

Legacy Advisor

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NOT-FOR-PROFIT ORGANIZATIONS

Managing Risk in Today's Economy



Michael West, CPA

Over the past few years, the overall economic outlook has been precarious, to say the least. Downward pressure on consumer spending and sentiment has forced financial managers to redefine their assessments of financial results. For some organizations, the stigma of break-even results has shifted from troubling disappointment to modest achievement. In such a volatile environment, not-for-profit boards should be asking: what can we do *now* to avoid trouble *later*? The simple answer is that every not-for-profit organization should establish, fund, monitor, and use operating reserves to manage and minimize risk. But, exactly *how much*

should be set aside as reserves?

Operating reserves are essentially funds set aside to overcome lean financial times and unexpected, unfavorable events. Generally, operating reserve funds consist of current, short-term net assets. In arriving at which funds make up an operating reserve, short-term is defined as zero to three months and long-term is defined as beyond three months. The most often used formula is current, short-term assets (including cash, cash equivalents, accounts receivable, and inventory), less prepaid expenses, less current liabilities, plus investments, plus deferred revenue.

In a cash crisis, the availability of operating reserves provides a practical and often preferred alternative to opening a line of credit, soliciting emergency donations, or selling off capital assets. Operating reserves act as a "rainy day fund," as a cushion to stabilize short-term cash flow fluctuations. Minimizing the effect of cash shortfalls ensures that an organization can overcome missed financial projections and poor economic conditions while maintaining essential programs and long-term strategic goals.

Unfortunately, the most straightforward response as to how much not-for-profit organizations should keep in operating reserves is "it depends." While there is no "one-size fits all" approach to benchmarking a reserve, there is a consensus about what an organization must target as a minimum reserve, which should be no lower than *three months* of operating expenses. A recent survey of 25 national trade and individual membership associations, conducted by Raffa, Inc., found that the median operating reserve was between three and four months of operating expenses. The results show that organizations are merely meeting the industry baseline. Ideally, an organization should target for a reserve above the baseline. The projection depends, therefore, on a case-by-case evaluation of each organization's unique set of facts and circumstances.

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Legacy News

We are looking forward to attending Association Forum's Holiday Showcase again this year on December 14 at the Hyatt Regency Chicago. Please stop by Booth #644 to say hello to Partner Rose Doherty and Marketing Director Julie Tucek.

The Illinois CPA Society's (ICPAS) Not-for-Profit Committee sponsors a series of Roundtables to provide opportunities for financial professionals who are involved with nonprofit organizations, both on the public accounting and organization side, to network, learn and share information. Rose Doherty is the chairperson of the Not-for-Profit Roundtable Subcommittee. The next Roundtables are scheduled for January 27, 2011 (topic: *Tax and Regulatory Compliance Filing*) and March 10, 2011 (topic: TBD). The programs run from 8:30 a.m. to 10:30 a.m. at the ICPAS office at 550 West Jackson Blvd., Suite 900 in Chicago and are free of charge. To register call ICPAS at 800-993-0393.

In an ongoing effort to stay informed, several members of our Nonprofit Group attended the ICPAS Not-For-Profit Conference which was held in Chicago on November 16-17, 2010. Topics included a Not-For-Profit Accounting & Auditing Update, Internal Controls for Small Organizations, the New Form 990, Making Sense of Form 5500, and Mergers, Alliances and Joint Ventures.

In our Summer 2010 issue, we covered the Red Flags Rule. As a reminder, the delay is set to expire on December 31, 2010. Visit www.ftc.gov (and search "Red Flags Rule") for updates on further delays or notice of enforcement. Back issues of *Legacy Advisor* are posted on our website.

In addition to our large nonprofit practice, we also audit employee benefit plans, including 401(k) and 403(b) plans, labor organizations, villages, municipalities, school districts, commercial entities, and other types of organizations. Contact Julie Tucek at 312-384-4292 or jtucek@legacycpas.com to discuss any opportunities.

This issue was edited by Rose Doherty, who can be reached at 312-384-4223 or rdoherty@legacycpas.com.

