

Nonprofit Operating Reserve¹ Ratio

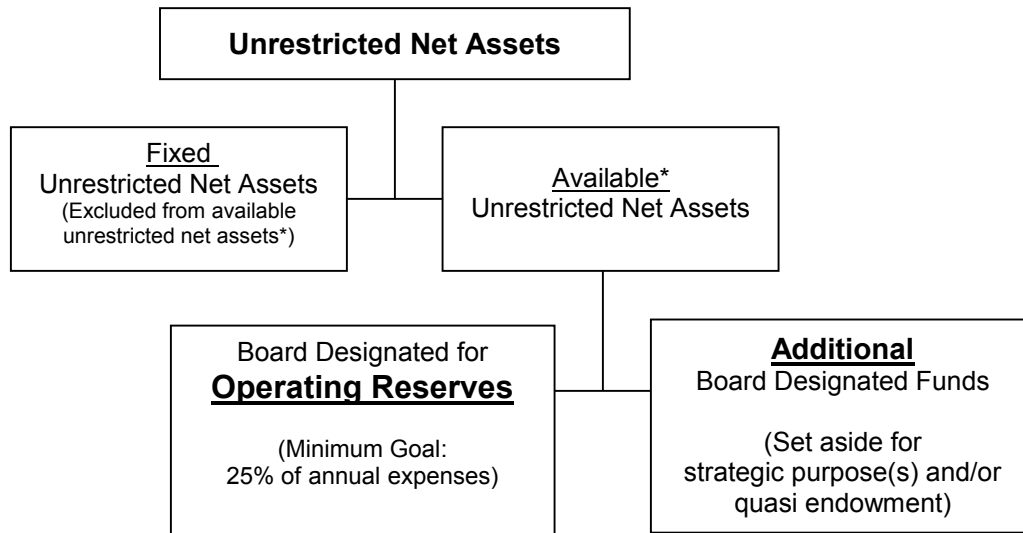
By Consensus of the Nonprofit Reserves Workgroup [list in Appendix I]
NCCS/CNP, The Urban Institute
[Draft/8-31-08]

**Operating reserve ratio = operating reserves divided by
annual operating expenses**

Summary

As used in this document, “**operating reserves**” means the portion of *unrestricted net assets* that have been designated by the board as a reserve for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. Other board-designated unrestricted net assets, if any, would be for non-operating purposes and not be available for operations. However, these board designated funds can be re-designated as **operating reserves** by board action if financial conditions change.² Detailed definitions are on page 10.

Figure 1 -- Suggested balance sheet net asset terms presented in an illustration that all nonprofit CEOs and boards need to understand [Figure 1 is described on page 7 of this document.]



* Available unrestricted net assets could also exclude other non-current, non-liquid assets such as receivables, inventory, prepaid expenses and deposits held by others

The basic premise is that many nonprofits do not have adequate **operating reserves** and that an initiative is needed to help them improve their financial condition by increasing their reserves.

As a general rule, an **Operating Reserve Ratio** of at least 25 percent – or three months of annual operating expenses or budget -- is the suggested minimum goal. However, the adequacy of **Reserve**

¹ While “reserves” is a popular term for referencing financial strength, it is not used with consistent meaning and is not described or found extensively in not-for-profit authoritative accounting literature. When it is used in various articles and documents on nonprofit reserves, it can refer to all available unrestricted net assets, which would include all board-designated funds or be limited to the portion of available unrestricted net assets designated for operating reserves. Further, the term “reserve” can also be used in an entirely different accounting context – in the insurance industry for example.

² Readers of this document are expected to be familiar with unrestricted net asset concepts, which are not described in detail in this document. See Figure 1 and Appendix B - Illustrative balance sheet hierarchy and checklist.

Ratios over 25 percent is variable and depends on a number of factors, which are described in Appendix C – *Factors to be considered*.

Once an “adequate” **operating reserve**, as determined by each organization’s board according to its particular circumstances and financial position, has been acquired, available unrestricted net assets in excess of this amount can be designated by the board for strategic purposes and/or quasi endowment. As a general rule, funding the **operating reserve** is viewed by the Workgroup as the first priority over other potential board designations of available unrestricted net assets.

