Colorado Paint Stewardship Program Financial Assessment

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Prepared for:
Colorado Department of Public Health and Environment (CDPHE) Hazardous Materials and Waste Management Division

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Executive Summary

The Colorado Paint Stewardship Program manages leftover paint operating under the state's Architectural Paint Stewardship Act, which was signed into law in June 2014. The program is operated by PaintCare, a nonprofit organization that operates similar programs in seven other states and the District of Columbia. Since the Colorado program launched on July 1, 2015, more than 2.37 million gallons of paint have been collected and 2.26 million of those gallons were processed for proper disposal. In 2018, PaintCare Colorado supported 169 year-round paint drop-off sites and conducted 113 large-volume pickups. Nearly 95 percent of Colorado residents reside within fifteen miles of a permanent drop-off site. The program is funded through fees on new paint sales in Colorado. Through 2018, the fee revenue has totaled approximately $24 million.

As the sole paint stewardship program provider, PaintCare's activities are guided by the Architectural Paint Stewardship Act and a program plan produced by PaintCare in 2015. Program compliance with requirements is monitored by the Colorado Department of Public Health and Environment (CDPHE). This report focuses on the financial practices and policies of the Colorado Paint Stewardship Program and supplements the annual *Status of the Colorado Paint Stewardship Program* reports provided by CDPHE's Hazardous Materials and Waste Management Division. As the program enters its fifth year of operation, it is a good time to review the program's finances, particularly the accumulated financial reserves from operations.

The Colorado program, at the end of 2018, held financial reserves of $4,887,694, which is equal to 84 percent of 2018 program expenses. PaintCare's revised reserves policy calls for a target reserve level of 100 percent of program expenses, with minimum and maximum levels of 75 percent and 125 percent, respectively. Financial projections, using a range of revenue and expense growth assumptions, support PaintCare's view that lowering the existing paint recovery fee is inadvisable at the current time. Doing so would make compliance with the existing reserves policy unlikely and raise the probability of the need for a future fee increase. While there is managerial discretion available with some program costs, the program has no control over the fee revenue that depends on paint sales. The Colorado program, to date, has operated in a period of economic growth and the potential for reduced fee revenue during an economic downturn is a valid concern justifying, in part, higher than average reserve levels.

Nonprofit organizations, like PaintCare, are governed by the nondistribution constraint, which means that a nonprofit can generate and accumulate surplus funds but the surplus must be used to support the organization's mission rather than be distributed to the individuals who control the organization. In fact, nonprofits are widely encouraged to establish operating reserves as part of sound financial management practices. Compared to peer product stewardship organizations, PaintCare and the Colorado program have reserve levels, respectively, that fall in the upper-middle of the range of reviewed organizations. Among PaintCare's nine active programs, Colorado's program reserves are substantially higher than the average reserves but also represents the median, or middle, reserve level with four programs with higher reserve percentages and four with lower reserve percentages. Broader comparisons to the nonprofit sector show that the reserve level of the Colorado program is substantially higher than the median organization for a variety of comparison groups and falls, generally, between the 75th and 90th percentile of reserve ratios.

Financial reserves can help sustain operations despite unexpected changes in program revenues or costs. Reserves are invested until needed based on the organization's investment objective. PaintCare's "sole objective of the portfolio is to earn a return equal to the rate of inflation and thus preserve the purchasing power of its capital." PaintCare has high levels of liquidity and maintains its reserves as a mix of cash and investments. The cash and investments belong to the various state programs based on respective reserves. In addition to cash holdings, the formal investment portfolio is comprised of cash, bonds, and equity investments. Beginning in 2015, PaintCare started to establish a separate, state-specific "wholly-owned subsidiary company dedicated to managing" each state program and investment assets for each program are being placed into state-specific accounts over time.

Over the past five years, 2014 through 2018, PaintCare's overall investment composition has averaged 35.8 percent in equities and 64.2 percent in fixed income instruments. Through 2018, *the estimated annual return of the PaintCare investments has exceeded the annual inflation rate of the same period*. The average investment activity for PaintCare, as a whole, was an annual gain of $106,791 over the period, although investment losses (realized and unrealized) in 2018 were large enough to result in a total investment loss of approximately $750,000. A simulation back tests PaintCare's most recent investment composition against inflation. The portfolio historically would have returned an inflation-adjusted 4.49 percent from 2003 to 2019, measured as the Compound Annual Growth Rate. Although past performance does not in any way guarantee future investment results, the back testing suggests that PaintCare's investment allocation is relatively conservative and has, historically, *more than kept pace with inflation*. PaintCare's investment portfolio has much less fixed income exposure than one peer product steward organization and similar exposure as another peer.

The Architectural Paint Stewardship Act requires that the funding mechanism for Colorado's PaintCare program is "equitable and sustainable." Compliance has two components. The funding mechanism must "provide a uniform paint stewardship assessment that does not exceed the amount necessary to recover program costs" and "any funds generated by the aggregate amount of fees charged to consumers be placed back into the program." The program's reserves come from fee revenue that, in any given year, might be considered excessive to cover program costs. But these accumulated funds should be thought of as program costs smoothed over time, particularly in the program's early years when operational uncertainty is high, reserves are being established, and volatility associated with operating under different market conditions is still difficult to predict. From a practical standpoint, the Colorado program has complied with these funding requirements but PaintCare and CDPHE should revisit the priorities of the program to determine that program activity is at the desired level and to consider contingencies if financial reserves grow beyond the established maximum.

PaintCare's financial strategies and practices are reviewed in four primary areas: 1) reporting and transparency, 2) projections, 3) financial condition, and 4) procedures. PaintCare provides visibility into the Colorado program and its finances through annual reports submitted to CDPHE and posted to the websites of PaintCare and CDPHE. The program's annual reports append an independent third-party audit of PaintCare's national organization, which serves as the state program's financial audit. PaintCare's Form 990 filings are available through the Internal Revenue Service (IRS) and some third-party data providers, but are not made readily available to the public on their website.

The combination of conservative projections and changing reserves policies raises concerns over the program's ability to accurately estimate financial outcomes. All projections have accompanying error, but PaintCare should consider presenting projections as flexible budgets based on different management decision and economic scenarios. This provides a range of outcomes rather than a single estimate for stakeholders to consider. The existing annual reports provide some useful explanations for discrepancies from projections, but a more formal variance analysis for primary revenue and expense categories would improve transparency to the public and help avoid misunderstandings around the causes of unanticipated budget surplus or shortfall. The projection assumptions are detailed in the annual reports, but some components of the projections lack transparency and deserve additional attention to be understood by an external audience.

PaintCare and the Colorado program have substantial liquid assets and a high-level of reserves. For the program, reserve levels are nearing compliance with the internal policy target of 100 percent. PaintCare's projections suggest the Colorado program will not meet the target level in the coming five-years and may, actually, fall below the target minimum reserve level. Assuming no significant fee revenue declines, discretionary spending by the program can likely be managed to maintain reserve levels within the policy thresholds. The reserves reflect low levels of liabilities for the organization and program.

PaintCare's financial practices appear reasonable. Existing practices potentially deserving review include the overhead cost allocation approach based on program population, the need for formal designation of financial reserves as board-designated, consideration of restrictions on reserves based on program claims, the impact on costs and investment management of the transition of state programs to independent limited liability companies (LLCs), policies to avoid potential conflicts of interest between PaintCare and the American Coatings Association (ACA) due to overlapping activities, employees, and boards, and optimizing the non-investment reserve held in cash based on historic liquidity needs.

Recommendations reflecting these topics are provided to PaintCare and CDPHE. Overall, the program continues to mature and is in a relatively strong position among programs nationally. Nonprofit organizations face a double-edged sword of being told to build adequate operating reserves, but face criticism when reserves are deemed excessive by stakeholders. Although not a charitable nonprofit, PaintCare programs face similar scrutiny due to being funded by mandatory fees on paint sales to the public. For this reason, the Colorado program should work to improve communications around reserve levels and policies, how reserve levels influence program spending, and contingency plans for future changes in reserves.

I. Overview

This project provides the Colorado Department of Public Health and Environment (CDPHE) with a financial analysis of the Colorado Paint Stewardship Program.[1] PaintCare is the entity responsible for managing unused paint in Colorado under the Architectural Paint Stewardship Act. During the 2018 legislative season, a bill was introduced to repeal the PaintCare program, and discussions largely focused on program surplus funds. Additional discussions questioned the costs of paint recovery fees on architectural coatings and whether these fees should be reduced. This project provides an independent financial analysis of the PaintCare Program through the evaluation of PaintCare's five-year projections, recovery fees, reserves policy, and finances of the program. The report addresses the following topics:

- Financial impacts of lowering the paint recovery fee;
- PaintCare's reserve policy compared to other stewardship organizations and 501(c)(3) organizations;
- PaintCare's investment activities;
- PaintCare's compliance with part 25-17-404(2)(j)(II)(A) and (B) of the Architectural Paint Stewardship Act;
- PaintCare's financial management strategies and financial practices; and
- Recommendations.

II. Background

Product stewardship represents a life-cycle approach to mitigating the negative health and environmental costs of a product. A broad set of stakeholders ranging from manufacturers to retailers to consumers bear responsibility for their roles in a product's lifecycle. Product stewardship is often used synonymously with extended product responsibility (EPR), which is a term that more squarely assigns responsibility to manufacturers for safe and responsible disposal of their products. State and local governments historically manage solid waste disposal in the United States, with hazardous household waste (HHW) disposal an especially challenging responsibility. A majority of states has enacted EPR laws to address the end-of-life disposal challenges of a wide range of consumer products (see figure 1, for details).

The most common, and expensive to manage, household hazardous waste for governments is unused architectural paint. At the same time, leftover architectural paint has the potential to be reused or recycled in many cases.[2] Following extensive stakeholder engagement between government and industry, the State of Oregon adopted an EPR law in 2009 focused on paint disposal endorsed by paint manufacturers.[3] Subsequently, nine states and Washington, D.C. passed similar legislation.[4] In each instance, the disposal

[1] For a broader programmatic evaluation of the PaintCare Colorado program, a report is expected from PaintCare in August 2019 based on a series of surveys conducted with the program's different stakeholder groups (*PaintCare Colorado 2018 Annual Report*, p. 53).

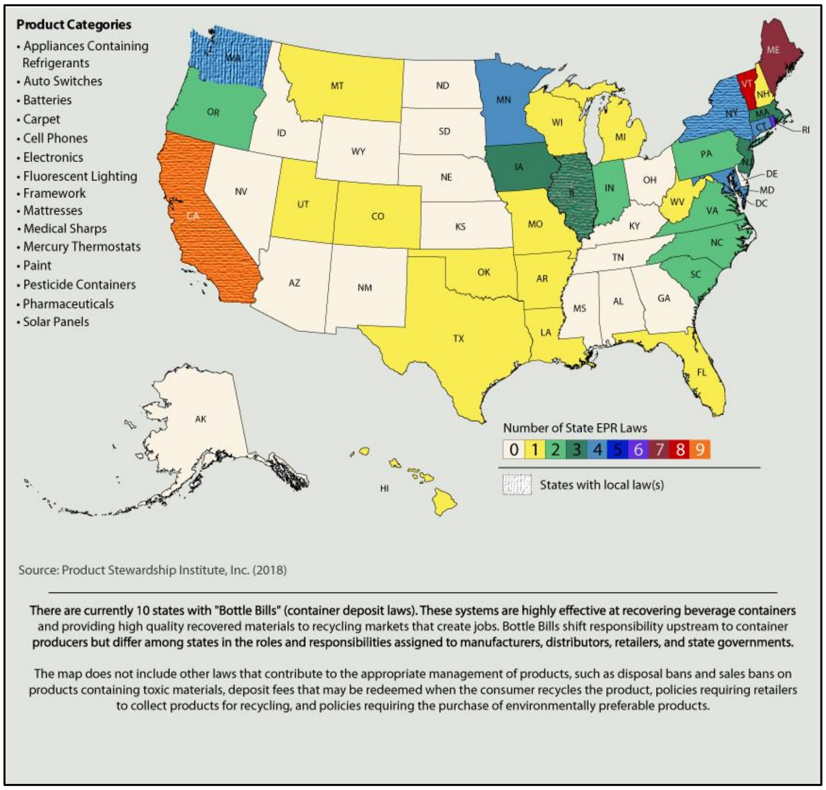
[2] U.S. Environmental Protection Agency. *Quantifying the Disposal of Post-Consumer Architectural Paint*, April 2007.

[3] Product Stewardship Institute, Inc. "Paint." Accessed at: https://www.productstewardship.us/page/PSI_and_Paint

[4] The State of Washington enacted a paint stewardship law on May 9, 2019 with the program to be implemented by November 30, 2020 (Amanda Nicholson. "Washington Enacts Law Creating New Paint Recycling Program," May

services are funded through a point-of-sale fee connected to paint purchases.[5] PaintCare, a nonprofit 501(c)(3) organization founded in 2009 by the American Coatings Association (ACA), operates the disposal programs with a mission "to manage the reuse, recycling, and proper disposal of unused architectural paint."[6] Colorado's Architectural Paint Stewardship Act, signed into law in June 2014, resulted in the launch of Colorado's paint disposal program operated by PaintCare beginning on July 1, 2015 (see, Title 25, Article 17, Part 4 of the Colorado Revised Statutes).

Figure 1: United States' Extended Product Responsibility (EPR) Laws as of May 2019



Source: Product Stewardship Institute, Inc. Accessed at: https://www.productstewardship.us/page/State_EPR_Laws_Map

III. Financial Impacts of Lowering the Paint Recovery Fee

The costs of the paint disposal program, including "the cost of collecting, transporting, and processing postconsumer architectural paint statewide," are covered by the paint stewardship assessment on paint sales. According to the law, the assessment, or fee, should be "equitable and sustainable." More specifically, the funding mechanism must "not exceed the amount necessary to recover program costs" and "any funds generated by the aggregate amount of fees charged to consumers be placed back into

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9, 2019. Accessed at: https://www.productstewardship.us/news/450750/Washington-Enacts-Law-Creating-New-Paint-Recycling-Program.htm).

[5] Technically, the fees are paid by registered paint manufacturers and suppliers who include the fee in the price paid by retailers and distributors. The retailers and distributors are reimbursed for the higher-cost product, due to the fee, by the fees paid by consumers. For details, see: PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 34.

[6] Paintcare Inc. *2016 Internal Revenue Service Form 990*, 2018.

the program."[7] The legislative focus on setting fees no higher than the level needed for the program to operate and ensuring that all funds are directed to the program means that the potential for operating reserves being generated, as well as the acceptable level of reserves, are not explicitly addressed. The following section compares Colorado's existing fee structure to other PaintCare programs, before providing background information on operating reserves in nonprofit organizations. The section concludes with a presentation of the Colorado program's reserve policy and simulations of potential financial outcomes based on various revenue and expense assumptions and alternate fee levels.

PaintCare Fee Structure

Colorado's paint recovery fees are identical to four other state programs operated by PaintCare and lower than four other state programs for containers 'Larger than half pint and smaller than 1 gallon' and 'Larger than 2 gallons up to 5 gallons,' as seen in the following table (table 1).[8] Fee levels have changed for a number of programs with Oregon's fees most recently increasing in late 2018.

Table 1: PaintCare Fees by Program (as of May 2019)

Container Size	Programs			
	California, Colorado, Connecticut, Maine, Rhode Island	**District of Columbia, Oregon**	**Minnesota**	**Vermont**
Half pint or smaller	$0.00	$0.00	$0.00	$0.00
Larger than half pint and smaller than 1 gallon	$0.35	$0.45	$0.49	$0.49
1 Gallon	$0.75	N/A	N/A	$0.99
1 Gallon up to 2 gallons	N/A	$0.95	$0.99	N/A
Larger than 1 gallon up to 5 gallons	$1.60	N/A	N/A	$1.99
Larger than 2 gallons up to 5 gallons	N/A	$1.95	$1.99	N/A

Source: PaintCare. "Current Fees for All Programs". Accessed at: https://www.paintcare.org/fees/

About half of the Colorado program's fee revenue comes from sales of one gallon containers. Fees on sales of containers 'larger than one gallon up to five gallons' comprised 42 percent of program fee revenue in 2018. As seen in table 2, there has been a slight uptick in relative fee revenue from the largest container category over time.

[7] Senate Bill 14-029. *Concerning the Establishment of a Paint Stewardship Program for the Environmentally Sound Disposal of Postconsumer Architectural Paint, and, in Connection Therewith, Making an Appropriation* (Title 25, Article 17, Part 4 of the Colorado Revised Statutes).

[8] The fee schedules across the programs do not align perfectly, so fee levels for containers of 1 to 2 gallons cannot be directly compared to each other.

