

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

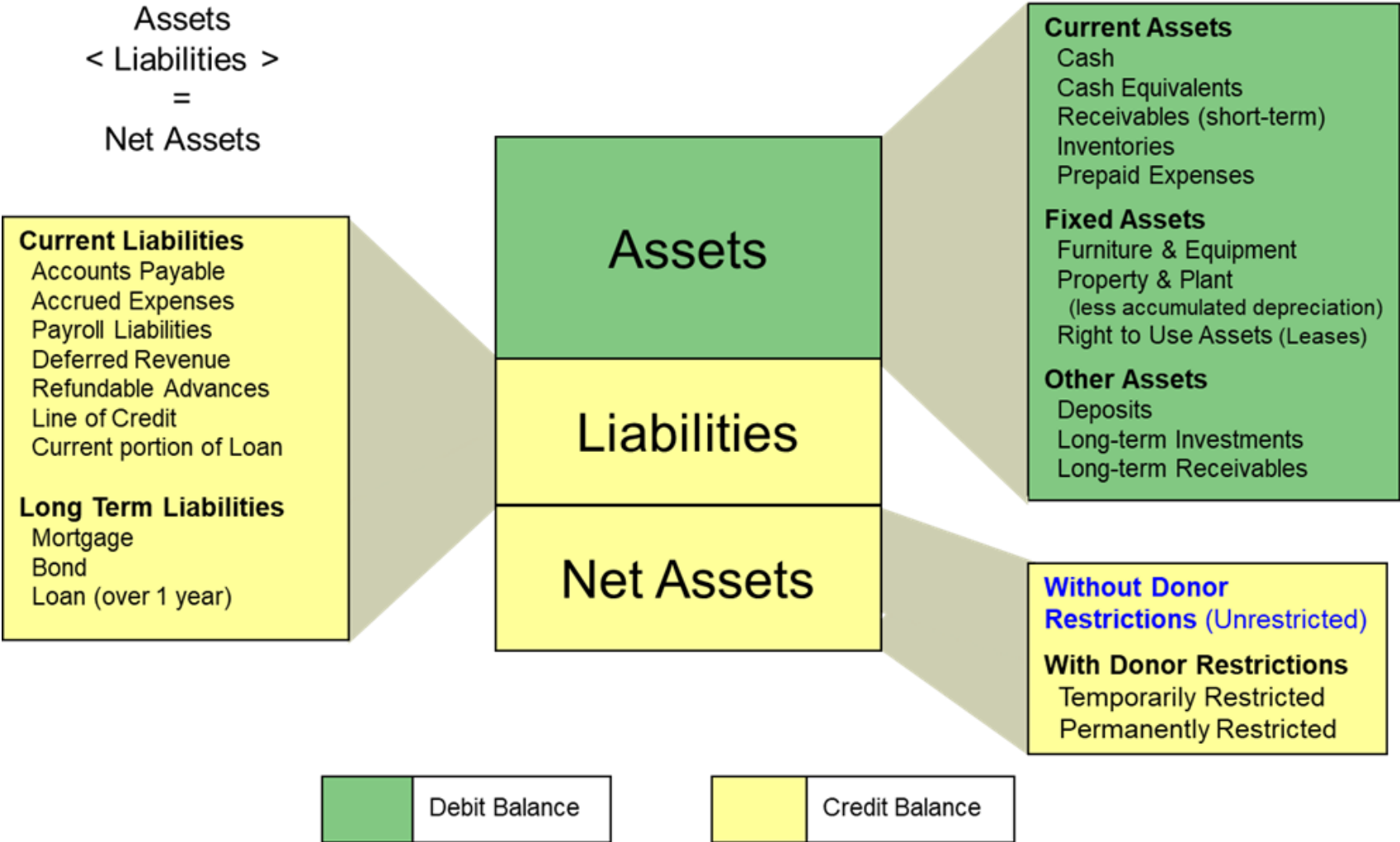
Demonstrates proactive, prudent management and planning and promotes donor confidence

- 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.