Note that Form 990, which is the basis for the statistics on DC area nonprofits in Table 1 below, does not provide for calculating **Operating Reserve Ratios** that exclude other board designations of unrestricted net assets.

Operating reserves can serve as an internal line of credit when needed to cover the normal fluctuations of day-to-day operations. Funds ‘borrowed’ from **operating reserves** would be ‘repaid’ when, for example, anticipated revenues are received.

The Operating Reserve Ratio can be used internally by nonprofit organizations as a general-purpose indicator of financial health. A simplified **Reserve Ratio** strategy is provided for smaller nonprofits while a comprehensive strategy is recommended for mid-sized to larger organizations (see page 8).

This document focuses on the internal use of **Operating Reserve Ratios** as a financial management tool, and the Workgroup is **not** recommending that donors, watchdogs, regulators and/or the media make use of the **Reserve Ratio** as an external charity evaluation tool.

The ultimate objective is to introduce the **Operating Reserve Ratio** concept along with guidance for implementation to nonprofit organizations in the Washington, DC area. As part of that effort, a series of workshops will be convened to educate and inform practitioners on the intended use for the tool. Strategies will be developed for getting NPO managers to use the Operating Reserve Ratio to measure their reserves and make the commitment to establish a plan designed to increase their reserves to an adequate level. This will include tips on “managing up” in order to get the CEO and Board to understand the situation and commit to achieving adequate financial viability for the organization.

Primary Stakeholders in assuring that nonprofits have adequate **Operating Reserves** include managers and boards of directors that are responsible for internal management and beneficiaries that are being served.

Stakeholders also include advocates in the community for the beneficiaries of services provided – i.e., beneficiary consumer groups, associations of nonprofit organizations, community foundations, United Ways, regional associations of grant makers, and local government planning offices. It is the community and the beneficiaries that suffer when nonprofits have to curtail services because they did not have adequate reserves to carry them through a decline in revenue or increase in expenses. The **Operating Reserve Ratio** can be applied by these community groups -- using IRS Form 990 data -- for a statistical profile of the financial health of nonprofit organizations in their area by age, size, type and region. The purpose of this effort would be to estimate the need for nonprofits in the community to build operating reserves and would not involve external evaluations of individual organizations.

Table 1 – 48 percent of DC nonprofits have available unrestricted net assets under 25%

According to a preliminary analysis of IRS Form 990 data (2003), nearly fifty percent of the 3,154 nonprofits located in Washington, DC have **Operating Reserves** below 25 percent:

362 nonprofits (11%) have negative reserves of minus 5 percent or worse,
258 nonprofits (5%) have negative reserves of zero to minus 5%,
271 nonprofits (9%) have reserves of zero to +5 percent, and
725 nonprofits (23%) have reserves of 5 to 25 percent,
for a total of 1,516 nonprofits (48%) with less than 25 percent.

Nonprofit Operating Reserve Ratio

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Three categories of financial condition

The **status** of an organization's financial condition can fall into one of three categories based on their **Operating Reserve Ratio**:

<u>Status</u>	<u>Reserve Ratio Range</u>	<u>Months of Reserve</u>	<u>Percent of D.C. NPO's in Category</u>
1. No reserve	Less than 0% (A)	None or minus one Or more months	15%
2. Low reserve	0% to 25% (B)	0 to 3 months	33%
3. Adequacy <i>depends</i> (C)	25% or more ³	3 or more months	52%

(A) Organizations with temporarily or permanently restricted net assets may be borrowing from those funds and, without measuring their **Operating Reserve Ratio**, may not be aware that they are doing so or that they have deficits in available unrestricted net assets.