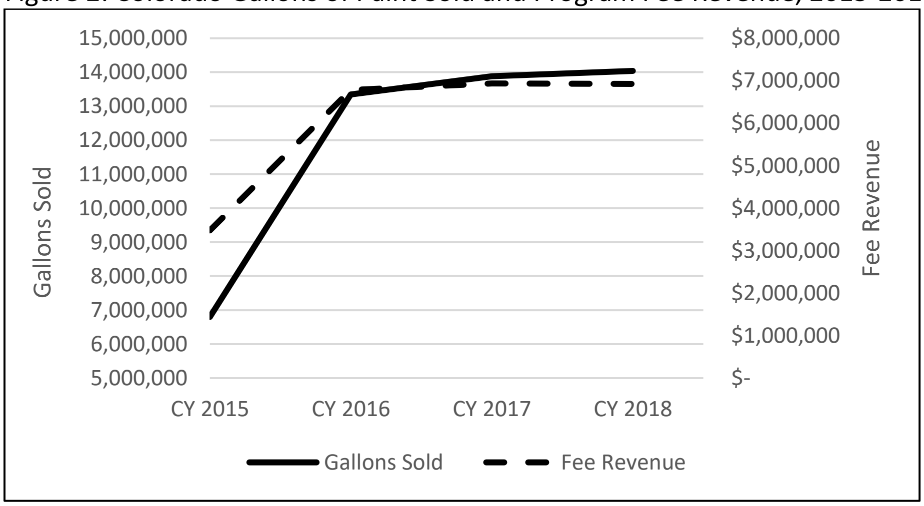
Table 2: Colorado Program Fee Revenue by Container Size, 2015-2018

Container size	Share of Fee Revenue (%)				Average Share of Fee Revenue, 2015-2018
	2015 (July-December)	2016	2017	2018	
Larger than half pint to smaller than 1 gallon	9%	10%	9%	9%	9%
1 gallon	53%	52%	51%	50%	51%
Larger than 1 gallon up to 5 gallons	38%	39%	40%	42%	40%

Source: 2018 Colorado PaintCare Annual Report

The program's dependence on fee revenue means that paint sales are highly correlated with revenue available to operate the program (figure 2). Although PaintCare has experience operating similar programs in other states, the programs are all relatively new. Oregon and California have the longest operating histories starting in 2012 and 2013, respectively.[9] The youth of the programs makes calibrating fees based on forward-looking projections especially challenging and supports the use of conservative estimates.

Figure 2: Colorado Gallons of Paint Sold and Program Fee Revenue, 2015-2018



Source: 2018 Colorado PaintCare Annual Report

There are a number of implications for long-term sustainability if program fee levels are set too low. These include the need to revise program plans to secure approval for and implement a fee increase, which requires administrative effort by PaintCare and the respective state, stakeholder engagement, and work with paint retailers. Irrespective of seeking a fee change, a financially constrained program may incur long-term liabilities to the national PaintCare organization, operate less effectively with reduced spending on activities like communications or expanding the number of drop-off sites, and decreases the capacity of the program to deal with unexpected changes in revenue or expenses. Although the associated paint fees are relatively small, maintaining a fee at a consistent level over time is preferred for both administrative and behavioral reasons to irregular increases or decreases.

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[9] PaintCare ran a pilot program in Oregon starting in July 2010.

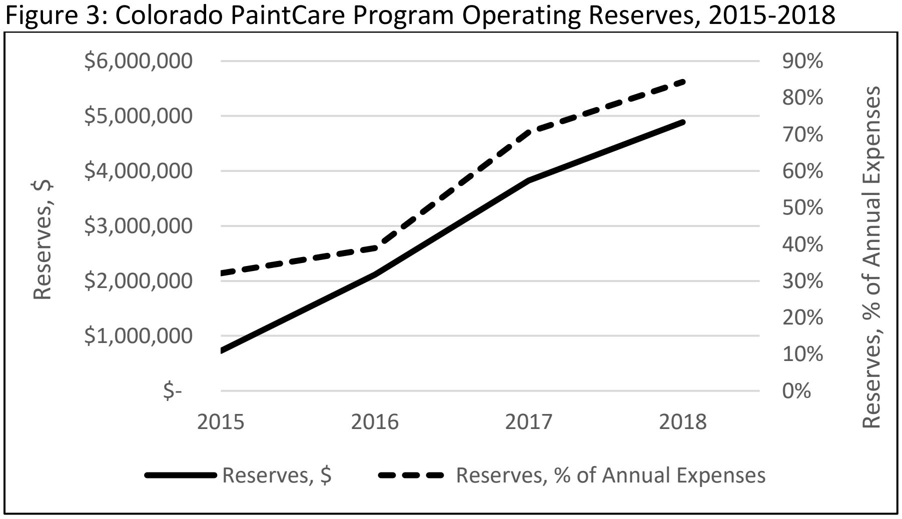
Alternately, fees set higher than necessary also present significant issues. Foremost, excess fees may violate a program's enabling legislation and be unfair to consumers. In some cases, slack resources can also result in wasteful spending when incentives exist to limit accumulated financial reserves. Accumulated fees from revenue in excess of current expenses, though, serve an important role in bolstering an organization's sustainability.

As seen in table 1, only a small number of fee structures have been applied to the various state programs despite differences in characteristics affecting both paint sales and the costs to collect and process disposed paint. Given the initial fee schedules and diversity in program settings, it is unsurprising that the financial performance of the programs, represented as financial reserves, has varied. Periodic review of the Colorado program's fee levels is warranted to determine whether the fee is "equitable and sustainable" as required. The following section discusses operating reserves in nonprofit organizations before addressing the Colorado program's reserves policy and considering the likely outcomes of changes to current fees.

Operating Reserves in Nonprofits

At the existing fee levels, the Colorado program has accumulated significant operating reserves since operations began in 2015. Operating reserves result from accumulated annual surpluses, where operating revenues exceed expenses. Nonprofit organizations, like PaintCare, are governed by the nondistribution constraint, which means that a nonprofit can generate and accumulate surplus funds but the surplus must be used to support the organization's mission rather than be distributed to the individuals who control the organization.[10] The fee revenue for the Colorado program has, to date, outpaced the associated current expenses to operate the program. The reserves, as of December 31, 2018, total $4,887,694 or 84 percent of annual expenses (see figure 3).

Figure 3: Colorado PaintCare Program Operating Reserves, 2015-2018



Source: PaintCare Colorado Annual Reports (multiple years).

[10] Bowman, Woods. (2011). *Finance fundamentals for nonprofits: Building capacity and sustainability*. John Wiley & Sons.

Nonprofits, despite the name, are widely encouraged to establish operating reserves via modest surpluses as part of sound financial management practices.[11] The availability of reserves helps attenuate one of the major disadvantages faced by nonprofits, which is access to capital. Reserves serve a number of functions including to help maintain and smooth spending on operations despite erratic revenues and expenses, to serve as capital for mission-enhancing investment opportunities, or even address liquidity issues. Operating reserves lack formal restrictions on use and are, generally, easy to access and use. Operating reserves can be designated by the organization's board.[12] Less formally, accumulated surpluses can be left undesignated but available for purposes similar to a board-designated operating reserve.

Operating reserves are comprised of a nonprofit's unrestricted net assets less any equity in fixed assets. The classic question related to nonprofit operating reserves is "how big should the reserves be?" The realistic, but less than satisfying, answer is that "it depends." A suggested minimum goal for reserves of 25 percent of annual operating expenses, or 3 months of funds, is commonly recommended including by the Nonprofit Operating Reserve Initiative Workgroup.[13] Other sources typically provide a recommended range for reserves of 3 to 6 months of expenses. The sector-wide rules-of-thumb are accompanied by calls to tailor reserve requirements to the specific organization and its expected risks.

Nonprofit organizations face a double-edged sword of being told to build adequate operating reserves, but face criticism when reserves are deemed excessive by external stakeholders. This is an especially sensitive issue for nonprofits supported by charitable donations and grant funding. Some nonprofit watchdog groups place upper limits for acceptable reserves maintained by charitable nonprofits. For example, the reserves standard of the U.S. Better Business Bureau's Wise Giving Alliance places the upper limit of nonprofit operating reserves at three years of operating expenses.[14] Although not a charitable nonprofit, PaintCare programs face similar scrutiny due to being funded by government-imposed fees on paint sales to the public. Such concerns over appropriate reserve levels are common and have been expressed, for example, in the nonprofit health insurance market.[15]

PaintCare Colorado's Reserves Policy

As noted, determining the adequacy and reasonableness of an organization's operating reserves is difficult due to the uniqueness of each organization. PaintCare justifies the Colorado program's reserves policy based on a review of peer product stewardship organizations and the maturity level of the state's

[11] Nonprofit Operating Reserve Initiative Workgroup (NORI). (2008). *Maintaining Nonprofit Operating Reserves: An Organizational Imperative for Nonprofit Financial Stability*. Washington, D.C.: Nonprofit Operating Reserve Initiative Workgroup.
[12] Sloan, Margaret F., Cleopatra Charles, and Mirae Kim. (2016). "Nonprofit leader perceptions of operating reserves and their substitutes." *Nonprofit Management and Leadership* 26.4: 417-433.
[13] Nonprofit Operating Reserve Initiative Workgroup (NORI). (2008). *Maintaining Nonprofit Operating Reserves: An Organizational Imperative for Nonprofit Financial Stability*. Washington, D.C.: Nonprofit Operating Reserve Initiative Workgroup.
[14] Rick Moyers. "There's No Penalty for Having Reserves." *The Chronicle of Philanthropy*, May 6, 2011.
[15] Ruth McCambridge. "When is a Nonprofit Not a Nonprofit? Health Insurer is Sued by Members". *Nonprofit Quarterly*, May 22, 2014.

program. Upon inception, the Colorado program established a reserve target of 50 percent of annual expenses, along with minimum and maximum reserve levels:

> PaintCare's Reserves Policy establishes a minimum threshold of 16% of annual expenses (i.e., at least two months of operating expenses); a target reserve amount of 50% of annual expenses; and a maximum amount of 75% of annual.[16]

The PaintCare Board of Directors revised the Reserves Policy upward in April 2018. The new policy increased the target reserves level to 100 percent, or one year, of operating expenses. The minimum and maximum amounts adjusted upward to 75 percent and 125 percent, respectively. According to PaintCare, the policy change "was made by considering the potential variability across the PaintCare programs (how reserve levels have fluctuated for existing programs, particularly those with sustained growth and costs) and by researching what other similar organization and NGOs use for a target."[17] PaintCare further justifies the increased reserves target based on the avoidance of future fee changes and the need for additional financial stability and access to capital as each program's legal structure shifts to an individual limited liability company:

> The analysis showed that if a fee reduction were to be implemented when a 50% reserve level is reached, programs would likely need to reverse course and implement a fee increase within a few years. Therefore, a higher reserve level provides better stability for the programs and for those affected by a fee change. A larger reserve also mitigates the risk of an extensive timeframe for receiving approval of fee changes. Finally, a larger reserve provides better financial security for individual state programs as they move from utilizing an organization-wide bank account to individual limited liability companies with separate banks accounts whereby borrowing of funds during times of deficit may be costlier (in the form of a loan).[18]

These justifications for the reserves policy are revisited later in this report.

Fee Levels and Financial Outcomes

PaintCare's reserves policy includes triggers for reconsidering the fee structure, stating that "if the reserves fall below the minimum threshold or rise beyond the maximum threshold, an evaluation of the program's expenses and revenue will be performed to determine if changes are needed in operations, outreach, and/or the fee structure to bring the reserve balance within range."[19] In November 2018, PaintCare delivered an internal financial analysis for the Colorado program to CDPHE and determined a change in existing fees was unwarranted based on projections and the desire to avoid the disruption caused by repeated fee adjustments. A similar determination was reached in the 2018 annual report's "evaluation of the program's funding mechanism" section.[20]

[16] PaintCare. *Colorado Paint Stewardship Program 2017 Annual Report*, April 2, 2018: p. 31.
[17] PaintCare. *PaintCare Colorado Program Financial Snapshot*, November 2018: p. 2.
[18] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: pp. 33-34.
[19] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 33.
[20] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 34.

Beginning in the 2016 annual report, PaintCare provides five-year projections for the Colorado program. Looking back, it is possible to examine the accuracy of these past projections. As previously mentioned, initial projection accuracy proved challenging for Colorado's program. In 2016, the projected reserve level for 2017 was underestimated by 25 percentage points. Since then, projection quality has improved but the reserve levels for 2018 were underestimated by 4 percentage points in the November 2018 financial snapshot. Figure 4 and table 3 present the past projections of reserve levels produced by PaintCare in the Colorado annual reports and financial analysis alongside the actual reserve percentages from 2017 and 2018.

Figure 4: PaintCare Colorado Reserve Percentage Projections and Actuals

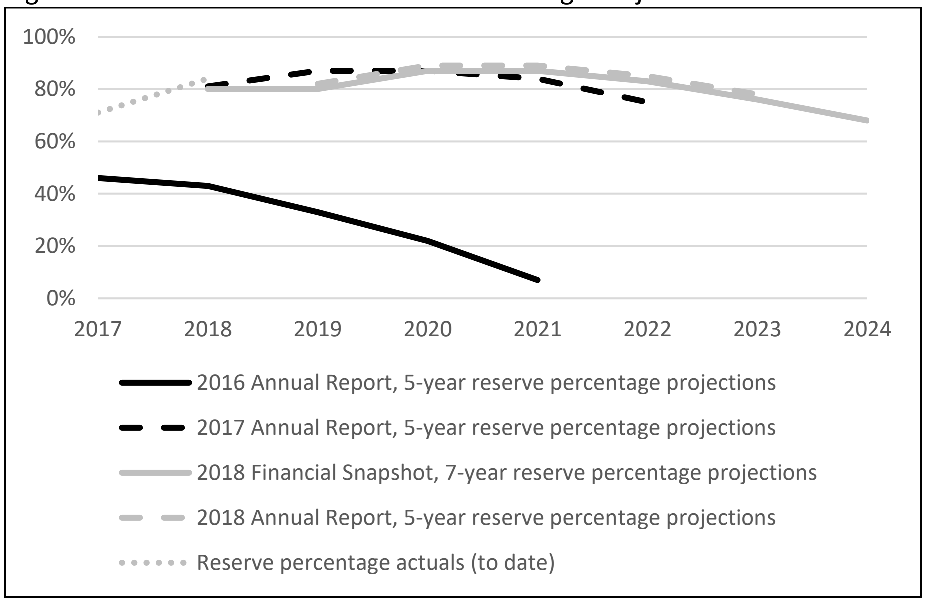


Table 3: PaintCare Colorado Reserve Percentage Projections and Actuals

		2017	2018	2019	2020	2021	2022	2023	2024
Reserve Percentage Projections	**2016 Annual Report (5-year projections)**	46%	43%	33%	22%	7%	-	-	-
	2017 Annual Report (5-year projections)	-	81%	87%	87%	84%	75%	-	-
	2018 Financial Snapshot (7-year projections)	-	80%	80%	87%	87%	83%	76%	68%
	2018 Annual Report (5-year projections)	-	-	82%	89%	89%	85%	78%	-
Reserve Percentage Actuals (to date)		71%	84%	-	-	-	-	-	-

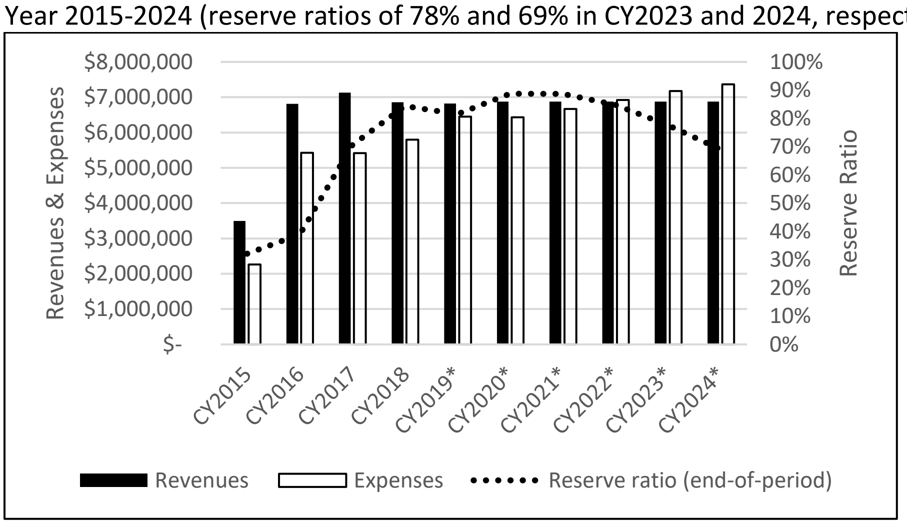
Source: *PaintCare Colorado Annual Reports* (multiple years). PaintCare. *PaintCare Colorado Program Financial Snapshot*, November 2018.