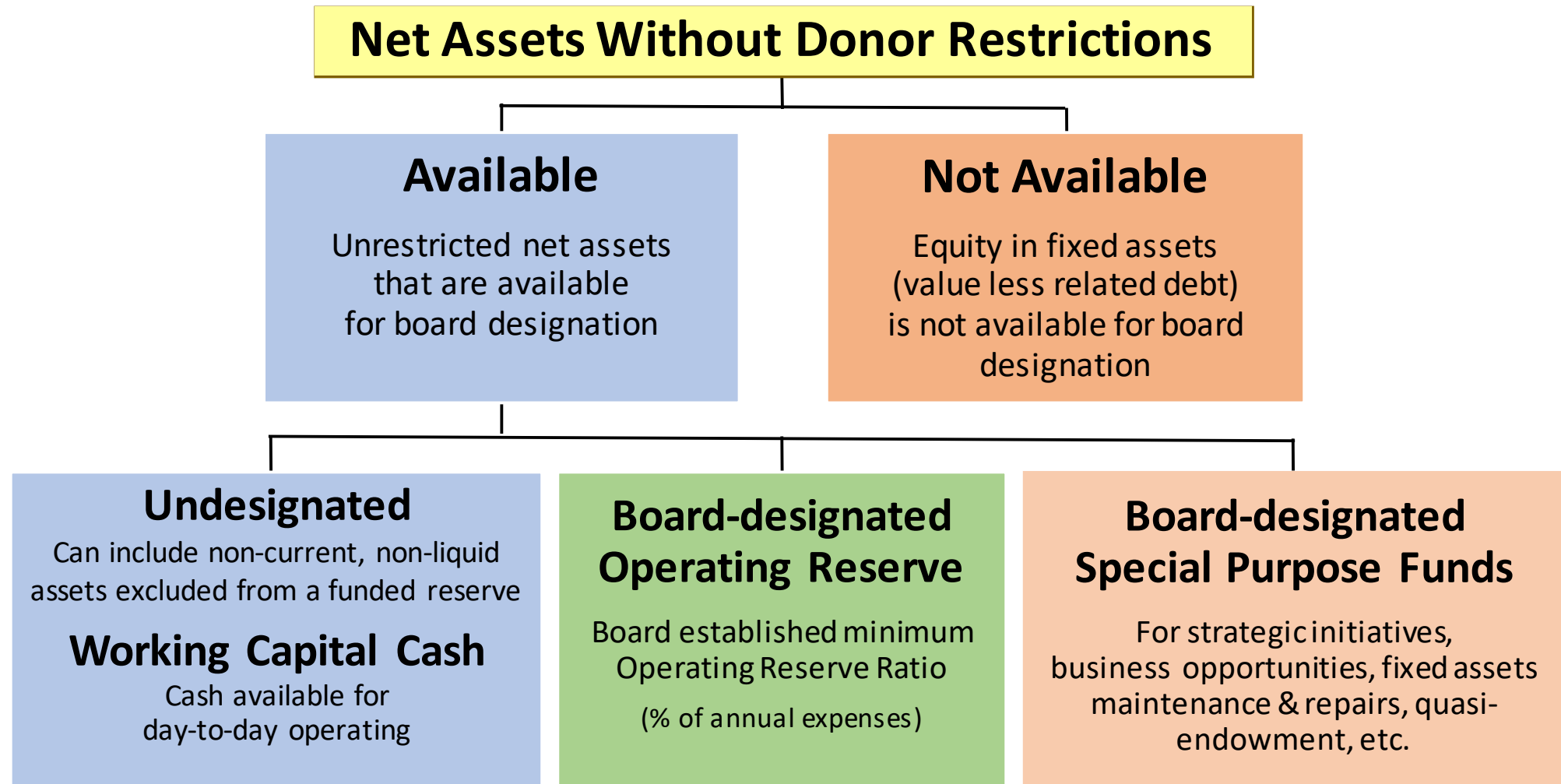
It promotes compliance to GAAP, regulatory and grant requirements, and good cash management protocols.

