Mueller Prost
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NONPROFIT INSIGHTS

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RISK & REWARD

The Challenge of Alternative Investments

Nonprofit investment committees are like any other investor: They want returns. Today, this increasingly means moving into alternative investments — everything from hedge funds and private equity funds to real estate, timber, oil & gas, LBOs and commodities.

Unique Challenges

Alternative investments can make sense for some nonprofits. But, by their very nature, alternative investments operate in less regulated, or even unregulated, markets. Moving beyond the tried-and-true can present a number of unique challenges to nonprofits.

- **Valuation** - Alternative investments are usually classified as level 3 investments, which require some expanded disclosures. Yet, establishing an accurate value for alternative investments is by far the biggest challenge for a nonprofit's investment committee. Unlike stocks, bonds and mutual funds, there isn't always a readily available "market price" for an alternative investment. A private equity fund is just that — private. You won't find its share price listed in The Wall Street Journal.

- **Liquidity** - Investing in alternatives often entails illiquid holdings, especially when compared to stocks, bonds and mutual funds. An organization must carefully consider the "lock-up" periods required, as well as its overall tolerance for illiquidity. Capital requests also come into play. Some alternative investments require additional phased-in investments, which the nonprofit must be adequately prepared to meet.

- **Tax Implications** - Alternative investments can carry substantial tax implications — primarily unrelated business taxable income (UBTI). For instance, a real estate fund could generate UBTI if it generated income with debt financing (e.g., purchasing real estate with a non-recourse loan). UBTI can likewise result from operations in flow-through entities (such as limited partnerships) that are unrelated to the nonprofit's exempt purpose and do not meet any of the exceptions for passive activities. Alternative investments can also trigger the need for foreign filings.

Are They Worth It?

While not appropriate for every organization, alternative investments do have their place. They can help with diversification and reduce the volatility of investment performance. But nonprofits need to think hard about the added complexity and obligations, as well as the core investment risks presented by these alternative opportunities.

Here are a few tips to help you succeed with alternative investments:

- **Utilize a "prudent expert."**
  When it comes to oversight of a nonprofit's investment portfolio, the primary role of the board/investment committee is to prudently evaluate, hire and monitor the investment professionals whose roles are to manage the organization's investments. Follow sound due diligence and clearly establish the standard of care and even ethical expectations you expect your investment managers to follow.

- **Establish a comprehensive investment policy.**
  Your board should also establish an investment policy that clearly outlines the organization's investment objectives, cash flow expectations and risk tolerance. Be sure to include requirements to periodically rebalance portfolios back to original policy targets.

- **Use your board/investment committee.**
  Once a prudent expert has been retained, ensure that your board provides oversight and monitoring and maintains a level of understanding sufficient to verify the valuation of any alternative investments. Consider establishing mechanisms for regular portfolio reviews as well as a periodic review of the services offered by your outside investment managers and/or brokerage firms.

Good Governance Is the Key

Ultimately, the key to success for nonprofits exploring alternative investments is good governance — clear policies, proper due diligence and thorough oversight.

Your Mueller Prost advisor can provide valuable guidance on establishing a sound investment policy for your organization, including the use of alternative investments, if appropriate.

AHEAD OF THE CURVE:
L3Cs Are Creating Buzz in the Foundation World

It's been called the "for-profit with a nonprofit soul." Utilizing a hybrid legal structure, the "low-profit limited liability company," or L3C, combines the legal and tax flexibility of a traditional LLC with the social benefits of a nonprofit organization.

The result is a for-profit, social enterprise venture legally focused on pursuing a socially beneficial purpose, not maximizing income.

One area in particular where this new entity is generating some buzz is in the world of private foundations. An L3C makes it easy for foundations to invest in for-profit ventures via so-called "program-related investments," or PRIs. These are the IRS sanctioned loans or grants that private foundations can make for charitable or educational projects — such as affordable housing or health clinics — even if they are run by for-profit entities.

To that end, the Council on Foundations supports federal legislation that would encourage foundations to make program-related investments to L3Cs through an expedited review process by the IRS.

A PRI Primer

First recognized in 2008, the L3C statutes broaden the concept of program-related investments. Congress first embraced the strategy some 40 years ago, hoping that private foundations would engage in otherwise prohibited profit-related transactions that have the expectation of a mission-related benefit.

Critics say that PRIs have been historically underutilized. The reason, they contend, is that private foundations have been leery of making significant program-related investments due to the challenges of verifying that the for-profit is using the funds in furtherance of an eligible activity.

If the IRS doesn't deem the project adequately charitable and refuses to recognize a PRI, the foundation is vulnerable to substantial penalties and possible loss of nonprofit status. The only way to be sure that an investment will be approved is to seek a private ruling from the IRS in advance — an expensive and time-consuming process often involving protracted negotiations with the IRS.

For a foundation, L3C ventures provide several positive benefits:

- **They further a foundation's charitable purpose.**
  If an investment qualifies as a PRI, it can help satisfy a foundation's mandate to distribute funds in furtherance of its charitable purpose (typically 5 percent annually).
- **They reduce the costs and risks of PRIs.**
  Proponents say an L3C can function as a pre-approved mechanism for PRI investments. For example, if the L3C legislation is written in such a way as to comply with all PRI regulations, the structure theoretically eliminates the need for private letter rulings or legal opinions.
- **They allow "recycling" of funds.**
  Foundations also see value in PRIs for allowing them to recoup their investment and possibly see a minimal return. This allows the same foundation money to be recycled and loaned out multiple times.
- **They attract outside investors.**
  L3Cs are structured specifically to attract investments from private foundations as well as additional money from private investors. Unlike a charity, the L3C can have owners and investors, and is permitted to make distributions of profits to them. Investment in a L3C can be structured to deliver returns that meet the demands/expectations of both foundations, which typically expect low or no return, and more typical market-driven investors, who typically expect returns commensurate with the risk they are assuming.