In addition to the short program history, July 2015 to the present, year-to-year changes in expenses are not closely tied to changes in paint collected or processed and appear to be somewhat idiosyncratic based on the explanations presented in the annual reports. For example, the 2018 annual report explains why costs climbed compared to 2017:

- Paint processing costs were higher in 2018 due to a shift from roll-offs to cubic yard boxes at two HHW sites, the continued rural paint sweeps and larger PaintCare events which are more expensive per gallon compared to retail and HHW [Hazardous Household Waste] sites, and an increase in LVPs [Large Volume Pick-Up Sites].
- Collection supplies and support costs were higher due to increased collection volumes at existing sites, an increase in supplying site infrastructure improvements to comply with storage requirements of program, and the shift from roll-off containers to cubic yard boxes at two HHW sites (the use of roll-off containers did not include a separate collection supply costs but collection supply costs are always incurred when cubic yard boxes are used).
- Personnel, professional fees and other increased due to salary and benefits of the full-time program coordinator, who was added during the second half of 2017, and travel costs of the staff support who helped with the one-day paint collection events.[21]

The financial analysis presented in the November 2018 financial snapshot projected expenses, revenues, and reserves covering seven program years ranging from Calendar Year (CY) 2018 to CY2024. The reserve percentage was projected to peak in CY2020 and 2021 at 87 percent of expenses before declining to 68 percent in CY2024. The 2018 annual report provided updated projections based on actual 2018 results, which are presented in figure 5 and result in a slightly higher reserve percentage of 69 percent in CY2024.[22] Although the appropriateness of the reserves policy thresholds are addressed later in the report, all of the projected reserves levels fall below the existing policy's target level of 100 percent and above the minimum level of 75 percent (with the exception of the CY2024 projection, which is below the established minimum).

Figure 5: PaintCare Colorado Program Actual and Projected Expenses, Revenues, and Reserves, Calendar Year 2015-2024 (reserve ratios of 78% and 69% in CY2023 and 2024, respectively)



Note: Calendar years denoted with an asterisk present projected rather than actual financial information. These amounts come from the PaintCare Colorado 2018 Annual Report dated July 15, 2019 and PaintCare Colorado Program Financial Snapshot dated November 2018. The complete Projected Expenses, Revenue, and Reserves are included in the Appendix as table 1.

[21] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: pp. 32-33.

[22] To provide an extended look at reserves, projections for CY2024 are also included based on the assumptions provided in the November 2018 financial snapshot.

PaintCare's assumptions used as the basis for these projections are presented in table 4 and discussed, before considering the impact of decreasing paint fees from existing levels based on these same assumptions. The most influential assumptions relate to fee revenue growth and changes in paint collection, transportation, and processing (CTP) costs. The 2019 projections reflect a decrease in fee revenue by over $100,000 and a $657,338, or 11.3 percent, increase in expenses from 2018 actuals due to new grant, site, and collection activity. Importantly, these elevated expenses then serve as a baseline for future years' CTP cost projections, although the 'Personnel, professional fees, and other' expense category does drop by more than $170,000 from 2019 to 2020 projections. From 2020 to 2023, the CTP costs grow annually by 3 percent plus $75,000 to cover operations of five new retail sites per year. Salaries and overhead also grow by 3 percent, while communication costs and state fees are held constant.

Table 4: Assumptions for Latest Five-Year Projections

Year(s)	Revenue	Expenses
2019	Revenue from paint sales is projected based on previous 12 months of actual revenue	Expenses will increase due to • a one-time $100K paint recycling R&D grant, • the addition of 10 new year-round paint drop-off sites in 2019, and • an increase in the volume of paint collected at existing sites.
2020 and beyond	Revenue from paint sales is held constant and no estimate is being made for investments gains or losses.	• Paint collection, transportation, and processing (CTP) costs…will continue rising by 3% each year as paint collection volumes continue to increase. • The program will add five new retail sites each year from 2020 to 2023. CTP costs for the paint collected at each retail site are $15k per year on average. • Salaries and overhead will also increase 3% each year. • Communications and state administrative fees will remain constant.

Source: PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019

The following figures, figures 6 and 7, use PaintCare's assumptions to determine the impact of a reduction in paint fees of 5 percent and 10 percent, respectively. These levels of fee reduction are selected to represent a modest and more sizable reduction in fees. Fee increases are not considered due to the level of existing reserves, although, as noted, PaintCare's own projections show the reserves percentage falling below the policy's minimum level by CY2024. A reduction in fees by 5 percent results in a consistent decline in reserves as revenues decline (rather than stay flat) and costs rise based on the assumptions. By CY2023, the reserve percentage is projected to fall to 54 percent, which is well below the reserves policy minimum of 75 percent. The 10 percent reduction in fees, reflected in figure 7, further accelerates the decline in reserves reaching 30 percent of anticipated expenses in CY2023 and 13 percent in CY2024. To comply with the existing reserves policy, even such limited fee reductions appear inadvisable given the assumptions used in the projections.

Figure 6: PaintCare Colorado Program Actual and Projected Expenses, Revenues, and Reserves, Calendar Year 2015-2024 (fee reduction of 5%, reserve ratios of 54% and 41% in CY2023 and 2024, respectively)

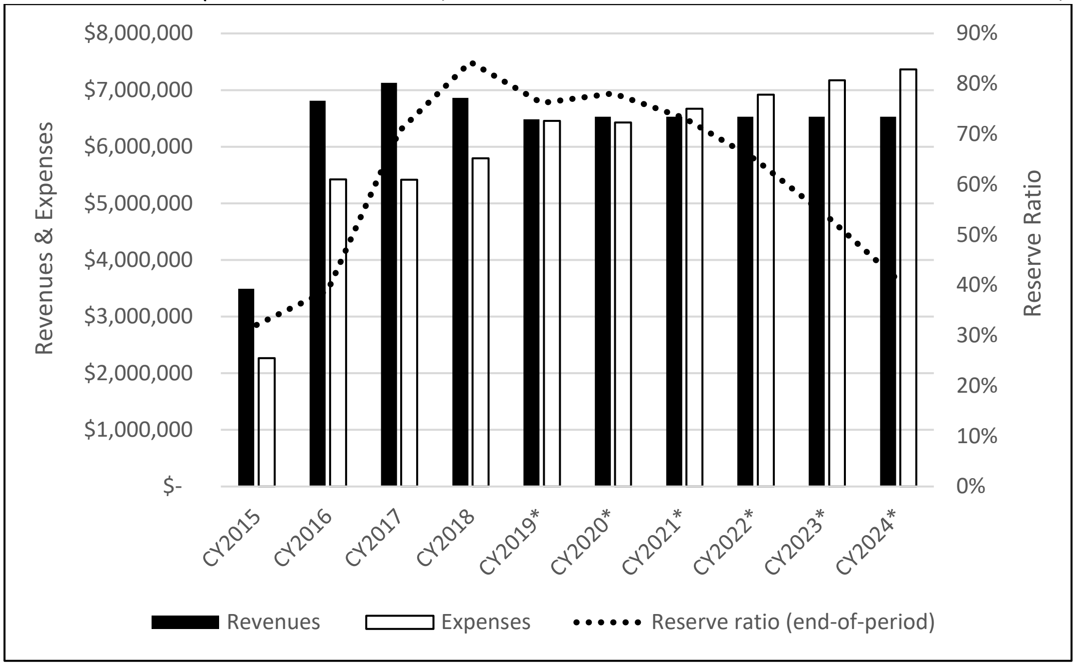
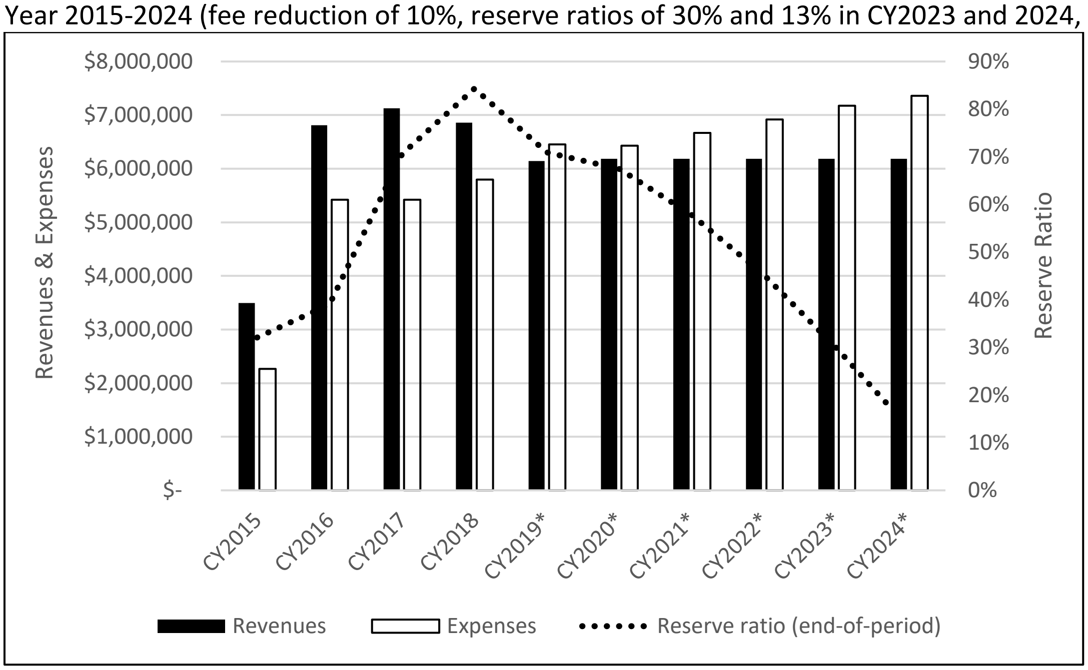


Figure 7: PaintCare Colorado Program Actual and Projected Expenses, Revenues, and Reserves, Calendar Year 2015-2024 (fee reduction of 10%, reserve ratios of 30% and 13% in CY2023 and 2024, respectively)



When considering fee changes, it is helpful to revisit the existing fee schedule. The aggregated fees collected matter greatly for program operations and reserve levels. The individual impact of a fee reduction on the cost of paint is, arguably, fairly minor for infrequent paint consumers. For example, a 10 percent reduction in fees would lower the cost for a gallon of paint by 7.5 cents and by 16 cents for a purchase of a container larger than 1 gallon up to 5 gallons (presented in table 5).

Table 5: Example 10 Percent Fee Reduction Based on Existing Fee Schedule

Container Size	Colorado (current fees)	Colorado (example: 10% reduction in fees)
Half pint or smaller	$0.00	$0.00
Larger than half pint and smaller than 1 gallon	$0.35	$0.315
1 Gallon	$0.75	$0.675
Larger than 1 gallon up to 5 gallons	$1.60	$1.44

After considering the adequacy of existing fee levels based on PaintCare's assumptions for revenue and expense changes, the next section relaxes those assumptions to determine how sensitive financial outcomes are to the existing assumptions.

Projections Using Alternate Growth Assumptions

PaintCare experiences uncertainty with both revenues and expenses. Again, revenues come overwhelmingly from fees tied to point-of-sale paint purchases, which vary with economic activity. A secondary, and increasingly relevant, revenue source is investment earnings but these are omitted from PaintCare's projections (the implications of excluding investment activity are discussed in later sections). Expenses vary by both the volume of leftover paint turned in by consumers and changing costs of operating the program. Year-to-year fluctuations in program revenue and expenses are expected.

The limited program history of three-and-a-half years of actual operations data fails to establish a clear link between program activity levels and expenses or between the population and number of households in the state and paint sales for revenue projection purposes. An example of the former is that changes in per gallon costs can vary based on timing. In 2018, for example, PaintCare explained that the increase in the Colorado program's cost per gallon of processed paint was "due to some paint being collected and not processed in the same year."[23] Aside from declines in operational expenses per gallon processed and total expenses per gallon processed following the first six months of the program, total expenses and operations expenses per gallon of paint collected or processed have not followed consistent patterns of change over time based on volume of program activity, as seen in table 6 and figure 8. Expenses per gallon have all trended upward from 2016 to 2018.

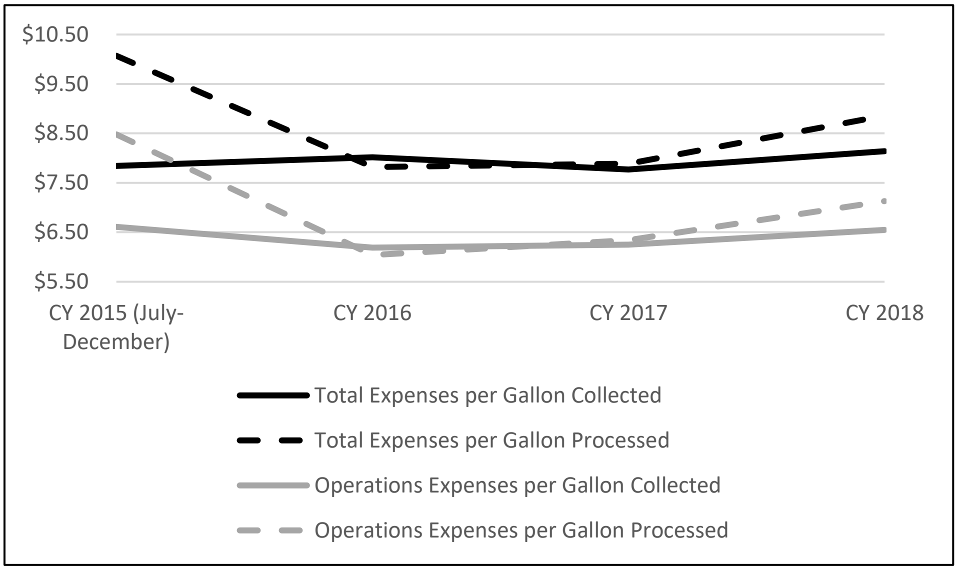
Table 6: Expenses per Gallon Collected and Process, CY2015-CY2018

	CY 2015 (July-Dec.)	CY 2016	CY 2017	CY 2018
Total Expenses per Gallon Collected	$7.84	$8.02	$7.77	$8.14
Total Expenses per Gallon Processed	$10.07	$7.82	$7.89	$8.86
Operations Expenses per Gallon Collected	$6.61	$6.19	$6.25	$6.55
Operations Expenses per Gallon Processed	$8.48	$6.04	$6.34	$7.13

Source: PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019. Note: Operations expenses omit communications, CDPHE administration fees, and overhead costs.

[23] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 5.

Figure 8: Expenses per Gallon Collected and Process, CY2015-CY2018



Source: PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019.

Projections and forecasts are invariably accompanied by error due to imprecise assumptions about the future. A number of alternate projections are conducted and presented to test the sensitivity of the Colorado program's reserve levels to changes in assumptions. Tables 7 and 8 present the projected reserves level at the end of CY2023 (five-year projection) and CY2024 (six-year projection), respectively, based on a range of plausible growth assumptions affecting revenues and expenses beginning in 2021 (PaintCare's projected 2019 and 2020 activity is used as a baseline).

'Paint collection, transportation, and processing' (CTP) costs comprised 75.7 percent of the program's 2018 expenses, so the following projections focus on changes in growth rates for these costs while maintaining PaintCare's growth assumptions for other expense categories. The flat revenue coupled with 3 percent annual growth of CTP, salaries and overhead, and $75,000 per year in additional costs for adding new retail collection sites reflects PaintCare's projections. PaintCare notes, in the most recent Colorado annual report, that they consider their own assumed rate of cost growth to be conservative:

> The conservative estimate of a 3% rise in costs shows program reserves slowly decreasing over time, while more aggressive projections would include adding more than the expected 20 drop off sites through 2023, adding two more HHW programs, much higher collection volumes at existing sites (>3%), and higher CTP costs, accelerating the decrease in reserve.[24]

Projections are presented based on fee revenue growth assumptions ranging from a 3 percent annual decline to a 3 percent annual increase. The 1 percent growth rate parallels the average growth in fee revenue for the Colorado program during full years of operation, which was 1.1 percent. Although paint sales have not closely tracked the number of households in Colorado, the use of population estimates to project fee revenue has been used by other PaintCare programs. The 2 percent growth rate in the projections slightly exceeds the projected annual household growth in Colorado, which is estimated to

[24] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 34.

be 1.8 percent over the projection period.[25] The PaintCare assumption of no growth in fee revenue is more conservative than using the historical growth rate of the program's revenue or the projected growth in the number of Colorado households.

The continued growth in paint collections over the program's history suggests that future reductions in overall costs are unlikely. This is especially true because of the Colorado program's plans to continue adding new retail sites over the coming years, which is reflected in all projections. For that reason, projections are based on a range of possible growth rates starting with no annual change in CTP costs through 5 percent annual increases in CTP costs.

PaintCare's projections use a 3 percent growth rate for the CTP costs, which slightly exceeds the program's average annual growth in gallons collected, which was 2.6 percent during the full years of operations. Averaging the projections using a 1 percent and 2 percent growth rate for costs closely reflects the average inflation rate of 1.43 percent, based on the consumer price index (CPI-U), during the Colorado program's history. The average annual growth rate of total expenses and operations expenses for the program's full years of operation were 3.4 percent and 5.6 percent, respectively. These rates of growth are captured and applied to the CTP costs by the inclusion of projections based on 4, 5, and 6 percent growth rates.