- 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



Reserves Terms & Concepts



How much to designate? It depends.

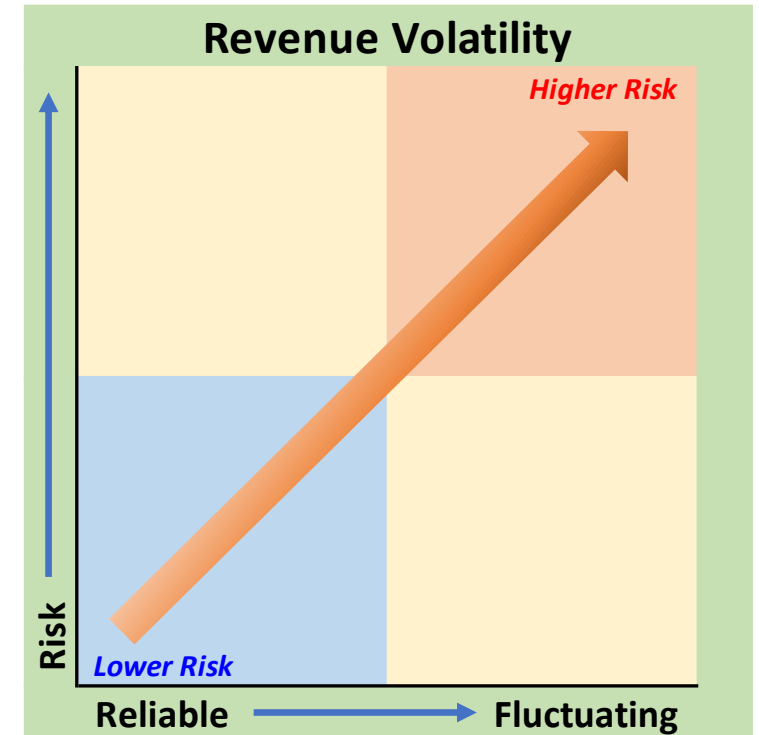
Determining the Appropriate Ratio

- 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.

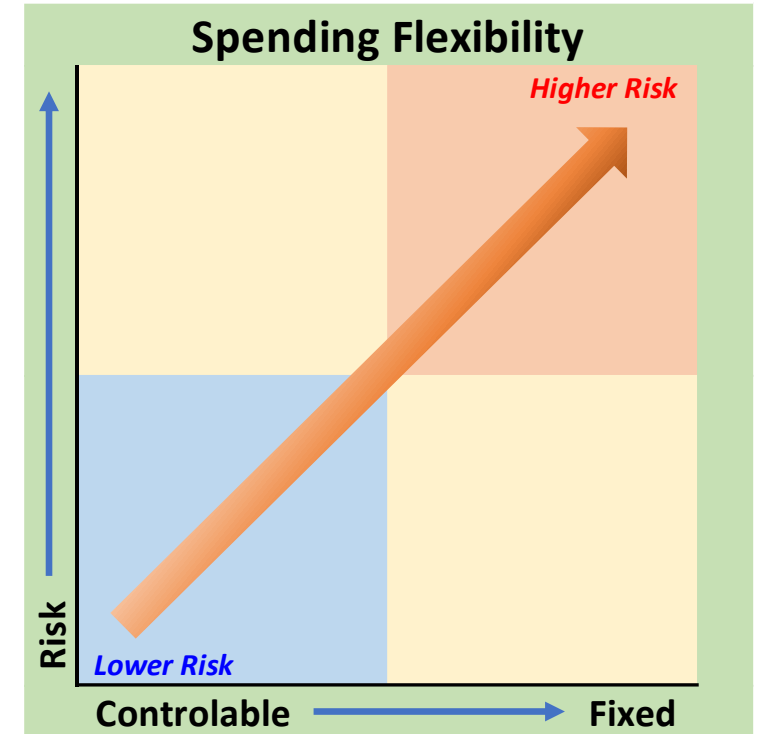


(Adapted from the Nonprofit Operating Reserves Policy Toolkit 2010 and Toolkit Update 2022)

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

1. Inception

Make the case for the need for an operating reserve to the Board. (NORI's whitepaper or reserve introduction document may be helpful.)

