Communicating the Need

Board:

- Be transparent about how reserves are calculated and their future use.
- Clearly delineate between uses for reserves.
- Make link between strategic planning and reserves very evident.



Reserves: Communicating the Need



External Stakeholders:

- Be transparent about how reserves are calculated and their future use.
- Advertise need and purpose of reserves through:
 - Discussions with stakeholders
 - Website
 - Financial documents
- Benchmarking against peers

Common Challenges

Meeting demands of the community for program

Cuts & delays in funding

Achieving long-term financial stability

Raising funds to cover all costs including administrative & fundraising

Raising revenue without restrictions

Maintaining regular cash flows

Developing cash reserves

Maintaining facilities



Common Challenges

- Conversations with funders can be difficult
 - Easier conversations:
 - Program expansion
 - Operating support
 - Program outcomes
 - Multi-year programs
 - More difficult conversations:
 - Developing reserves
 - A rainy day fund
 - Working capital & Cash flow needs
 - Achieving flexible capital to support growth



Discussion

- How often do you speak with your board, funders, & other stakeholders about the need for reserve funds?
- How difficult it is to communicate these needs to:
 - Board
 - Clients
 - Funders
- What challenges do you face in gaining support for the need for reserves?





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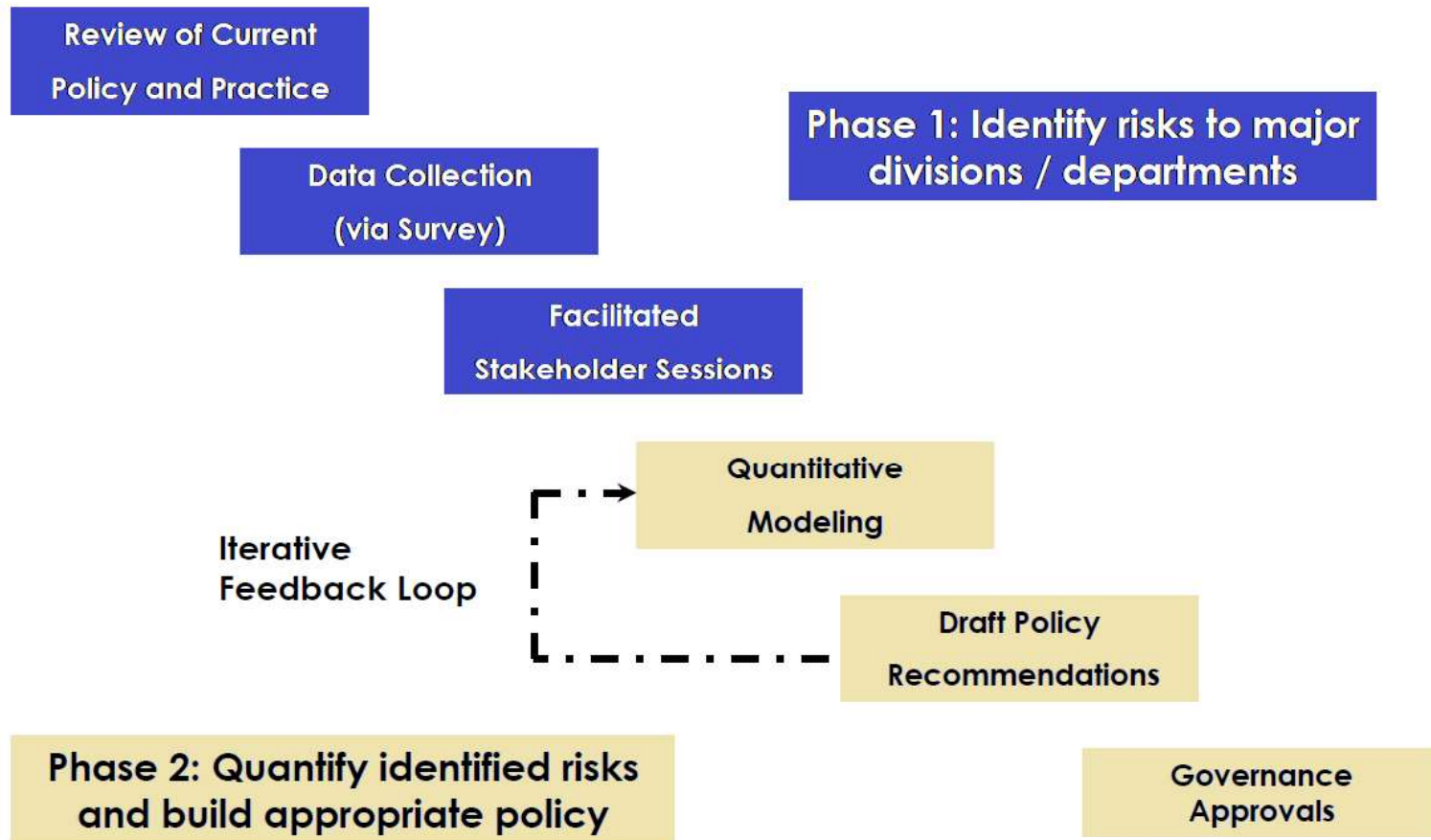
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Developing Reserves: Considerations

- Historical expenditures, cash flow and revenue
 - Monthly and yearly
 - Are there cyclical or seasonal trends?
- Budgeted expenditures, cash flow and revenue
 - Evenly distributed or peaks and valleys
- Risk Tolerance
- Planned expansion/contraction



Reserve Development Process



Review of Current Policy and Practice

- Current reserve policy and historical context.
- Business and financial reporting structure.
- Historical reserve targets vs. actual performance and use.
- Related risks for each program, department, or entity-wide.
- Capital improvement plans.
- Investment allocation risk analytics.



