

Creating Reserves for Nonprofits

*The Nonprofit Operating Reserves Initiative
and the
Operating Reserve Policy Toolkit*

NORI

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Way 

Nonprofits and Squirrels *by Richard F. Larkin*



Today's Presenters

- **Bob Berdelle**

Senior Vice President and Chief Financial Officer
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Agenda

- Why are we talking about operating reserves?
- Overview of Reserve Guidance
 - *Nonprofit Operating Reserves Initiative (NORI) White Paper*
 - *Making the Case*
 - *Defining the Operating Reserve*
 - *Factors for determining a Reserve Ratio*
 - *Operating Reserves Policy Toolkit*
- Practical Applications
 - *Missing the “red flags”*
 - *Building reserves from the ground up*
 - *A step beyond – cash flow forecasting*
- Investments Considerations
- Questions & Answers

Why are we talking about reserves?

2011 State of the Sector Survey

by Nonprofit Finance Fund (NFF)

<http://nonprofitfinancefund.org/2011-nonprofit-sector-survey-highlights>

Key findings include:

- The majority (60%) has less than three months of cash available.
- 28 percent reported that they had one month or less of operating cash.
- 10% have none.



Why are we talking about reserves?

The Chronicle of Philanthropy series in **Against the Grain** (blog) by Rick Moyers

“Operating reserves are essential to the financial and programmatic stability of almost every nonprofit organization. And far too many organizations have insufficient reserves or none at all.”

- Four Things Boards Should Understand About Operating Reserves, April 26, 2011
- What Operating Reserves Are and Why They Matter, April 29, 2011
- How Nonprofits Build Operating Reserves, May 3, 2011
- There’s No Penalty for Having Reserves, May 6, 2011

The Nonprofit Operating Reserves Initiative (NORI)

A diverse group of experienced individuals representing multiple facets of the nonprofit sector convened to address the need for maintaining operating reserves at levels adequate for achieving financial stability.

- **Two over-arching objectives:**

- Define operating reserves
- Bring focus to the importance of financial stability

- **Process:**

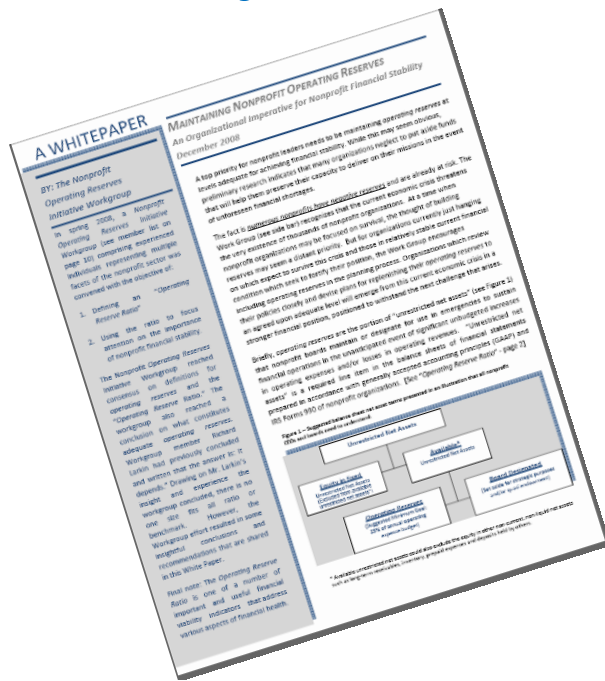
- Convened broad-based group of nonprofit leaders, service providers, and concerned professionals who gathered multiple times to discuss concept and terms and arrive at a general consensus

- **Results:**

- Call to action → increase the number of nonprofits that maintain operating reserves at levels adequate for achieving financial stability
- Whitepaper → Maintaining Nonprofit Operating Reserves
- Operating Reserve Policy Toolkit

The NORI Whitepaper

“Maintaining Nonprofit Operating Reserves, An Organizational Imperative for Nonprofit Financial Stability”



- Used the *United Way Guide to Establishing and Maintaining Reserves* as a starting point
- Incorporated many of the NCCS definitions
- Endorsed by many prominent national non-profit organizations
- To read the whitepaper, go to:

<http://www.nccs2.org/wiki/images/3/3c/OperatingReservesWhitePaper2009.pdf>

Making the Case for Having an Operating Reserve

Supports Fulfillment of Mission and Fosters Strategic Decisions

- Preserve capacity to deliver on the mission
- Position organization to accept and manage reimbursable grants
- Promotes long-term planning



Making the Case for Having an Operating Reserve

Sound Investment

- Donors and funders have confidence
- Reserve is a strong indicator of prudent/forward thinking management
- Indicates organization's commitment to reliable program delivery and sustainability



Making the Case for Having an Operating Reserve

“Nonprofit” does not mean “no surplus allowed”

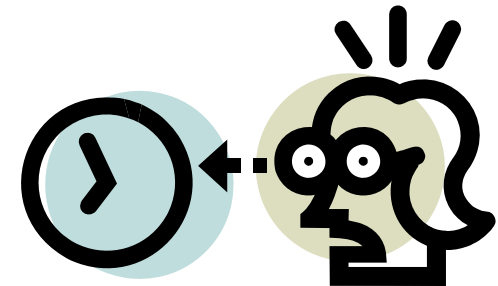
- Spending every penny can leave the organization with no financial flexibility
- Potentially jeopardizes mission
- Surpluses of an adequate level of operating reserves are necessary for sustainability



Making the Case for Having an Operating Reserve

Improves Cash Management and Reduces Stress

- Reduces burn-out related to sustained, chronic cash flow issues
- Line of credit is a good cash management strategy, but a line of credit is not a substitute for adequate reserves



Making the Case for Having an Operating Reserve

Evidence is clear

- Research shows many nonprofits to be undercapitalized
 - National Center for Charitable Statistics
 - Nonprofit Finance Fund

