

2011 Nonprofit Industry Update



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Overview

For the first time in several years, there are no significant new accounting pronouncements affecting nonprofit organizations in the current year (unless you are involved in a merger or acquisition), and the changes to the 2009 Form 990 are very modest. However, nonprofit organizations are still in the process of responding to the major new requirements instituted recently. And with the new 2008 990s now becoming publicly available through Guidestar, we are beginning to see responses from the charity ratings organizations and the media to the new disclosures as we had predicted when the new form was released.

Organizations receiving federal funds have greater compliance requirements if contracts include funding from the American Recovery and Reinvestment Act (ARRA or the Stimulus). These likely include more significant reporting requirements than similar contracts have required in the past.

Most urgently for larger organizations, audits are now required for 403(b) plans with 100 or more eligible participants. If your organization has an audit requirement and has not yet engaged a firm to conduct an audit for the 2009 plan year, you should take action immediately.

On the horizon, the FASB has recently released several new exposure drafts which could have major impacts on the financial statements of many nonprofit organizations. In particular, the proposed change in lease accounting would cause organizations to capitalize almost all leases. This proposed standard is unlikely to be effective before 2012, but organizations with significant leasing activities should be aware of the proposed changes in order to effectively plan for a transition.

State of the Sector

Economic and Investment Indicators

As of June 30, 2010, the United States remains in a tough economic slump. While stock market levels have recovered somewhat from the historic lows, they remain far below the peak experienced before the financial crisis. Unemployment rates remain extremely high, which continues to depress contributions. As was the case last year, nonprofit organizations are being asked to respond to increased demands with fewer resources.

Investment portfolios have rebounded somewhat, although the stock market is still well below its peak. For organizations that benchmark part of their portfolios against the stock market, the following table shows recent performance for the S&P 500 for both calendar year and fiscal year organizations:

	Close	Change from PY	% Change from PY
Calendar Year			
12/31/2007	1,468.36	50.06	3.5%
12/31/2008	903.25	(565.11)	-38.5%
12/31/2009	1,115.10	211.85	23.5%
June 30 Fiscal Year			
6/30/2008	1,280.00	(223.34)	-14.9%
6/30/2009	919.32	(360.68)	-28.2%
6/30/2010	1,030.71	111.39	12.1%

Interest rates have remained very low, resulting in much lower interest income for organizations with investments in treasury bills, bond funds and certificates of deposit. The performance of both the stock market and interest rates underscore the importance of developing a strategic investment policy that matches an organization's time horizon and risk tolerance.

An important driver of charitable giving is employment. Since the beginning of 2007, the unemployment rate has doubled for both Los Angeles and California as a whole. There has been little movement in the overall unemployment rate over the past year and most economists are predicting slow job growth. Higher unemployment means increased demand for social services organizations and impacts contributions, since individual giving is correlated highly to household income.

Unemployment Rate: January 2007–June 2010



Giving

Charitable giving has declined as a result of the prolonged recession, but the overall decline from in 2009 was only 3.6% ¹. This overall statistic was skewed somewhat by a few extremely large bequests in 2008. Changes in giving from various sources were:

	2009	2008
Individuals	-0.4%	-2.1%
Bequests	-23.9%	34.7%
Foundations	-8.9%	5.5%
Corporations	5.5%	-6.1%

Although many corporations decreased giving in 2009, a few large corporate donors increased their cash and in-kind gifts significantly, resulting in an overall increase.

Giving priorities have changed somewhat among donors during the recession. Gifts to educational institutions and arts organizations declined in both 2008 and 2009. In 2008, gifts to human services and health organizations dropped significantly (12.4% and 6.5%, respectively), but giving to both of these types of charities increased in 2009.

The Foundation Center conducted a survey of foundations regarding their giving intentions for 2010. About 60% of all types of foundations (independent, corporate and community) expect to increase or maintain their giving in 2010, hopefully signaling an end to the trends of declining gifts from foundations. A more recent survey indicates about 21% of foundations expect to increase their funding in 2011 with 59% responding “no change.” Only 15% responded that they would decrease giving. ²

¹ Charitable giving statistics are from Giving USA. See www.givingusa2010.org.

