

SOME KEY CONTRIBUTORS TO THE CURRENT FINANCIAL CRISIS IN AFSC

There are a number of factors, both external and internal, which have contributed to the current financial crisis we are experiencing in the American Friends Service Committee.

KEY EXTERNAL FACTORS

First, it is important to say that we cannot overly discount the current worldwide financial crisis which has led to widespread financial insolvency for some of our greatest corporations and financial institutions. Bear Sterns and Lehman Brothers investment banking firms are no more, a large number of other banks have failed, Chrysler and General Motors have filed for bankruptcy, along with a number of other corporations and institutions. Financial restructurings and downsizings have moved at an accelerated pace, right across the board, for both profit and non-profit institutions, including a number of our sister Quaker organizations. Significant layoffs have been announced across a wide range of organizations. Paul Light, an NYU Professor, has estimated that 100,000 non-profits will go out of business in the next few years.

Individual contributions, bequests and grants to AFSC have all been directly affected by the current financial crisis. Donor willingness and ability to make charitable contributions have been affected by general economic insecurity, falling stock market prices, and increased unemployment. Falling real estate values and falling stock market prices have reduced the value of estates, and for residual gifts, estate values may have been reduced to the point at which there is no residue. Both of these factors have affected bequests. Grants have been affected by the effect falling stock prices have had on reducing foundation portfolios and thus the amount of money available to make a grant. In addition, with reduced contributions, there is also greater competition for existing grant income. Foundation giving is expected to decline from high single digits to low double digits for the near future.

KEY INTERNAL FACTORS

However, it is also important to note that the current financial crisis has not only led to a severe general economic downturn, it has also exposed specific weaknesses in the internal financial management of a number of institutions. In our own case, there are about five key weaknesses in our financial management and control systems in our approach to financial management which have significantly contributed to our current financial crisis within the AFSC. A number of these key factors have also made our financial posture highly leveraged. The five factors are as follows::

(A.) The Inadequacy of our Policy on Reserves and Endowments

(B.) Our High Dependency on Risky, and Sometimes Volatile Sources of Income

(C.) The Imbalance in our Financial Focus Towards Maximizing Spending, as Opposed to Income and Risk Minimization

(D.) A Slow and Cumbrous Financial Management System and a Broken Financial Structure

(E.) An Approach to Financial Management Which Does not Always Maximize Our Fiduciary Responsibilities

The detailed elements contributing to these five factors are discussed below.

(A.) THE INADEQUACY OF OUR POLICY ON RESERVES AND ENDOWMENTS

Reserves cannot completely insulate an organization from continuing financial losses, but they can buffer an organization from extreme financial shocks, buy precious time to address ongoing financial problems, and provide the capability to ride out financial emergencies. Our current reserve policy does not enable us to do this for the following reasons.

(1.) Insufficient Buffer from our Reserves

The level of our overall reserves does not provide us with a sufficient buffer to ride out a major financial crisis. If we had another \$20m to \$30m in general reserves, we could ride out the current emergency without immediate recourse to drastic organizational surgery. A recently as twelve years ago, we had very abundant reserves and preoccupied ourselves with the problem of how we could "spend this abundance down" and avoid having such a large amount in reserves. At that time, much of what we call reserves today was held in a large general reserve fund. Under the pressure of continuing budget overruns and other spending needs, we had been running down this general reserve for years. The Board's policy on controlling the general reserve was to set an overall limit on what we thought the size should be, and then determine not to allow it to go below that level, but the general reserve kept declining through every level that was set. The clear sense of the Board was that we should not be holding in reserves any more funds than were absolutely necessary, because our primary mission was to spend as much as we could to alleviate suffering and injustice in the world. At the same time, there was also a feeling that we needed a better definition of certain minimums beyond which we should not go. We implemented a policy of only having reserves that could be "justified": and then "designated" for a specific use. We then moved away from the commitment to maintain a strong base of reserves to mitigate against general financial risk, even though protection against general financial risk is one of the major reasons for maintaining organizational reserves. We also did not approve building and maintaining a large endowment, which can serve much the same purpose. We saw as a major criterion of success, how quickly we could spend down the perceived "excessive" reserves we held. Under this approach, our old General Reserve was