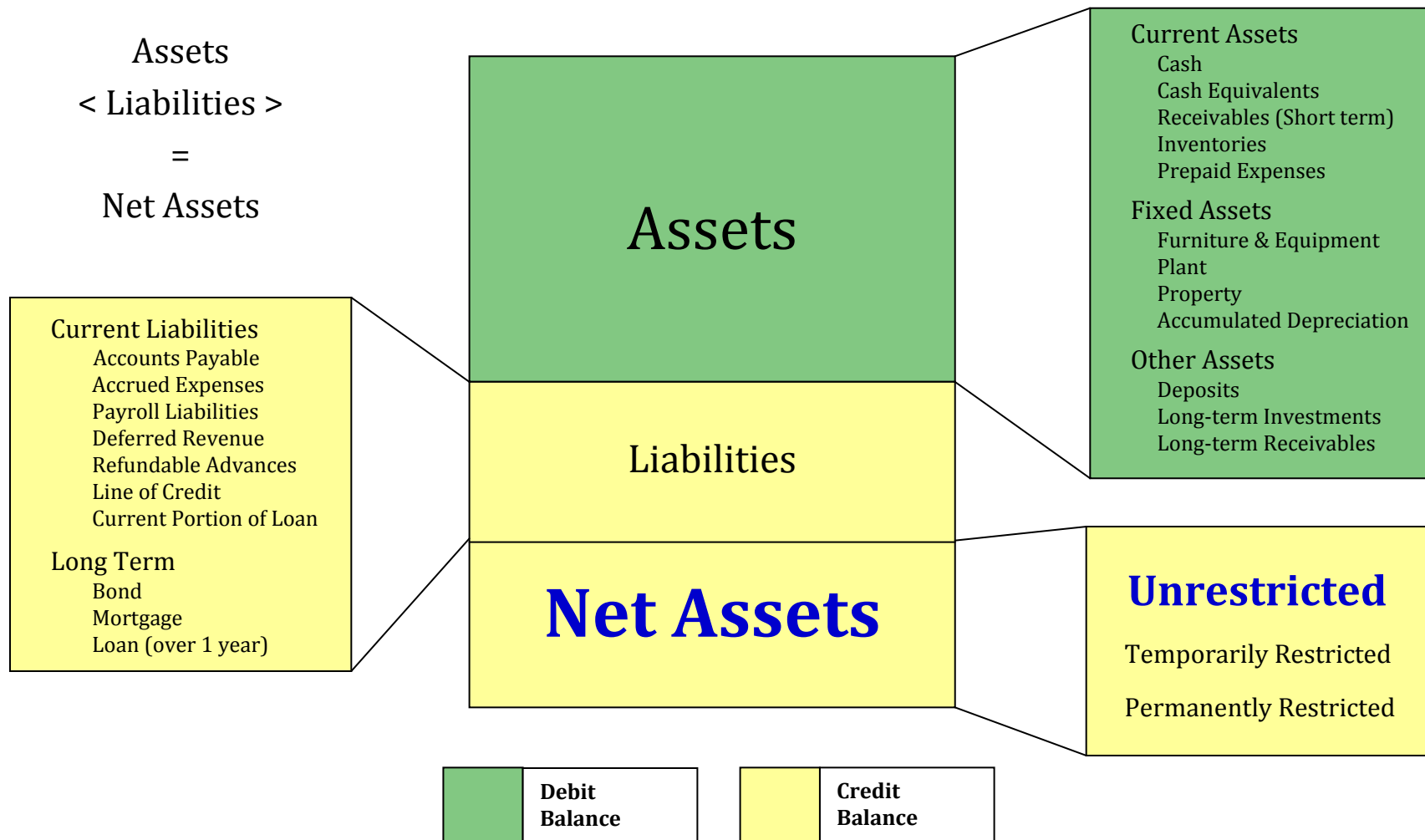


The Real Question

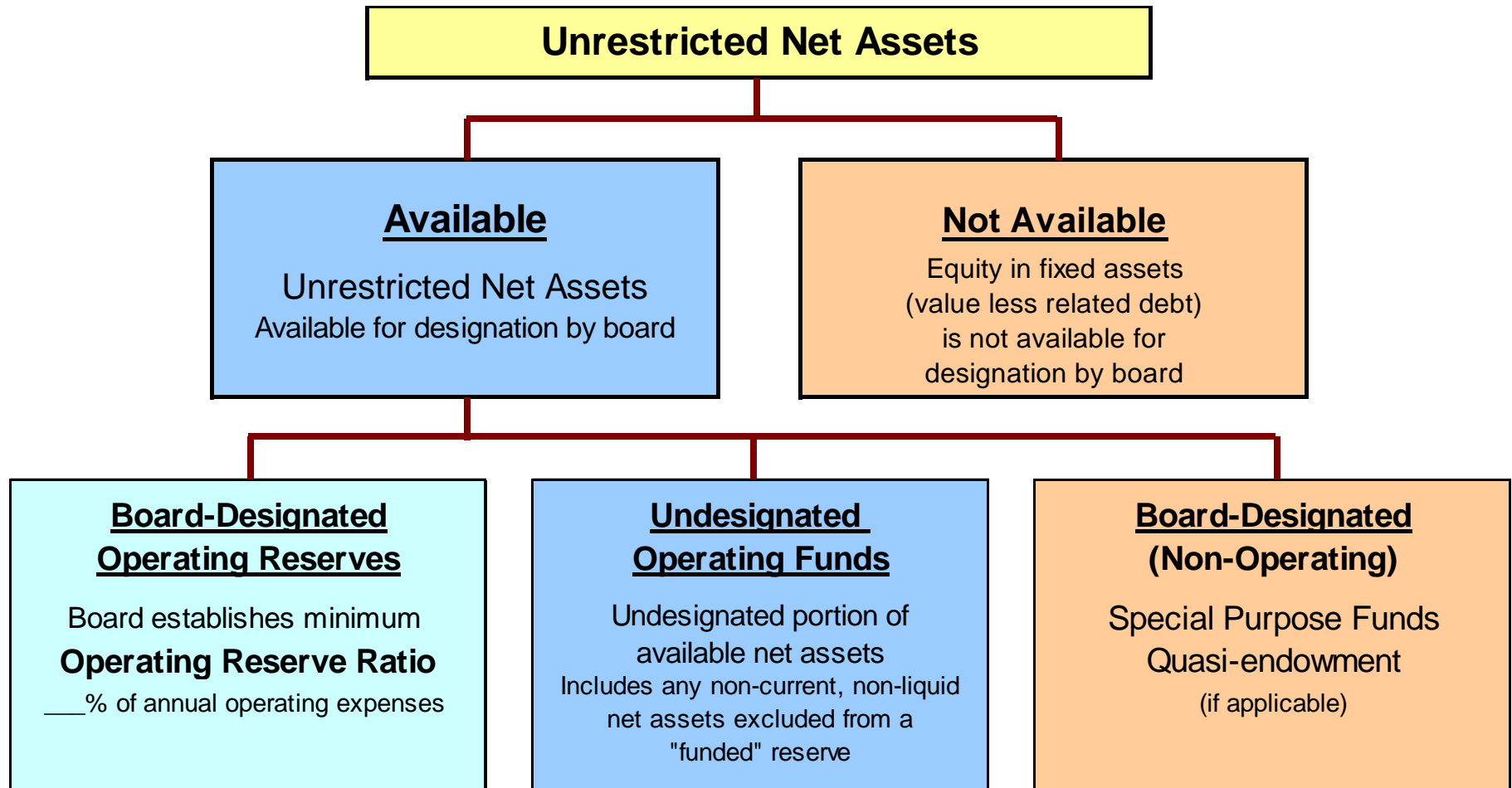
**Can we afford not to
have an operating reserve?**

