

# LAW MEMO

## Savings and Investment Tips

Most arts organizations are income-focused. Because balancing the books at the end of the fiscal year is such a monumental task, even thinking about developing operating surpluses, investing cash reserves or establishing an endowment is a low priority.

Yet every organization could easily make use of extra cash — especially money that is unrestricted — to provide an internal line of credit for periodic cash shortfalls, launch a new program, make capital purchases or improvements, take advantage of an unexpected opportunity, or recover after an emergency.

This issue of *Arts Law Memo* summarizes some of the legal issues surrounding nonprofit finances and offers some practical savings and investment strategies.

### MYTHS & MISREPRESENTATIONS

Like individuals, organizations have numerous savings and investment options. Making good decisions begins with dispelling several myths and misconceptions:

#### **We are not allowed to make a profit.**

Nonprofits can make money, though "profits" are usually called "surpluses" or "excess revenue." The fundamental difference between nonprofit organizations and for-profit enterprises lies in the concept of ownership and benefits. A for-profit corporation has owners (either individuals or stockholders) who expect to gain financially; the purpose of the company is to make a profit.

A nonprofit organization has no owners. It exists for the public good, and its board of directors is responsible for assuring that its activities benefit the public, or some specific segment of the public. If those activities make money, that money must go back into the work of the organization.

#### **If we show a surplus, grantmakers will be less inclined to support our work.**

Most grantmakers take a positive view of strategies designed to promote financial stability. Don't be reluctant to share your

plans with them or to add a note explaining your rosy financial statement.

Of course, in extreme cases, excessive reserves may hamper fund raising efforts. In the early 1990s, for example, Father Flanagan's Boys Home (better known as Boys Town) was criticized by a watchdog group for maintaining an endowment so large that the organization could have operated for six years without raising any additional funds.

The lesson is simple: a reasonable percentage of surpluses should be reinvested in mission-related activities rather than simply allowed to accumulate year after year.

**It takes a lot of money to make a lot of money.** Picking winning investments will certainly build a portfolio. But to make more money, you also need more money. Setting aside even \$50 dollars a month can quickly grow your organization's "rainy day" fund. And, if your cash flow projections show excess cash on hand, it is worth temporarily transferring it into a savings account, money market or certificate of deposit.

#### **What we need most is an endowment.**

Most endowments are donor-restricted funds. Also known as permanently restricted net assets, most endowment funds specify that the principal will be held in perpetuity, but that earnings of the principal may be used for the organization's operating expenses or for a specific purpose.

Increasingly, established cultural institutions are relying on these earnings to help cover operating expenses. For example, the Saint Louis Symphony Orchestra's financial problems have been blamed, in part, on its relatively small endowment. In 2001, the orchestra's endowment was \$17 million, compared to \$75 million in Baltimore, \$112 million in Pittsburgh and \$141 million in Cleveland.

The Missouri Arts Council's new Capital Incentive Program also has stimulated interest in establishing

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VLAA helps artists and arts organizations solve and avoid legal and accounting problems by:

- Making referrals to lawyers and accountants;
- Mediating arts-related disputes;
- Publishing *Arts Law Memo* and concise how-to guides;
- Sponsoring seminars and public forums;
- Arranging for guest speakers;
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- Operating an arts space clearinghouse;
- Supplying model contracts and other arts law and business materials;
- Facilitating meetings;
- Conducting and disseminating research on issues affecting the arts;
- Contributing articles to publications;
- Collaborating on arts advocacy initiatives;
- Matching volunteers with arts organizations seeking board members; and
- Providing access to the national VLA network.



This issue was written by Sue Greenberg, VLAA's executive director. Special thanks to Patrick Donelan, Lisa McLaughlin and Kevin Blansit.

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endowment funds. The program earmarks part of the public Cultural Trust funds (provided by 60 percent of the tax on nonresident professional athletes and entertainers) to leverage private dollars. In most cases, an applicant's endowment campaign must have at least a \$100,000 goal, and a third-party administrator, such as the Kansas City Community Foundation, Community Foundation of the Ozarks or the St. Louis Community Foundation, must manage the endowment.

If your organization has an operating surplus, either planned or because expenses were under budget, you may be better served by creating a board-designated reserve fund. Because it is self-generated it is not restricted like an endowment and it will offer greater flexibility, including the ability to tap into the principal, if need be.

**We aren't interested in establishing an endowment; we don't have a planned giving program; we don't even have a development department, so we can safely ignore this entire topic.** Surprise! A dedicated volunteer, former employee or long-time donor makes an unsolicited restricted gift or names your organization as a beneficiary in her will.

Nationally, bequests already account for eight percent of total charitable contributions and, as the World War II generation passes on its substantial wealth, the potential for increasing philanthropy from this source is enormous. Be prepared!

**We are required to invest conservatively.** Nonprofits are required to invest prudently, not conservatively. Traditionally, trustees operated under what was known as the Prudent Man Rule. The rule, which dated back to a court case from 1830, severely restricted the types of investments that could be considered by a nonprofit, mandated that each investment be judged on its own, and forbade trustees from delegating responsibility or retaining investment help.

The result was that nonprofits tended to invest exclusively in U.S.

## THE PRUDENT INVESTOR RULE

*Total Portfolio Approach.* The standard of prudence is applied to any investment as part of the total portfolio and the total return from the portfolio, rather than to individual investments. The term "portfolio" embraces all assets.

*Risk and Return.* The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration.