subdivided into three categories: Designated Reserves, which were those set up for specific purposes, such as funding our pension obligations, Released Reserves, which were those reserves for which no designated purpose could be found, and which were therefore viewed as having been "released" for program spending, and Undesignated Reserves, which was in reality, just a name for whatever was left over in our total portfolio value after subtracting the Designated and Released Reserves. Thus defined, the Undesignated Reserves could, and often did, decline to zero or levels below zero as a result of stock market volatility. Although some of our designated reserves provided a minimal floor against having no reserves, whatsoever, the floor we set was not sufficient to insure against significant general financial risk. Because of some inadequacies in our historical data, and the fact that we had to implement a major change in our accounting methodology about twelve years ago, due to Financial Accounting Standards Board (FASB) mandates, our historical data on reserves for years prior to then is both limited and also not comparable to what we now have. The reserves to expense ratio is one measure of the adequacy of an organizations reserves to cover unexpected risks or exposures to its operating expense, or drops in its operating income. From 1997 to 2008, our reserves to expense ratio has, in general, moved steadily downward from a level of 174% in 1997 to a level of 87% in 2008, with levels in between those points usually lower than 140%.

(2.) Highly Leveraged Funding of Our Reserves

To sufficiently accomplish its purpose, a financial reserve should be funded from more stable and financially liquid resources, such as cash, certificates of deposit (CDs), and money market funds. Our reserves were funded from our general market mix of our investment portfolio, about 70% of which was in equities. This was done because of the sense many had that by doing this, we would maximize our opportunities for realizing investment gains on the part of our portfolio which was in these reserves. However, a few years ago we were significantly "burned" from this policy, when, after the Board had set aside nine million dollars from our Undesignated Reserves as "Released Reserves", to fund the Africa Initiative and Project Voice, a sudden downturn in the stock market cut the value of this reserve by over half in just a few months. This clearly showed the excessive risk we were running in this approach to funding reserves.

(3.) Spending From Reserves To Support Operations

Designated Reserves came in two flavors: those which were essentially non-discretionary, such as our requirement for covering pension funding, and those which were discretionary, such as the Short-Term Income Fluctuation Reserve, which was established based on certain general judgments of how bad our income could be affected by a decline in our investment income. It is worth noting that we could never come to unity upon establishing a general reserve to cover either a drop in the value of our investment portfolio, as opposed to fluctuations in the income coming from it, or a hedge in the increasing riskiness of our income from bequests, resulting from changing demographics and giving patterns in our donor base.

The minimal level of designated reserves was significantly eroded over time by our repeatedly going into them and specifically into the Short Term Income Fluctuation Reserve and Undesignated Assets Reserve to help fund immediate organization spending needs, such as restoring lost value in the funding commitment for the Africa Initiative and Project Voice, Friends Center, and International Operations. In the fiscal years from FY 2001 through FY 2008, some \$14,770,597 was spent from our reserves for these purposes. These actions further weakened our already weak reserve posture and made us even more highly leveraged, in terms of eroding our reserves to expense ratio.

Many of these basic weaknesses in our policy on reserves were covered up by the general bull market of the 1990s, and the seeming return to those halcyon days, after the impact of 9/11 appeared to have subsided.

(B.) OUR HIGH DEPENDENCY ON RISKY AND SOMETIMES VOLATILE SOURCES OF INCOME

We have known for years that our primary income source from bequests was increasingly at risk because of:

- a. Aging Demographics, leading to a continuing diminishment of those donors who can remember the work-camps and the heady days of AFSC receiving the Nobel Peace Prize in 1947.
- b. Excessive dependence on a few larger donors giving significant amounts

These underlying risk factors have been exacerbated by our growing movement toward Insufficient smoothing of our bequest income used for budgeting purposes.

