A Guide to Building Reserves

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A Guide to Building Reserves

Introduction
The Arts and Culture Program Team believes that a building reserves policy is an important component of an effective capitalization strategy. For all grants associated with facilities, the program requires submission of a building reserves policy with application materials.

The principle of building reserves is to ensure that organizations have provided for the inevitable need to reinvest in the assets of their facilities, both to guarantee continuity in the provision of programs and services, and to protect the value of hard-won net assets. Reserves are a discretionary fund partitioned from the organization’s unrestricted net assets. Best practice suggests that reserve funds be formally designated by action of the board of directors, with established policies to govern their use and replenishment.

In reality, creation and observation of building reserves and reserve policies have not been common practices among arts and culture organizations. Some fear that the availability of designated reserves may limit their ability to raise capital grants, by creating the appearance that the organization has more money, and therefore less need, than other organizations who have not taken this step. This strategy puts the organization at risk, however, since a leaking roof or failed heating system requires immediate attention, while fundraising takes time to produce results. At a minimum, an organization without a building reserve but with ownership responsibility for a facility must maintain higher-than-normal working capital levels, to have the ability to respond to an unexpected call on capital. A second concern among some organizations is that setting aside building reserves restricts their ability to use funds if needs arise, but not all board-designated funds constrain the flexibility to redeploy net assets when circumstances change. The “reserve” designation indicates intent rather than a legal restriction. Furthermore, a comprehensive building reserve policy will address the use of funds in emergency situations.

Recognizing that reserves and reserve policies have not been common practice, we have identified some key aspects of thoughtful and successful building reserves policies based on our experience. Like all components of an organization’s capitalization strategy, building reserves policies are only effective and meaningful when they reflect an organization’s needs and operating context. In other words, they must be unique to the organization. The points here are meant to serve as examples of the elements that a policy will likely address. They do not constitute the model policy for all organizations.
Defining Purpose and Planned Expenditures

The sum necessary for a building reserve is determined by reasonably estimating the costs of improving and replacing capital equipment and facilities over a defined period of time, based on projected life spans for each system. There are a number of ways to determine this, the most common of which is a Systems Replacement Plan (SRP). Any policy should be designed with the needs and timetables determined in the SRP or other planning documents.

Defining the Scope of Need

As described above, defining the purpose of the fund will help an organization determine the appropriate size. There are many ways to determine how large a fund should be. Below are two suggested methods:

Reserves that approximate accumulated depreciation. The theory of capitalized fixed assets and their depreciation requires a basic assumption about the lifespan of these investments. As the accumulated depreciation expense grows, so does the likelihood that these systems will experience a need for significant repair or replacement. Since depreciation is calculated as a pro rata share of the initial investment, this is an appropriate proxy for reinvestment reserves. There are, however, two caveats. First, this calculation is based on the initial cost of systems and improvements, with no provision for inflation in such costs. Second, accountants use generic depreciation schedules for different types of assets, rather than individually evaluating the probable lifespan of investments. As a result, the accumulated depreciation calculation may significantly understate the likely current cost of replacement and repair.

Reserves funded in accordance with a systems replacement or capital needs assessment. More sophisticated organizations, especially those whose facilities are central to mission delivery, often will maintain a detailed analysis of building components and their individually evaluated condition and projected life spans along with estimated replacement values. The Nonprofit Finance Fund has promoted this approach through its Systems Replacement Plan program. Architects and construction consultants often provide this service as well. Some organizations may have skilled professionals on their boards who can assist with creation of a plan without incurring consulting costs, which can be substantial. With a plan to rely on, a detailed projection of costs can become the basis of goal setting for building reserves that represent a reliable provision for facility needs.
Seeding the Reserve Fund
In addition to determining the purpose and size of the reserve, organizations should determine the most appropriate method for seeding the fund, based on their business drivers and model. In our experience, we have seen several approaches to creating effective building reserves. Some examples follow:

Reserves as a component of a capital campaign. When a new facility is contemplated, an organization ideally will incorporate more than initial costs into its planning. A comprehensive capital campaign (or other fundraising strategy) will include physical development costs, costs of moving and furnishing the facility, transitional operating funding to help the organization adapt to higher annual maintenance costs and, often, seeding a building reserve. A fixed sum of a percentage (such as 2 percent) of building costs is raised and set aside for reserves as a component of fundraising, to be supplemented in future years by funding depreciation. While a common impulse is to disregard the need for reserves for a new or newly renovated facility, assuming that there will be no immediate need for reinvestment or repair, this is not an accurate assumption. New system components may put pressure on other elements previously thought sound; brand new equipment can fail and need replacement pending warranty claims; or some other unanticipated emergency can strike.

Endowment to support building maintenance and replacement. Organizations that operate with a long-term time horizon may choose to secure their facility with an endowment restricted to this purpose. Two examples of these types of organizations include a museum, which has a responsibility to maintain a collection in perpetuity, and a performing arts center, whose main responsibility is to support a building. As with all endowments, the principal (corpus) must be sized to produce an estimated 5 percent annual income stream that is sufficient to meet the needs it is designed to support. This can be limited to replacement costs of major building systems, or expanded to include ordinary maintenance as well as major needs. Because of the scale required to have an effective endowment, and the extreme competition for resources, it is unusual for an organization to start a building endowment in the current economic environment. However, those that already have an endowment will want to continually evaluate whether its size is keeping up with the organization’s projected needs. If need exceeds the income produced by the endowment, an organization must plan to add to the corpus or scale back the scope of needs the endowment is expected to support, and provide for the balance in annual budgeting.
Building Reserves Policies

Appropriate building reserves policies also would include the following elements:

**Identified sources of replenishment.** Just as there are many ways to seed a fund, an organization can replenish the reserve in a variety of ways. These methods should be as specific as seeding methods. Regular and planned contributions to the reserve are recommended, as making contributions on an inconsistent basis does not instill the discipline necessary to successfully develop the fund. Possible sources include, but are not limited to: budgeted surpluses, funded depreciation or a dedicated revenue stream. In all cases, planning documents must support the likelihood of achieving these sources of revenue at the required level.

**Clearly articulated timeline.** Building reserve policies necessarily take the long view of an organization’s needs. Policies should be attached to a timeline that anticipates replacement and improvement needs, but the policies also should be flexible enough to respond to the unexpected timing of some needs. Planning documents used to determine reserve needs will inform the timeline.

**Drawdown policy.** A comprehensive building reserve policy will include rules for withdrawing and using funds, such as who recommends and approves the expenditures. In the course of an organization’s lifetime, it most likely will need to tap the building reserves for an unexpected occurrence. The policy should anticipate and accommodate these occurrences, and contain a mechanism by which sudden needs can be met.

**Tracking and monitoring methods.** The policy should identify how and where the funds should be held within the organization. While organizations should be able to access their funds when needed, we do not recommend that the reserve funds be kept in a segregated account. Instead, if possible, funds should be combined with an organization’s portfolio to maximize return. Organizations should work with their auditors to ensure transparency in financial statements, so their discipline in maintaining the fund can be monitored easily.

Building reserves policies should reflect an organization’s needs and circumstances and will vary from organization to organization. The only unacceptable position is to fail to plan to maintain a facility, when it represents a key element of an organization’s financial and mission success. The above points do not reflect the preferences of the Arts and Culture Program Team. In our review of policies submitted for our Facilities Investments and Building Reserves grant opportunity, the most successful policies were unique to an organization, comprehensive (not project specific), and detailed.

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