Non-Profit Spending Policy: Implementing and Maintaining Compliance

All businesses should have some kind of spending policy in place. This is especially true when it comes to nonprofit organizations.

Nonprofit organizations have to balance the needs of their community today with maintaining and expanding support for their communities tomorrow. The spending policy they choose will play a key role in managing their current distributions and planning for the future.

An effective spending policy provides a steady anchor for nonprofit investors to serve as a guide for actions in today's uncertain and ever-evolving markets. Many organizations don't take the time to set a formal spending policy to follow every year and instead determine their spending every year.

Creating a clear standing policy is essential because it ensures strategic alignment with an organization's mission. It also helps to create fiscal discipline and consistency across volatile market environments.

What is a Spending Policy?

Extending policy refers to how much of the value of their investment assets they intend to use every year to fund operations, help pay for projects, and more.

Many nonprofits talk about their endowments which describe a cluster of both restricted and unrestricted gifts in addition to board-designated funds. However, a spending policy includes all of an organization's investments, portfolio management, including operating cash.

An organization's spending policy should not be one-size-fits-all. Every organization is different, and as such, their spending policy should be customized to uniquely address the needs of the organization, and the market they serve.

Nonprofits have a variety of revenue sources and expenses. That's why it is essential for organizations to develop and Implement a spending policy that is specific only to their organization.

Why Do You Need a Spending Rule?

One of the biggest reasons to have a form of spending rule in place is to comply with the Uniform Prudent Management of Institutional Funds Act or UPMIFA. It is a regulation that many states have adopted.

It applies to the Board of Directors or the Board of Trustees for an organization. UPMIFA was recently updated to include new language on how an organization's board should consider spending institutional funds such as endowments.

The new language provides 7 guidelines for organizations to use when determining their annual expenditures. That's why it's important for nonprofit organizations to implement a formal policy.

It's worth noting that UPMIFA typically does not apply to funds that are held by a bank as a trustee. Funds held in a trust may be subject to additional spending limitations depending on the terms of the trust and applicable state laws.

Regardless of whether an organization follows these guidelines, having firmly defined spending rules can help with budgeting and the financial management process.

Let’s imagine for a moment the difference between going into the grocery store with a budget and a shopping list and going into the grocery store without a budget or list in hand. When you shop with the budget and the list, your outcome is fairly predictable based on a disciplined process.

It typically results in you spending what you intended and getting the items on the list. In some cases, you may spend less than what you intended if you purchase certain items on sale.

You may even find that you grabbed a few extra items that weren’t on your list if you shop hungry. However, you are much more likely to stick to that budget and list buy shopping with one than you are if you shop without.

If you carry this example over to a nonprofit, the spending rule helps to find your budget or at least how an asset is contributed to a budget which helps determine what purchases, operations, and other considerations need to be added to your shopping list.

This helps keep your organization from overspending in any given year. Too much endowment spending this year could cause issues with your purchasing power and your investment assets if you have to use them to cover your additional spending.

From an investment point of view, using a spending policy helps the board of directors and board members, and investment committee to determine the investment programs’ required rate of return and risk tolerance objectives.

For instance, if your spending policy is set at 4% and uses 2% for long-term inflation with 0.5% for management overhead fees, the math indicates that you need a required rate of return of at least 6.5%.

With this information in mind, your investment manager could then use risk optimization to minimize the risks against the return rate of 6.5%. This allows the portfolio to meet its investment all effectively and efficiently.

Without adjusting the portfolio set on your required rate of return, your portfolio and asset allocation could return too much or too little.

In a situation where there is too much return, it takes on significantly more risk than necessary to meet the goal of 6.5%. In the case of too little, your portfolio created with too low of a return would be taking on less risk than you need to meet your goal and as a result, would likely fail to meet your return requirement.

> *Regardless of which spending policy an organization chooses, it's important to make sure it aligns with its investment strategy.*

Types of Spending Policies

Generally speaking, there are six types of spending policies to choose from. Organizations can pick one and make adjustments where needed so that it best fits their organization.

Income-Based

For most organizations, the income-based spending policy is an ideal place to start. It is one of the simplest methods nonprofits can use. Under this approach, the organization allows itself to spend the income it generates every year through its investment portfolio.

Income is generally defined as the interest and dividends produced by the Investments.