² *Moving Beyond the Economic Crisis: Foundation Assess the Impact and Their Response*, Foundation Center, 2010

Internal Revenue Service

Implementation of the New Form 990

Smaller organizations (gross receipts less than \$1 million) were exempt from filing the full 990 for the 2008 tax year. The filing threshold declines for the 2009 and 2010 tax years. Organizations with gross receipts of \$500,000 or more and total assets of \$1.25 million or more will be required to file the full form and all applicable schedules for 2009. (For 2010, the thresholds are gross receipts less than \$200,000 and total assets less than \$500,000.)

In the initial year of implementation, organizations spent the most time on developing new policies so that they could respond affirmatively to questions regarding governance. As predicted, the charity ratings agencies and media are now beginning to use this information. (See Charity Navigator)

If your organization has not already done so, it is time for the board of directors to consider the following practices and revise or adopt policies as needed:

- Independent directors
- Conflict of interest policy, and how it is monitored and enforced by the Organization
- Meeting minutes documentation
- Whistleblower policy (required by federal law)
- Document retention and destruction policy (required by federal law)
- The role of members in the decision-making of membership organizations
- Board of directors involvement in reviewing and approving the Form 990
- Determination of executive compensation
- Public access to the Form 990, 1023, governing documents, conflict of interest policy, and financial statements
- Fundraising activity (particularly if the organization conducts gaming events)
- Gift acceptance policy
- Donor privacy policy ³

Changes to the 2009 Form

There are a number of changes to the new form, but many are helpful in that they clarify existing questions. The few new requirements are not very time-consuming but should be addressed early enough that they don't slow down filing. The IRS listing of significant changes is included as an appendix to this document.

One interesting clarification concerns the 990 itself. The IRS has provided guidance on what constitutes notice to all board members regarding review of the 990 – “The organization can answer “Yes” if it emails all of its governing body members a link to a password-protected web site on which the entire Form 990 can be viewed, and notes in the email that the Form 990 is available for review on that site.”

College and University Compliance Project – Unrelated Business Income Tax

The IRS periodically conducts compliance projects that usually focus on a particular segment of the nonprofit sector. In 2008, the Exempt Organizations Unit (EO) sent compliance questionnaires to 400 public and private colleges and universities with questions focusing on unrelated business taxable income, endowment funds and executive compensation practices. In May, the EO released its interim report. As a result of these initial findings, the IRS has begun examinations of more than 30 colleges and universities, apparently including Harvard.

Depending on the additional findings, the IRS may increase its focus on unrelated business income for all organizations. While most

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nonprofits do not have activities that would result in significant unrelated business income, many may have small sources that they are not accurately tracking. The IRS defines unrelated business income as net income from “any trade or business, the conduct of which is not substantially related to the exercise or performance by the organization of its charitable, educational or other purpose or function constituting the basis for its exemption.” An example is advertising within an organization’s newsletter (as distinct from sponsorship acknowledgement).

Advisory Committee on Tax Exempt and Government Entities

At a June 9, 2010 meeting, this committee reported various recommendations for new initiatives at the IRS. Consistent with the trend of emphasis on compensation, this committee has recommended that the IRS add a webinar to its Charity site to provide guidance on compensation. While this will not impose any new requirements, it underscores the IRS’ ongoing emphasis in this area.

Employment Tax National Research Project

The IRS has begun a compliance project focusing on employment taxes and will include nonprofit organizations in its sample of audited entities. The project will consider compliance in four areas:

- Classification of workers as employees or independent contractors
- Reasonableness of executive compensation
- Tax treatment of employee reimbursements
- Tax treatment of fringe benefits

Factors the IRS considers in determining whether a worker is an employee or independent contractors include:

- Behavioral – Does the employer have control or have the right to control what the worker does and how the worker does the job?
- Financial – What is the payment arrangement? What expenses are being reimbursed? Does the organization provide
- Tools and supplies? Is there an opportunity for profit or loss? Can the worker seek other business opportunities?
- Type of relationship – Does the relationship continue indefinitely, rather than for a specific project? Does the worker provide services that are a key aspect of the business?