Defining Operating Reserves

Statement of Financial Position



Defining Operating Reserves



Defining Operating Reserves

Available

The simplest definition of reserves

- The portion of unrestricted net assets that is available for designation as reserves after excluding non-available net assets

Not Available

Can't be considered as operating reserves

- Equity in Fixed Assets (the value of Fixed Assets net of mortgages and notes that are secured by such assets)

Non-Current

Should not be considered as part of operating reserves

- Non-current and/or non-liquid assets such as long-term pledges, inventory, prepaid expenses and deposits held by others.

Board-designated Operating Reserve

Formally designated by the board

- Fixed amount or based on a minimum operating reserve ratio determined as a percentage, or number of months, of annual expenses (prior year actual or current year expense budget). Preferably “funded” – represented by highly liquid available assets.

Other Board-designated Funds

Formally designated by the board

- Funds for special purpose(s)
- Quasi-endowment

Undesignated

- Funds that fluctuate up or down according to day-to-day changes in normal cash flow activity

Deeper Definitions

- **Funded Reserve**

- A fund consisting of liquid assets and investments
- Accounted for in the financial statements separately from operating funds and available net assets
- Not required to be physically segregated in separate bank account

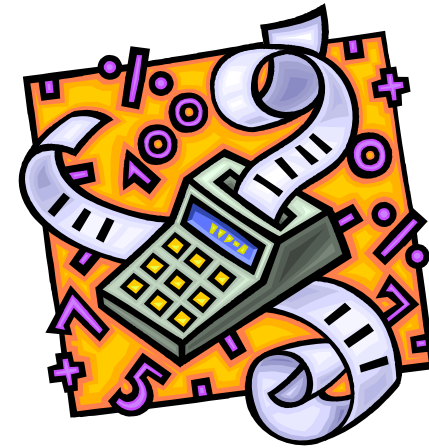
- **Liquid Assets**

- Assets that can be converted to cash quickly and easily



Operating Reserves Ratio

Calculating the Ratio



- Can be calculated in terms of a percentage:

Operating reserves divided by annual operating expense*

$\$75,000$ (available) \div $\$600,000$ (annual expense) = 0.13 or 13%

- Or number of months:

Operating reserves divided by 1/12th of the annual operating expense

$\$600,000$ (annual expense) \div 12 = $\$50,000$ per month

$\$75,000$ (available) \div $\$50,000$ (1/12th annual expense) = 1.5 or 1 ½ months

** Use either prior year actual expenses or current year budgeted expenses*

How much? 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 must begin by examining the common factors at play in their operation
 - **Revenue volatility factors**
 - **Spending flexibility factors**
 - **Governance & Management factors**
 - **Level of programmatic risk**
 - **Organization life cycle stage**



Some Revenue Volatility Factors

Common risk factors for volatility in revenue streams include, but are not limited to:

- Stability of donated revenue from primary sources
- Predictability of pledge collections
- Reliability of grants and contracts for services
- Uneven cash flow (cash inflows and outflows out of sync) such as deferred revenue for future programs or covering expenses for reimbursable grants
- Level of dependence on one or two major donors
- Level of dependence on a single fundraising event
- Foundation 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 Initiative Toolkit 2010)

Some Spending Flexibility Factors

Common factors that influence the ability to adjust spending levels include, but are not limited to:

- The organization's importance in community crisis situations (for example if the organization's mission involves disaster relief)
- The extent to which economic downturns or other types of events may affect demand for services, either up or down
- Ability to downsize operations quickly and still provide programs
- Long term leases with substantial penalties for cancelation
- Balance of permanent fulltime staff vs. temporary part-time
- Relationship with (obligations to) labor unions, union contracts
- Dependence on key person
- The extent of funding commitments made for longer than one year
- Amount of unsecured debt carried by the organization

(Adapted from the Nonprofit Operating Reserves Initiative Toolkit 2010)

Some Governance & Management Factors

Indicators for a higher level of Operating Reserve

- Our governing board takes a longer-term view of provision of services and its attitude is to be very sure there are always resources available.
- Our governing board's approach to planning and budgeting is a conservative and prudent one, and considers that maintaining operating reserves is a fundamentally sound financial management practice.
- Our planning and budgeting processes have historically proved to be less accurate in forecasting financial results.