However, as individual and institutional investors have moved away from focusing on annual return in favor of Total return, using an income-based spending policy has become less popular.

Because of the low-interest rate environment, there is a market where a decent investment yield is difficult to find. Now that overall portfolio yields are lower, any nonprofit that has used the income-based spending strategy has probably found a significant decrease in spending of endowed funds.

That decrease may have significantly impacted operations.

That said, an income-based approach could cause an institution to align its portfolio in such a way that focuses too heavily on current income and ignores Investments that are a good option for the long-term sustainability of an institution.

Simple Spending Rate

The simple spending rate is a policy where spending is equal to the specified spending rate, multiplied by the beginning period market value.

Rolling Multiperiod Average/Moving Average-UPMIFA

With the rolling multi-period average policy aka moving average, spending is equal to the spending rate multiplied by an average of market values of the previous periods.

Using this approach, the volatility of required distributions from year to year is reduced.

Geometric Spending Rule

Under the geometric spending rule, spending in the current period is equal to the previous year's distribution that has been adjusted for inflation, times a smoothing rate to further reduce volatility, plus the beginning market value of the portfolio multiplied by the spending rate and the residual of the smoothing rate.

Inflation-Linked Rule

The inflation-linked rule begins with the set dollar amount that is typically determined by a percentage of trailing market value. The fixed amount is adjusted each year by an inflation index.

Hybrid Rule

Using the hybrid rule, part of the annual spending amount is determined by an inflation adjustment based on the previous year's spending.

The balance is determined by applying a fixed rate to the portfolio's market value.

Choosing Your Spending Policy

Now that you know what your options are for creating a spending policy, it's important to understand the factors that you should evaluate before you choose the policy to implement.

Time Frame

Generally speaking, the majority of institutions aim to exist in perpetuity. Though, many of them also have short-term funding needs to operate their current programs.

As such, a spending policy needs to allow for sufficient funds over the short term while protecting the organization's purchasing power for the future.

Your organization may receive gifts that are earmarked for specific purposes. Those funds have to have a defined time horizon and may require different spending approaches compared to your general funds.

All of these factors should be discussed when an organization determines how to best implement its investment spending policy.

Budget Needs

Nonprofits rely on endowed funds to cover a certain percentage of their annual operating budget. For example, Harvard's endowment returns cover a little more than a third of its annual operating budget.

Institutions like Harvard, therefore, have to place less emphasis on adjusting for market volatility and more emphasis on producing a predictable, stable flow of assets.

Your organization must also consider the possibility of other funding sources for the budget such as donations from the public to ensure that your spending policy is complementary to those other resources.

Spending Under UPMIFA

The UPMIFAis what makes it possible for each organization to either spend or accumulate funds as the board sees fit. This regulation provides flexibility and how funds are used but it does mention that the board has to take into account a number of financial rules.

That’s why it’s important to review the regulations and choose an appropriate spending policy that adheres to those standards. UMPIFA suggests that the board consider:

- Duration and preservation of the endowment fund
- The institution and its endowment’s mission
- General economic conditions that could affect the nonprofit
- Effect of inflation or deflation
- Expected total return from income and investment appreciation
- Other resources available to the institution
- The institution’s overall investment policy

How Procurement Software Can Help Ensure Compliance

Regardless of what spending policy your nonprofit chooses to implement, you will face a number of issues in procurement. That’s where using a procure-to-pay software like the one PLANGERY provides can be quite helpful.

Having all of your staff document purchases in PLANGERY keeps you from going over budget.

Automated workflows ensure that everyone stays compliant and within budget. It’s possible to allow your staff to order items only from specific, approved vendors where a contract is in place for the best possible rates. You can set budgets on a departmental and monthly basis to ensure no one overspends.

In cases where relatively large purchases need to be made, you can set up controls so that more than one person has to approve the purchase.

Reporting features may it easy to see average spending, cash flow, and can make it easier to plan fundraising efforts as well as future spending.

The fact is that there is no perfect spending policy that will work for every organization.

Your spending policy needs to be vetted and chosen specifically on your needs and priorities. Your board needs to view the policy as a long-term commitment that is aligned with your long-term goals and vision.

The information presented in this article should not be construed as investment advice. Investment decisions should only be made with a financial advisor familiar with your portfolio value and financial goals.

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