The IRS website has a number of resources on this topic, although organizations using contractors extensively may wish to consult with an attorney to make sure they are in compliance. If a worker is determined to be an employee, rather than a contractor, financial consequences to the employer can be significant.

Interns

Nonprofit organizations often make use of interns, which can also pose compliance problems. If not conducted properly, an organization could end up liable for unbudgeted salary and payroll tax costs. There are six factors that must be met in order to use an unpaid intern. They are:

1. The internship, even though it includes actual operation of the facilities of the employer, is similar to training which would be given in an educational environment;
2. The internship experience is for the benefit of the intern;
3. The intern does not displace regular employees, but works under close supervision of existing staff;
4. The employer that provides the training derives no immediate advantage from the activities of the intern; and on occasion its operations may actually be impeded;
5. The intern is not necessarily entitled to a job at the conclusion of the internship; and
6. The employer and the intern understand that the intern is not entitled to wages for the time spent in the internship.

While this is another area that an attorney might be necessary, the Department of Labor does provide a fact sheet at <http://www.dol.gov/whd/regs/compliance/whdfs71.pdf>

³ The IRS does not ask about donor privacy policies – yet. However, it is one of the items in the new Charity Navigator metric. See next page, “Ratings Agencies and Watchdog Organizations”.

California Attorney General

Enforcement

In May, the Attorney General’s office filed a lawsuit against Monterey County AIDS Project and several former directors of the organization charging them with misuse of endowment funds. On behalf of the people of the State of California, the suit seeks an accounting of the assets contributed by a donor for housing purposes as well as damages resulting from breach of fiduciary duty, negligence and several other complaints. The suit, as well as other recent investigations of nonprofits by the AG’s office, suggest that the Attorney General continues to place an emphasis on compliance with donor restrictions and endowments.

Endowments (UPMIFA)

Organizations with endowment funds need to make sure that they are in compliance with UPMIFA, the Uniform Prudent Management of Institutional Funds Act, which became effective in California as of January 1, 2009.

This new law provides stronger guidance for investing in a prudent manner. The most important legal change is the elimination of the “historic dollar value” concept in place of a prudent spending policy. Because this is a new concept, many organizations may not have a spending policy in place. Under the new law, one is required.

The act requires that an organization conduct itself as follows with respect to its endowment investments:

- Avoid speculation
- Comply with any additional requirements set for in an organization’s articles, bylaws or grant agreement
- Diversify, unless it is determined that the purpose of the fund will be better served without diversification
- Expend no more than 7% of the fair value of the fund, calculated as indicated in the law, unless the organization can establish why a greater expenditure is not imprudent
- Consider general economic conditions, possible effects of inflation/deflation, tax consequences of investment decisions, expected return, role of the investment within the overall portfolio, etc.

You can obtain a copy of the California law at:

http://info.sen.ca.gov/pub/07-08/bill/sen/sb_1301-1350/sb_1329_bill_20080930_chaptered.pdf

Ratings Agencies and Watchdog Organizations

Charity Navigator

Charity Navigator, one of the main ratings groups, is in the process of implementing a significant change to its ratings methodology. The organization is adding ratings for metrics related to “Accountability and Transparency.” As indicated on their website, they define accountability and transparency as follows:

Accountability is an obligation or willingness by a charity to explain its actions to its stakeholders, including government, donors, beneficiaries, and the public at large.

Transparency is an obligation or willingness by a charity to publish and make available critical data about the organization, such as its finances, governance and effectiveness

Charity Navigator has placed a complete list of what they will be using to make their judgments on their website. The two sources for this rating will be an organizations’ website and the responses to various questions on the new 990. Many organizations do not post financial information on their own websites, assuming that the completed 990s are easily available at Guidestar.org or other sources. However, the availability of the 990, audited financial statements and a donor privacy policy on the charity’s own site will figure prominently in Charity Navigator’s new rating system. Organizations that wish to receive Charity Navigator’s highest rating should take a close look at their websites now to see if changes need to be made. RBZ will provide public disclosure copies of the Form 990 (omitting donor data) and electronic copies of audited or

reviewed financial statements for organizations that wish to post these on their sites.