We wish everyone a very happy holiday season, and we look forward to continuing to serve you in the new year!

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The following factors should be evaluated when developing a reserve target benchmark:

- Depth of customer and membership base
- Timing of cash inflows and outflows
- Availability of external financing
- Nature of capital requirements
- Debt structure and commitments
- Likelihood of internal or external expansion
- Likelihood of unplanned, unexpected events
- Reliability, predictability, stability of revenue streams
- Flexibility of expense commitments (ratio of variable to fixed costs)
- Overall industry health

Two approaches to developing a target reserves benchmark are discussed below.

Comparative, Qualitative Approach – You Know Your Organization Best

Under the comparative approach, after obtaining an understanding about key organizational facts and circumstances, the board weighs the above factors and makes a subjective determination about what operating reserve target is appropriate. The board should project its target from the three-month operating reserve baseline. For example, an organization that relies heavily on annual membership renewals, which are received at the beginning of the year, may expand its operating reserve target to 6 months of operating expenses because this intermittent revenue stream results in low cash positions during the year. An organization should ensure that it manages risk to make it through every cash cycle.

Contingency, Quantitative Approach – Murphy's Law

Under the contingency approach, the board must brainstorm and identify future capital requirements, possible unplanned events, and potential strategic opportunities. Generally, the board should identify items outside of the ordinary operating budget. Then, the board should consider the relative likelihood of occurrence of these events, along with a projected financial impact. By multiplying the likelihood of occurrence by the projected financial impact of such events, an organization can project the operating reserves needed over a certain time period, above and beyond the minimum three-month operating expense target. For example, an organization with a concentration of income on a few large members may lead the board to assess

the potential loss of a member. The board should then determine the likelihood of the loss and the financial impact of the loss. The loss projection should be included in the organization's assessment of its operating reserve target.

Regardless of the approach used, an organization should have an operating reserves policy in place to specify target levels, funding options, use criteria, and board responsibilities. Options for funding a reserve include earmarking one or more of the following inflows: percentage of annual gross income, net operating surplus (or a percentage thereof), large contributions, net investment income, etc. Balancing the need for building a reserve with the importance of continually providing essential services to its stakeholders is a challenge, admittedly. If an organization decides to build its operating reserves, an open and clear message about its strategy may help avoid potentially negative reaction from stakeholders, such as members and contributors.

To help monitor a reserve, the best practice is to classify operating reserve funds as board-designated, unrestricted net assets. Classification as board-designated offers the advantage of a clear presentation of reserves in the general ledger and on the statement of financial position. Therefore, the board may easily monitor and control their use.

Also, the operating reserves policy should set forth the investment options and strategies for reserve funds. Corresponding with the scope of the reserves target, the policy should specify what liquidity, maturity, and risk levels are appropriate. For instance, if an organization sets up a twelve-month operating expense target, the organization may want to place half its reserve into highly liquid, low-risk securities and half into less liquid, higher risk securities to maximize returns.

Without a doubt, effective planning is the most important aspect of developing an operating reserve. Do it as soon as possible. A little forethought now can go a long way later.

For additional reference, see the National Center for Charitable Statistics' Operating Reserve Policy Toolkit for Nonprofit Organizations. See also websites for the Urban Institute, Guidestar, and National Council of Nonprofits. For business model and reserve policy templates, see the National Center for Charitable Statistics and the Nonprofits Assistance Fund.

By Michael West, CPA, Supervising Senior, Chicago office mwest@legacycpas.com

Voiding Checks in QuickBooks

A common reason for voiding checks is to eliminate older, stale-dated, outstanding checks. There are two ways that these checks can be voided when using QuickBooks. However, depending upon which method you use, you may unintentionally alter your financial reports.

