

Reserves and Reserve Policies Guidelines for United Ways



United Way of America

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PREFACE & ACKNOWLEDGEMENTS

The United Way of America Standards of Excellence calls for members to “*Establish policies and procedures that govern acceptable organizational reserves and usage*” (Practice #5.11(c) – Reserves). In support of the SoE, the Financial Issues Committee (FIC) formed a sub-committee to draft guidance for member United Ways to use in determining how and why to establish reserves and reserve policies. Additionally, this guidance focuses on defining what types of reserves are appropriate for a United Way to maintain and offers what, in FIC’s opinion, could be considered “best practice” for United Way organizations.

In the Spring of 2007, the sub-committee presented, and FIC approved, this document as a guide for the United Way system. This publication is the result of the dedicated efforts of both FIC and other leaders of the United Way financial community, representing both large and small local United Ways. Their insights and contributions to this publication helped to create a document appropriate for use by all United Ways, regardless of metro size.

It is the hope of FIC that all members will consider the value of establishing and maintaining adequate levels of reserves in keeping with the spirit of the Standards of Excellence and good stewardship. To that end, we offer this guide as a starting point and encourage each member United Way to embrace its principles.

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March, 2007

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Reserves and Reserve Policies Guidelines For United Way Organizations

What are “Reserves”?

Reserves are amounts reported in the net asset section of the balance sheet. FASB 117 established three classes of net assets for financial statements; 1.) permanently restricted, 2.) temporarily restricted, and 3.) unrestricted.

This document relates solely to unrestricted net assets. When considering reserve policies and procedures, the definition is further refined to specifically include only unrestricted, undesignated net assets. The definition does not include land/building/equipment net assets or net assets designated/appropriated by the Board for specific purposes. As illustrated below, this document would only apply to the \$6,000,000* of unrestricted, undesignated net assets.

Sample Balance Sheet---Net Assets

Unrestricted Net Assets:	
Board-Designated Endowment	\$ 5,000,000
Board-Designated Other	1,000,000
Land, Building, and Equipment	1,000,000
Undesignated	<u>6,000,000</u> *
Total Unrestricted Net Assets	\$13,000,000
Temporarily Restricted Net Assets:	
Annual Campaign	\$20,000,000
Other	<u>4,000,000</u>
Total Temporarily Restricted Net Assets	\$24,000,000
Permanently Restricted Net Assets:	<u>\$ 5,000,000</u>
Total Net Assets	<u><u>\$42,000,000</u></u>

What is a funded reserve?

A fund consisting of liquid assets and investments accounted for separately from operating funds. Liquid assets are those that may be converted to cash quickly and easily. It is not required that reserves be physically segregated in a separate account although a local United Way may decide to do so.

Why establish a reserve fund?

The establishment and maintenance of reserves is a prudent business practice. United Way of America Standards of Excellence specify the need for local United Ways to establish policies and procedures that govern acceptable reserves and usage (Standard 5:11c).

Adequate reserves enable organizations to support strategic business practices, and:

1. To manage cash flow interruptions due to:
 - Deficiencies in the revenue attainment
 - Larger than expected pledge receivable write-offs
 - Business interruption with a major employer, corporate restructuring due to merger and acquisition
 - Natural or other disasters
2. To minimize the need for short term borrowing for working capital
3. To provide flexibility for organizational expansion and/or new organizational priorities

How much do United Way organizations keep in reserves?

The most recent United Way of America survey reports that most responding United Way organizations have between 3 to 6 months of reserves. Since the survey did not define the term “reserves,” each respondent used its own definition.

It is widely agreed that reserves are a hedge against the risk for volatility in revenue streams. However, reserves must also consider local community conditions, spending requirements, and financial obligations.

Factors that impact the risk for volatility in revenue streams include, but are not limited to:

- Stability of the campaign revenue
- Predictability of pledge receivable collections
- Level of dependence on one or two major employers
- Economic health of the community
- Timing of funding commitments to agencies
- Likelihood of natural disasters such as floods, hurricanes or earthquakes
- Publicity that could adversely affect current or future revenues

Factors that influence the ability to adjust spending levels include, but are not limited to:

- In the event of a crisis, more than ever, United Way’s work needs to continue in the community
- Funding intentions longer than one year
- Unsecured debt
- Long term leases with substantial penalties for relief

- Level of dependency of agency programs on a stable United Way funding stream (there may be some communities where a high percentage of an agency's operations are funded by United Way)
- Ability to downsize operations quickly and still provide services to the community e.g. staff have more than one essential duty.