The projected reserve ratios that fall within the current stated reserves policy guidelines are color-coded green, those that fall below the policy minimum are colored red, and values greater than the policy maximum are colored yellow in tables 6 and 7. Given the range of assumed growth rates for fee revenue and CTP costs, the majority (57 percent) of CY2023 reserve percentage estimates (table 7) exceed the minimum reserve policy level of 75 percent of expenses. Only six estimates reach the target level of 100 percent of expenses and none exceed the policy's maximum reserves level of 125 percent of expenses. Of note, all but one of the projected reserve levels exceed the original target level of PaintCare's reserves policy for Colorado of 50 percent. Although projections based on fee revenue declines and higher than anticipated expense growth result in reserve levels that violate the state policy minimums, they do not exhaust the existing reserves under these assumptions.

[25] Colorado Department of Local Affairs. *Household Projections 2010-2050*. Accessed at: https://demography.dola.colorado.gov/data/

Table 7: CY 2023 Reserve Percentage Five-Year Projections by Revenue and Cost Assumptions

		Fee Revenue (CY2020-2023)						
	Assumed rate of annual growth or decline	**-3%**	**-2%**	**-1%**	**0%**	**+1%**	**+2%**	**+3%**
'Paint collection, transportation, and processing' (CTP) costs (CY2020-2023)[26]	**0%** (no change)	79%	85%	91%	97%	103%	109%	115%
	+1%	72%	78%	84%	90%	96%	102%	109%
	+2%	66%	72%	78%	84%	90%	96%	102%
	+3%	61%	66%	72%	78%*	83%	89%	95%
	+4%	55%	61%	66%	72%	77%	83%	89%
	+5%	50%	55%	60%	66%	71%	77%	83%
	+6%	44%	50%	55%	60%	66%	71%	77%

Notes: The simulation uses the CY2020 fee estimate as the base for any growth beginning in CY2021. Reserve ratios that fall within the stated policy are color-coded green, those that fall below the state policy minimum are colored red, and values greater than the policy maximum are colored yellow. An important limit to these projections is the assumption that growth rates for revenues and costs are constant over time, which overlooks potential sequence risk. *This reserve percentage projection is based on PaintCare's assumptions, while the remaining cells represent projections with varied assumptions.

Extending the projections an additional year is possible using information from PaintCare's financial analysis of the Colorado program dated November 2018. The main difference, aside from carrying the projections to CY2024, is that additional retail sites are not added in the final year. The projections based on PaintCare's assumptions show the reserves ratio falling to 69 percent of annual expenses at the end of CY2024, which is below the 75 percent minimum threshold set by PaintCare's latest reserve policy approved by the board in 2018. The assumptions used in the PaintCare projections guarantee flat fee revenue and continuously increasing costs, which guarantees an erosion of reserves over time. The projections are otherwise similar to the five-year results, although the highest fee revenue growth rate assumption and lowest cost growth rate assumption generate reserves that slightly exceed the policy's maximum level of 125 percent of expenses.

Table 8: CY 2024 Reserve Percentage Six-Year Projections by Revenue and Cost Assumptions

		Fee Revenue (CY2020-2024)						
	Assumed rate of annual growth or decline	**-3%**	**-2%**	**-1%**	**0%**	**+1%**	**+2%**	**+3%**
'Paint collection, transportation, and processing' (CTP) costs (CY2020-2024)	**0%** (no change)	69%	79%	88%	99%	109%	119%	130%
	+1%	59%	69%	79%	88%	98%	109%	119%
	+2%	50%	60%	69%	78%	88%	98%	108%
	+3%	42%	51%	60%	69%*	78%	88%	98%
	+4%	33%	42%	51%	60%	69%	78%	88%
	+5%	25%	34%	42%	51%	60%	69%	78%
	+6%	18%	26%	34%	43%	51%	60%	69%

Notes: See notes for Table 7. *This reserve percentage projection is based on PaintCare's assumptions, while the remaining cells represent projections with varied assumptions.

[26] All projections include the addition of five new paint retailer location sites per year from CY2020 to 2023 at a continuing annual cost of $15,000 per site.

Challenges to Projections

One of the challenges of projecting the Colorado program's expenses is that spending is driven, in part, by discretionary policy decisions. In other words, the review of financials suggests that the Colorado program has many levers to reduce costs if needed. These levers include slowing expansion of new retail sites, reducing communications costs, avoiding discretionary activities like grant programs, among others.

PaintCare's actual spending patterns appear flexible across the different state programs. For state programs with reserves below reserves policy minimum, an average 83 percent of expenses are for CTP costs compared to only 68 percent for programs with reserves falling within the policy guidelines. Communications spending for programs with reserves lower than the policy minimum account for 2 percent of expenses on average, while making up 14 percent of expenses for programs with reserves higher than the policy minimum (see table 2 in the appendix for 2018 common-sized expenses, which allows for easy comparison of costs across PaintCare programs).

A performance audit conducted for the Oregon program found "no clear correlation of the amount spent on education and outreach activities to actual gallons collected could be determined," noting that such a relationship is difficult to establish given possible "lags between the purchase, use, and recycling of leftover paints which may occur over a number of months or years."[27] These findings reinforce that the Colorado program maintains discretion over certain spending with uncertain program benefits.

A second challenge related to generating accurate projections of reserve levels is that the projections, both by PaintCare and those presented here, ignore the allocation of investment activity. The decision to assume zero investment activity is likely a conservative choice over time, meaning that it biases projected reserves downward. PaintCare's "sole objective of the portfolio is to earn a return equal to the rate of inflation and thus preserve the purchasing power of its capital," so positive returns similar to anticipated increases in costs are anticipated.[28] Investment activity allocations have averaged $44,260 per year over the life of the Colorado program, but have been uneven based on market performance (see table 9 for details).

Investment activity should grow, on average, over time as long as the size of the Colorado program's reserves continue to increase. The reserves, and associated investments, have increased by more than $4 million, or 572 percent, since the end of the program's first six months of operations. The investment activity allocation from PaintCare to the state programs depend on interest and dividend income, net realized and unrealized (losses) gains, and investment fees. Despite the fairly conservative investment portfolio there remains risk to the existing reserves from market losses. A simulation of the historical performance of the reserve funds' current asset composition shows losses can occur (see the 2018

[27] PlanB Consultancy. *Performance Audit of PaintCare and its Oregon Operations*. Oregon Department of Environmental Quality, April, 2018: p. 33.
[28] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017*, p. 13.

allocated losses as a recent example in the Appendix, table 1). The scale of cumulative investment gains and losses directly affect the reserve levels of the Colorado program, but are absent from projections.

Table 9: Investment Activity Allocation to PaintCare Colorado, CY2015-2018

	CY2015	CY2016	CY2017	CY2018	Average
Investment activity allocation (Colorado program)	$17,964	$32,066	$194,159	$(67,151)	$44,260
Percent of fee revenues	0.52%	0.47%	2.80%	-0.97%	0.71%

Source: PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019

Finally, costs trends may change as a program matures. Increased program familiarity among the population may warrant reductions in communications costs, which were 11 percent of actual expenses in CY2018 for the Colorado program. Similarly, PaintCare Colorado conducted a series of surveys in the most recent reporting year including a mail survey with an 8 percent response rate.[29] Such activities, which can be costly in time and expense, may also be less necessary as the program becomes better established in the state. Just as Colorado's program is maturing, so too is the national PaintCare organization. Each year, the national organization allocates the costs of corporate activity to the various programs based on the population of the geography served (for Colorado, this was 8.6 percent of the total in 2018). As additional states implement programs, like Washington State beginning in 2020, there should be savings from scale economies for some of the included costs ("corporate staffing, insurance, maintenance of data management systems, auditing fees, software licenses, legal fees, occupancy, and general communications").[30] The planned shift, during 2019, to an independent limited liability company as the stewardship organization for the Colorado program may have short and long-term cost implications not presently considered in budgeting and projections, although PaintCare reports there will be no associated changes in staffing.[31]

IV. Comparison of PaintCare's Reserve Policy to Other Stewardship Organizations and 501(c)(3) Organizations

A number of comparisons are available to assess the adequacy and reasonableness of operating reserves. An organization's reserves policy and actual reserves can be compared to peer organizations. For PaintCare and the Colorado program, peer organizations include other product stewardship nonprofits, other PaintCare programs, and other nonprofit organizations. Even with the use of reasonable comparison groups, determining the adequacy and reasonableness of an organization's financial reserves is difficult due to the uniqueness of each organization.

PaintCare justifies its Colorado reserves policy based on a review of peer product stewardship organizations, the maturity of Colorado's program, and the experiences of other PaintCare programs.[32] The targeted reserve of 100 percent of annual expenses, adopted by the PaintCare board in 2018 for

[29] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 51.
[30] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 31.
[31] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 54.
[32] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: pp. 33-34.

Colorado, is a change in policy from previous years, where the policy set forth "a minimum threshold of 16% of annual expenses (i.e., at least two months of operating expenses); a target reserve amount of 50% of annual expenses; and a maximum amount of 75% of annual expenses."[33]

Product Stewardship Organization Reserves

Judging the adequacy and reasonableness of a reserve policy is aided by benchmarking the reserve levels and policies of peer organizations. Just as PaintCare looked to "other similar organization and NGOs" to set their target reserve level, a comparison group of product stewardship nonprofits was established here for review. Specifically, PaintCare notes that they "confirmed that a 12-month reserve target is not uncommon for non-profit organizations, including other stewardship organizations."[34]

A series of structured searches using GuideStar identified seven nonprofit organizations engaged primarily in product stewardship activities with a recycling and disposal focus (for details of the peer organizations, see table 3 in the Appendix). These organizations address the end-of-life disposal of a range of products including architectural paint, batteries, mattresses, mercury-containing thermostats, carpet, rigid high-density polyethylene (HDPE) plastic agricultural product containers, household hazardous waste, lights, smoke alarms, and carbon monoxide alarms. The organizations vary widely in size with PaintCare being the largest based on recent revenue, assets, and operating reserves. Most of the peer product stewardship organizations depend heavily on fee revenue tied to the initial sale of products whose end-of-life issues are being addressed.

The following figure, figure 9, presents the operating reserves ratios for PaintCare, PaintCare's Colorado program, and peer product stewardship organizations based on the most recent available IRS Form 990.[35] Reserve policies may differ meaningfully from the actual reserve levels observed at a single point in time, but this exercise allows PaintCare's existing reserves and reserve policy target to be compared to the reserves of other product stewardship organizations. The comparison suggests that operating reserve levels vary meaningfully across the product stewardship organizations. PaintCare and the Colorado program have reserve levels that fall in the upper-middle of the range of reviewed organizations. The Colorado program's reserve level currently trails the total reserves of the PaintCare organization itself, although this is largely an artifact of California's reserves. The product stewardship organizations with the lower reserve ratios are substantially smaller than those with ratios higher than PaintCare's own, one is supported by member contributions rather than consumer fees, and another is related to a larger product stewardship organization.

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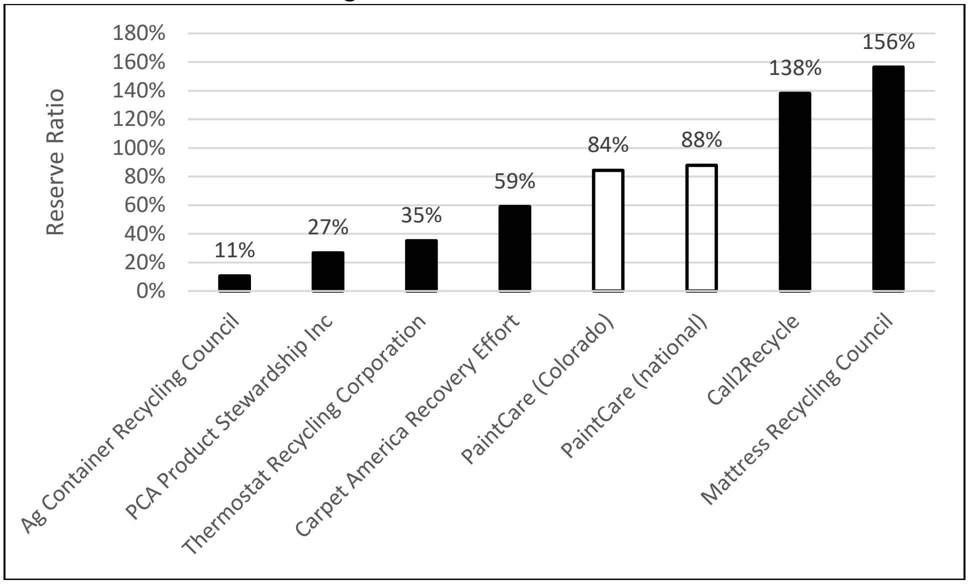
[33] PaintCare. *Colorado Paint Stewardship Program 2017 Annual Report*, April 2, 2018, p. 31.
[34] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: pp. 33-34.
[35] The informational filing required by the Internal Revenue Service (IRS) for tax-exempt nonprofit organizations is the Form 990, which serves as a primary source of nonprofits' annual financial data.

Figure 9: Operating Reserve Ratios[36] of PaintCare and Peer Product Stewardship Organizations, Calendar Year 2018 IRS Form 990 Filings



Note: Financial information is taken from the organizations' 2018 calendar year filings with the IRS accessed through the 2018 IRS Form 990 Masterfile Extract. The reserve value for PaintCare's Colorado program comes directly from the program's 2018 annual report, since it is not a stand-alone organization. Operating reserves calculated from the IRS Form 990 do not distinguish between reserves serving as working capital or board-designated reserves. Product Care Association is excluded from the figure since it does not follow Statement of Financial Accounting Standard (SFAS) 117.

The updated target reserve level for the Colorado program of 100 percent of annual expenses would shift the program's position on the continuum of reserve levels to the right, but, if achieved, would still be below the existing reserve levels of two of the reviewed organizations. Reserve policies for all of the peer organizations are unavailable publicly. An example of one peer reserve policy, detailed in the *2017 California Annual Report* from the Mattress Recycling Council, states that the "reserve is intended to equal 12 months of what MRC has forecasted it will spend in 2020 to run a financially sustainable recycling program that can also address substantial risks and other unknown factors."[37] This is aligned with Paintcare Colorado's latest target of 100 percent of annual expenses. Alternately, Carpet America

[36] Based on the IRS Form 990, operating reserves consist of 'Unrestricted net assets (Part X, column (B), line 27) minus 'Land, buildings, and equipment less accumulated depreciation' (Part X, column (B), line 10c) less long-term debt. Long-term debt consists of 'Tax-exempt bond liabilities' (Part X, column (B), line 20), 'Secured mortgages and notes payable to unrelated third parties' (Part X, column (B), line 23), and 'Unsecured notes and loans payable to unrelated third parties' (Part X, column (B), line 24). The order of operations matters for the calculation of operating reserves and is as follows: = unrestricted net assets - (land, buildings, equipment - (tax exempt bonds + secured mortgages + unsecured notes)). The operating reserves ratio is calculated by dividing the operating reserves by total expenses (Part IX, column (A), line 25) less depreciation expense (Part IX, column (A), line 22): = operating reserves / (total expenses – depreciation expense).

[37] Mattress Recycling Council (MRC). *2017 California Annual Report*, 2018: p. 71.

Recovery Effort, or CARE, reduced the reserve target for its California program to "a one quarter average reserve based on the previous four quarters" in 2015.[38]

The peer product stewardship organizations present numerous justifications for their accumulated reserves and reserves policies that are relevant for Colorado's PaintCare program. MRC California, for example, is required by California statute to maintain reserves ("Cal. Pub. Res. Code § 42988 requires that MRC maintain a reserve that is sufficient to fund the Program's operations over a multiyear period in a fiscally prudent and responsible manner."). MRC has established a board-designated reserve in addition to maintaining unrestricted net assets as working capital and for liquidity purposes. In their annual report, MRC details a range of reasons for the desired level of designated reserves with some parallels to the less detailed justifications provided in PaintCare's annual reports:

> The amount that MRC sets aside as reserves is influenced by several factors. For example, MRC must be prepared in case its operational expenses increase or planned revenues decrease as a result of factors beyond MRC's control. Unforeseen circumstances that could have a substantial impact on MRC's revenues and expenses include accidents, disasters, or operational and financial failures of MRC's systems, recyclers, retailers and other sellers that collect the charges, etc. Significant or sudden changes in market dynamics that affect costs (e.g., fuel) or the failure of secondary markets for recycled components, or political uncertainties could also significantly affect the Program and its budget.
>
> Second, the reserve protects the long-term viability of the Program by setting aside money that can fund unusual budget deficits without necessitating frequent adjustments in the recycling charge. Given the amount of time required to request a fee change and the fact that the Act requires MRC to notify the public at least 180 days in advance of a decision to raise or lower the charge, a reserve sufficient to allow MRC to operate the Program smoothly without financial disruption during such a transition is imperative.
>
> Finally, it is important to note that MRC's network of recyclers and transporters rely on timely payments for services rendered. Therefore, to keep the Program functioning, and its vendors paid and operating, it is critical that MRC hold sufficient cash reserves to cover cash flow shortfalls. Unlike a government entity or more mature organization, MRC does not have access to government or adequate bank financing that may be required to cover substantial unexpected shortfalls and must rely on its reserve to address various financial risks it may encounter. Therefore, having less than approximately 3 months of operating cash on hand would be fiscally irresponsible.[39]

Another peer stewardship organization, operating in Canada, is Product Care. Product Care states that their reserve fund was initiated for slightly different reasons, in part related to liability concerns. Like MRC, Product Care internally restricts the reserve funds to be used at the direction of the board. The reserve fund allows the organization to:

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[38] Carpet America Recovery Effort (CARE). *CARE California Carpet Stewardship Program Annual Report January 2017 – December 2017*, 2018: p. 116.
[39] Mattress Recycling Council California, LLC (MRC). *2017 California Annual Report*, 2018: pp. 69-71.