Accountable California

Local 721 of the Service Employees International Union (SEIU) launched a website last year (www.accountablecalifornia.com) featuring investigative reports on various nonprofit organizations and local government entities. For nonprofit organizations, the most interesting feature of the site is its focus on executive compensation and the fact that the information used was gleaned from Form 990s filed by the organizations it has scrutinized. We anticipate that more of these types of reports will appear in the press and by advocacy groups as more reporters and researchers learn how much information is available in the federal filings. Accountable California has highlighted some questionable-sounding practices at certain organizations, but it has also posted executive salaries simply because they are high. With the IRS also currently focusing on compensation, organizations should ensure that they have a rigorous executive compensation procedure in place.

New Accounting Standards

Unless you are involved in a merger or acquisition, there are no significant new accounting standards to implement this year. Accounting standards were reorganized, however, into the “Accounting Standards Codification.” This has made the references to Statements of Financial Accounting Standards (SFAS) somewhat obsolete, although the original standards are still available on the FASB’s website (www.fasb.org), along with the codification.

Mergers and Acquisitions

For organizations involved in a merger or acquisition after December 15, 2009, the new accounting standard (originally issued as SFAS 164) may impact how such a transaction is recorded. In the past, nonprofits tended to treat all combinations as mergers and continued to use “pooling of interest” accounting which basically combined the financial accounts.

Under the new standard, organizations must determine whether they are engaged in a merger or acquisition. In a merger, two organizations cede control to a new organization (although for practical purposes, one of the two original entities may be used as this vehicle.) To qualify as a new organization, the combined entity must have a newly-formed governing board. In an acquisition, one entity obtains control of another.

If the transaction is determined to be a merger, the accounting uses the “carryover method,” essentially a combination of the financial statements of the two parties. In an acquisition, the acquiring organization uses a method similar to conventional purchase accounting and records the assets and liabilities of the acquired entity at their fair value on the date of the acquisition, along with any goodwill or charges. Generally, an organization will only be able to recognize goodwill as an asset if the acquired entity is a business-type entity.

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Proposed Lease Accounting

The FASB has been working on a proposal to put leases on the balance sheet for several years. This summer, the board finally released an exposure draft. The old standards for capitalization would be gone, and virtually all leases of a year or more in length would be capitalized.

The proposed standard would result in the following changes for accounting of lessees:

- Lessees would record a “right-of-use” asset and a lease payment liability on their balance sheets
- Lessees would record interest expense and amortization of the right-of-use asset over the term of the lease
- Lessees could recognize impairment losses on the asset.
- The lease payment liability would be calculated as the present value of the lease payments over the lease term.
- The lease term would be estimated taking into account the probability of exercising available options.
- Lease payments would include the estimate of contingent rentals and escalations.

Lessors would face two possible recording regimes: performance obligation or derecognition of an asset. Essentially, if the lessor does not retain significant risks or benefits related to the underlying asset, the derecognition approach mirrors installment sale accounting. Most leases would probably result in the performance obligation approach, which would result in the following accounting changes:

- Lessors would record a right to receive lease payments asset and a lease liability, presented together as a net lease asset or net lease liability. The property would remain on the lessors’ books in separate accounts.
- Lessors would record interest income and lease income as the lease liability is satisfied. This interest income, lease income and depreciation expense on the underlying asset would total to net lease income or net lease expense.
- A lessor could incur an impairment loss on the right to receive lease payments.

In addition to the impacts on GAAP financial statements, the proposed changes would impact ratios, non-GAAP measures like EBITDA and potentially contractual arrangements and covenants. Organizations with extensive leasing activities may wish to review their lease arrangements and other contracts to consider the potential impact of these changes.

Revenue Recognition

Earlier this year, the FASB released an update to the Codification that improved revenue recognition when an organization is involved in multiple element arrangements. The proposed new standard is consistent with this change, as well as SEC revenue recognition requirements that have been in place for many years. It is unclear at this point how the proposed standard might impact contribution accounting. Other types of revenues received by nonprofit organizations could be subject to the new standard if those revenue arrangements are determined to be “contracts with customers.” The proposed standard would require that an entity:

- Identify a contract with a customer
- Identify the separate performance obligations in the contract
- Determine the transactions price
- Allocate the transaction price to the separate performance obligations
- Recognize revenue when the entity satisfies each performance obligation.