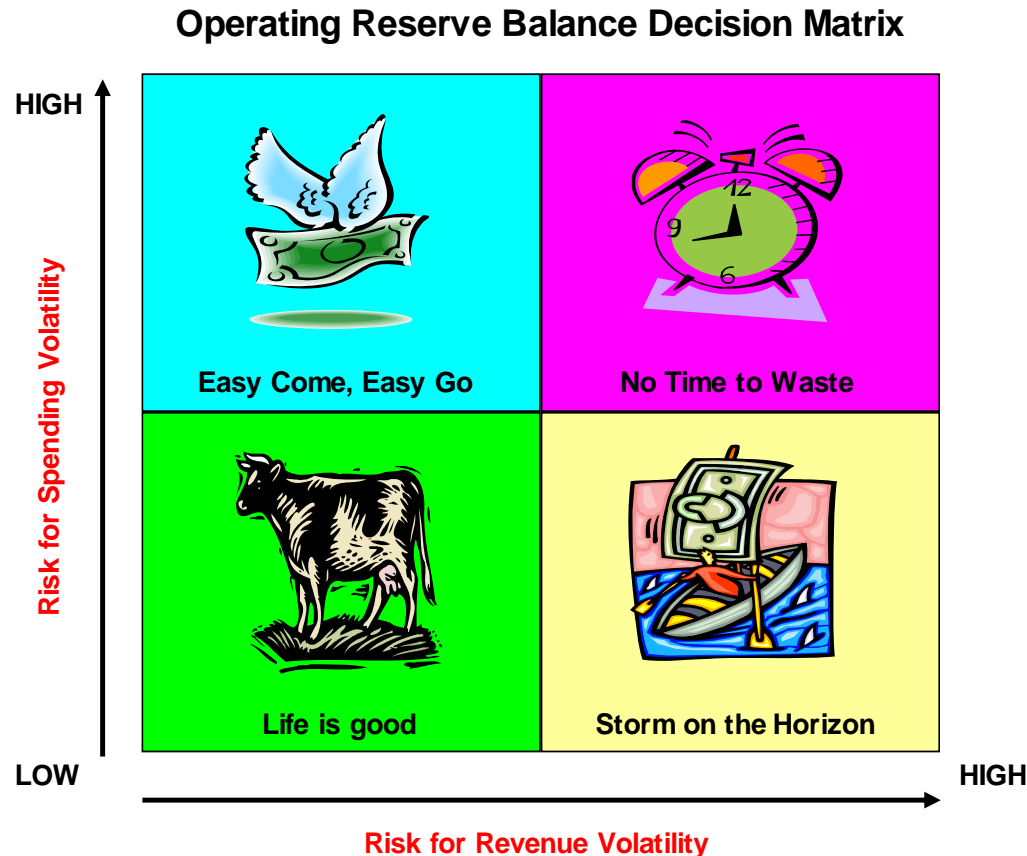


Indicators for a lower level of Operating Reserve

- The governing board believes it is of overriding importance that every possible resource is used in the provision of current program services.
- The governing board believes it is of overriding importance that every possible resource is used in the provision of current program services.
- Our planning and budgeting processes have historically proved to be fairly accurate in forecasting financial results.



Reserve Balance Decision Matrix



- As the level of risk for revenue volatility increases, so does the level of reserves
- As the level of spending volatility increases, so does the level of reserves

NORI's Call to Action

Every nonprofit organization should have a written Operating Reserve Policy that:

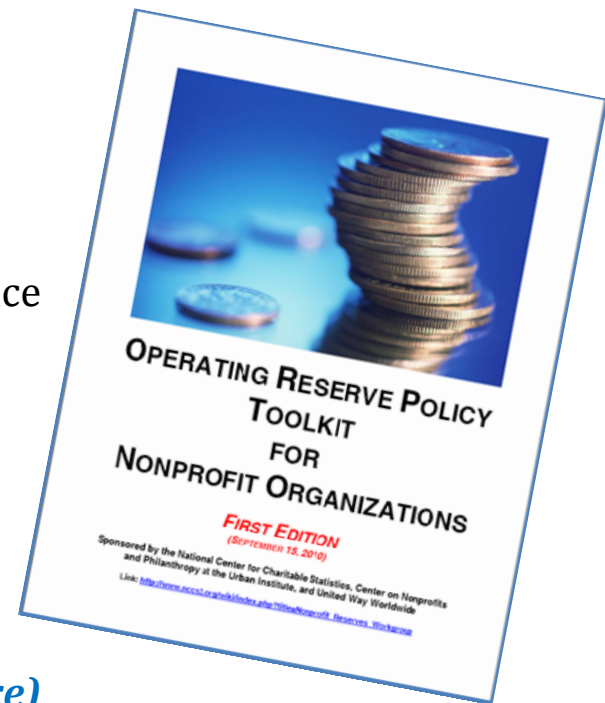


- **Defines its own “adequate” operating reserve level**
(general recommendation is three months of operating expenses +/- risk factors),
- **Defines how its operating reserves are calculated, and**
- **Provides the rationale that led the Board to create those policies.**

An Operating Reserves Toolkit

Work Began on the Toolkit in the fall of 2009

- A Task Force established to create the toolkit including representatives from:
 - American Heart Association
 - American Sport Education Program
 - Association of Fundraising Professionals
 - BBB Wise Giving Alliance
 - BDO Seidman's Institute for Non-Profit Excellence
 - EHF Nonprofit Finance Consulting
 - GuideStar USA
 - Merrill Lynch Wealth Management
 - National Center for Charitable Statistics of the Urban Institute
 - National Human Services Assembly
 - Spectrum Nonprofit Services
 - United Way Worldwide (*Chair of the Task Force*)
 - World Learning
- An Exposure Draft was released for comment in March 2010
- The Toolkit was officially launched in September 2010



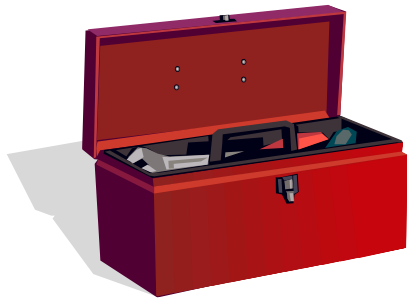
What kind of stuff is in the Toolkit?