(B) Suggested minimum goal for the **Operating Reserve Ratio** is 25%

(C) The *adequacy* of **Operating Reserve Ratio's** over 25 percent is variable and *depends* on factors such as age, size, environment, revenue sources, type of programs and the need for board designations of funds for specific purposes. [See Appendix A - Board Designations]

Status of an organization's financial condition

The **Operating Reserve Ratios** for each **status** category have been reviewed and accepted by consensus of the Reserve Workgroup.

The **Operating Reserve Ratio** is an indicator of whether or not the organization has enough operating reserves or *unrestricted net assets available for operations* to meet payroll and other personnel related expenses and pay its bills for a reasonable period if it were to receive no income during that period.

The **status** of an organization's financial health or viability falls into one of the following categories based on the **Reserve Ratio**.

Status 1 – No reserves

Reserve range: less than 0%. **Months** of reserves: none

Impact: If the **Reserve Ratio** is zero or less (i.e., a deficit in *available unrestricted net assets*), the organization is in a very poor financial situation, if not in a crisis situation. For example, it may be having difficulty meeting payrolls, and/or it may be seriously behind in paying its bills. It is likely operating hand-to-mouth -- disbursing funds as soon as they are deposited -- and

³ The Workgroup has also decided to leave excessive reserves issues to sub-sector umbrella groups, charity review groups (e.g., BBB), and federal and state regulators. However, some indicated that this is an important issue for the Workgroup to keep on its agenda. Further, the Workgroup advocates that nonprofits make certain their external communications (a) present an accurate representation of their financial situation and (b) do not suggest there is a financial crisis when they actually have significant reserves or available unrestricted net assets.

could not operate for more than a few weeks without income. The staff and members of the board are devoting a disproportional amount of time on day-to-day financial management, resulting in a reduction in the delivery of program services. In some cases, staff may be asked to forego all or portions of their salaries. And, some staff members may leave for a more stable environment or may be subject to furloughs or layoffs. Internal controls may be ignored with less staff to do more work. .

Organizations with significant temporarily or permanently restricted net assets may be borrowing from those funds to cover deficits in available unrestricted reserves. This is a very serious financial management problem since it violates the organization's fiduciary responsibility to assure that restricted funds are used only for purposes designated by the donors. Note that the numerator of the **Reserve Ratio** includes only unrestricted net assets and excludes all restricted net assets.

Organizations with a **Reserve Ratio** of zero or less would not be able to meet all of its financial obligations if it were to go out of business unless liquidation of their non-current assets would cover the deficit. Any organization sustaining a substantial and persistent deficit is at least in demonstrable financial danger, and may even be fiscally irresponsible.

Status 2 – Low reserve

Reserve range: 0% to 25%. **Months** of reserve: none to 3 months

Impact: If the **Operating Reserve Ratio** is at or above zero but less than 25%, the organization can be in a weak financial situation. The nearer to zero the **Reserve Ratio** is, the weaker the financial situation becomes. A ratio of less than 25% indicates available unrestricted net assets are only sufficient to cover less than three months operating expenses. The need is for action to avoid a serious financial situation should there be an unexpected downturn in revenue or increase in expenses. The need is to bring this ratio up to 25% (assuming this is the fiscal objective set by the board) within a reasonable time period (e.g., over a 6 to 48 month period).

Operating within a proper budget is essential to financial sustainability

In response to the question of how to get from status 1 - no reserve or status 2 – low reserve, some have suggested: “Teach them how to budget in a way that builds adequate reserves.”

The basic concept is that nonprofits with below minimum operating reserves need to revise and improve their budgeting and other financial management practices to first grow, and then maintain adequate operating reserves. Reserves are generated through a series of annual surpluses of income less expenses. Likewise, reserves are depleted through a series of deficits of income less expenses.

For nonprofits with annual deficits of income less expenses and/or negative or below minimum operating reserves, the key is to budget their revenues and expenses for annual surpluses that will grow their reserves to some minimum level over a period of years. The minimum level for their organization is set by the board in a formal reserve policy. The annual revenue budgets need to be realistic. That is, revenue budgets need to be estimates based on prior revenue generation adjusted for any projected changes that would reduce revenues in some revenue

categories. Revenue goals can be significantly higher than revenue budgets, which need to be conservative with reasonable expectations that they can be achieved.