What is recommended as an adequate funded reserve balance?

It is recommended local United Ways have a goal to achieve and maintain a funded reserve balance of three to six months of annual operating expenses and program funding (not including expenses which are funded by grants).

This provides the means by which both the local United Way and agencies receiving funding can sustain operations for a set period of time. This allows time to develop alternative plans if there is an unanticipated decline in available funds. Additionally, it provides a rational basis by which to determine a target range that is not excessive.

What sources can fund the reserve balance?

- Annual campaign
- Special gifts such as legacies, bequests, memorials (unless restricted by donor)
- Unrestricted grants
- Realized Investment income
- Endowment fund investment income (unless restricted by donor)
- Recapture of unused program funding/allocations
- Collections of pledges receivable in excess of allowance for uncollectibles
- Budget surplus from operations
- Other sources deemed to be appropriate

To supplement a sound reserve policy, local United Ways may also consider obtaining a line of credit to help manage short-term fluctuations in cash flow. However, a line of credit is not a replacement for adequate reserves.

Is there an IRS limitation on the amount of reserves allowed?

There is no IRS limit on reserve levels. However, an unusually large balance in unrestricted net assets, as reported in the Form 990, may trigger an IRS audit. The IRS may question the non-profit's use of revenues and expenses towards its non-profit charter.

How often should the reserve balance be reviewed?

The reserve balance should be reviewed at the end of each fiscal year based on the context of the audited financial statements. If the balance exceeds its target level, the excess should be made available for other uses. In the event the reserves fall below the policy agreed upon, aggressive measures should be taken to restore the reserve balance to its minimum required level. It is recommended that this take no longer than a three year period.

Reserve Calculation:
$$\frac{\text{Unrestricted, Undesignated Net Assets as of fiscal year end}}{[\text{Budgeted Annual Operating Expenses} + \text{Program Funding}] \times (1/12)} = \text{No. Of Months}$$

Additionally, agencies receiving United Way program funding should be encouraged to adopt and implement reserve policies of their own.

Are there other ways to define reserves?

There are a variety of ways to define and measure the level of reserves including:

- Months of operating expenses and program funding (recommended)
- Percentages of annual allocations and/or operating costs
- Percentage or months of campaign revenue
- Percentage of campaign revenue and net assets
- Percentage of average campaign revenue over a specified number of years
- Fixed dollar amount
- Fixed dollar amount with a floor and ceiling
- Ratio Analysis (i.e. Primary Reserve Ratio)
Primary Reserve Ratio = Expendable Net Assets / Total expenses.

If the formula is based on the campaign revenue, designated gifts should be excluded since these amounts are typically paid out only upon receipt.

Developing a Written Reserve Policy

Every United Way should have a Board approved policy on reserves.

A written reserve policy should include the following elements:

- **Statement of Purpose** - The reason for establishing the reserve.
- **Policy** – The objective to be achieved.
- **Definitions** – Descriptions of the meaning of key terms used in the policy.

- **Procedures** – Details of how the policy is to be implemented including the sources for the reserves, how reserves are to be invested and the formula for calculating the amount of the reserve balance.
- **Uses** – Circumstances in which the reserves can be used.
- **Governance** – Procedures for approving the use of reserves; persons authorized to establish policies and oversee the reserve balance; provisions for recalculating the formula of the reserve balance and distributing the excess reserve balance or funding reserve deficiencies.

See Attachment A for reserve balance decision matrix.