- **Content**

- Operating Reserves: What are they and why have them?
- Can we afford a Board Designated Operating Reserve?
- Developing a Written Operating Reserve Policy
- Managing the Operating Reserve
- Investing assets related to the Operating Reserve
- Legal, Tax, and Accounting Implications

- **Appendices**

- Glossary of Terms
- Sample Operating Reserve Policies
- Sample Text for Audit Footnotes and IRS Form 990 Disclosure
- Illustrative Statements of Financial Position
- Operating Reserve Needs Analysis Worksheet
- Investment considerations



- **Some highlights from the Toolkit**

Steps in Developing Policy

- **Suggested sequential process for developing an Operating Reserve Policy**

1. Make the case for the need for an operating reserve to the board of directors.
 - In advance of the board meeting, a copy of the whitepaper “Maintaining an Operating Reserve” by the Nonprofit Operating Reserves Initiative Workgroup is provided to board members as background.
2. The board concurs with the case and asks the finance (or other) committee to create an operating reserve policy draft.
3. The finance committee and chief administrative and finance staff use tools from the “Operating Reserve Policy Toolkit” to determine a reserve ratio and/or a target amount for the reserve and to draft the actual policy document using outlines and sample language from the Toolkit.
4. The draft policy is presented to the board.
5. The board discusses and either approves the policy or requests changes based on discussion.
6. The policy is finalized and approved.
7. Implementation of the policy commences.

Basic Components of a Reserve Policy

- **Statement of purpose / philosophy**
 - Why is this board designating the funds?
 - What are the objectives?
- **Establishment of the fund**
 - When established? Opening balance? Target amount? Ratio calculation method?
- **Definition of terms (if appropriate)**
- **Use and replenishment**
 - Who may access the fund? What authorization is given or required?
 - What communication methods are acceptable?
 - What is the standard expectation for repayment of accessed funds?

Basic Components of a Reserve Policy

- **Management and monitoring**

- Who is responsible for managing the fund?
- Is a separate bank account is required? Who may open and/or monitor bank accounts?
- What are the accounting procedures, reporting requirements, and disposition of any interest income?
- What are the liquidity requirements for funds comprising the operating reserve? Can they be invested?

- **Role of the Finance Committee**

- How will the committee monitor the activity in the funds?
- How often and in what manner will they report to the Board about funds activity?
- How often will the Operating Reserve Policy be reviewed and updated?

Legal, Tax & Accounting Implications

Two Considerations

- UMIFA/UPMIFA/Prudent investment
- FASB Staff Position 117-1



Sample Text for Audit Footnotes



- Board-Designated Operating Reserves are a portion of the accumulation of unrestricted surpluses that are available for use at the discretion of an organization's board. The presence of a Board-Designated operating reserve increases an organization's ability to absorb or respond to temporary changes in its environment or circumstances, for example the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues.
- The organization maintains an Operating Reserve policy that requires the board set aside a portion of Available Unrestricted Net assets at the end of each fiscal year to fund a Board-Designated Operating Reserve. The policy also establishes a goal for the Board-Designated Operating Reserve of a minimum target balance equal to two months of operating expenses (\$300,000) and a maximum balance of five months operating expenses (\$750,000).

Sample Text for Audit Footnotes *(cont)*

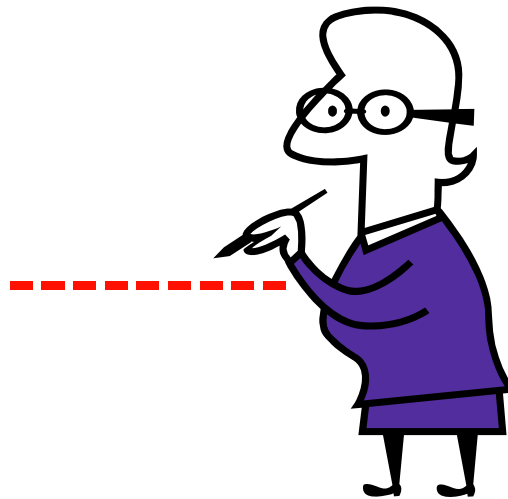
- Available Unrestricted Net Assets are defined as the portion of total unrestricted net assets that are available for designation by the board for operating reserves and for non-operational special purposes or board-designated quasi-endowment that further the mission of the organization.

Unrestricted Net Assets at 12/31/09 are:

Total Unrestricted Net Assets	\$967,450
Less Equity in Fixed Assets	<\$ 75,300>
Less Board Designated for Special Initiatives	<\$ 50,000>
Less Board Designated Quasi-Endowment	<\$375,000>
Less Board Designated Operating Reserve	< <u>\$350,000</u> >
Undesignated Operating Funds	\$117,150

- The Board of the organization has established an objective of \$350,000 (2.3 months of operating costs) of Unrestricted Net Assets as an Board-Designated Operating Reserve in accordance with the policy.

Practical Applications



Missing the “Red Flags”

- If you saw this on a NFP financial statement, would you be concerned about their reserves?

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Total Unrestricted Net Assets	4,377,519	6,415,144	7,374,403	7,239,967	6,473,898



Missing the “Red Flags” (cont)



- What if you saw it this way?