*Allowable Investments.* All prior restrictions on specific categories of assets have been lifted. Trustees may invest in any assets that play an appropriate role in achieving the risk/return objectives of the trust and which meet other requirements of prudent investing.

*Diversification.* The definition of prudent investing now includes the duty to diversify investments.

*Delegation.* If trustees are not knowledgeable about investments, the prudent investor rule requires them to retain an investment adviser.

government bonds or certificates of deposit.

The Prudent Investor Rule, which has been adopted by Missouri and Illinois, created a set of new standards. It provides common sense investment guidelines that bring the management of trust assets in line with modern portfolio theory, which focuses on total return from all assets.

**We can handle all of our investment decisions internally. Conversely, we should turn the entire matter over to a financial adviser.** Generally, the transfer of money between checking and savings accounts (or other liquid investments) is handled by the staff.

Some organizations choose to invest directly in a mutual fund. Organizations with substantial assets, often defined at more than \$100,000, typically hire an adviser/manager. That person may be paid as a percentage of the portfolio, on a retainer basis, or by commission on trades.

No matter who is performing the day-to-day work, the board of directors has a fiduciary duty to protect the organization by establishing guidelines and overseeing investment management.

### PLANNING AND GOAL SETTING

Without planning and goal setting it is unlikely that your organization will ever accumulate extra cash. According to Susan Kenny Stevens and Lisa M. Anderson, authors of *All the Way to the Bank: Smart Money Management for Tomorrow's Nonprofit*, financial goal setting should begin with a five-year examination of your organization's fiscal history. Analyzing a spreadsheet that compares operating income and expenses will clarify trends.

Next, examine needs and discuss priorities. When setting goals, remember that they should be achievable and in the best interest of the overall fiscal health of your organization. Here are three examples:

- 1) Within five years, we would like to have sufficient cash reserves to operate, without additional revenue, for a six-month period.
- 2) In accordance with our technology plan, we would like all of our computers to be new enough to support our Internet access, database use, and network configuration needs.
- 3) We would like to establish an endowment to provide investment income to offset the costs of operating our facility.

## INVESTMENT PLANNING: A SELF-ASSESSMENT

- *How much money is available for investment purposes?*
- *How soon will the money be needed?*
- *Are we familiar with the various investment options and their merits? Have we researched and compared services, yields and fees?*
- *Is our primary objective short-term earnings or long-term equity growth?*
- *For long-term stability, how much cash should we hold in reserve?*
- *What level of risk is acceptable to our organization? Can we afford to lose any of the money? Should we depend on the earnings from investments as a main source of funding for a program?* The Denver Theatre Company recently closed its literary office and suspended development of new works because of declining earnings in the stock market. The theatre also discontinued its new play festival and competition for women playwrights. Its main source of funding for the programs was an endowment invested in stocks.
- *How will the rate of inflation impact our decisions? What cost \$10,000 in 1980 cost \$17,055 in 1990 and \$22,869 in 2000. Inflation erodes purchasing power. Organizations usually protect the long-term value of investment assets by putting some of the earnings (typically three or four percent) back into the principal so it keeps pace with inflation.*
- *Are we prepared to respect the covenants and restrictions surrounding endowments? Can we resist the temptation to "borrow" from endowment funds? Should we instead or in addition, create a board-designated reserve fund?*
- *Does the board understand its fiduciary responsibilities? The prudent investor rule? Modern portfolio theory?*
- *What roles will the staff and board play in short-term cash management decisions?*
- *Can the entire board or its finance committee handle oversight? Or should we create an investment committee? If so, should the committee include non-board members with needed expertise?*
- *Do we need to update our conflict of interest policy?*
- *Do we need to hire an outside investment adviser?*
- *Do we know how to find qualified outside help? Prepare a Request for Proposal (RFP)?*
- *Should we establish any non-financial investment guidelines for investments? Examples might include specifying a preference for buying stocks in locally owned companies or forbidding investment in specific industries.*
- *Do we need a written investment policy? According to Robert P. Fry, Jr., author of *Nonprofit Investment Policies*, "The case for adopting investment policies is simple: The adoption of policies invariably leads to an increase in return on investment and a decrease in fiduciary liabilities." Policies can be a paragraph-long or run for several pages. They should be reviewed by legal counsel before adoption.*

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## RESOURCES

### Sample Investment Policies

Does your organization have an investment policy? Please send it to us so we can share it with other arts organizations.

### Recommended Site

CompassPoint ([compasspoint.org](http://compasspoint.org)) is a California nonprofit consulting and training organization that provides nonprofits with the management tools and concepts necessary to best serve their communities. This site includes Genie, which provides quick and easy-to-understand answers to FAQs, and *Board Café*, a free monthly electronic newsletter.

### Publications

*All the Way to the Bank: Smart Money Management for Tomorrow's Nonprofits* (1997) by Susan Kenny Stevens and Lisa M. Anderson underscores the importance of solid financial management. It provides suggestions for improving cash flow and tips for selecting a bank and securing financing. It also explains how to develop an operating reserve and how and when to borrow money.

*Nonprofit Investment Policies* (1998) by Robert P. Fry, Jr. can help your organization create a sound, comprehensive investment policy. Fry is the author of two 24-page pamphlets, *Creating and Using Investment Policies* (1997) and *Investing for the Future* (2000). Both can be ordered by visiting [boardsource.org](http://boardsource.org).

These books and many others on arts law and business practices are available at the **St. Louis Volunteer Lawyers and Accountants for the Arts library** located within the Regional Arts Commission office, 3540 Washington, in Grand Center.