Nonprofit Operating Reserves

~ Creating a Policy ~

An imperative for sustainability of mission program delivery and organizational fiscal health
Making the Case for Having an Operating Reserve

Supports fulfillment of mission and fosters strategic decisions

→ Provides sufficient resources to continue mission programs uninterrupted by ups and downs in cash flow.
→ Permits acceptance of reimbursable grants.
→ Allows for bulk purchases at lower prices.
→ Facilitates long-term planning and thoughtful decision-making.

Improves cash management and reduces stress

→ Reduces stress on staff caused by sweating payroll, managing late payments to vendors, etc.
→ Promotes staff retention, reduces costly turn-over of key staff who burn-out under the sustained condition of chronic cash flow issues.
→ Positions the organization to negotiate a bank line of credit.
→ Allows for better cash flow forecasting & intentional use of an operating reserve to help smooth out cash flow in low balance months.
→ Enables and supports conversations with donors about possible changes to the timing of their gifts.
Making the Case for Having an Operating Reserve

Demonstrates proactive, prudent management and planning and promotes donor confidence

→ Strongly indicates that the board is prudent, forward thinking, & committed to reliable program delivery and that it has positioned their organization to continue to operate for the long haul.

→ Sound Investment in sustainable organization.

→ Suggests the organization is a better risk for investment of contributions & grant funding, for individual donors & institutional funders alike.

It promotes compliance to GAAP, regulatory and grant requirements, and good cash management protocols.

→ Creating a separate operating reserve can provide a buffer to prevent accidental use of assets with donor restrictions or board-designated endowments.
Statement of Financial Position

Assets
< Liabilities >
=
Net Assets

Current Liabilities
Accounts Payable
Accrued Expenses
Payroll Liabilities
Deferred Revenue
Refundable Advances
Line of Credit
Current portion of Loan

Long Term Liabilities
Mortgage
Bond
Loan (over 1 year)

Assets

Liabilities

Net Assets

Current Assets
Cash
Cash Equivalents
Receivables (short-term)
Inventories
Prepaid Expenses

Fixed Assets
Furniture & Equipment
Property & Plant
(less accumulated depreciation)
Right to Use Assets (Leases)

Other Assets
Deposits
Long-term Investments
Long-term Receivables

Without Donor Restrictions (Unrestricted)

With Donor Restrictions
Temporarily Restricted
Permanently Restricted

Debit Balance
Credit Balance
Reserves Terms & Concepts

Net Assets Without Donor Restrictions

Available
Unrestricted net assets that are available for board designation

Not Available
Equity in fixed assets (value less related debt) is not available for board designation

Undesignated
Can include non-current, non-liquid assets excluded from a funded reserve

Working Capital Cash
Cash available for day-to-day operating

Board-designated Operating Reserve
Board established minimum Operating Reserve Ratio (% of annual expenses)

Board-designated Special Purpose Funds
For strategic initiatives, business opportunities, fixed assets maintenance & repairs, quasi-endowment, etc.
How much to designate? It depends.

Determining the Appropriate Ratio

- The minimum operating reserve ratio at the lowest point during the year suggested by the Nonprofit Operating Reserves Initiative Workgroup is **25% or about 3 months** of the annual operating expense budget.

- Regarding what level of operating reserves above this minimum might be adequate for financial stability, the Workgroup reached the conclusion that “it depends” – each organization must arrive at its own rationale for what it considers adequate.

- There is no single correct solution or benchmark – **one size simply does not fit all** when it comes to setting the amount for Operating Reserves.

- An organization might begin by examining common factors at play in its operation:
  - Revenue volatility factors
  - Spending flexibility factors
  - Governance & Management factors
  - Level of programmatic risk
  - Organization life cycle stage
Revenue Volatility Factors

Common factors indicating level of volatility in revenue streams could include:

- **Stability** of donated revenue from primary sources
- Predictability of **pledge collections**
- **Reliability** of grants and contracts for services
- Level of dependence on one or two major donors
- Level of dependence on a **single fundraising event**
- Funder policies on support of **overhead**, indirect expenses (operating vs. restricted support)
- Economic health of the **community**
- **Publicity** that could adversely affect current or future revenues
- Likelihood of severe weather or natural **disasters** that would affect implementation of programs.