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Board Designated Funds for Special Purposes	3,450,749	4,902,030	4,437,006	4,776,432	3,475,611
Board Designated Operating Reserve	536,737	536,737	536,737	536,737	718,386
Property & Equipment (net of outstanding debt)	2,101,663	2,214,055	2,295,114	2,404,539	2,541,808
Undesignated Operating Funds/ Borrowed from Designated funds If Negative	(1,711,630)	(1,237,678)	105,546	(477,741)	(261,907)
Total Unrestricted Net Assets	4,377,519	6,415,144	7,374,403	7,239,967	6,473,898

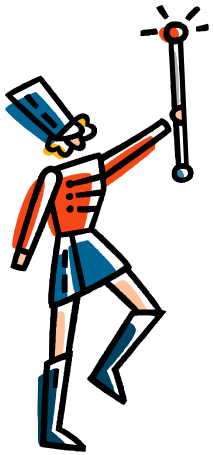
This organization had used some or all of its designated operating reserve plus some of the other designated funds for operations in all but one of the five years shown.

Strategies to Build Reserves

- Budgeting for operating surpluses
 - **Specific budget line item to build the reserve (and what to call it)**
- Funded Depreciation
- Capital Budgets
- Capital Campaigns



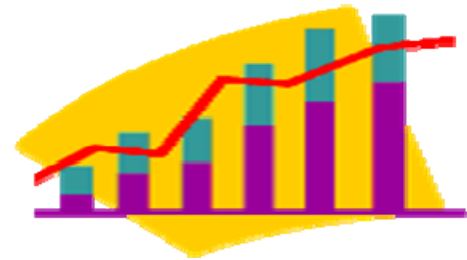
Strategies to Build Reserves



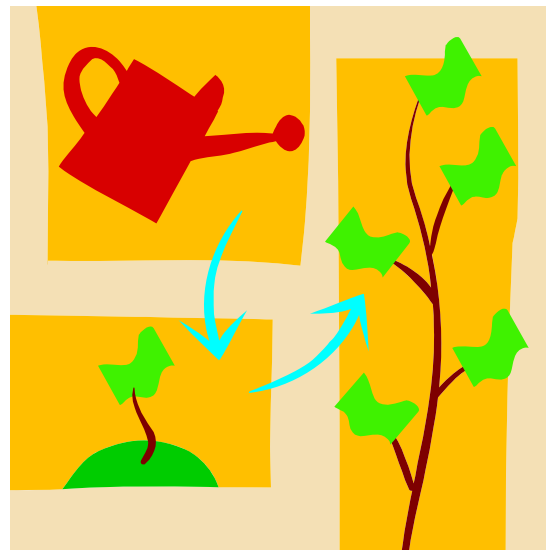
- **A Volunteer “Champion”**
- A Strong Finance Committee/Strong Board
- **Sometimes you have to just say no.**
- Realistic conservative budgeting with an emphasis on cash.
- Strong Financial Reporting
- No “deficit funding/deficit operations”
- **Adopt an Operating Reserve Policy based on guidance from NORI and United Way.**
- Understand that the organization’s mission needs to be met five years from now and not just today.
- Understand that every dollar of interest expense is a dollar taken from the organization’s mission.
- Require a motion from the Finance Committee to the Board of Directors for any access to this fund.
(Protects future boards)

Cash Flow Forecasting

- Eliminate surprises
 - Cash flow forecasting serves as a tool for monitoring interim levels in the reserve fund
 - Forward-looking approach to reserve adequacy much safer than looking in rear-view mirror
- May reduce need for Line of Credit
- Timing of pledge payments is clear
- Influences investment decisions to enhance yield
 - Money Market rates near zero
 - CD's or other instruments provide greater investment return