> (1) respond to environmental impairment liability exposures and director and officers liability exposures up to predetermined levels in conjunction with the overall insurance program and (2) to fund the ongoing operations, future program expenses, potential penalties and various other projects of the Association from time to time.[40]

Product Care provides an illustrative example of a market change affecting a stewardship organization and requiring the use of accumulated reserves. Specifically, a program to safely dispose of mercury-containing lamps is experiencing lower revenues from the associated product sales and increased disposal activity and plans to use reserves to support continued operations:

> As anticipated, PCA's lighting programs are moving rapidly into the next phase of the program lifecycle, with an accelerating technology shift from mercury containing lamps to LEDs. This particularly impacts our programs which are limited to mercury containing lamps. In all cases PCA has established reserves in order to weather the transition of declining revenues and increasing return rates.[41]

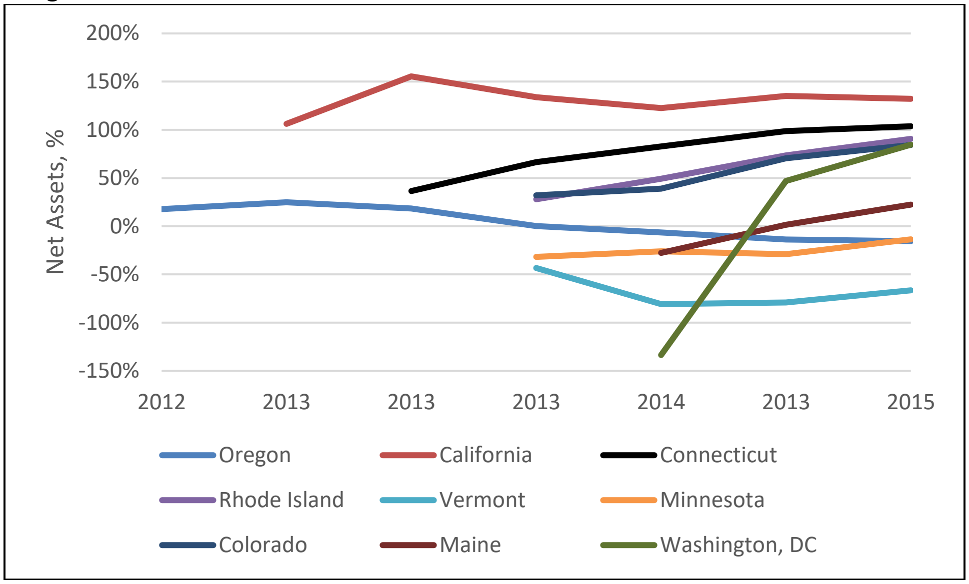
The next section shifts from looking at the reserves of separate product stewardship organizations to a comparison of Colorado's program with other PaintCare programs.

PaintCare Program Reserves

PaintCare's eight programs outside of Colorado consist of seven states and the District of Columbia. The programs have varied operational histories and associated trends of accumulating financial reserves, as seen in figure 10. All but Oregon show overall upward trajectories, or a plateau in the case of California, in growth of reserves. This does not mean that all programs have reserves, as three programs had negative net assets as of the end of 2018 (Oregon, Minnesota, and Vermont). The programs in Minnesota and Vermont were initiated the same year as Colorado's program, while Oregon's program began full operation in 2012.

[40] Product Care Association of Canada. *Product Care Association of Canada Financial Statements For the year ended 31 December 2017*, 2018: p. 12.
[41] Product Care Association of Canada. *2017 Annual Report*, 2018: p. 5.

Figure 10: Net Assets (Reserves) as a Percentage of Annual Expenses, FY2012-FY2018 by PaintCare Program



Source: 2018 PaintCare Annual Reports (multiple programs).

Based on the latest annual reports for the programs, the mean financial reserve as a percent of annual expenses is 47.0 percent and the median is 84.3 percent.[42] The Colorado program's reserve level of 84.3 percent is therefore substantially higher than the average PaintCare program, but it is also the median reserve value with four programs with higher reserve percentages and four with lower reserve percentages. The reserve ratios are included for all PaintCare programs in table 10.

Table 10: Net Assets (Reserves) as a Percentage of Annual Expenses by PaintCare Program, 2012-2018

	2012	2013	2014	2015	2016	2017	2018
Oregon	18%	25%	19%	0%	-6%	-14%	-15%
California	-	106%	155%	134%	123%	135%	132%
Connecticut	-	-	37%	67%	83%	99%	104%
Rhode Island	-	-	-	28%	49%	74%	91%
Vermont	-	-	-	-43%	-81%	-79%	-66%
Minnesota	-	-	-	-32%	-26%	-29%	-14%
Colorado	-	-	-	32%	39%	71%	84%
Maine	-	-	-	-	-28%	1%	22%
Washington, DC	-	-	-	-	-134%	47%	85%

Source: 2018 PaintCare Annual Reports (multiple programs).

To date, Colorado's program has closely mirrored the reserve accumulation experience of Rhode Island in percentage terms. While Colorado's program is in the middle for the reserves percentage, the dollar amount of the program's reserves are second only to California's (see table 11).

[42] These figures take into account those state programs with negative net assets, despite not formally having reserves.

Table 11: Net Assets (Reserves) by PaintCare Program, 2012-2018

	2012	2013	2014	2015	2016	2017	2018
Oregon	$684,420	$944,952	$851,941	$4,672	$(327,755)	$(708,934)	$(789,716)
California	-	$9,892,568	$27,462,632	$35,114,056	$39,442,812	$43,762,360	$45,853,006
Connecticut	-	-	$812,687	$1,796,810	$2,564,674	$3,073,688	$3,391,903
Rhode Island	-	-	-	$190,112	$379,278	$556,235	$702,737
Vermont	-	-	-	$(535,568)	$(665,658)	$(588,831)	$(523,198)
Minnesota	-	-	-	$(1,149,487)	$(1,496,076)	$(1,561,043)	$(718,902)
Colorado	-	-	-	$727,424	$2,114,696	$3,824,865	$4,887,694
Maine	-	-	-	-	$(287,187)	$16,284	$270,717
Washington, DC	-	-	-	-	$(318,151)	$164,083	$355,274

Source: 2018 PaintCare Annual Reports (multiple programs).

California is a positive outlier with a reserve percentage exceeding the 125 percent maximum established by PaintCare's board in April 2018. According to PaintCare, the larger than anticipated reserves resulted from "delays that took place in the first two years to sign up HHW programs." Within the PaintCare reserves policy, there is no mechanism described for dealing with reserve levels that exceed the established maximum percentage aside from evaluating the program's funding mechanism. In California, the level of reserves has drawn the attention of CalRecycle and uses of the funds going forward have been promoted:

> In year 7, staff expect PaintCare to continue to develop Program areas such as: 1) considering incentives to ensure highest and best use of collected paint (e.g., using excess reserve funds to offer grants to expand paint reuse programs); 2) focusing efforts to improve convenience in underserved areas (e.g., target funds to increase convenience in underserved regions, as well as in rural jurisdictions lacking permanent sites, and to increase investments in recycling infrastructure); and 3) considering additional expenditures to further improve the Program and to address the $45 million dollars in accumulated surplus funds.[43]

PaintCare instituted an Innovative Recycling Grant Competition "using funding from the PaintCare programs in California, Colorado, and Connecticut" to make awards up to $100,000 each. These are three states with high reserve levels and dollar amounts and provide an example of how PaintCare is able to make discretionary expense decisions based on a program's financial condition.[44]

The state programs with negative net assets have generally used two strategies to, over time, build desired reserves. Some states requested fee increases to boost revenue. Specifically, Vermont increased fees in 2016 and Minnesota instituted higher fees beginning September 2017. Oregon increased fees effective October 2018. Alternately, and sometimes combined with fee increases, programs cut costs by limiting certain activities. For example, Maine's program "did not hold any paint-only drop off events in

[43] Howard Levenson. *Request for Approval: Consideration of California Paint Stewardship Program Year 6 Annual Report*. State of California Materials Management and Local Assistance Division, January 15, 2019: p. 3.
[44] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 53.

FY2018 to allow the program to build some financial reserves."[45] The strategy used in Maine highlights the discretion of program managers to alter certain categories of expenses on an annual basis. In Oregon, efforts to lower program costs have included reductions to the program's communications budget.

Nonprofit Sector Reserves

Product stewardship organizations and other PaintCare programs provide narrow groups for comparison with PaintCare and its Colorado program. PaintCare's reserves, at the national organization level, can also be compared to the nonprofit sector as a whole and to more specific comparison groups using the IRS Form 990 Annual Masterfile Extract from 2018, which includes more than 200,000 501(c)(3) organizations. Despite the diversity of the sector, PaintCare's reserve levels are first compared to all 501(c)(3) organizations. Next, PaintCare's reserves are compared to similarly-sized 501(c)(3) organizations, those receiving a similar share of revenue from program services, and organizations of a similar age (organizations with a tax-exempt ruling date in 2011). Finally, PaintCare's reserve levels are compared to organizations in three nonprofit subsectors represented among the previously reviewed product stewardship organizations. Unlike the majority of the peer product stewardship organizations who are classified as Recycling organizations, PaintCare is identified as a 501(c)(3) organization with a National Taxonomy of Exempt Entities (NTEE) classification of E22 representing General Hospitals.[46]

The median operating reserves ratio for each comparison group is presented in table 12, along with the share of organizations with no operating reserve and the share with at least a three, six, and twelve-month operating reserve. As a reminder, PaintCare and Colorado's program have reserve levels of 88 and 84 percent, respectively. PaintCare's reserve ratio is substantially higher than the median organization in each of the presented comparison groups, but falls generally between the 75th and 90th percentile of organizations' reserve ratios.

[45] PaintCare Inc. *Maine Paint Stewardship Program Annual Report July 1, 2017 – June 30, 2018*, October 15, 2018: p. 10.
[46] Although not problematic for operations, PaintCare should consider correcting the NTEE classification to better reflect the organization's activities.

Table 12: Median Operating Reserves Ratio and Shares by Operating Reserve Size, CY2018 IRS Form 990 Filings

	Calendar Year 2018 IRS Form 990 Filing Extract						
			Share of Organizations with:				
Comparison Group	**Number of Orgs.**	**Operating Reserves Ratio (median)**	**No Operating Reserve (<=0% reserve ratio)**	**3-month Operating Reserve (>25% reserve ratio)**	**6-month Operating Reserve (>50% reserve ratio)**	**12-month Operating Reserve (>100% reserve ratio)**
501(c)(3) Organizations	189,297	37.5%	17.0%	58.6%	43.4%	28.3%
501(c)(3) Organizations with Total Expenses between $50 million and $60 million	611	21.5%	18.8%	46.5%	28.3%	13.6%
501(c)(3) Organizations with Program Service Revenue Share > 75%	48,791	24.4%	22.4%	49.4%	32.3%	16.6%
501(c)(3) Organizations with Ruling Date in 2011	3,884	27.5%	19.5%	51.9%	36.4%	21.1%
501(c)(3) Organizations, NTEE Code C27 - Recycling	84	17.3%	25.0%	38.1%	17.9%	11.9%
501(c)(3) Organizations, NTEE Code E22 - Hospital	1913	29.3%	20.9%	53.3%	34.2%	13.6%
501(c)(3) Organizations, NTEE Code C20 - Pollution Abatement and Control Services	113	33.1%	13.3%	57.5%	38.9%	23.9%

Note: Calculated based on the 2018 IRS Form 990 Annual Masterfile Extract and 2017 Exempt Organizations Business Master File Extract.

<u>Calibrating Appropriate Reserve Levels</u>

Based on the different peer comparisons, PaintCare and the Colorado program have reserves (and a reserves policy) that are on the high-end of the spectrum, but do not appear unusually excessive. Appropriate reserves are a function of the risks associated with an organization's revenue and expenses. From an external perspective, the previous changes to PaintCare's target reserve policies can appear to be reactions to exceeding the existing reserve policy thresholds and inaccurate projections rather than a measured and well-justified response to changing risk profiles for each state's program. This does not mean the latest reserve policy for Colorado's program is unreasonable, but rather that the shifting targets amid rising balances has not been accompanied by a strong public-facing case for the revisions. The following discussion of the California program's accumulated surplus exemplifies this perspective on the shifting reserves policy and inaccurate projections:

> In April 2018, the PaintCare Board of Directors increased the targeted reserve of six months of annual expenses to 12 months. This is the third targeted reserve increase in the six years of Program operations, as PaintCare's Plan had a target reserve of three months…PaintCare's reserve levels have continually surpassed the targeted reserve level over the six years of

> Program operations. Since year 3 of Program implementation, PaintCare has been projecting a future decrease in the reserves. For years 3 and 4, PaintCare determined that reserves will start declining in year 6. While reserve levels have continually increased, the rate of increase slowed, and PaintCare's five-year projections in both years 5 and 6 indicate that reserves will start to decline in 2019.[47]

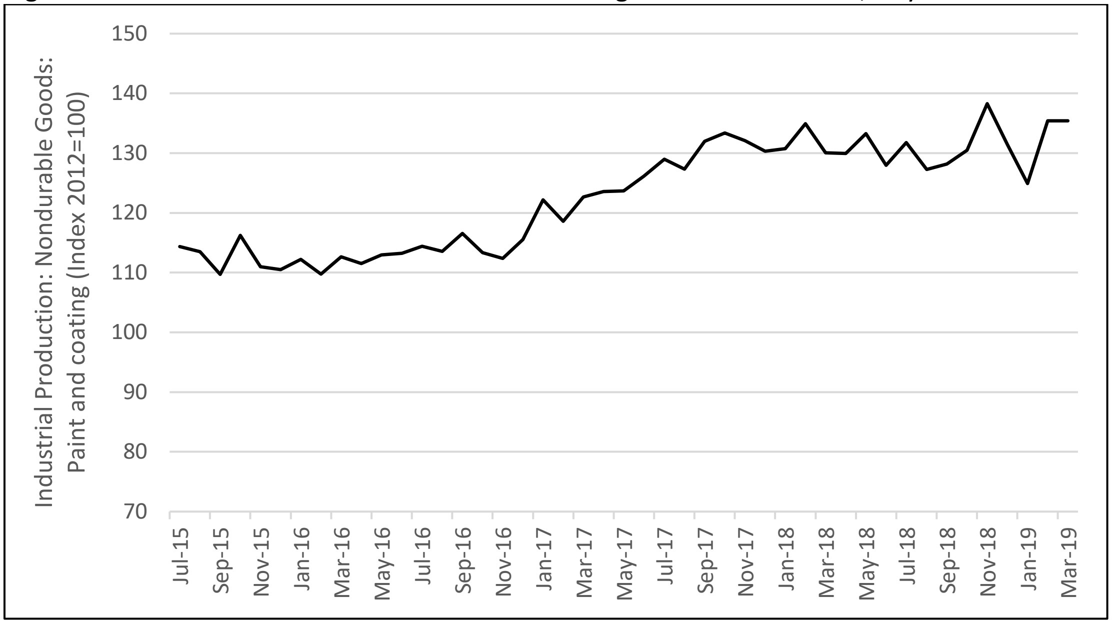
Financial risks for PaintCare's Colorado program fall into two main categories. The first is that fee revenues fall due to declining paint sales, while program demands continue at a rate of activity that exceeds the paint market activity. Second, the core costs referred to by PaintCare as CTP increase at a rate that exceeds revenue growth from paint sale fees whether due to higher per unit costs or paint collection activity. With limited insight into the long-term trends for CTP costs, the volatility of paint sales and associated fee revenue are instead considered.