Data Collection (via Survey or Interview)



Suggest surveying internal departmental directors

Direct service delivery at department or site level
Business and finance
Information technology
Physical plant or maintenance department



Ask questions around:

Identifying specific business risks
Likelihood and timing of their occurrence
Their anticipated financial impact
Alternative mitigation strategies

Sample Survey Questions

It is important that organization maintain reserves for following reasons:

- ☐ To adjust for down years
- ☐ To support initiatives and opportunities
- ☐ To react to changes in business model
- ☐ To survive large scale changes
- ☐ To respond to emergencies
- ☐ To provide stability
- ☐ To pay for litigation
- ☐ To maintain best practice
- ☐ Others _____



Facilitated Stakeholder Sessions (Optional)

Test departments' response to seeing data in aggregate.

Fill any data gaps that require interpretation.

Move to consensus, most likely scenario for identified risks.

Test materiality of smaller risks.

Explore rationale for assigning likelihood, timing and impact

Tests risks identified by respondents to ensure they are:

- Appropriately included or excluded
- Void of any overlaps and disputes

Phase 2 – Quantify Risks and Build Policy

- Quantitative Modeling

Objective: Develop data-driven financial reserve model that quantifies risks identified in survey and stakeholder sessions against current reserve levels, and provides organization with reasonably comprehensive yet practical tool to carry forward.

- **Result:** Compilation of total financial risk that can be analyzed by various characteristics – reserve type, time horizon, likelihood, etc.



Example Reserve Categories

- **Operating Reserve**

- Provides an internal source of funds situations such as:
 - Sudden increase in expenses
 - One-time unbudgeted expenses
 - Unanticipated loss in program service funding
 - Uninsured losses

- **Capital Asset Reserve**

- Repair or acquisition of buildings, leaseholds, furniture and equipment necessary for effective operation of organization and programs.



Example Reserve Categories (Continued)

- **Fundraising Reserve**
 - Poor performance on fundraising or grant-seeking activities.
- **Opportunity Reserve**
 - Organizational capacity building:
 - Staff development
 - Research and development
 - Investment in infrastructure that will build long-term capacity
- **Major Initiatives**
 - Entity-wide strategic undertakings not yet executed



Monetize Impact

Projected requirement of \$6.7 million at full risk valuation.

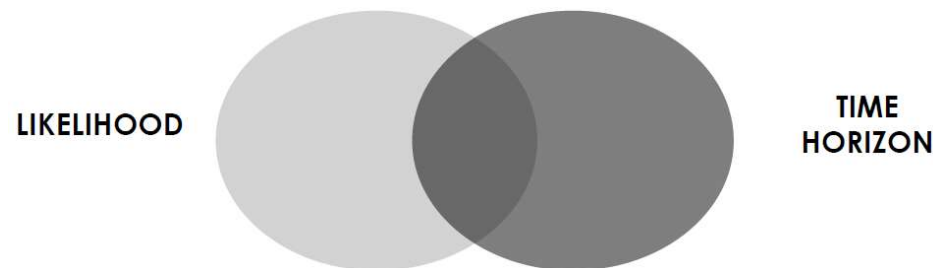
Recommended reserve categories are as follows:

| | | |
|------------------|---------------------|-------------|
| Operating | \$ 3,300,000 | 49% |
| Capital Asset | 1,100,000 | 16% |
| Fundraising | 800,000 | 12% |
| Opportunity | 600,000 | 9% |
| Major Initiative | 900,000 | 13% |
| Total | \$ 6,700,000 | 100% |



Monetize Impact

- Not everything will happen at once.
- Reserve level of approximately \$4.7M would capture all risks assigned either a medium or high likelihood and a time horizon of 5 years or less.
 - Accounts for 70% of all risks at their full valuation.
 - Represents 47% of forecasted fiscal year operating expenses
 - Offers a subjectively reasonable bottom range



Reserve Range

Based on risks forecasted for fiscal year operating expenses of \$10 million, organization should maintain reserve levels between \$4.7 million and \$6.7 million.

| | Reserve Level | \$ of Forecasted FY Expenditures | % of Current Risks at Full Value |
|----------|---------------|-------------------------------------|-------------------------------------|
| Ceiling | \$ 6,700,000 | 67% | 100% |
| Baseline | \$ 4,700,000 | 47% | 70% |



Other Considerations

- Reserves should act like a line of credit.
 - Funds taken out should repaid
- Nature of these risks will continue changing.
- Update data model for:
 - Significant budget growth or reduction
 - Changing risk profile based on activities



Risk is...Well, Risky...What to Watch Out For



- Segregate current risks from hypothetical ones
 - Conversely, changes in strategic direction warrant reassessment
- Know which risks should be mitigated through insurance and / or litigation rather than reserves.
- Separate reasonable, ongoing risks to your business/ program lines from singular catastrophic events that could jeopardize entity-wide solvency.
- Beware of duplicative risks.
- Address nuances of precedent relationships between risks when analyzing for aggregate financial impact.





Developing a Reserve Policy

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Policy Development – What to Include

1. Purpose of building and maintaining reserve.
2. Definitions of types of reserves, intended use, and calculation and timeline of target amounts.
3. Policy for contributing and building reserve funds.
4. Authorization procedures for using funds from each type of reserve fund.
5. Responsibilities for reporting reserve fund amounts and use of reserve funds.
6. Policies, if needed, about investment of reserve funds.



Discussion

- What are the foreseen challenges with implementing these policies at your organization?
- How would such a policy be received by management and governance at your organization?





Conclusion

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Conclusion

- Consider which reserve methodology best fits your organization.
- Implement or adjust your reserve policy to improve financial health of your organization and to adequately plan for the future.
- Use risk identification grid to encourage discussions about developing risk-based reserves.



THANK YOU!

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