(Adapted from the Nonprofit Operating Reserves Policy Toolkit 2010 and Toolkit Update 2022)
Spending Flexibility Factors

Common factors that influence the ability to adjust spending levels could include:

– Ability to **downsize** operations quickly and still sustain core programs
– Balance of **fulltime** permanent staff vs. part-time temporary staff and/or contractors
– Extent to which **economic or environmental events** may affect demand for services
– Long term **leases** with substantial penalties for cancelation
– **Obligations** to labor unions, union contracts
– Organization’s importance in **community crisis** situations (e.g. if the mission involves disaster relief)
– Dependence on **key person**
– Obligations resulting from **funding commitments** made for longer than one year
– Amount of unsecured **debt** carried by the organization

(Adapted from the Nonprofit Operating Reserves Policy Toolkit 2010 and Toolkit Update 2022)
Operating Reserves Ratio

Setting the Target ~ 25% or 3 months example

$600,000 (annual expense) x 25% (0.25) = $150,000
$600,000 (annual expense) ÷ 12 = $50,000 per month x 3 months = $150,000

Calculating the Ratio

- **Percentage basis formula:**
  
  Operating reserves ÷ annual operating expense*
  
  $75,000 (available) ÷ $600,000 (annual expense) = 0.125 or 12.5%

- **Number-of-months basis formula:**
  
  Operating reserves ÷ 1/12th of the annual operating expense
  
  **Step 1:** $600,000 (annual expense) ÷ 12 (months) = $50,000 per month
  
  **Step 2:** $75,000 (available) ÷ $50,000 (1/12th annual expense) = 1.5 or 1 ½ months

*Use either prior year actual expenses or current year budgeted expenses
## Developing Policy

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<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Inception</strong></td>
<td>Make the case for the need for an operating reserve to the Board. (NORI’s whitepaper or reserve introduction document may be helpful.)</td>
</tr>
<tr>
<td><strong>2. Recognition of Need</strong></td>
<td>Board concurs with the case and asks finance (or related) committee to create draft.</td>
</tr>
<tr>
<td><strong>3. Development</strong></td>
<td>Utilize the NORI Toolkit and Templates (e.g., reserve ratio, outlines and sample language) to draft policy.</td>
</tr>
<tr>
<td><strong>4. Draft Policy</strong></td>
<td>Present draft policy to Board members.</td>
</tr>
<tr>
<td><strong>5. Board Feedback</strong></td>
<td>Board may approve or request revisions.</td>
</tr>
<tr>
<td><strong>6. Final Draft</strong></td>
<td>Policy is finalized and approved.</td>
</tr>
<tr>
<td><strong>7. Implementation</strong></td>
<td>Put into practice the guidelines established in the Operating Reserve Policy.</td>
</tr>
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</table>
# Basic Policy Components

<table>
<thead>
<tr>
<th>Section Title</th>
<th>Topics Addressed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Purpose/Philosophy</td>
<td>- Why is this board designating the funds?</td>
</tr>
<tr>
<td></td>
<td>- What are the objectives of the fund?</td>
</tr>
<tr>
<td>Establishment of the Reserve Fund</td>
<td>- When was it established?</td>
</tr>
<tr>
<td></td>
<td>- Target amount? Ratio calculation method used?</td>
</tr>
<tr>
<td></td>
<td>- Opening balance? Funding plan to reach target?</td>
</tr>
<tr>
<td>Definitions</td>
<td>- Define technical terms used throughout the reserve policy to establish clarity</td>
</tr>
<tr>
<td>Use and Replenishment of Fund</td>
<td>- Who may access the fund?</td>
</tr>
<tr>
<td></td>
<td>- What authorization is given or required?</td>
</tr>
<tr>
<td></td>
<td>- How much can be withdrawn? %/$?</td>
</tr>
<tr>
<td></td>
<td>- What communication methods are acceptable?</td>
</tr>
<tr>
<td></td>
<td>- What is the standard expectation for repayment of accessed funds?</td>
</tr>
</tbody>
</table>
## Basic Policy Components

<table>
<thead>
<tr>
<th>Section Title</th>
<th>Topics Addressed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management and Monitoring</td>
<td>▪ Who is responsible for managing the fund?</td>
</tr>
<tr>
<td></td>
<td>▪ Is a separate bank account required?</td>
</tr>
<tr>
<td></td>
<td>▪ When is the reserve used vs. a line of credit?</td>
</tr>
<tr>
<td></td>
<td>▪ What are the accounting procedures and reporting requirements?</td>
</tr>
<tr>
<td></td>
<td>▪ What happens to any interest income?</td>
</tr>
<tr>
<td></td>
<td>▪ What are the liquidity requirements for funds comprising the operating reserve? Can they be invested?</td>
</tr>
<tr>
<td>Role of the Finance Committee</td>
<td>▪ How will the committee monitor the activity in the funds?</td>
</tr>
<tr>
<td></td>
<td>▪ Will the committee be charged with developing the criteria to be used in deciding whether/how much to designate to the reserve each year?</td>
</tr>
<tr>
<td></td>
<td>▪ How often will the Operating Reserve Policy be reviewed and updated?</td>
</tr>
</tbody>
</table>
Communicating About Our Operating Reserves