2. Recognition of Need

Board concurs with the case and asks finance (or related) committee to create draft.

3. Development

Utilize the NORI Toolkit and Templates (e.g., reserve ratio, outlines and sample language) to draft policy.

4. Draft Policy

Present draft policy to Board members.

5. Board Feedback

Board may approve or request revisions.

6. Final Draft

Policy is finalized and approved.

7. Implementation

Put into practice the guidelines established in the Operating Reserve Policy.

Basic Policy Components

Section Title	Topics Addressed
Statement of Purpose/Philosophy	<ul style="list-style-type: none">▪ Why is this board designating the funds?▪ What are the objectives of the fund?
Establishment of the Reserve Fund	<ul style="list-style-type: none">▪ When was it established?▪ Target amount? Ratio calculation method used?▪ Opening balance? Funding plan to reach target?
Definitions	<ul style="list-style-type: none">▪ Define technical terms used throughout the reserve policy to establish clarity
Use and Replenishment of Fund	<ul style="list-style-type: none">▪ Who may access the fund?▪ What authorization is given or required?▪ How much can be withdrawn? %/\$?▪ What communication methods are acceptable?▪ What is the standard expectation for repayment of accessed funds?

Basic Policy Components

Section Title	Topics Addressed
Management and Monitoring	<ul style="list-style-type: none">▪ Who is responsible for managing the fund?▪ Is a separate bank account required?▪ When is the reserve used vs. a line of credit?▪ What are the accounting procedures and reporting requirements?▪ What happens to any interest income?▪ What are the liquidity requirements for funds comprising the operating reserve? Can they be invested?
Role of the Finance Committee	<ul style="list-style-type: none">▪ How will the committee monitor the activity in the funds?▪ Will the committee be charged with developing the criteria to be used in deciding whether/how much to designate to the reserve each year?▪ How often will the Operating Reserve Policy be reviewed and updated?

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.

ORG NAME Statement of Financial Position as of [DATE]	TOTAL	Without Donor Restrictions				Restricted	Notes
		Available for Operations	Board Designated		Fixed Assets		
			Ops Reserve	Equip Reserve			
ASSETS							
Cash	225,461	22,961	140,000	25,000		37,500	Cash comprises 4 categories
Receivables	74,293	58,793				15,500	AR includes a portion of restricted
Fixed Assets (net)	226,784				226,784		FA Net of Depreciation
Total Assets	526,538	81,754	140,000	25,000	226,784	53,000	
LIABILITIES							
Payables	24,999	24,999					Operations-related payables
Due to/from Reserve		10,000	(10,000)				\$10K borrowed from reserve
Loans	15,544				15,544		Loan related to fixed asset
Total Liabilities	40,543	34,999	(10,000)	-	15,544	-	
NET ASSETS							
Without Donor Restrictions							
Available for Operations	46,755	46,755					Available for day-to-day operations
Operating Reserve	150,000		150,000				Funded Operating Reserve
Other Reserves	25,000			25,000			Building Maintenance Fund
Property/Equip (net)	211,240				211,240		Fixed Assets net of related loan
With Donor Restrictions	53,000					53,000	Restricted for summer project
Total Net Assets	485,995	46,755	150,000	25,000	211,240	53,000	
Total Liabilities & Net Assets	526,538	81,754	140,000	25,000	226,784	53,000	

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

A WHITEPAPER

BY: The Nonprofit Operating Reserves Initiative Workgroup

In spring 2008, a Nonprofit Operating Reserves Initiative Workgroup (see member list on page 10) comprising experienced individuals representing multiple facets of the nonprofit sector was convened with the objective of:

1. Defining an "Operating Reserve Ratio"
2. Using the ratio to focus attention on the importance of nonprofit financial stability.