Investment Considerations



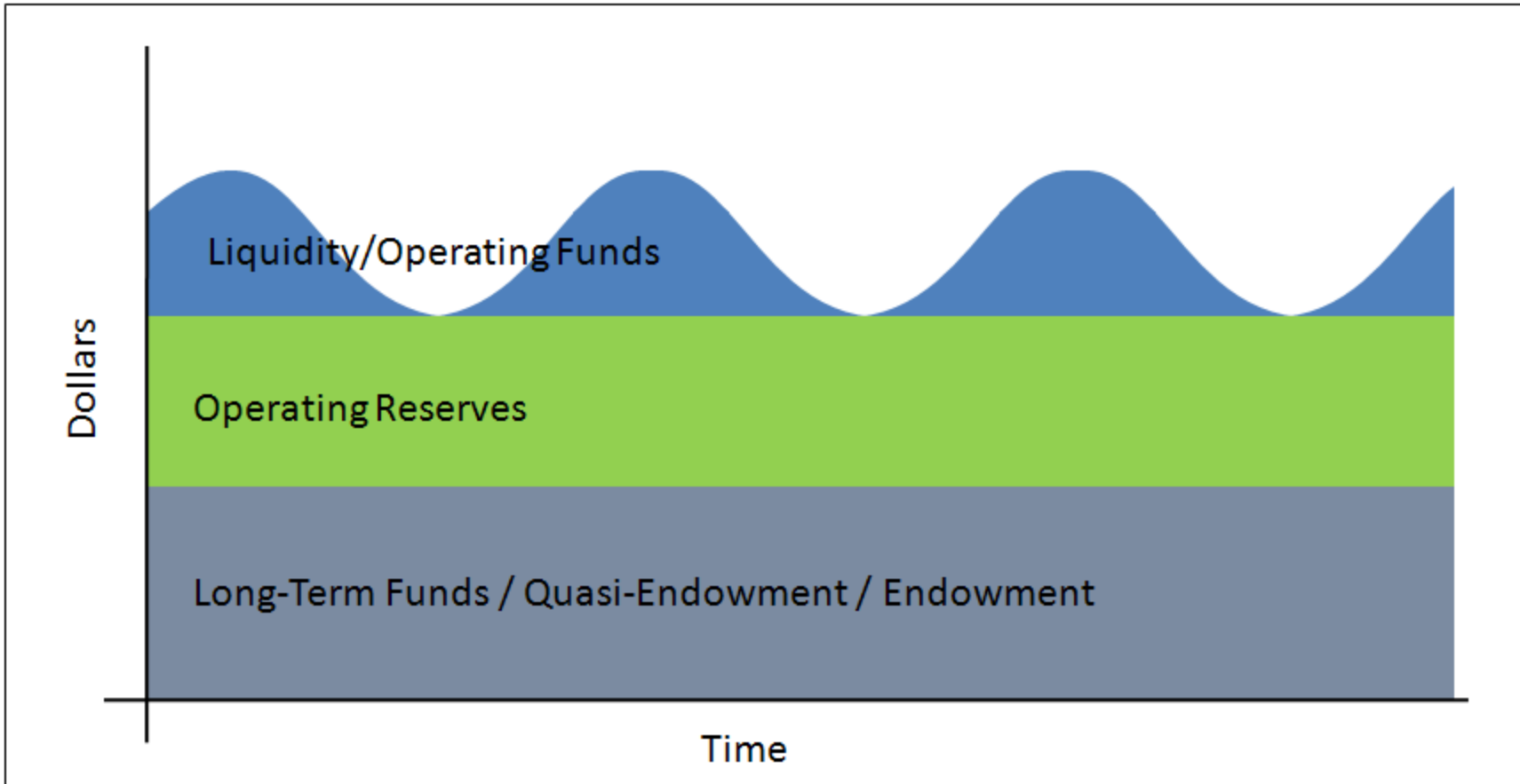
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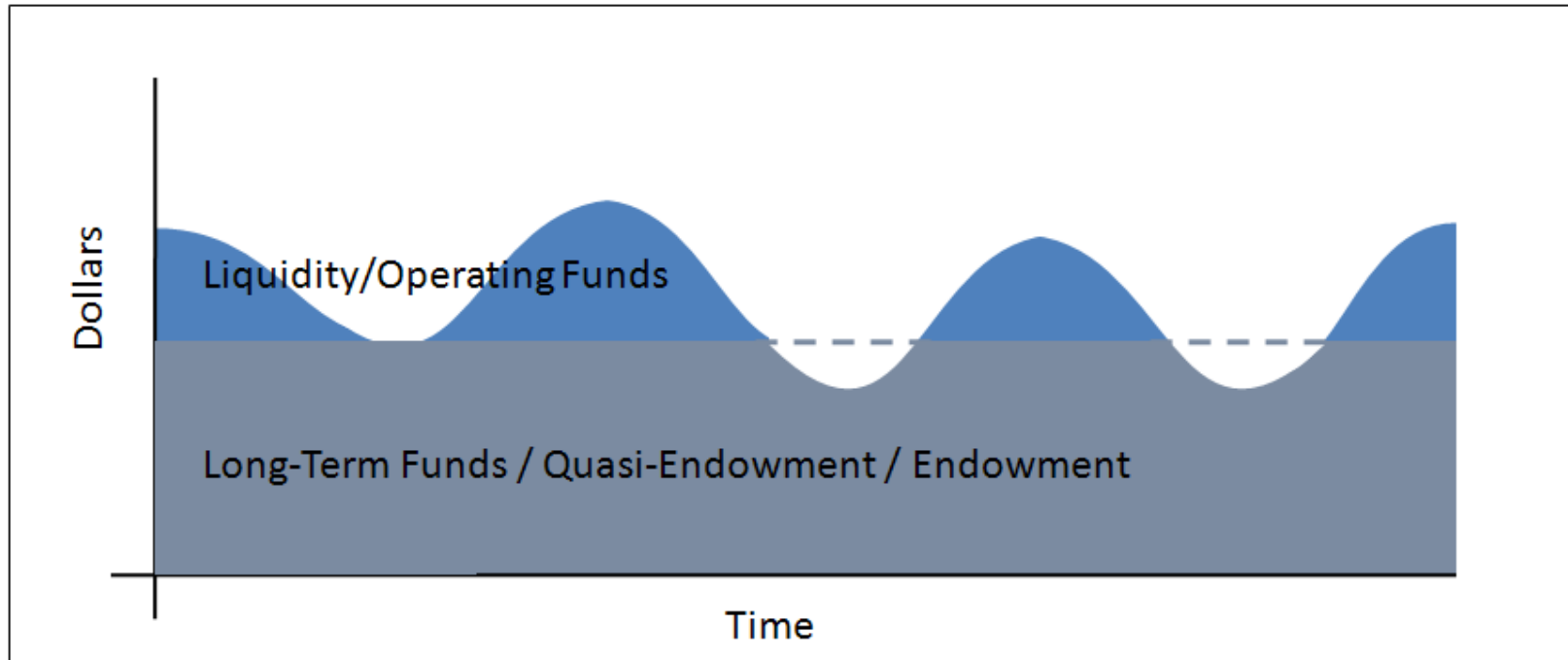
Establish Different Investment Funds



For illustration only

A Common Mistake

- Nonprofits often do not create a separate Operating Reserve
- May lead to draw-downs from long-term / quasi-endowment / endowment assets at inopportune times



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Time Horizon



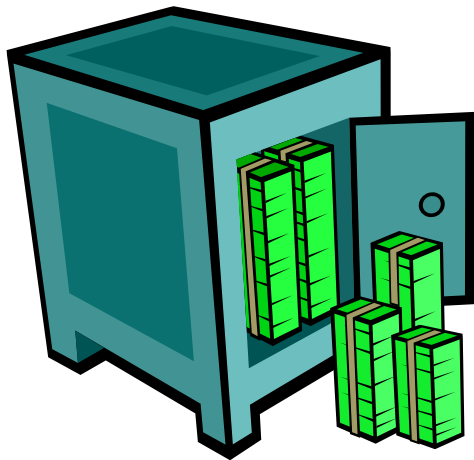
- Determining Investment Time Horizon For Operating Reserves
 - Not “when is the money needed?”
 - But “when *might* we need the money?”
 - The answer is “Soon.”