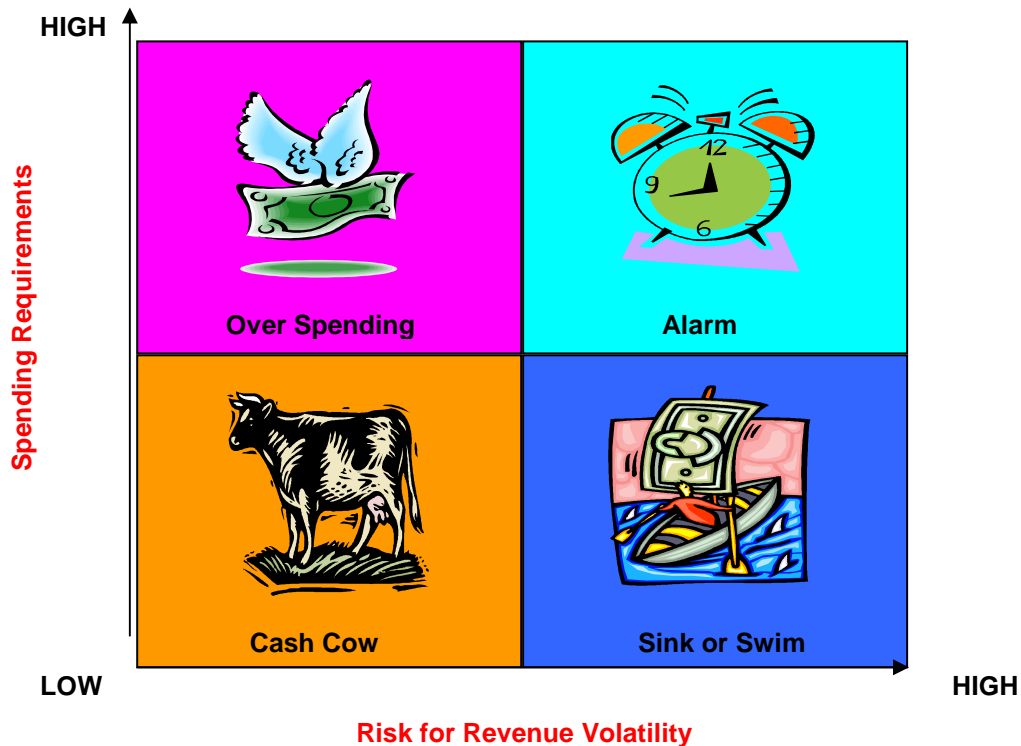
See Attachment B for a sample reserve policy.

Attachment A: Reserve Balance Decision Matrix

It is recommended that local United Ways have a goal to achieve and maintain a reserve balance of three to six months of annual operating expenses and program funding. Each United Way is different in terms of the risk factors involved in setting the reserve balance of unrestricted, undesignated net assets. The matrix below is a guideline to use when determining whether your local United Way should have a reserve balance closer to three months or a reserve balance of six months or greater. Local United Ways needs to consider the level of risk for volatility in revenue as well as spending requirements.

The more risk factors a United Way has (whether they are revenue risks or risks related to spending requirements), the greater the need for a higher reserve. For example, if a United Way has two risk factors related to revenue volatility and seven risk factors related to spending requirements, the United Way would be in the “over spending” category and should have a reserve of three to six months. If a United Way has seven risk factors related to revenue volatility and two risk factors related to spending requirements, the United Way would be in the “sink or swim” category and should have a reserve between three and six months. If a United Way has several risk factors in both categories the United Way would be considered in “Alarm” status and should have six months or greater set aside in reserves.

Reserve Balance Decision Matrix



- As the level of risk for revenue volatility increases, so does the level of reserves
- As the level of spending requirements increases, so does the level of reserves

Example One:

Illustration: Local United Way operates a campaign of \$15M annually. The campaign is comprised of several medium size employers in the area, with no reliance on one specific employer. The community is growing and the number of young professionals relocating to the area is increasing. Job growth has been on a consistent rise within the past several years. The organization is not geographically located within a floodplain nor is it near the coast, making it unsusceptible to hurricanes. Operationally, the organization only guarantees commitments to agencies for three months. This is a very conservative approach and the organization could even commit to agencies at six month intervals if it so chooses. The overhead rate of this United Way is 9% and if necessary, the organization could be downsized.

Analysis: Based on the information listed, this United Way has low risk in terms of its revenue stream. Spending requirements are also low as spending levels could also be adjusted if necessary and currently the United Way does not promise more than it could fund. Accordingly, this United Way would be classified as a cash cow as its risk for revenue volatility is low as is its spending requirements. Therefore, its reserves of unrestricted, undesignated net assets could be as low as three months of operating and program expenses.

