

# What Is Capitalization?

While many of the leaders of our region's nonprofits are veterans in the struggle to fully capitalize their organizations, others—including board leadership, funders and donors—are less familiar with conversations focused on business models and balance sheets. The following summary is offered to create a common language and shared understanding of these issues. A bibliography of further reading on capitalization will be posted on the Berkshire Taconic Community Foundation website, [www.berkshiretaconic.org](http://www.berkshiretaconic.org).

Capitalization is the accumulation of resources that provide the cash to cover short-term needs and long-term obligations as well as to invest in innovation or organizational change. A well-capitalized organization is one that has a business model that enables it to generate surpluses over time and use the accumulated surpluses to establish operating reserves and other forms of capital funds that support its mission and artistic vision.

Appropriate capitalization enables the organization to support the right infrastructure—enough staff, facilities that are appropriate for its programs and programs that match the interests and attendance patterns of its audience—to realize its vision. Crucially, capitalization also provides the flexibility and liquidity to change with market and economic conditions.

Six types of capital funds can be found on an organization's balance sheet:

1. Operating Funds—are used to pay for budgeted expenses. These are funds that are unrestricted or released from temporary restriction; they do not include restricted revenue or one-time receipts from capital campaigns or gains from investments or sale of property.
2. Working Capital—is used to maintain day-to-day operations through cycles of low cash flow. These funds enable the organization to borrow from itself based on anticipated income and then to repay the fund. Working capital, current assets less current liabilities, is a measure of an organization's liquidity. A line of credit can often substitute for working capital.
3. Operating Reserves—are funds set aside to support unexpected downturns. Because a “rainy day” does not present any obvious source of replacement or future revenue, the use of a line of credit is not appropriate. On the balance sheet, operating reserves are seen as Total Unrestricted Net Assets, but can also be labeled as Board Restricted Net Assets (Unrestricted).
4. Capital Improvement Reserves—are also known as Building Reserves or Capital Replacement Reserves. For organizations with facilities, these funds are the foundation of plans that anticipate the need to replace such
5. things as HVAC systems, roofs or theater lighting equipment. Similar to Operating Reserves, these are often labeled Board Restricted Replacement (or Capital Improvement) Reserves.
6. Endowment—ensures the long-term operations of the organization by providing investment earnings that support ongoing costs of fixed assets such as a collection or building. An endowment can be legally and permanently restricted or quasi-restricted based on a vote of the board.
7. Innovation Fund—is risk capital that allows an organization to try new ideas, grow or realign its strategic direction. On the balance sheet, it is also a board restricted reserve fund.

There is no single “right” capitalization structure; some types of capital funds are not appropriate for some nonprofits. The organization's needs and business model determine what kind of funds it should seek to accumulate. An artist-led organization that is focused on its next production or exhibition has far different capital needs than a museum that maintains a facility and owns a collection that it is perpetually obligated to steward. But in both cases, the key to success is a business model that over time generates sufficient surpluses to support the organization's mission.

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The Kresge Foundation, long known for its challenge grant support of facilities, has recently revised its grant making to emphasize the ongoing maintenance and sustainability of facilities and the nonprofits that own them. As part of this realignment, Kresge has launched a nation-wide conversation among nonprofits and their institutional supporters about the nature of nonprofit financial structures. As its website notes:

*The vitality of arts and cultural institutions and their capacity to serve the public are often threatened by weak finances. In assessing financial health, organizations and their supporters often look at a single budget year. In reality, it is the strength of an organization's balance sheet that allows it to achieve its long-term goals. The need for a healthy balance sheet is even more acute given the presence of a facility.*

*By building their asset base through years of surplus operations, organizations develop the capacity to plan for the future, react quickly to new opportunities, and support missions that may require major fixed assets and a long-term view.*

*We believe well-capitalized organizations will ultimately produce higher quality products and be more impactful, innovative, and relevant in and for their communities.*

*Thinking about capitalization is a relatively new effort in the nonprofit arts and culture sector and best practice is just emerging, but at the core capitalization is the accumulation of aggregate resources put to use to achieve an organization's mission. Beyond this definition, our research reveals a strong need across the sector for a better understanding and implementation of the effective practices that will lead to this result.*

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