(C.) THE IMBALANCE IN OUR FINANCIAL FOCUS TOWARDS MAXIMIZING SPENDING INSTEAD OF MAXIMIZING INCOME AND MINIMIZING RISK

For years, our financial focus has been primarily on our income statement, as opposed to our balance sheet, and within the income statement, our financial focus has been primarily on budgeting issues, as opposed to actuals, on maximizing spending, as opposed to income. This imbalance has lead us to focus more on finding ways to fund popular programs and maximize the sense of financial stability and security, while assuming ever increasing risk upon the central financial administration. Along with our spend down of general reserves, which significantly increased our financial risk, for years, we have been hampered by an inflexible allocation system that froze percentage shares and amounts of unrestricted funds sent to regions and units, independent of program needs and performance. For years, we

even moved toward trying to guarantee three years of unrestricted funding security to our regions and units. When it was eventually realized that this was not possible, even with the new Financial Planning and Budgeting System, we clung to the desire to guarantee at least one year of unrestricted funding to the regions and units.

These things place inordinate demands on an already over strained central financial structure, which is akin to government commitments to fund an increasing range of social entitlements, without providing for sound future funding of them. In addition, the tremendous demands upon the financial staff and the Finance Committee, take valuable time and energy away from the focus on cash management, balance sheet risk and asset protection, and accounting/control issues. As we have increasingly dipped into our financial reserves on our balance sheet to cover periodical operating income and spending problems, this has also led to an increased blurring of the line between Finance and Budgeting.

One of the prime examples of the increased focus on spending over income, was the Finance Committee's statement that our budget should be viewed primarily as an "intention to spend", as opposed to being a precarious balance between income and expense, in which the balance must always be carefully monitored and ensured.

(D.) A SLOW AND CUMBERSOME FINANCIAL MANAGEMENT SYSTEM AND A BROKEN FINANCIAL STRUCTURE

Although we have moved recently to make our financial planning and budgeting process more flexible and responsive to emerging problems, we still have a very rigid and inflexible financial planning, budgeting and financial decision making process.

Part of the reason for this is the huge institutional inertia against changing our approach. The prime expression of this was the years of excessive discussion, debate and resistance toward moving away from the old allocation system, with all its rigidities, and the fact that we still have not completed implementation of the new financial planning and budgeting system.

The Simplicity Committee was initially commissioned because of a need to reduce a "structural deficit" which had emerged within the AFSC, because of the increasing costs of financing our large Board, many meetings, and preparation for them, and an increasingly expensive and time consuming manner of addressing issues. After commencement, the Committee did wind up addressing many other important operational issues, but did not really achieve much on the cost reduction front, which was its original charter.

A lot of the rigidity in our approach starts from the fact that we approve a budget many months before the beginning of a fiscal year, and then lock in the budgets we approve, which is to, in effect, freeze allowable spending decisions some eighteen months before

they are to occur. We are slow to respond to quickly emerging financial imperatives, and we limit the ability of the General Secretary and her staff to implement immediately necessary corrective budgeting and spending actions by, in effect, freezing spending authority to regions and units for the fiscal year for which budgets are set. Most institutions recognize that since the financial environment and situation can sometimes "turn on a dime", their own internal processes for financial monitoring, management and control must also be able to "turn on a dime."

We do not provide the General Secretary and her staff with the ability to rapidly deploy a wide range of actions most institutions believe are essential to immediately place brakes on spending in the event of an unforeseen financial emergency. Such tools include:

- a. Immediate Hiring Freezes
- b. Staffing reductions, either through reliance on full attrition, or implementation of selective reductions in force
- c. Immediate travel controls and restrictions
- d. Immediate reductions in purchasing of non-people related expenses
- e. Immediate reductions in spending authority to Regions and Units, or reallocation of spending authority between them.

Although some action can be taken, and has been taken recently in some of these areas, specifically with respect to reduced hiring, the process of doing so has been cumbersome, and management has been reluctant to take immediate action on a more timely basis because of the fear of resistance from the Board and/or the staff. This is buttressed by a fear by a lack of trust of senior management by some on the Board and staff, complemented by a fear that vesting authority to take timely action on these fronts would constitute giving "too much power" to senior management of the AFSC.