In practice, this may not have much impact on organizations and businesses with relatively straightforward sales arrangements.

Employment Retirement Security Act (ERISA)

Plan Document

Regulations passed in 2007 require most organizations with 403(b) retirement plans to comply with the same rules as 401(k) plans. Organizations now need to have a written plan document. Organizations that have 100 or more participants in their 403(b) plans will need to have an audit of the plan for the 2009 year. Additionally, deposits must be made no later than 15 days after the funds are withheld from an employee’s salary.

To be exempt from ERISA, a 403(b) plan must meet all of the following criteria:

1. There are no employer contributions.
2. There is minimal administrative involvement by a plan administrator. (Third-party vendors or service providers must take on most administrative responsibilities.)
3. It must be a voluntary plan.

Audit Requirement

For the first time, 403(b) plans sponsored by nonprofit organizations (and covered by ERISA) are required to meet the same reporting and audit requirements that 401(k) plans have had for many years. Organizations that sponsor plans with 100 or more eligible

participants will be required to have audited financial statements when filing their 2009 5500s.

Calendar year organizations that have filed for an extension to file their 2009 Form 5500 have until October 15 to file the form and, if required, complete the audit. While there is still time to conduct an audit before the deadline, organizations that have not begun this process need to take action now.

Employment plan audits are very different from financial statement audits. Auditors are required to focus on compliance with the ERISA rules and look at many detailed transactions. The Department of Labor will accept audits with a scope limitation (the “limited scope” audit) that allow auditors to focus only on the organization itself and omit procedures on the transactions at the plan trustee. These types of audits are common with 401(k) plan administrators because the cost is much less than a full audit.

Since most 403(b) plans have never been previously audited, there may be challenges in obtaining beginning balance information. DOL will also accept a qualified opinion, which may be necessary if beginning balance information is difficult to obtain or desired by the plan administrator to reduce costs.

Federal Funds (Single Audit and Yellow Book)

ARRA

The American Recovery and Reinvestment Act (ARRA) imposed additional reporting requirements for funds expended through this program. Most nonprofits receiving funds are subrecipient organizations and do not directly report to the Federal government, but the state and local agencies awarding funds to nonprofits are required to gather information on job creation and rate of expenditure.

Organizations must track expenditures of ARRA funds separately from other funding, since these will need to be disclosed on the Schedule of Expenditures of Federal Awards. Auditors must consider ARRA funds as higher risk items in their consideration of major program determination, and may apply additional procedures to these grants.

Compliance Supplement

The Office of Management and Budget has issued its 2010 Compliance Supplement. Organizations receiving Federal funds should review the applicable sections of the Supplement to determine whether any compliance requirements have changed.

Financial Management

Reserve Funds

The economic repercussions of the past few years have caused many organizations to look at their reserves. Some organizations had established significant reserves before the recession and faced the question of whether to deficit spend in order to keep service levels high. Other organizations had little to no reserves and were forced

to lay off staff and eliminate services in order to maintain their cash flows.

Almost all organizations should maintain a reserve, but determining the appropriate level and related policies can and should vary according to the funding sources and spending needs of individual organizations. Like investment and spending policies, reserve policies should be tied to overall organization strategy.

The National Center on Charitable Statistics has established the Nonprofit Operating Reserves Initiative Workgroup. The Workgroup has published an excellent whitepaper with guidance on establishing reserve policies. One of the most important aspects of this whitepaper is that it provides a clear definition of reserve funds (in contrast with endowments, unrestricted funds and board designated funds).

The Workgroup has recommended a minimum reserve of 25% of the annual operating budget, which is consistent with the minimum of three months of operating expenses that RBZ has recommended to its clients. They defined an “Operating Reserve Ratio” as available unrestricted net assets (i.e., unrestricted net assets less fixed assets net of debt) divided by the annual expense budget. For organizations without any reserves, they recommend budgeting for modest surpluses of approximately 5% per year and building up a reserve over a five to six year period.