The Nonprofit Operating Reserves Initiative Workgroup received consensus on definitions for operating reserves and the "Operating Reserve Ratio." The workgroup also reached a conclusion on what constitutes adequate operating reserves. Nonprofit financial health has previously concluded and written that the answer to it depends "Crucially on Mr. Larson's insight and experience the workgroup concluded, there is no one size fits all ratio or benchmark. However, the Workgroup effort resulted in some thoughtful conclusions and recommendations that are shared in this White Paper.

Final note: The Operating Reserve Ratio is one of a number of important and useful financial visibility indicators that address various aspects of financial health.

MAINTAINING NONPROFIT OPERATING RESERVES
An Organizational Imperative for Nonprofit Financial Stability
December 2008

A top priority for nonprofit leaders needs to be maintaining operating reserves at levels adequate for achieving financial stability. While this may seem obvious, preliminary research indicates that many organizations neglect to set aside funds that will help them meet or exceed their capacity to deliver on their mission in the event of unforeseen financial shortages.

The fact is **unrestricted net assets are essential** and are at risk. The Work Group (see side bar) recognizes that the current economic crisis threatens the very existence of thousands of nonprofit organizations. At a time when nonprofit organizations may be focused on survival, the thought of building reserves that seem a distant priority. But for organizations currently just hanging on which expect to survive this crisis and those in relatively stable current financial conditions which seek to fortify their position, the Work Group encourages including operating reserves in the planning process. Organizations which review their policies closely and devise plans for replenishing their operating reserves to an agreed upon adequate level will emerge from this current economic crisis in a stronger financial position, positioned to withstand the next challenge that arises.

Specifically, operating reserves are the portion of "unrestricted net assets" (see Figure 1) that nonprofit boards maintain or designate for use in emergencies financial shortages, including operating reserves in the wake of significant unanticipated increases in operating expenses and/or losses in operating revenues. "Unrestricted net assets" is a required line item in the balance sheets of financial statements prepared in accordance with generally accepted accounting principles (GAAP) and IRS Form 990 of nonprofit organizations. (See "Operating Reserve Ratio" - page 2)

Figure 1 - Suggested Reserves that are at least being provided in an illustration that all nonprofit CFOs should understand

Final note: The Operating Reserve Ratio is one of a number of important and useful financial visibility indicators that address various aspects of financial health.

OPERATING RESERVE POLICY TOOLKIT FOR NONPROFIT ORGANIZATIONS

FIRST EDITION
(Revised March 18, 2010)

Sponsored by the National Center for Charitable Statistics, Center on Nonprofits and Philanthropy at the Urban Institute, and United Way Worldwide

For information about becoming a supporting sponsor, or to inquire for updates, please contact:
Bess FromNORI, NORI Chair: BeessFromNORI@gmail.com

THE URBAN INSTITUTE 2000 M STREET, N.W. / WASHINGTON, D.C. 20037

The Nonprofit Operating Reserves Initiative

How long could an organization last or continue to fulfill its mission if there were an unexpected loss of revenue or surge in demand for services? That question compelled experienced individuals representing multiple facets of the nonprofit sector to form the Nonprofit Operating Reserves Initiative (NORI) Workgroup in spring 2008, with the objective to define "Operating Reserves" and establish guidelines to help nonprofit leaders determine benchmarks for financial stability that are specific to their organizations. Their efforts have resulted in a whitepaper, *Maintaining Nonprofit Operating Reserves: An Organizational Imperative for Nonprofit Financial Stability* published in January 2009, and the *Operating Reserve Ratio: A Guide for Nonprofit Organizations*, revised in September 2010. The white paper and the toolkit have been endorsed by many prominent nonprofit organizations and business leaders concerned with the well-being of the sector.

The Case for Nonprofit Operating Reserves

Support: Fulfillment of Mission and Financial Strength: "Operating reserves help organizations preserve their capacity to deliver on their mission in the event of unforeseen financial shortages, position them to accept and manage reimbursable grants, and help promote good long-term decision-making. Without an operating reserve, cash flow issues can force expensive short-term crisis-based decisions, or worse, lead to cancellation or termination of programs."