Nonprofits need to have financial management practices in place that enable them to operate, year after year, within their expense budgets and to be prepared to adjust expenses downward if and when revenue projections fall below budgeted amounts.

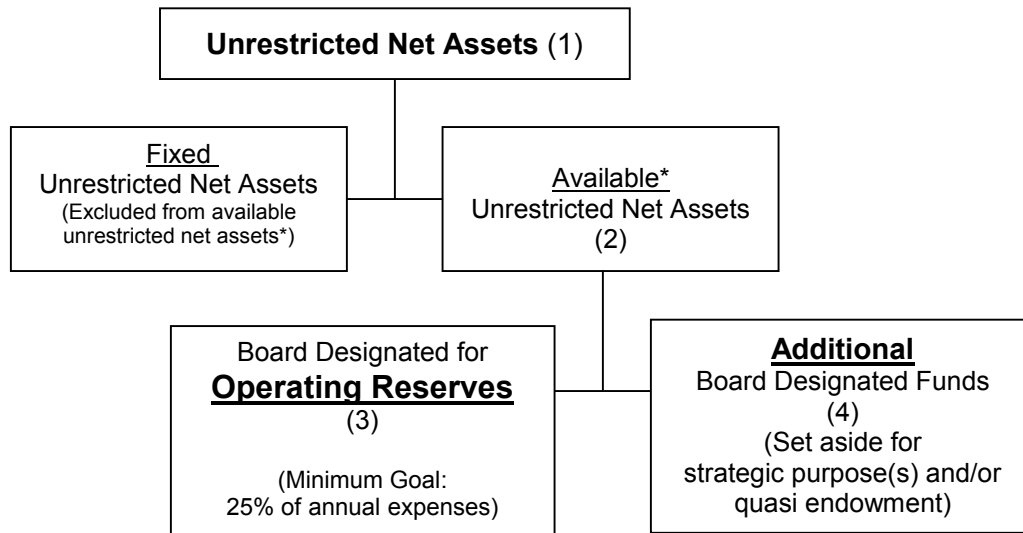
A 5 percent average annual surplus of revenues over expenses can improve a reserve of minus 10 percent to the minimum 25 percent in 7 years.

Status 3 – Adequacy: it depends

Reserve range: 25% or more. **Months** of reserve: 3 months or more.

Impact: If the **Operating Reserve Ratio** is at or above 25%, the organization's financial situation *may* be considered **adequate** – *depending* on factors such as age, size, environment, revenue sources, type of programs and the need for board designations of funds for specific purposes.

Figure 1 -- Suggested balance sheet net asset terms presented in an illustration that all nonprofit CEOs and boards need to understand



* Available unrestricted net assets could also exclude other non-current, non-liquid assets such as receivables, inventory, prepaid expenses and deposits held by others

(1) “Unrestricted net assets” are created through annual surpluses – i.e., excesses in unrestricted revenues and releases of temporarily restricted net assets over expenses.

(2) “Available Unrestricted Net Assets” are available for use in operations and are also available for non-operational special purposes that further the mission of the organization.

(3) **Operating Reserves** are the portion of unrestricted net assets available for operations that can be used within the budget for operations without board action. The **additional** board-designated funds are not available for operations since the board intends that they be used for purposes other than operations and board action is needed to re-designate them for **operating reserves** before they become available for operations.

(4) Once you reach the board designated goal for **operating reserves**, you can establish **additional** board designated funds. **Additional** board designated funds include board-designations for:

- Specific purposes
 - Disaster relief
 - Emergencies
 - Special project
 - Unanticipated opportunity
- Purchase of fixed assets
- Fixed asset replacement and maintenance [esp. technology]
- Sustainability of operations [major fluctuations]
- Stabilization [e.g., United Way funds for agencies]
- Quasi endowments
 - Endowed artistic position
 - Scholarships

Simplified use of Operating Reserve Ratios for smaller nonprofits

The Reserve Workgroup intends that the recommendations for smaller nonprofits be as simplified as possible.