Vermont became the first state to recognize the L3C as an official legal structure in 2008. In the following years, eight additional states have passed L3C legislation: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, and Wyoming. Currently, 26 states have proposed legislation in various stages of review.

Integrating Mission and Income

In the states that have approved them, L3Cs have been created that cover an array of intriguing social purposes — from job creation programs and low-income housing to alternative energy, environmental remediation and medical research.

Advocates say that the L3C is an innovative, even revolutionary, way of doing business. But L3C detractors say there are too many unknowns at this point. The IRS has issued only a few non-binding opinion letters, and nothing definitive has been said concerning whether investment in an L3C will qualify as a PRI.

Yet, using two recently created L3C entities as examples, it's easy to see the potential for these so-called "benefit corporations":

Cool Pass (http://www.coolpass.com) is a carbon offset program that assists low-income homeowners with obtaining EnergyStar appliances, insulation and other energy-efficient upgrades.

Faithful Travelers (http://faithfultravelers.com) is a travel service that matches faith-based customers with service-based excursions.

Ultimately, the intent of an L3C is to harness the use of profit-seeking capital for socially beneficial goals — a win-win scenario.

What Your Investment Committee Needs to Know

While generally accepted accounting principles (GAAP) require alternative investments to be valued at fair value, these values can be hard to come by. Typically, the outside investment manager or the issuer of the alternative investment ends up determining a value — there is no requirement for the investor to have an independent valuation performed.

But your board is responsible for the proper reporting of organizational investments. Therefore, it must have a sufficient understanding of:

- The underlying investments.
- The portfolio strategy of the alternative investment.
- The method and significant assumptions used by the fund manager to value the underlying investments.

Your board is responsible for the proper reporting of organizational investments

Creating a Fair Value Hierarchy

Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures (ASC 820), establishes a framework for classifying assets based on the certainty with which fair values can be calculated. Previously known as Statement of Financial Accounting Standards No. 157, or "FAS 157," ASC 820 also establishes a "fair value hierarchy" of inputs that are to be used for valuation:

- **Level 1 Inputs** — These are the quoted prices found in active markets for identical assets and liabilities (e.g., NYSE, NASDAQ, the Chicago Board of Trade).

- **Level 2 Inputs** — These are inputs other than quoted market prices that are directly or indirectly observable for the asset, including quoted prices in an active market for similar assets; quoted prices in a market that is not active for the same or similar assets; inputs other than quoted market prices that are observable for the asset; and inputs derived from observable market data by correlation or other means.

- **Level 3 Inputs** — These are unobservable inputs that reflect assumptions about the inputs that a market participant would use to price the asset or liability. Level 3 Inputs are developed based on the best information available in the circumstances (e.g., investment manager pricing for private placements, private equities and hedge funds).

Ultimately, under ASC 820, readers of the financial statement should be able to fully understand what inputs were used to determine an investment's value and into which value hierarchy each investment falls.

What You Can Do

What if a detailed listing of the underlying investments is not available? Here, you may gain sufficient understanding of a fund through other activities:

- Periodically interview fund managers so you understand a fund's strategy, positions and valuation methodologies.
- Compare data obtained from the fund manager with other available information, such as sector data, indexes and cash distributions.
- Corroborate this information through the annual audited financial statements of the alternative investment.

Your Responsibilities

Ultimately, your organization is responsible for complete and accurate financial reporting of all its investments. To that end, you'll need to:

- Establish processes to determine fair value measurements and disclosures.
- Select appropriate valuation methods.
- Identify and adequately support any significant assumptions used in preparing the valuation.
- Ensure that the presentation and disclosure of the fair value measurements are in accordance with all reporting requirements and GAAP.

Please contact your Mueller Prost advisor at 314.862.2070 if you have questions or need assistance in properly valuing alternative investments.

Who Is Opening Your Bank Statements?

Here's a deceptively simple internal control you may not have considered:

Have someone outside of your accounting function review unopened bank statements.

How? Simply have bank statements sent to the home of your executive director or a board member who is not involved in accounting. This person can review the statement for unusual items and checks for proper signers. At the same time, he or she can check both the payees and amounts paid. A final step would be to verify the endorsements, which will show who actually received the money, and then initial and date the statement.

Consider these additional internal control steps to help reduce fraud:

- **Reconcile to the general ledger.**
  Reconcile the balance in your bank account to the amount on the general ledger, not just the amount in the checkbook. Doing it this way verifies that no transactions belonging to someone else hit your account. Ideally, someone other than your bookkeeper should perform this step (again, a board member or your executive director).
- **Look for oddballs.**
  Review bank reconciliations with the prior month's reconciliation on hand. Look at odd deposits that have not cleared the bank and old checks that are still outstanding.
- **Compare.**
  Get some perspective by comparing two month's worth of reconciliations. Here, you'll be looking for anything odd, such as a deposit with one amount noted in the books and another amount in the bank statement.
- **Consider a two signature check policy.**
  Barring collusion, this would prevent someone from writing checks to him or herself.
- **Cover yourself — just in case.**
  Make sure your organization's insurance policy covers fraud losses, and consider bonding employees who are responsible for cash accounting.

Mueller Prost offers vulnerability assessments to help you uncover vulnerabilities in your systems. Click here or call your advisor at 314.862.2070 to find out more.

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