Resources

The following documents are available on our firm website at www.rbz.com/nonprofit-resources/

- Nonprofit Industry Update – Task List
- 990 Review Checklist Tool – For Audit Committee or Other Governing Groups
- 2009 Form 990 – Significant Changes (IRS)
- *The Mission Statement* newsletter – Our September 2009 edition includes the following relevant articles:
 - Improve Cash Management to Control Budget Deficits
 - New Merger & Acquisition Accounting Standard for Nonprofit Organizations
 - Form 990: Schedule G Changes Tracking of Fundraising and Gaming
- Getting Started: Meeting the New Form 5500 Reporting and Audit Requirements
- Navigating the New Normal: Financial Management Ideas (also on back cover)
- RBZ Nonprofit Services & Nonprofit Service Team

Navigating the New Normal: Financial Management Ideas

1. Keep a close eye on your key indicators. Monitor the use of temporarily restricted net assets and the balance of your unrestricted net assets to ensure that you are spending funds only in accordance with donor restrictions. Report regularly on efficiency ratios so that you are well-positioned to communicate with donors on your program emphasis.
2. Be careful in managing payables. To the extent possible, pay vendors after you have received the funding dollars. But beware of pitfalls – do not be tempted to retain payroll taxes or employee pension contributions. A delay in making these deposits can get an organization, and its board members, in trouble with the IRS. If you are extending payments, communicate with vendors, or set up a payment schedule upfront.
3. Be creative with benefits. If budgets prevent pay increases, consider offering employees other perks. Extra days off around Independence Day or New Year's may result in little lost productivity, but welcome extra time for your employees. Flex time may allow an employee to reduce their childcare or commuting costs with no additional costs to your organization.
4. Maximize the benefits you are eligible for from your professional associations. Membership in the California Association of Nonprofits provides organizations with discounts on many goods and services, as well as access to liability insurance through a member-owned insurance company. Chambers of commerce generally provide complimentary services and discounts to members. Some companies offer discounts to nonprofit organizations.
5. Use your professionals. Have your insurance broker shop your insurance or look at alternative plans. Go to lunch with your accounting firm to see if they can share ideas or tools.
6. Consider outsourcing. Although hourly rates for outsourced services may be higher than a salary, frequently the overall cost is lower due to the efficiency of specialized service providers and the fact that their fees include all benefits and carrying costs. Administrative functions like accounting, IT and HR are good candidates for outsourcing. An organization can even use an employee leasing company to "outsource" its entire employment function, transferring benefits, workers' compensation and payroll tax reporting responsibilities completely to another entity.
7. Keep in touch with your donors and make the case for your organization's ongoing relevance. When major donors must make hard choices about funding, make sure they know how important your organization's activities are to your community and their priorities. Email updates of accomplishments, client testimonials and site tours are low-cost ways of letting funders see your impact in action.
8. Look at different ways of pricing your fee-based services. Fixed fees and package prices can help your constituents budget for your program. Sliding scale fees not only generate some revenue, but increase commitment to your program. And lower prices for programs operating below capacity may actually increase overall revenue. A forum that draws 100 attendees at \$50 each generates \$5,000; if the same forum draws 200 at \$30, the overall revenue increases by \$1,000.
9. Consider partnering with other organizations. You may be able to achieve more with less by finding a partner. Look for program partnerships with organizations serving similar demographic groups or providing complimentary services. Consider sharing non-core resources: space, administrative functions, or grant-writing.
10. Don't automatically renew software licenses and subscriptions. Consider whether you are still getting value from these expenditures.
11. Talk to your landlord. With commercial property vacancies high, you may be able to renegotiate a lease and extend it at a lower rate. Some landlords may even be willing to give rent concessions without a lease extension if the alternative is to lose a tenant. Don't expect an offer without asking.
12. Consider seeking releases of permanent restrictions. Using restricted assets for purposes other than the donor intended can result in donor dissatisfaction and potentially scrutiny from the Attorney General. However, many dedicated donors would be willing to reduce restrictions in order to help an organization further its mission during tough times. California's new Uniform Prudent Institutional Management of Funds Act actually allows organization's to remove donor restrictions on endowments of less than \$100,000 that are more than 20 years old.

For more ideas or to hear more about these, contact:

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