The adequacy of reserves depends, from a program revenue perspective, on the sensitivity of paint sales to economic conditions or shifting consumer preferences. A performance audit of Oregon's PaintCare program noted that PaintCare does not use market projections for paint sales to inform its projections. Specifically, PaintCare informed the performance auditors "that manufacturer information on anticipated production and sales is not made available through their relationship with ACA [American Coatings Association]."[48] The absence of paint and coatings sales data, historic or forecasted, makes judging the volatility of paint sales more challenging and, in turn, assessing adequate levels of reserves for PaintCare programs. In the absence of actual sales data, the industry production index from the Board of Governors of the Federal Reserve System is used here as an indicator of variation in paint and coating demand over time.

The Colorado program began operations on July 1, 2015. Figure 11 presents the growth of the paint and coating industry during the program's operation. The program has operated during a period of positive growth for the broader industry. This is likely true of all PaintCare programs, given that the national organization was established in 2009 and programs began operation following the Great Recession.

[47] Howard Levenson. *Request for Approval: Consideration of California Paint Stewardship Program Year 6 Annual Report*. State of California Materials Management and Local Assistance Division, January 15, 2019: pp. 8-9.
[48] PlanB Consultancy. *Performance Audit of PaintCare and its Oregon Operations*. Oregon Department of Environmental Quality, April, 2018: p. 4.

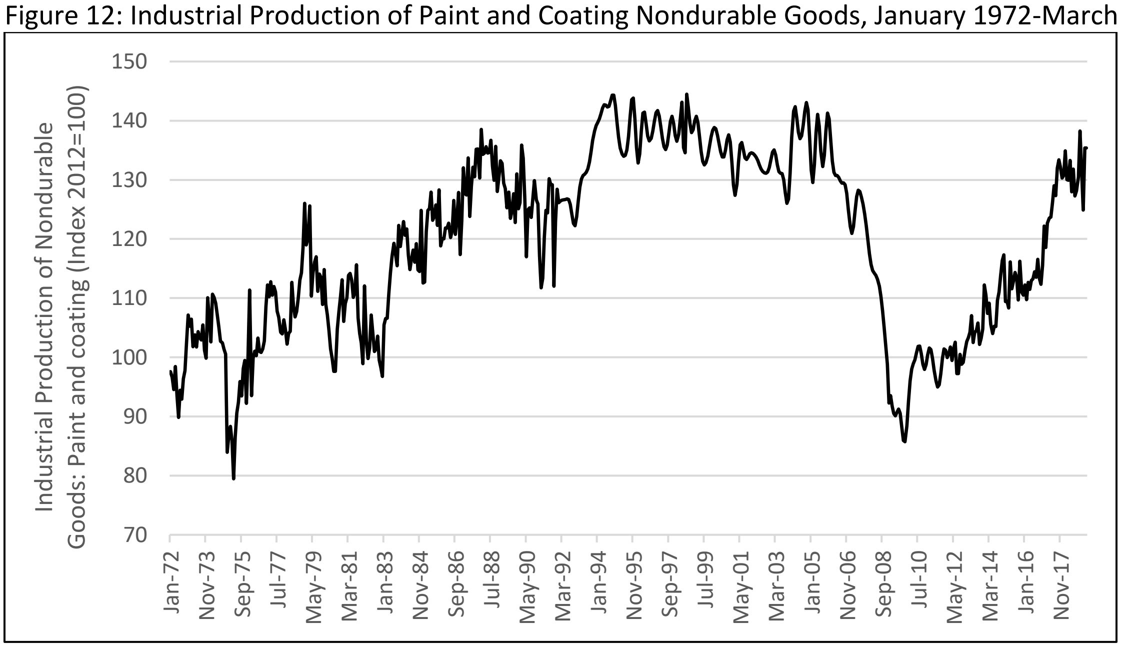
Figure 11: Industrial Production of Paint and Coating Nondurable Goods, July 2015-March 2019



Source: Board of Governors of the Federal Reserve System (US), Industrial Production: Nondurable Goods: Paint and coating [IPG32551S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/IPG32551S, May 9, 2019.

Contrasted with the industry's overall production through a number of recessions, as seen in figure 12, the period of Colorado's program operations has been less volatile. These industry-wide data are imperfect for understanding the sensitivity of Colorado's demand for paint to broader economic fluctuations, but suggest that industry activity is correlated with the economy.

Figure 12: Industrial Production of Paint and Coating Nondurable Goods, January 1972-March 2019



Source: Board of Governors of the Federal Reserve System (US), Industrial Production: Nondurable Goods: Paint and coating [IPG32551S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/IPG32551S, May 9, 2019.

Although dated, economists with the Bureau of Labor Statistics previously reported the correlation of employment and industry final demand in the 'Paints and allied products' industry to gross domestic product (GDP). Employment in the industry was highly correlated with GDP with a Pearson product moment coefficient of correlation (*r*) of 0.849. Historic correlation of industry demand to GDP was 0.482 (1977 to 1993), while the researchers projected the correlation to increase to 0.656 from 1994 to 2005.[49] Such responsiveness of industry activity is potential justification for maintaining ample reserves, especially for a program that has operated only during economic expansion in Colorado.

V. Evaluation of PaintCare's Investment Activities

Nonprofit boards of directors have the fiduciary obligation of duty of care, which includes oversight of investments.[50] According to PaintCare's audited financial statements:

> PaintCare invests a portion of its accumulated surplus in a portfolio with Bank of America/Merrill Lynch. The sole objective of the portfolio is to earn a return equal to the rate of inflation and thus preserve the purchasing power of its capital.[51]

Maintaining purchasing power over time for the accumulated surplus, or reserves, is the goal for PaintCare's investments. A challenge is to determine the appropriate composition of investments to balance expected risk and return to achieve the goal. Investment portfolios of nonprofit organizations are typically structured to satisfy three competing objectives. First, investments intend to protect or maintain the value of the original assets. Second, the investments seek to increase the value of the assets. Third, the investments allow the organization to access the assets as needed.[52] Growth beyond inflation is not prioritized in the investment objective, although the inflation rate of program expenses may differ from the more general inflation rate.

As an organization, PaintCare has high levels of liquidity. At the end of 2018, PaintCare had "$43,654,714 of financial assets available within one year of the statement of financial position date" and the organization "strives to maintain liquid financial assets sufficient to cover 90 days of general expenditures."[53] PaintCare maintains its reserves as cash and investments. PaintCare's investment portfolio, detailed below, does not include its separate cash holdings, which provide additional liquidity for the organization. The cash holdings considered reserves were roughly 17 percent of reserves over the past two years, as seen in table 13.

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[49] Berman, Jay, and Janet Pfleeger. "Which industries are sensitive to business cycles." *Monthly Labor Review*. 120 (1997): 19.
[50] Bowman, Woods, Elizabeth Keating, and Mark Hager. "Investment income." *Financing nonprofits: Putting theory into practice* (2007): 157-182.
[51] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2017 and 2016*, 2018: p. 10.
[52] See, National Council of Nonprofits at: https://www.councilofnonprofits.org/tools-resources/investment-policies-nonprofits
[53] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017*, 2019: p. 11.

Table 13: Cash and Investment Composition of PaintCare's Reserves, 2015-2018

	2018	2017	2016	2015
Cash (estimated reserves)	$8,902,245	$8,261,469	$9,032,486	$4,905,227
Investments (reserves)	$44,527,270	$40,277,238	$32,374,147	$31,242,792
Total cash and investments (reserves)	$53,429,515	$48,538,707	$41,406,633	$36,148,019
Cash (non-investment) share of reserves	16.7%	17.0%	21.8%	13.6%

Note: PaintCare's cash position held outside of the investment portfolio includes working capital in addition to reserves. The share of cash attributed to reserves is estimated as the difference between the aggregated state program reserves and the total reported investments in audited financial statements.

The investment portfolio is comprised of cash, bonds, and equity investments distinct from the previously described cash amounts. PaintCare's investment portfolio is managed at the national level and is detailed in financial statements (for the investment composition, see table 4 in the Appendix). Investment activity including interest, dividends, and capital gains or losses, "are allocated to each state program based on the relative net asset balances of each state program."[54] Beginning in 2015, PaintCare started to establish a separate, state-specific "wholly-owned subsidiary company dedicated to managing" each state program.[55] Investment assets for each state are reportedly being placed into state-specific accounts over time, although it is unclear if, or how, this affects investment decisions and financial reporting. Other PaintCare programs have shifted reserves away from non-cash investments, including Rhode Island's, whose "reserves are being held in a checking account, and no longer in an investment portfolio" as of January 2016.[56] Subsequently, for Connecticut and Oregon, "net asset balances, including gains earned from the investment portfolio, have been moved into those individual bank accounts and their programs' participation in an investment portfolio has ended."[57]

Best practices for nonprofits include written investment policy statements addressing both short and long-term investments.[58] Investments and investment policies are the purview of an investment committee comprised of knowledgeable board members. According to PaintCare's audited financial statements, the PaintCare Budget and Finance Committee oversees investments.[59] Beyond the stated investment objective included in the audited financial statements, it is unclear whether PaintCare has a formal written investment policy guiding investment decisions.

<u>Investment Allocation and Back Test</u>

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[54] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2017 and 2016*, 2018: p. 10.
[55] PaintCare. *PaintCare Colorado 2017 Annual Report*, April 2, 2018: p. 34.
[56] PaintCare. *PaintCare Rhode Island Annual Report July 1, 2017 - June 30, 2018*, October 15, 2018: p. 25.
[57] PaintCare. *PaintCare Colorado 2017 Annual Report*, April 2, 2018: p. 34.
[58] Nonprofit Operating Reserves Initiatives Workgroup (NORI) (2010). *Operating Reserve Policy Toolkit for Nonprofit Organizations*. National Center for Charitable Statistics: p. 24.
[59] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2017 and 2016*, 2018: p. 10.

Over the past five years, 2014 through 2018, PaintCare's overall investment composition has averaged 35.8 percent in equities and 64.2 percent in fixed income instruments (see table 14).[60] The fixed-income heavy asset allocation reflects the stated investment objective of prioritizing capital preservation over growth beyond the inflation rate.

Table 14: Investment Asset Allocation, 2014-2018

	2018	2017	2016	2015	2014	Average
Equities	37.7%	32.2%	30.2%	40.3%	38.5%	35.8%
Fixed Income	62.3%	67.8%	69.8%	59.7%	61.5%	64.2%

Sources: Annual Audited Financial Statements, multiple years

A simulation is used to back test PaintCare's most recently-reported investment composition (detailed in table 15) against inflation.[61] Two scenarios are simulated. The first rebalances asset classes annually to maintain the beginning-of-year investment composition. The second does not rebalance, despite differences in returns across classes over time.[62] Reported investment fees averaged 0.28 percent of investments, or $135,627, based on beginning-of-year balances and are represented in the simulation.[63]

Table 15: Investment Asset Composition Used in Simulation (approximate), CY2018

Asset Class	Allocation (%)
US Stock Market	37.69%
Cash	2.00%
10-year Treasury	27.25%
Total US Bond Market	16.56%
Corporate Bonds	16.50%

Source: PaintCare Inc., Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017, Notes to Financial Statements: 6. Investments and Fair Value Measurements, p. 14.
Note: Domestic versus international stock holdings are not disclosed in audited financial statements. Equity exposure is not broken down by sector in the simulations.

With annual rebalancing and a beginning asset allocation similar to PaintCare's 2018 investments, the portfolio return measured as the Compound Annual Growth Rate (CAGR) would have been 6.70 percent from 2003 to 2019.[64] The inflation-adjusted CAGR is 4.49 percent, the worst single-year performance was a loss of 7.10 percent, and a maximum drawdown of funds of 16.50 percent would have occurred from November 2007 to February 2009 (with drawdown recovery by September 2009). Although past performance does not in any way guarantee future investment results, the back testing suggests that PaintCare's investment allocation is relatively conservative and has, historically, *more than kept pace*

[60] The classification of investments into equities and fixed income is approximate given the level of detail provided in the financial statements.
[61] The portfolio simulation is performed using Portfolio Visualizer's Backtest Portfolio Asset Allocation tool (https://www.portfoliovisualizer.com/backtest-portfolio).
[62] It is unclear from the notes to financial statements whether PaintCare rebalances to a preferred asset allocation on an annual basis.
[63] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017*, 2019: p. 15.
[64] Data availability representing each asset class resulted in selecting 2003 as the first year of the back testing.

with inflation. Without rebalancing annually, the portfolio would have had a slightly higher historical rate of return of 6.84 percent tempered by greater single-year losses and maximum drawdown of 12.28 percent and 21.57 percent, respectively. Importantly, the cash held external to the investment portfolio is not considered in the simulation and would reduce reported returns but also reduce volatility and drawdowns. PaintCare invests available cash "in money market funds and other short-term investments."[65]

Table 16: Back Testing Results of PaintCare Investment Composition, January 2003-July 2019

	Compound Annual Growth Rate (CAGR)	**Best Year**	**Worst Year**	**Maximum Drawdown**	**Sharpe Ratio**	**U.S. Market Correlation**
Portfolio with Annual Rebalancing	6.70%	14.04%	-7.10%	-16.50%	0.95	0.81
Portfolio without Annual Rebalancing	6.84%	15.10%	-12.28%	-21.57%	0.86	0.88

Notes: The back testing exercise applied the latest investment portfolio composition of PaintCare at the end of 2018 to a portfolio initiated in January 2003 and held to July 2019.

Investment Portfolio Performance

Back testing is informative with regards to risk under various market conditions, but examining the actual return on the Colorado program's investments provides a more direct answer whether PaintCare has met the investment objective of maintaining purchasing power. Table 17 presents estimated annual investment returns for PaintCare's portfolio for the years since the Colorado program was launched. Interest and dividend income has averaged 2.63 percent over the period, which on its own has exceeded the annual inflation rate of 1.86 percent.

The estimated total return, including interest and dividend income, net realized and unrealized gains, and less investment fees, averaged 2.92 percent exceeding the average inflation rate by about 1 percent annually. Net realized and unrealized gains represent the change in value of investments, whether realized through a sale or still held in the portfolio. Two of the four years experienced net realized and unrealized losses with the other two experiencing gains. The average was an annual gain of $106,791 over the period, although the losses in 2018 were large enough to result in a total investment loss of approximately $750,000 for PaintCare's portfolio. It is unclear whether returns from the previously discussed cash position held as a portion of PaintCare's reserves are included in the reported investment returns, but cash-equivalent investments since 2015 have a CAGR of 0.70 percent. This rate of return trails inflation by about 1 percentage point.

[65] PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017*, 2019: p. 11.

Table 17: PaintCare's Estimated Investment Returns, 2015-2018

	2018	2017	2016	2015	Average
Total investments	$44,527,270	$40,277,238	$32,374,147	$31,242,792	$37,105,362
Interest and dividend income	$1,169,172	$1,027,363	$810,900	$688,130	$923,891
Net realized and unrealized gain	$(1,773,718)	$2,001,559	$439,166	$(239,843)	$106,791
Investment fees	$(145,423)	$(125,830)	-	-	($135,627)
Total investment (loss) income	$(749,969)	$2,903,092	$1,250,066	$448,287	$962,869
Annual Return (approximate)	-1.77%	7.99%	3.93%	1.54%	2.92%
Inflation Index (CPI-U)	250.5	245.1	240	237	$243
Inflation Rate (CPI-U)	2.20%	2.13%	1.27%	0.13%	1.86%

Note: Investment return is approximate based on the following calculation: (total investment income or loss)/((beginning-of-year investment balance plus end-of-year investment balance)/2). The calculation does not represent the actual rate of return due to the timing and amount of inflows and investment of additional funds during each year (as well as possible outflows). Investment fees were not disclosed in 2015 or 2016 financial statements.

Comparison of Investments to Peer Organizations

Investments for peer product stewardship organizations with relatively high reserve levels are reviewed for comparison to PaintCare's investments. The peer organizations with sufficient investment information to serve as comparisons are Call2Recycle and Mattress Recycling Council – California.

The composition of Call2Recycle's long-term investments at the end of 2018 was 55 percent cash and fixed income, 28 percent equities (stocks), and almost 15 percent in hedge fund investments.[66] The fixed income investments of PaintCare at the end of 2018 are similar to Call2Recycle with 62 percent of the portfolio. The equity portion of PaintCare's investment portfolio is larger, at almost 38 percent, but Call2Recycle invests in the alternative category of hedge funds making it difficult to compare risk exposure based on asset classes.

Mattress Recycling Council – California has a much more conservative investment composition than that of PaintCare, with 89.2 percent of the board-designated reserves in fixed income investments and the remaining 10.8 percent in "U.S. and International ETF's and mutual funds."[67] The 10.8 percent in equities is less than a third of the average equity exposure of PaintCare's investments since 2014 (see table 18 for details), which was 35.8 percent.

This is not to say that one approach is more appropriate given potentially different investment objectives across the programs and statutory requirements. Given the diversity of nonprofit organizations, even among product stewardship peers, "there is no single 'right' way to invest operating

[66] The 2.2 percent of Call2Recycle's investments reported in mutual funds are not assumed to be in either fixed income or equity investments.