One way to write off checks is to select the check in the register and void it through the “Edit” menu, clicking on “Void Check.” Voiding a check changes the dollar amount to \$0 but keeps the empty transaction. However, when the “Void Check” function is used, QuickBooks also zeros all of your accounts or balances that this check affected in the prior period, as if the check never existed. While this does eliminate the check from the list of outstanding checks on the bank reconciliation, various problems can occur, especially if the check is from a prior fiscal year. Since the check amount is now \$0, your checking account balance is increased as of the date the check was originally issued, and thus last year’s balance will not agree with your previous bank reconciliations, financial statements, or tax filings. Similar problems will occur if you are doing monthly or quarterly reports and the check was issued in a previous month or quarter.

Unless you are voiding a check in the same month it was issued, the better way to void a check is to enter a journal entry. The journal entry can be made through the “Company” menu and “Make General Journal Entries.” Use a date after

your last bank reconciliation was completed. If the check being written off was issued in a prior year, debit (increase) the checking account from which the check was originally issued and credit miscellaneous income. If voiding a check written in the same fiscal year, you would again debit the checking account, but you can credit the original expense account to which the check was posted when issued.

In the “Memo” section for both the debit and credit entries, write the date that the check was originally issued and the check number being voided. If you utilize the class field functionality, make sure you use the same category as was originally used. We recommend that you go into the original check and note in the check memo field that the check is voided, the date of the journal entry and journal entry number. During the next bank reconciliation, you would mark as cleared (✓) both the journal entry listed as a deposit and the original check from the list of outstanding checks.

In general, for checks entered against expense accounts, we recommend using the “Journal Entry” method to avoid throwing your reports off balance. Voiding a payroll check or a payment of a payroll liability requires slightly more involved procedures. If you need assistance with voiding checks or any other QuickBooks function, please let us know.

By Jim Jones, Manager, Chicago office, jjones@legacycpas.com

IRS Issues Draft Form W-2

On October 12, 2010, the Internal Revenue Service (IRS) issued a draft of the 2010 Form W-2 which employers will use to report wages paid and employee tax withheld for the year ending December 31, 2010. The IRS also announced that it will defer the new requirement for employers to report the cost of coverage under an employer-sponsored group health plan, rendering that reporting optional in 2011.

The draft Form W-2 includes the codes that employers may use to report the cost of coverage under an employer-sponsored group health plan. The Treasury Department and the IRS have determined that this relief is necessary to provide employers the time they need to make changes to their payroll systems or procedures in preparation for

compliance with the new reporting requirement. The IRS expects to publish guidance on the new requirement in the next few weeks.

Although reporting the cost of coverage will be optional with respect to forms issued in 2011, the IRS continues to stress that the amounts reportable are not taxable. Included in the Affordable Care Act passed by Congress in March, the new reporting requirement is intended to be informational only, in order to provide employees with greater transparency regarding overall health care costs.

Visit www.irs.gov for more information.

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Benchmarking Performance

It is no secret that as the current economic downturn is affecting business everywhere, the American nonprofit sector is particularly affected. GuideStar.org recently conducted a survey of approximately 7,000 charitable organizations in order to gauge how these organizations performed during the first five months of 2010. The results shed light on the overall industry financial performance.

Of those organizations surveyed, 40% of respondents reported a decline in contributions while 63% reported an increase in demand for their services. Since a decline in contributions reduces the funds available to finance services, a simultaneous increase in demand for services intensifies the pressure upon an organization to more effectively leverage its assets to continue to meet demand.

The following are the top five factors reported by organizations as the cause for a decline in contributions:

1. Fewer individual contributions
2. Smaller gifts from individuals
3. Smaller corporate gifts
4. Decreased size in private foundation grants
5. Discontinued private foundation grants

According to GuideStar.org, the impact of the economic decline is evenly distributed among all types of nonprofit organizations. Mental health and crisis intervention organizations, however, proved the most susceptible to this weak economy by experiencing a more dramatic drop in contributions. Conversely, food and nutrition organizations, such as food banks, saw an uptick in contribution income.

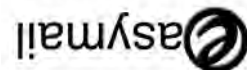
For complete results of the survey please refer to the article, "The Effect of the Economy on the Nonprofit Sector: A June 2010 Survey" published by GuideStar USA, Inc.

*By Benjamin Arthur, Staff Accountant, Chicago office
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Benchmarking



Happy Holidays!
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