Example Two:

Illustration: Local United Way operates a campaign of \$50M annually. The campaign is primarily comprised of two large employers and several smaller companies. The United Way is also located along the gulf coast and is susceptible to hurricanes. The United Way relies heavily on these two employers to make their annual campaign goal. Operationally, the organization guarantees commitments to agencies for six months. The overhead of the organization is 10% but the organization could be downsized if necessary.

Analysis: Based on the information listed, this United Way has higher risk in terms potential volatility in its revenue stream. However, spending levels could be adjusted if necessary so this United Way does not appear to be over-committing its spending. Because this United Way has higher risk for revenue volatility but lower risk in terms of spending requirements, it would be classified in the sink or swim category. As such, its reserves of unrestricted, undesignated net assets should be in the range of three to six months. Considering one natural disaster or one employer merger could significantly alter the campaign, it would be prudent for this United Way to take the more conservative position and have reserves of unrestricted, undesignated net assets of six months of operating and program expenses.

Attachment B: Sample Reserve Policy

I. Philosophy

The establishment and maintenance of a funded reserve is a high priority. This will enable United Way to support strategic business practices and to:

- Manage cash flow interruptions
- Minimize the need for working capital borrowing
- Meet commitments, obligations or other contingencies
- Provide flexibility for new organizational priorities
- Generate investment income

II. Policy

To establish and maintain a funded reserve unencumbered and uncommitted at a level relative to the annual program funding and the costs of operating and maintaining the organization.

The reserve is intended to serve a dynamic role and is available to be utilized as needed rather than being static, devoted only to generating interest income.

III. Definitions

- **Unrestricted Reserves** – Amounts reported in the Unrestricted Net Assets section of the balance sheet and identified as undesignated.
- **Program Funding** – Undesignated allocations to Agencies and Initiatives. It does not include expenses funded by grants.
- **Costs of Operating and Maintaining the Organization** – United Way net expenses for Program Services, Fund Raising & Administration and United Way of America membership fees
- **Funded Reserve** - A fund consisting of liquid assets and investments accounted for separately from operating funds. Liquid assets are those that may be converted to cash quickly and easily. It is not required that reserves be physically segregated in a separate account although a local United Way may decide to do so.

IV. Strategies and Procedures

- A. Reserves shall be accounted for separate and apart from Operating Funds.
- B. The Investment Committee will have the responsibility for developing and recommending policies and guidelines for the investment of the reserve assets and the Finance Committee will approve such policies and guidelines.
- C. The reserve goal shall be to achieve and maintain between three and six months of Program Funding and Operating Costs as defined in Section III.

V. Sources

Assets for the reserve accounts shall come from the Annual Campaign, undesignated Legacies/Bequests/Memorials, earnings on investments, recapture of undistributed Allocations/Initiatives, Special Grants and other sources the Executive Committee may deem to be appropriate.

VI. Uses

- A. Working funds to financially operate the organization
- B. Funds to stabilize a level of allocations or a level of increased allocation when events affect the source and application of funds
- C. Funds to meet unfunded and unexpected organization needs
- D. Funds for emergency and emerging needs of Agencies
- E. Funds to make up a deficiency in the Campaign, either in results or collection experience

VII. Governance

The procedure for approving use of the reserve funds will be as follows:

- 1. Request submitted to Finance Committee
- 2. Action taken by Finance Committee
- 3. Recommendation to the Executive Committee by the Finance Committee
- 4. Approval by the Executive Committee
- 5. Notification of action taken to the Board of Directors

VIII. Maintenance

The status of the funded reserve will be calculated at the end of each fiscal year based upon audited financial results.

Reserve Calculation

The calculation formula will be based upon amounts defined in Section III as follows:

$$\frac{\text{Unrestricted, Undesignated Net Assets as of 12/31}}{[\text{Budgeted Annual Operating Expenses} + \text{Program Funding}] \times 1/12} = \text{No. of Months}$$

The Reserve Calculation will be presented to the Executive Committee at their meeting following approval of the financial audit results by the Audit Committee. The Committee will consider the adequacy of the reserve amount and will recommend any changes as deemed necessary.

IX. Policy Review

This policy will be reviewed every three years by the Finance Committee or sooner if conditions warrant. Any changes thereto will be reviewed by the Executive Committee and approved by the Board of Directors.