A disaggregated presentation of the Statement of Financial Position that separates restricted and designated funds from those available for operations. This presentation helps the reader to understand the composition of the organization’s net assets and its liquidity status.

<table>
<thead>
<tr>
<th>ORG NAME</th>
<th>Statement of Financial Position as of [DATE]</th>
<th>TOTAL</th>
<th>Available for Operations</th>
<th>Board Designated</th>
<th>Fixed Assets</th>
<th>Restricted</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>225,461</td>
<td>22,961</td>
<td>140,000</td>
<td>25,000</td>
<td></td>
<td></td>
<td>Cash comprises 4 categories</td>
</tr>
<tr>
<td>Receivables</td>
<td>74,293</td>
<td>58,793</td>
<td>10,000</td>
<td></td>
<td></td>
<td></td>
<td>AR includes a portion of restricted</td>
</tr>
<tr>
<td>Fixed Assets (net)</td>
<td>226,784</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>226,784</td>
<td>FA Net of Depreciation</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>526,538</td>
<td>81,754</td>
<td>140,000</td>
<td>25,000</td>
<td>226,784</td>
<td>53,000</td>
<td></td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>24,999</td>
<td></td>
<td>24,999</td>
<td></td>
<td></td>
<td></td>
<td>Operations-related payables</td>
</tr>
<tr>
<td>Due to/from Reserve</td>
<td></td>
<td>10,000</td>
<td>(10,000)</td>
<td></td>
<td></td>
<td></td>
<td>$10K borrowed from reserve</td>
</tr>
<tr>
<td>Loans</td>
<td>15,544</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>15,544</td>
<td>Loan related to fixed asset</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>40,543</td>
<td>34,999</td>
<td>(10,000)</td>
<td></td>
<td></td>
<td>15,544</td>
<td></td>
</tr>
<tr>
<td><strong>NET ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Available for Operations</td>
<td>46,755</td>
<td>46,755</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Available for day-to-day operations</td>
</tr>
<tr>
<td>Operating Reserve</td>
<td>150,000</td>
<td></td>
<td>150,000</td>
<td></td>
<td></td>
<td></td>
<td>Funded Operating Reserve</td>
</tr>
<tr>
<td>Other Reserves</td>
<td>25,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>25,000</td>
<td>Building Maintenance Fund</td>
</tr>
<tr>
<td>Property/Equip (net)</td>
<td>211,240</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>211,240</td>
<td>Fixed Assets net of related loan</td>
</tr>
<tr>
<td>With Donor Restrictions</td>
<td>53,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>53,000</td>
<td>Restricted for summer project</td>
</tr>
<tr>
<td><strong>Total Net Assets</strong></td>
<td>485,995</td>
<td>46,755</td>
<td>150,000</td>
<td>25,000</td>
<td>211,240</td>
<td>53,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Liabilities &amp; Net Assets</strong></td>
<td>526,538</td>
<td>81,754</td>
<td>140,000</td>
<td>25,000</td>
<td>226,784</td>
<td>53,000</td>
<td></td>
</tr>
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</table>
Budgeting for & Funding Reserves

- Budget for operating **surpluses** annually.
- Include a “contribution to reserve” (or similar) budget **line item**.
- Fund non-cash **depreciation** expense.
- Include in multi-year **capital** budgets.
- Include as component of capital **campaigns**.
- Include in **planned giving** campaigns.
- Designate **board** contributions.
- Designate staff **vacancy savings**.
- Designate **windfalls**.
- Tariff (%) of unrestricted gifts.
- ... What else?
Key NORI Documents

Whitepaper

Original Policy Toolkit

Reserves Intro

Policy Template

NEW Toolkit Edition

All documents available at the NORI Document Library:
https://www.nonprofitaccountingbasics.org/nonprofit-reserves/document-library

Nonprofit Accounting Basics Website ➔ https://www.nonprofitaccountingbasics.org/

For more information contact BessFromNORI@gmail.com