[67] Mattress Recycling Council – California (CA) LLC (A Wholly Owned Subsidiary of the Mattress Recycling Council). *Audited Financial Statements (Including Report Required by CA Public Resources Code 42990) For The Year Ended December 31, 2018*, 2019: p. 13.

reserves."[68] Product Care Association provides audited financial statement noting that "the assets in the reserve fund consist of cash and investments in fixed income and equity securities and are independently managed," but no details of the investment portfolio are included.[69]

Table 18: Peer Product Stewardship Organizations' Investment Allocation of Reserves/Long-Term Investments

<table>
<tr><th>Peer Product Stewardship Organization</th><th>Investment Allocation</th></tr>
<tr><td>Thermostat Recycling Corporation</td><td rowspan="2">Unavailable (no audited financial statements posted on website with investment details)</td></tr>
<tr><td>Carpet America Recovery Effort Care Inc.</td></tr>
<tr><td>Call2Recycle</td><td>
<table>
<tr><th>2018</th><th>Fair Value</th><th>Share</th></tr>
<tr><td>Cash held for long-term investment</td><td>$2,033,344</td><td>10.2%</td></tr>
<tr><td>Equity investments</td><td>$5,615,378</td><td>28.1%</td></tr>
<tr><td>Fixed income</td><td>$8,943,289</td><td>44.8%</td></tr>
<tr><td>Mutual fund investments</td><td>$445,081</td><td>2.2%</td></tr>
<tr><td>Hedge fund investments</td><td>$2,929,403</td><td>14.7%</td></tr>
<tr><td>Total:</td><td>$19,966,495</td><td></td></tr>
</table>
Source: Call2Recycle, Inc. Financial Statements Years Ended December 31, 2018 and 2017 with Independent Auditors' Report, 2019: p. 17.</td></tr>
<tr><td>Mattress Recycling Council - California</td><td>
<table>
<tr><th>2018</th><th>Fair Value</th><th>Share</th></tr>
<tr><td>U.S. ETF and Equity Securities</td><td>$2,020,419</td><td>4.9%</td></tr>
<tr><td>International ETF and Equity Securities</td><td>1,247,463</td><td>3.0%</td></tr>
<tr><td>Fixed Income</td><td>36,792,111</td><td>89.2%</td></tr>
<tr><td>Mutual Funds</td><td>1,208,915</td><td>2.9%</td></tr>
<tr><td>Total:</td><td>$41,268,908</td><td></td></tr>
</table>
Source: Mattress Recycling Council – California (CA) LLC (A Wholly Owned Subsidiary of the Mattress Recycling Council). Audited Financial Statements (Including Report Required by CA Public Resources Code 42990) For The Year Ended December 31, 2018, 2019: p. 13.</td></tr>
<tr><td>Product Care Association</td><td>No investment details included in audited financial statements.</td></tr>
</table>

[68] Nonprofit Operating Reserves Initiatives Workgroup (NORI) (2010). *Operating Reserve Policy Toolkit for Nonprofit Organizations. National Center for Charitable Statistics*: p. 24.
[69] Product Care Association of Canada. *Financial Statements 31 December 2017*, 2018: p. 12.

VI. Compliance with Part 25-17-404(2)(j)(II)(A) and (B) of the Architectural Paint Stewardship Act Evaluation

The Architectural Paint Stewardship Act requires that the funding mechanism for Colorado's PaintCare program is "equitable and sustainable." Compliance, as previously discussed, has two components. The funding mechanism must:

> (A) provide a uniform paint stewardship assessment that does not exceed the amount necessary to recover program costs; and
>
> (B) require that any funds generated by the aggregate amount of fees charged to consumers be placed back into the program.

The point-of-sale fee is uniformly applied across the state, although the fee structure does treat consumers who purchase different amount of paints differently. This is in accordance with the fee structure used in all PaintCare programs, but someone buying, for example, five one-gallon containers of paint will pay more in fees ($3.75) than a consumer purchasing a single five-gallon container of paint ($1.60). The logic behind the fee schedule amounts and container size cutoffs are unclear given the fee schedule was used previously in other PaintCare program locations.[70]

That fees be equitable and sustainable also requires that the fees are set at a level where they do not surpass the amount needed to cover program costs. A number of practical factors complicate the exact matching of fee revenue and program costs. First, PaintCare, as a going concern, plans beyond a single budget year and doing so requires the establishment of financial reserves to address expected and unexpected changes in operations. These reserves come from fee revenue that, in any given year, might be considered excessive to cover program costs. These accumulated funds should be thought of as program costs smoothed over time, particularly in the program's early years when operational uncertainty is high, reserves are being established, and the volatility associated with operating under different market conditions is still difficult to predict. As stated earlier, gauging appropriate reserve levels is difficult, but reserves are necessary to achieve long-term program sustainability. Having reserves that are too large can be addressed by lowering fees or increasing spending on operations. Alternately, too few reserves may require changes in programmatic activity or the request for fee increases, which are likely to come at the same time as other economic disruption.

Second, program costs are not a fixed amount. Rather, the activity level of the program determines the costs and the activity level is, to at least some degree, at the discretion of PaintCare program managers. In other words, program costs can vary widely based on the quality and quantity of program activities. An increasing number of paint collection sites, for example, improves the quality of the program by

[70] No information on whether PaintCare monitors manufacturers, distributors, and retail outlets for compliance with fee collection and remission was available and it is unclear whether this is an issue for the Colorado program's fee mechanism. Questions regarding monitoring of fee remission and sales reporting are raised in the performance audit of PaintCare's program in Oregon (PlanB Consultancy. *Performance Audit of PaintCare and its Oregon Operations*. Oregon Department of Environmental Quality, April, 2018: pp. 20-22).

expanding convenience and accessibility for consumers, but is not required of the program once Colorado's accessibility requirements are met.

From a practical standpoint, the Colorado program has provided "a uniform paint stewardship assessment that does not exceed the amount necessary to recover program costs." PaintCare used an independent audit of the Colorado fee structure and projected budget to initially demonstrate compliance. The audit findings were communicated in March 2015, prior to the program launch in July 2015. The firm, HRP Associates, Inc., provides environmental and civil engineering consulting services and also conducted similar audits for other PaintCare state programs, including Connecticut, Minnesota, Rhode Island, and Vermont. The complete audit report was not included in the Colorado program plan, but the audit summary letter reported that:

> HRP independently reviewed the calculations performed by PaintCare for accuracy and the calculations were deemed sufficient. Based on our review, we find the Paint Stewardship Assessment, determined by PaintCare, to be reasonable and not to exceed the actual operational costs to administer the Paint Stewardship Program.[71]

No mention of reserves are included in the Colorado program plan, but the initial program budget presented in the plan included a projected surplus of $212,948.[72] PaintCare and CDPHE should revisit the priorities of the program to determine that program activity is at the desired level and to consider contingencies if financial reserves grow beyond the reserves policy maximum. The 100 percent of annual expenses reserve target is relatively high for the nonprofit sector as a whole, but not out of line with other product stewardship organizations and organizations with limited track records under different economic conditions.

The requirement that fees from consumers "be placed back into the program" is met. The fee revenue is spent either directly on the program or held on behalf of the program, as reserves, for the future resource needs of the program. For example, the addition of a research grant program for $100,000 both expanded the scope of the program's normal activities and supported the program's long-term need for cost-effective approaches to paint recycling and reuse in Colorado. The research grant program illustrates how the program itself can change over time so ensuring that such activities align with the program's intent and highest use of available funds requires dialogue between CDPHE, PaintCare, and other stakeholders.

VII. PaintCare's Financial Management Strategies and Financial Practices

PaintCare's financial management strategies and practices are reviewed in this section based on publicly-available information. The financial strategies and practices are discussed in four primary areas: 1) reporting and transparency, 2) projections, 3) financial condition, and 4) procedures.

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[71] HRP Associates, Inc. *Letter to Ms. Valerie Bernardo, RE: Paint Stewardship Fee Assessment Independent Audit, Paint Stewardship Program, Colorado (HRP # PAI2003.RC)*, March 27, 2015.
[72] PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 38.

Financial Reporting and Transparency

PaintCare provides visibility into the Colorado program and its finances through annual reports submitted to CDPHE and posted to the websites of PaintCare and CDPHE. As seen in table 19, the annual reports are typically submitted around the beginning of April but the 2018 report was delayed until mid-July. The annual reports cover 1) Paint Collection, Transportation and Processing, 2) Paint Collection Volume and Disposition Methods, 3) Independent Audit and Financial Summary, and 4) Outreach. The 2018 annual report added a forward-looking section covering plans for the following year. The 2018 Independent Audit and Financial Summary section discusses the Independent Financial Audit, provides a Financial Summary and Discussion, review of Investment Activity, details on Reserves including the associated policy, presents a high-level Evaluation of the Program's Funding Mechanism, and includes Five-Year Projections.

Table 19: Colorado Paint Stewardship Program Annual Report Submission Dates

Year	Date Submitted
2018	July 15, 2019
2017	April 2, 2018
2016	March 31, 2017
2015	April 6, 2016

The program annual reports append an independent third-party audit of PaintCare's national organization. This is intended to serve as the program audit, as well, with presentation of each program's costs and revenues in the Schedule of Activities, Organized by Program (located in the supplementary materials). PaintCare notes that "while the audit is conducted of the organization as a whole, it will also serve as the annual financial audit of the Colorado Paint Stewardship Program."[73] The audit opinion is unqualified for PaintCare in each year of the Colorado program's operations.

In addition to annual audited financial statements, as a nonprofit organization PaintCare is required to file the informational Form 990 with the Internal Revenue Service annually. PaintCare's Form 990 filings are available through the IRS and some third-party data providers, but are not made readily available to the public on their website. Doing so is widely considered a best practice for tax-exempt, 501(c)(3) organizations.

Financial Projections

PaintCare hired an external firm, Decision Metrics, Inc., to complete studies in 2012 and 2014 "to build a national and state-level model for predicting annual sales of architectural paint."[74] These models predated the Colorado program, but research combined with the growing experience of PaintCare programs demonstrate a multi-year lag between paint purchase and disposal. For this reason, the most recent sales data is used to project program revenue but program costs are based on past sales data to accommodate the lag. Revenue projections are influenced both by the volume of sales, but also by the

[73] PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 40.
[74] PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 34.

composition of the sales by container size due to the existing fee schedule. For Colorado, as detailed in table 2, the composition of sales by container size has been relatively stable which should simplify projections.

PaintCare presents expectations for collection volumes in the program plan based on existing studies and program history in other settings. Roughly 7 percent of sold paint, referred to as the recovery rate, is expected to be leftover and available for collection once a program reaches maturity. Colorado's reported recovery rate in 2018, based on current sales, was 4.7 percent. Based on a two-year lag using 2016 sales (the first full program year), the recovery rate climbs to 5.3 percent. The recovery rate, over time, should be strongly correlated with processing volumes and program costs.[75] PaintCare should continue to refine projections based on primary cost drivers.

As discussed previously, the combination of conservative projections and changing reserves policies raises concerns over the program's ability to accurately estimate financial outcomes. All projections have accompanying error, but PaintCare should consider presenting projections as flexible budgets based on different management decision and economic scenarios. This provides a range of outcomes rather than a single estimate for stakeholders to consider. The existing annual reports provide some useful explanations for discrepancies from projections, but a more formal variance analysis for primary revenue and expense categories would improve transparency to the public and help avoid misunderstandings around the causes of unanticipated budget surplus or shortfall.

The projection assumptions are detailed in the annual reports, but some components of the projections lack transparency and deserve additional attention to be understood by an external audience. For example, the five-year projections in the 2018 annual report do a good job of explaining assumptions around expense growth for the CY2019 and CY2021 to CY2023 years. The projection discussion is not as clear about how the fee revenue was set for CY2019 at an amount $100,000 less than CY2018 actuals ("based on previous 12 months of actual revenue") or how the flat fee revenue assumption results in a jump from CY2019 to CY2020 of approximately $50,000. More important, the expenses for CY2020 serve as the baseline for future growth but how the expense level is set following some one-time expenses in CY2019 is unclear.

In projecting expenses, PaintCare should consider detailing how the program's compliance with the convenience criteria relates to future program activity and costs. For example, recent projections discuss an average $15,000 annual cost for paint collected at each retail site. The Colorado program appears to have exceeded the convenience criteria on distribution that requires, "At least 90% of Colorado residents must have a permanent site within a 15-mile radius of their homes. Similarly, the program uses supplemental sites to increase population coverage, including unserved population, to 97.5 percent of Colorado's population. The program, on the other hand, continues to address "density" requirements in Denver-Aurora and Colorado Springs where "an additional permanent site must be provided for every 30,000 residents of an Urbanized Area, as defined by the United States Census Bureau, and distributed in a manner that provides convenient and reasonably equitable access for residents within each

[75] PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 35.

Urbanized Area, unless the Executive Director of CDPHE approves otherwise." A long-term plan for site buildout should link to financial projections. Consideration of the costs and benefits of "an additional 30 sites to meet the goal" for density should be provided so stakeholders, particularly CDPHE, can determine whether such compliance with the original plan makes financial and programmatic sense given that PaintCare believes "adding 30 sites in these two areas will be difficult as staff have already visited and tried to recruit the few remaining non-participating retail stores."[76]

<u>Financial Condition</u>

PaintCare and the Colorado program have substantial liquid assets and a high-level of reserves. For the program, reserve levels are nearing compliance with the internal policy target of 100 percent. PaintCare projections suggest the Colorado program will not meet the target level in the coming five-years and may, actually, fall below the target minimum reserve level at some point. As previously noted, assuming no significant fee revenue declines, discretionary spending by the program can likely be managed to maintain reserve levels within the policy thresholds. The reserves reflect low levels of liabilities for the organization and program.

<u>Financial Practices</u>

As noted, PaintCare's financial practices have been reviewed for other state programs. Specifically, the performance audit conducted for the Oregon program was comprehensive and much of the analysis focused on practices of PaintCare as a national organization and the relationship with operating state programs. Before considering a number of financial practices in greater detail, some of the conclusions of the Oregon performance audit merit mention, here, due to relevance for Colorado's program:[77]

- Appropriate documentation existed for allocating PaintCare's revenue and expenses to the appropriate state programs.
- Overhead costs were accurately distributed from the national organization to the states based on a formula determined by relative populations.[78] The Oregon report recommended a shift away from cost allocation based on population to using an activity-based measure possibly more indicative of program activity and resource use.
- State program funds were adequately separated from PaintCare corporate activities.
- Although limited visibility exists for investment positions, there do not appear to be conflicts of interest based on the connection of PaintCare and the ACA to the paint industry.[79]
- Accounting software and financial reporting process were reviewed and detailed.

Designation of Reserves and Restrictions

[76] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 17.
[77] PlanB Consultancy. *Performance Audit of PaintCare and its Oregon Operations*. Oregon Department of Environmental Quality, April, 2018: pp. 37-51.
[78] For Colorado, the allocated overhead costs represented 8.6 percent of PaintCare's total overhead costs which is in line with the relative population of PaintCare programs.
[79] For this review, the sectors with equity investments were examined and investments in the Construction sector are absent, which includes 'Paint & Related Products' and 'Paints, Varnishes, Lacquers, Enamels & Allied Products.'

Unlike some peer product stewardship organizations and common practice among nonprofits, PaintCare does not board designate its financial reserves. Board designation is not binding like donor-imposed restrictions, but provides clarity in financial reporting around funds treated as reserves rather than working capital. Board designation is also accompanied by a policy for use of the funds. PaintCare should consider formal designation of reserves.

Although PaintCare's accumulated net assets are presented as unrestricted, compliance with state laws suggests that fee revenue tied to one program must be used for that same program. Logically, this extends to reserves funded by program fees and maintained for future program costs. PaintCare should explore whether the reserves are legally restricted for use in the program for which they were generated and whether this needs to be reflected in audited financial statements. The ongoing creation of separate limited liability companies (LLCs) for each program may make this question irrelevant in the future.

Risk Management and Insurance

Managing risk is a critical function for any organization. PaintCare justifies the transition of state programs to independent LLCs on the basis of reducing liability risks:

> By shifting program operations and responsibilities to a disregarded LLC in each state or jurisdiction, and by segregating program funds accordingly, each state or jurisdiction's PaintCare program (and its associated funds) is better sheltered from any liability that might arise from the operation of a PaintCare program in a different state or jurisdiction.[80]

The shift in the formal stewardship organization for Colorado during 2019 is not anticipated to result in operational changes, as the LLC will remain a part of PaintCare, Inc.