Categorize Your Cash by Time Horizon

	Operating Reserves		
	Operating Cash	Core Cash	Strategic Cash
Investment Horizon	0-6 months	6-12 months	12-24 months
Liquidity Needs	Regular access to cash	Occasional access to a portion of cash	Varies; accessibility determined prior to investments
Investment Focus	Liquidity	Low-risk, incremental return	Optimization of returns

Increased Complexity in Cash Management

- Cash was once considered as safe and a no-risk asset class
- Now cash is recognized as:



- Multi-faceted
- Complex
- Subject to some risk

Develop a Cash Investment Policy

- An Investment Policy Statement (IPS) be incorporated as part of the overall investment policy statement
 - May be overshadowed by more complex investments typically used in long-term / endowment funds
- Consider a separate document
 - Gives cash management more attention



Important Considerations: Risk Tolerance

Risk tolerance is the most important factor to consider when developing a cash Investment Policy Statement.

Types of Risk		
Primary Risks	Definition	Factors
Credit Risk	Risk that a security's value will change due to a ratings downgrade or, in the case of a distressed security, default.	<ul style="list-style-type: none"> ▪ Ratings downgrade ▪ Default
Interest Rate Risk	Risk that a security's value will change due to a change in interest rates or the shape of the yield curve	<ul style="list-style-type: none"> ▪ Change in the level of interest rates ▪ Change in the shape of the yield curve
Liquidity Risk	Risk that arises from the difficulty of selling an asset: security cannot be bought or sold quickly enough to prevent or minimize a loss	<ul style="list-style-type: none"> ▪ Secondary market bid availability
Spread Risk	Risk of change in value of a security due to a change in the relative spreads in the market	<ul style="list-style-type: none"> ▪ Hybrid of credit and liquidity risk

Important Considerations: Portfolio Objective

- **Some examples:**

- Preserve principal
- Meet forecasted cash flow needs
- Provide income/yield
- Deliver prudent, risk-managed total return
- Seek above-benchmark returns



A nonprofit may have multiple cash pools each with a distinct purpose and investment objective.

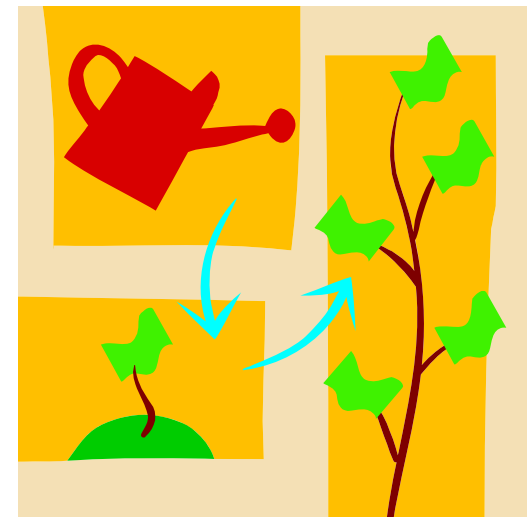
Cash Investment Policy Statement

Components of a Typical Cash Investment Policy Statement

1. Definition of Portfolio
2. Investment Objective
3. Benchmark
4. Maturity/Duration
Guidelines
5. Asset Guidelines
6. Asset Allocation
7. Credit Criteria
8. Other Investment
Practices
9. Reinvestment of Income
10. Custodian
11. Accounting Agent
12. Other Vendors

Investment Considerations Summary

- A separate cash investment policy statement is important
- Cash investments are just as important as long-term investments – pay attention to cash management
- There can be several distinct cash funds, each for a specific purpose



Questions and Answers



Additional References

Determining Appropriate Levels of Reserves, and Nonprofits and Squirrels or, How big a reserve do you need?

by Richard Larkin, CPA, National Technical Director of Not-for-Profit Accounting and Auditing, BDO USA, LLP, Bethesda Maryland

[http://www.nccs2.org/wiki/images/7/73/Determining Appropriate Levels of Reserves.pdf](http://www.nccs2.org/wiki/images/7/73/Determining_Appropriate_Levels_of_Reserves.pdf)

Washington-Area Nonprofit Operating Reserves

by Amy Blackwood and Tom Pollak, National Center for Charitable Statistics, Center on Nonprofits and Philanthropy, The Urban Institute

<http://www.urban.org/url.cfm?ID=411913>

Hidden in Plain Sight: Understanding Nonprofit Capital Structure *by Clara Miller, 2003*

[http://www.nonprofitfinancefund.org/docs/Miller Capital Structure.pdf](http://www.nonprofitfinancefund.org/docs/Miller_Capital_Structure.pdf)

The Grasshopper or the Ant: A Review of Endowment Giving Policy Options

By Russell Willis Taylor for the Doris Duke Charitable Foundation Arts Program, 2006

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State of the Sector Survey by Nonprofit Finance Fund

<http://nonprofitfinancefund.org/2011-nonprofit-sector-survey-highlights>

Additional References

Cash Investment Policy Statement – Developing, Documenting and Maintaining a Cash Management Plan, *published by BlackRock, 2009*,

copies available from Enver Majid at enver_majid@ml.com

A Whitepaper: Maintaining sufficient reserves to protect your not-for-profit organization

by Grant Thornton LLP, 2010

http://www.gt.com/staticfiles/GTCom/Not-for-profit%20organizations/NotForProfit%20files/NFP_Sufficient-Reserves_WP.pdf

Organizational Slack (or Goldilocks and the Three Budgets)

by Woods Bowman

http://www.thecentrepoint.ca/email_brdrcasts/centrepoint_focus/fall_2007/organizational_slack.pdf

Operating Reserves – NonprofitAccountingBasics.org website *sponsored by the Greater Washington Society of CPAs Educational Foundation*

<http://www.nonprofitaccountingbasics.org/internal-reporting-good-management/financial-management/operating-reserves>

There's No Penalty for Having Reserves – Against the Grain blog on The Chronicle of Philanthropy's website, published April-May 2011

<http://philanthropy.com/blogs/against-the-grain/and-finally-theres-no-penalty-for-having-reserves/27704>

Thank You !!

All NORI documents can be found at:

http://www.nccs2.org/wiki/index.php?title=Nonprofit_Operating_Reserves

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