Finally, no changes toward making the financial process as flexible, effective and efficient as we want it to be can be made unless we make significant progress toward improving the quality, capability and timeliness of our financial information systems.

(E.) AN APPROACH TO FINANCIAL MANAGEMENT WHICH IS NOT ALWAYS TIMELY AND DOES NOT ALWAYS MAXIMIZE FIDUCIARY RESPONSIBILITIES

There needs to be more awareness of, and education in, the fiduciary responsibilities we share as Board members. The Finance Committee should also strengthen its role in acting as the prime financial guardian of these responsibilities, and as the first funnel for transmitting these concerns to the Board. There needs to be a greater sense of caution, and

less resistance to "putting on the brakes" when the times call for it. As this report has shown, the seeds of our difficulties are both external and internal in nature, and many of our internal problems have to do with our limited reserves, strong bias toward spending to support the many needs of a troubled and suffering world, outmoded financial processes, systems and decision making approaches. Other problems have to do with our inbuilt inertia as a Board, and our inability to move quickly and decisively on financial emergencies. However, we need to also examine why the Finance Committee and the Board were not more timely in recognizing the seriousness of the current financial crisis as it emerged, and in making recommendations to the Senior Management team with respect to our need to take more significant and immediate corrective actions to help offset this calamity.

We knew that income declined in FY 2008. Unrestricted contributions didn't grow but actually fell by a few thousand dollars. Bequests were \$3m less than in FY 2007 and \$5m less than budget. Our expenses increased \$6m in FY 2007 as our income declined by \$5m. It was all well within budget and expenses were covered by unspent general funds, local reserves, and carry forwards. On the other hand, we were poorly positioned for FY 2009 with an expense platform that was 15% higher than the previous year and an income platform that was 13% lower, and getting weaker. When it became clear that the country was in a recession and that we faced significant income reductions, it took six months to reach a Board decision on a maximum operating budget for FY 2010.

In addition, the Finance Committee must back away from advancing such notions as the view that our budget is primarily an "intention to spend", and the view that we should encourage Regions and Units to lock in spending plans as budgets, with the central administration pledged to cover any income shortfalls. We must preserve a strong separation between spending from restricted and unrestricted funds, realizing that there is a very significant difference between these two income streams, which lies in their different sources of funding, and that we have an organizational imperative to maximize incentives for seeking restricted funds. In most organizations with these mixed funding sources, it is realized that separate income statements should be kept for these two distinct funding and spending sources for these very reasons. The Finance Committee also needs to break its internal logjam on resolving the handling of this and other issues, take more timely action to both educate the Board on the implications these issues present for effective financial management, and make appropriate recommendations to the Board for resolution of these matters.

SUMMARY AND CONCLUSION

The intent of this document is to be as diligent as possible in faithfully reflecting upon, and commenting on all the key factors which have affected our internal financial systems, operations and decision making processes in preparing for the current financial crisis, minimizing our financial risk and exposure to such a crisis, and enabling us to

recognize its onset and respond in a timely and effective manner to addressing it. The intent of this is not to cast blame on AFSC individuals and institutions, but rather, in a spirit of openness, to (1.) learn what we can from this most unfortunate development, (2.) extract the very hard won lessons we must take to heart to both explain to ourselves and our constituents more about how we got to where we were, and (3.) offer some meaningful approaches to fixing these problems, as led by our experience in how they come about.

Our Quaker process is outstanding for spiritual discernment. But, the slow and patient working toward unity which lies at the heart of it, does not always lend itself as well to the required pace of timely and responsive financial management decisions which our organizational reality and the dynamics of our surrounding society require. Our acquired practice of dealing with these and other issues as a "Committee of the Whole" further slows down our process and inordinately lengthens the response time we require to address a fast moving financial crisis. These are some of the other larger issues we should ponder, along with the more specific ones addressed in this document.

In Peace and Loving Friendship,

Jim Fletcher and Don Gann