In Colorado's program plan, PaintCare details its requirement that all contractors carry adequate insurance and that insurance coverage is reviewed for each contract. PaintCare itself reports carrying "Pollution Liability, Commercial General Liability and Excess Umbrella Coverage to cover any liability PaintCare may incur."[81]

Board Composition, Related-Party Transactions, and Governance

PaintCare is operated as "a program of the American Coatings Association (ACA), a membership-based trade association of the paint manufacturing industry."[82] The mission of the ACA, a 501(c)(6) organization, is to "advance the interests of the coatings industry and serve as its chief advocate and spokesperson before the government and public; domestically and globally." The Board of Directors for PaintCare "consists of eleven non-paid representatives of architectural paint manufacturing companies"[83] and all PaintCare employees actually work for ACA. The representation on the board of

[80] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019: p. 54.
[81] PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 24.
[82] PaintCare Inc. "About." Accessed at: https://www.paintcare.org/about/#/overview
[83] PaintCare Inc. *Colorado Architectural Paint Stewardship Program Plan*. June 12, 2015: p. 7.

paint industry representatives reflects the operation of PaintCare as a program of the ACA, but likely limits the diversity of perspectives present in discussions about the organization's activities. Given the tightly-couple operations of the ACA and PaintCare, conflict of interest policies to address concerns over dual roles should be in place. A one-year, automatically-renewable affiliation agreement exists between ACA and PaintCare. The agreement provides ACA with an administrative fee, totaling $2,117,301 in 2017, for "allocation of time incurred by PaintCare officers, allocation of other direct labor, and allocation of occupancy and infrastructure costs."

Investment Management

As discussed, investment management is overseen by the PaintCare Budget and Finance Committee. Given the different investment strategies currently in place across PaintCare's programs, the Committee should maintain a written investment policy tied to each program. PaintCare should work to optimize the non-investment reserve held in cash based on historic liquidity needs.

VIII. Recommendations

Recommendations and observations identified during this review include the following:

- For now, the paint fee supporting the Colorado program should be maintained at the current level.
    - The uncertainty and administrative effort resulting from a fee reduction is not commensurate with the gains to individual consumers.
    - PaintCare and CDPHE should determine the desired balance of program cost and quality, as this balance influences future reserve levels and whether future fee decreases are feasible.
    - Plans should exist for reserves in excess of the reserves policy maximum.
    - PaintCare's own extended projections suggest the Colorado program's reserves will fall below the policy minimum of 75 percent by CY2024. Planned spending levels and actual revenue should be closely monitored to comply with the current policy.
- PaintCare's reserves and reserve policy are on the high end compared to multiple comparison groups, but not unreasonable.
    - As the Colorado program matures and reaches "steady state" operations, PaintCare should revisit the reserves policy to ensure that it reflects current and future program needs with fees set at the appropriate level to cover program costs.
    - Increasing transparency around spending required to meet convenience criteria versus discretionary program spending, like the recent research grant award, will help better determine the needed size of the reserve.
    - PaintCare should consider presenting projections as flexible budgets based on different management decision and economic scenarios. Existing annual reports provide some useful explanations for discrepancies from projections, but a more formal variance analysis for primary revenue and expense categories would improve transparency to the public and help avoid misunderstandings around the causes of unanticipated budget surplus or shortfall.

- Visibility into the investments of stewardship organizations and other 501(c)(3) organizations is limited, but PaintCare, generally, has a higher allocation to equity investments than two peers but this is attenuated by maintenance of a large cash position external to the investment portfolio.
    - PaintCare provides better transparency for investment activity in audited financial statements than peer product stewardship organizations.
- Through 2018, PaintCare's investment allocation has kept pace with inflation. Simulations demonstrate historic returns greater than inflation for the portfolio's current composition.
    - Investment activity, even with PaintCare's conservative portfolio, is volatile. The average investment activity was an annual gain of $106,791 over the period for PaintCare, although investment losses (realized and unrealized) in 2018 were large enough to result in a total investment loss of approximately $750,000. The Colorado share of the 2018 losses was only $67,151.
    - PaintCare should more clearly identify cash holdings that are part of the programs' reserves and the associated earnings on the cash. Currently, it is difficult to calculate the total rate of return on the cash and investments.
- PaintCare is preserving the purchasing power of its capital when comparing the average annual rate of return of 2.92 percent to the average inflation rate of 1.43 percent, based on the consumer price index (CPI-U), during the Colorado program's history. The average annual growth rate of total expenses and operations expenses for the program's full years of operation were higher, though, at 3.4 percent and 5.6 percent, respectively, which exceed the investment return. An important consideration is that the expenses on which these growth rates are calculated include spending that might be classified as discretionary or, at a minimum, controllable over time (like communications and the one-time grant program).
- PaintCare should embrace best practices for nonprofit organizations and post its IRS Form 990 filings on its website.
- Existing practices by PaintCare that may deserve additional review include the overhead cost allocation approach based on program population, formal designation of financial reserves, use of restrictions on reserves based on program claims, financial impact of transition of state programs to independent LLCs, policies to avoid potential conflicts of interest between PaintCare and the American Coatings Association (ACA) due to overlapping activities, employees, and boards, and optimizing the non-investment reserve held in cash based on historic liquidity needs.
- PaintCare and the Colorado program should work to improve communications around reserve levels, policies, how reserve levels influence spending levels, and contingencies for future changes in reserves.

IX. Work Plan

The following table includes the activities specified by CDPHE in the related request-for-proposal.

<table>
<tr><td>Primary Activity #1</td><td>The Contractor shall review data and create a report.</td></tr>
<tr><td>Sub-Activities #1</td><td>1. The Contractor shall review the following, at a minimum:
a. Colorado population trends
b. Colorado economic trends
c. PaintCare's fee analysis Report
d. PaintCare five year projections
e. PaintCare's assumptions used in the five year projection
f. PaintCare's reserves policy,
i. the previous 75% maximum limit
ii. the newly adopted 100% maximum limit
g. PaintCare's independent financial audit
h. PaintCare's investment objective in relation to investment activities

2. The Contractor shall create a final report.
a. The Contractor shall create a rough draft of the final report.
b. The Contractor shall create a final version of the final report.</td></tr>
<tr><td>Standards and Requirements</td><td>1. The content of electronic documents located on CDPHE and non-CDPHE websites and information contained on CDPHE and non-CDPHE websites may be updated periodically during the contract term. The contractor shall monitor documents and website content for updates and comply with all updates.

2. The CDPHE Project Manager will hold a CDPHE-contract kick off meeting no later than 15 days following the execution of this contract.
a. The CDPHE Project Manager will provide the contractor with information on locating all documents for this project.

3. The Contractor shall submit all deliverables and correspondence to the CDPHE Project Manager via email.
a. The CDPHE Project Manager will approve or request changes within ten (10) business days.
b. The Contractor shall update any requested changes within five (5) business days.
c. The Contractor shall submit requested changes to the CDPHE Project Manager by the close of business on the fifth business day.
d. The CDPHE Project Manager may approve extensions to the Contractor's deliverables schedule via email.

4. The Contractor shall create a final report with the following, at a minimum:
a. Detailed explanation of methodology
b. Detail all assumptions
c. Assess financial impacts of lowering the paint recovery fee
i. consider the impacts of projected population changes</td></tr>
</table>

	ii. consider the impacts of current economic trends iii. provide a recommendation on whether the fee should be lowered, raised or kept the same. d. Compare PaintCare’s reserve policy to other stewardship organizations and 501(c) 3 i. Evaluate reserve limits 1. the old 75% limit 2. the new 100% limit ii. Recommend best practices iii. Evaluate annual reserve requirements for the successful operation and maintenance of the program e. Evaluate PaintCare’s investment activities i. Compare PaintCare’s investments to other stewardship organizations and 501(c)(3) organizations ii. Evaluate if PaintCare is earning a return equal to the rate of inflation iii. Evaluate if PaintCare is preserving the purchasing power of its capital f. Assess PaintCare’s compliance with part 25-17-404(2)(j)(II)(A) and (B) of the Architectural Paint Stewardship Act., available at http://www.leg.state.co.us/clics/clics2014a/csl.nsf/fsbillcont3/C37EE35E40BDD15B87257C3000060A11?Open&file=029_enr.pdf and incorporated and made a part of this contract by reference. i. Based on analysis, provide an opinion on PaintCare’s compliance with the above requirements and how any compliance issues might be resolved. g. Evaluate PaintCare’s financial management strategies h. Evaluate PaintCare’s financial practices i. Provide Recommendations

X. Appendix

Table 1: Projected Expenses, Revenue, and Reserves, CY2019-CY2023[84]

	CY2018	CY2019	CY2020	CY2021	CY2022	CY2023
	Actual	**Projection**	**Projection**	**Projection**	**Projection**	**Projection**
Revenue:						
Total recovery fees	$6,926,702	$6,826,557	$6,875,000	$6,875,000	$6,875,000	$6,875,000
Other income	$0	$0	$0	$0	$0	$0
Total revenue:	$6,926,702	$6,826,557	$6,875,000	$6,875,000	$6,875,000	$6,875,000
Expenses:						
Collection supplies and support	$503,530	$669,903	$634,300	$664,600	$695,800	$727,900
Paint transportation	$717,570	$767,967	$802,300	$837,600	$874,000	$911,500
Paint processing	$3,167,860	$3,357,333	$3,510,600	$3,668,400	$3,831,000	$3,998,400
Communications	$636,823	$650,000	$650,000	$650,000	$650,000	$650,000
State administrative fees	$120,000	$120,000	$120,000	$120,000	$120,000	$120,000
Personnel, professional fees, and other	$279,296	$491,835	$317,000	$322,000	$328,000	$334,000
Allocation of corporate activities	$371,644	$397,023	$395,000	$406,850	$420,000	$433,000
Total expenses:	$5,796,723	$6,454,061	$6,429,200	$6,669,450	$6,918,800	$7,174,800
Change in net assets from operations:	$1,129,979	$372,496	$445,800	$205,550	$(43,800)	$(299,800)
Investment activity allocation	$(67,151)	$0	$0	$0	$0	$0
Total change in net assets:	$1,062,828	$372,496	$445,800	$205,550	$(43,800)	$(299,800)
Reserves, beginning of period:	$3,824,866	$4,887,694	$5,260,190	$5,705,990	$5,911,540	$5,867,740
Reserves, end of period:	$4,887,694	$5,260,190	$5,705,990	$5,911,540	$5,867,740	$5,567,940
Reserve percentage	84%	82%	89%	89%	85%	78%

[84] PaintCare. *PaintCare Colorado 2018 Annual Report*, July 15, 2019.

Table 2: Common-sized Expenses by State (shares of total expenses), CY2018

Expenses	Share of Total Expenses (excluding central overhead expenses of Management fees, Insurance, and Depreciation)									
	Oregon	California	Connecticut	Rhode Island	Minnesota	Vermont	Maine	Colorado	District of Columbia	Average
Salaries and related benefits	2.2%	2.2%	3.1%	4.0%	2.6%	5.2%	6.4%	3.4%	7.1%	4.0%
Collection support	0.2%	10.0%	13.8%	14.2%	8.3%	9.7%	11.7%	9.3%	9.7%	9.7%
Transportation and processing	94.1%	72.9%	68.4%	68.8%	83.6%	80.5%	72.3%	71.6%	56.1%	74.3%
Communications	1.4%	10.4%	13.3%	11.8%	3.8%	1.5%	2.9%	11.7%	24.4%	9.0%
Legal fees	0.0%	3.1%	0.1%	0.0%	0.0%	0.0%	0.4%	0.1%	0.3%	0.4%
State agency administration fees	1.0%	0.6%	0.7%	-	0.6%	2.0%	4.2%	2.2%	-	1.6%
Professional fees	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%
Office and supplies	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%
Subscriptions and publications	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Professional development	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.2%	0.0%	0.1%
Travel	0.5%	0.5%	0.3%	0.5%	0.4%	0.8%	1.7%	1.2%	2.1%	0.9%
Meetings	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%
Bank fees	0.0%	-	0.1%	0.4%	-	-	-	-	-	0.2%
Other expenses	0.3%	0.2%	0.1%	0.1%	0.5%	0.0%	0.0%	0.0%	-	0.2%
Total Expenses	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017*, 2019: p. 5.

Table 3: Peer Product Stewardship Nonprofit Organizations

Name	EIN	Tax-exempt Status	NTEE Code	Mission	Ruling Year	Operating Reserves* (latest year available)	Operating Reserves Ratio* (latest year available)
Ag Container Recycling Council	52-1763751	501(c)(6)	Recycling (C27)	Collection and recycling of rigid HDPE plastic agricultural crop protection, specialty pest control, micronutrient/fertilizer, and/or adjuvant product containers through member funding of cost effective programs that foster public health & safety, environmental protection, resource conservation and end user convenience.	1992	$478,875	10.5%
Pca Product Stewardship Inc	27-2076305	501(c)(3)	Recycling (C27)	To operate environmentally sound and cost-effective product stewardship programs which include the collection, transportation and processing of post-consumer products for end-of-product-life management.	2010	$343,393	26.7%
Thermostat Recycling Corporation	54-1830284	501(c)(6)	Recycling (C27)	The thermostat recycling corporation (TRC) is a non-profit organization that facilitates and manages the collection and proper disposal of mercury-containing thermostats	2000	$1,014,834	35.2%
Carpet America Recovery Effort Care Inc	02-0639766	501(c)(3)	Land Resources Conservation (C34)	The mission of care is to advance market-based solutions that increase landfill diversion and recycling of post-consumer carpet, encourage design for recyclability and meet meaningful goals as approved by the care board of directors.	2002	$649,828	58.9%
PaintCare (CO only)	See PaintCare, below					$4,887,694	84.3%
PaintCare	27-1354262	501(c)(3)	Hospital (General) (E22)	A non-profit organization designed to provide a system for the collection of post-consumer architectural paint and the management of its end-of-product life, including reuse, recycling, energy recovery, and proper disposal.	2011	$47,661,288	87.8%

Call2Recycle	54-1714316	501(c)4	Recycling (C27)	On behalf of corporate stewards, we optimize battery collections, share our experience and expertise, and responsibly manage the end-of-life of batteries and other material	1994	$18,175,278	138.2%
Mattress Recycling Council	46-4208045	501(c)(3)	Recycling (C27)	To work to establish an environmentally sound and cost-effective program for recycling mattresses, subject to state laws requiring recycling of used mattresses; and educate consumers, retailers, waste haulers, and others about collection opportunities for used mattresses and promotion of waste prevention and recycling.	2014	$45,652,596	156.3%
Product Care Association	98-0701785	501(c)(3)	Pollution Abatement and Control Services (C20)	The objectives of the corporation are: 1) to develop, implement, manage and address all environmental product stewardship issues and concerns for its member product sectors throughout Canada and North America; and 2) to protect the interests of brand owners who are regulated under product stewardship legislation while taking into consideration the concerns of stakeholders such as retailers, government agencies and other interest groups.	2017	N/A	N/A

* Operating Reserves Ratio is calculated by dividing Operating Reserves by Annual Expenses. Based on guidance from the Nonprofit Operating Reserves Initiative Workgroup, the IRS 990 Form is used to determine the ratio where Operating Reserves (the numerator) equal "Unrestricted net assets less fixed assets net of debt" and "Fixed assets net of debt equals (Land, buildings, and equipment -- i.e., fixed assets) minus (Mortgages and other notes payable)". The ratio's denominator of Annual Expenses is represented as "(Total functional expenses) less (Depreciation)" in the current reporting period (The Nonprofit Operating Reserves Initiative Workgroup, 2009: 2-3). The reserve ratio of PaintCare's Colorado program is taken directly from the most recent program reporting. The operating reserve ratio, and its calculation using the Form 990, is criticized by some for potential measurement error due to the unrestricted net assets including receivables, prepaid expenses, and inventories.[85] While a valid concern for assessing nonprofits generally, these concerns are lessened for PaintCare and similar stewardship organizations with little use of traditional receivables and inventories. Form 990 data come from the CY 2018 IRS Form 990 Masterfile Extract. Product Care Association is a peer organization, but no reserve ratio is calculated since the organization does not follow Statements of Financial Accounting Standards (SFAS) 117.

[85] Zietlow, John, et al. *Financial Management for Nonprofit Organizations: Policies and Practices*. 3rd Edition, Wiley: Hoboken. 2018, p. 284.

Table 4: PaintCare Investments as of December 31, 2018

Investment Category	**Amount**	**Share of Total Investments**
Equities:		37.7%
Energy	$596,941	
Materials	453,819	
Industrials	1,339,480	
Consumer discretionary	1,285,508	
Consumer staples	1,035,110	
Health care	1,728,636	
Financials	1,874,340	
Information technology	2,041,301	
Telecommunication service	1,040,963	
Utilities	464,489	
Real estate	550,772	
Bend	60,382	
Mutual funds (mid/small U.S. equity)	4,305,076	
Mutual funds (fixed income):		35.07%
Fixed income	7,374,973	
Corporate bonds	7,348,981	
Cash equivalents	891,387	
Government securities:		27.253%
U.S. Treasury	8,136,916	
U.S. Agency	3,998,196	
Total investments	$44,527,270	100%

Source: PaintCare Inc. *Financial Statements and Independent Auditors' Report, Twelve Month Periods Ended December 31, 2018 and 2017*, 2019: p. 14.
Note: It is unclear what equity sector is referred to as "Bend" in the table and financial statements.