Sound Investment: "Individual donors and institutional funders can boost their contributions and grants with confidence in organizations that have built and maintain operating reserves. The presence of an operating reserve is a strong indicator that the organization is managed by prudent, forward thinkers, who are committed to create program delivery and have positioned their organizations to remain sustainable. Such organizations are a better risk for investment of contributions and grant funding."

"Nonprofit" does not mean "no liability allowed" - spending money to pay for each program may seem infeasible, but it leaves the organization with no financial flexibility to respond to emergencies. The organization is vulnerable to being overwhelmed, thereby jeopardizing its mission. Accumulated surpluses comprising an adequate level of operating reserves is a necessary component of nonprofit sustainability.

Improve Cash Management and Reduce Stress: "Having operating reserves reduces stress on the organization and its leaders, and reduces turn-over of key staff who can burn-out under sustained, chronic cash flow issues. Having a line of credit to serve as part of a good cash management strategy, but a line of credit is not a replacement for adequate operating reserves."

Evidence is clear - The need for nonprofits to establish and maintain operating reserves is well documented. This report synthesizes data and research conducted by the National Center for Charitable Statistics (www.nccs.org), *Maintaining Nonprofit Operating Reserves* (June 2009) and results of the Nonprofit Finance Fund's *Nonprofit Financial Health Study*.

What Are Operating Reserves?

Operating reserves are the portion of "unrestricted net assets" (see following illustration) that nonprofit boards designate for use in financial emergencies. "Unrestricted net assets" is a required line item in the balance sheets of financial statements prepared in accordance with generally accepted accounting principles (GAAP). Figure 1 shows suggested net asset terms that all nonprofit CEOs and boards need to understand in preparation for developing operating reserves.

For information about becoming a supporting sponsor, or to inquire for updates, please contact:
Bess FromNORI, NORI Chair: BeessFromNORI@gmail.com

Outline for development of written reserve policies with example language

For the full Nonprofit Operating Reserves Initiative Toolkit see: www.nonprofitaccountingbasics.org/nori-toolkit

NAME OF ORGANIZATION

BOARD-DESIGNATED OPERATING RESERVE FUND

I. Statement of Purpose / Philosophy

Define the purpose(s) and objective(s) of this Organization's operating reserve.

[example 1]

The CNG Board of Directors designated an OPERATING RESERVE FUND by resolution at its July 2008 board meeting. The general purpose of the fund is to help to ensure the long-term financial stability of the organization and provide it is required to varying economic conditions and changes in the organization's financial position and the ability of the organization to continuously carry out its mission.

CNG will maintain a Board-Designated Operating Reserve Fund to achieve the following objectives:

1. To enable the organization to sustain operations through delays in payments of committed funding and to accept reimbursable contracts and grants without jeopardizing ongoing operations.
2. To promote public and funder confidence in the long-term sustainability of the organization by presenting financial data that can attest to its reputation and force its leaders to make expensive short-term crisis-based decisions.
3. To create an internal line of credit to manage cash flow and maintain financial flexibility.

[example 2]

The establishment and maintenance of a Board-Designated Operating Reserve is a high priority. This will enable CNG to support strategic business practices and to:

- A. Manage cash flow interruptions.
- B. Attract the most talented capital financing.
- C. Meet commitments, obligations or other contingencies.
- D. Generate investment security.

II. Board-Designated Operating Reserve Fund Balance

Describe the establishment of the fund. Include such details as:

- The ultimate goal amount for the fund and method / rationale for determining the amount (to provide history and background for future board members and staff leaders).
- Current operating reserve fund balance, if any, or amount of existing funds to be designated.

By: CNG Policy, approved and adopted by the Nonprofit Operating Reserves Initiative Toolkit
www.nonprofitaccountingbasics.org

BOARD-DESIGNATED OPERATING RESERVE POLICY TOOLKIT FOR SMALL & MIDSIZE NONPROFIT ORGANIZATIONS

UPDATED EDITION
(April 2023)

Sponsored by the Greater Washington Society of CPAs
Nonprofit Operating Reserves

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 BeessFromNORI@gmail.com