The Reserve Workgroup advocates that all CEOs and board members of *even the smallest* nonprofits become familiar with balance sheet accounting concepts for [see Appendix B]:

- a. assets, liabilities and net assets, and the unrestricted, temporarily restricted and permanently restricted net asset categories⁴; and
- b. available unrestricted net assets, annual operating expenses and **reserve ratios** as defined and discussed in this document.

The Reserve Workgroup recommends that *even the smallest* nonprofit adopt the following minimal reserve policy:

- a. Have the board of directors establish a minimum **Operating Reserve Ratio**, e.g., 25 percent
- b. Set up their accounting system to measure their **Operating Reserve Ratio** quarterly.
- c. Report the **Operating Reserve Ratio** to the board of directors not less than quarterly and include it in financial reports provided for each board meeting.
- d. Strive to maintain their **Operating Reserve Ratio** at the board-approved level.

The Reserve Workgroup recommends that mid-sized and larger nonprofits:

[See Appendix F - Guidelines for Developing a Reserve Policy.]

- a. Establish a formal, written board-mandated **Reserve Policy** that includes a precise definition for their **Reserve Ratio**.
- b. Set a long-term objective for their **Reserve Ratio** -- which would be a minimum of 25% at the lowest point during the year. Several intermediate annual milestones can be set, if needed, in order to achieve the long-term objective.
- c. Incorporate implementation of their **Reserve Policy** into their budgeting procedures and investment policies.
- d. Track their rolling month-end **Reserve Ratio** over a multi-year period.
- e. Provide a “**Reserve Ratio** Trend Analysis Report” to the board of directors not less than quarterly and include it in financial reports provided for each board meeting.

Distinguishing *at-risk* organizations from *financially-healthy* organizations.

The Nonprofit Reserves Workgroup distinguishes between nonprofits with operating reserve and financial sustainability issues and financially healthy nonprofits that can afford to have other non-operating board designated funds.

At-risk organizations are those with significant operating reserve problems (e.g., a negative Reserve Ratio) and financial sustainability issues. *Financially-healthy* organizations are not financially stressed and have adequate unrestricted net assets available for operations. Only *financially-healthy* organizations can afford to have additional non-operating, board designated funds, which by their very nature and existence signal a high likelihood that financial sustainability is not an issue. Organizations with *adequate* available unrestricted net assets for *sustainability* can have *adequate* or *inadequate* board-designated net assets for *optimal mission accomplishment* – e.g., for special purposes that further program needs, goals and objectives.

⁴ Readers of this document are expected to be familiar with these concepts, which are not described in this document. See Attachment A - *Balance sheet hierarchy and checklist – illustrative.*

And, the adequacy of board-designated net assets depends on a variety of circumstances (see Appendices C and D).

Financially healthy nonprofits are expected to have adequate operating reserves *in addition* to their board designated net assets and, therefore, have different challenges when it comes to financial management.

Only nonprofits that have available unrestricted net assets in excess of their minimum operating reserve goals, can afford to consider designating portions of the excess for use in non-operating special purpose activities – such as special program-related projects and activities, purchases of buildings, equipment and other fixed assets and creation of quasi endowments for various purposes. These nonprofits have different more diverse challenges that extend beyond fundamental financial sustainability issues. They need to address the wide range of uses for additional funds that may be restricted or unrestricted but are typically board designated for specific short and/or long-term projects or purposes. If an organization which has these types of funds encounters unexpected depletion of operating reserves resulting in operating reserve levels falling below what they had established for themselves, their first step to correcting the problem is to un-designate portions of their un-obligated, board-designated net assets.

The financial challenges of negative or low operating reserves are most critical to small to mid-size nonprofits which often have small staffs and immature boards. If operating reserve problems such as borrowing from restricted net assets to pay operating expenses for which the assets were not intended are unaddressed, the result could be the demise of many organizations that deliver much needed services to our communities throughout the DC metropolitan region. The Workgroup will provide resources for public consumption and discourse designed to raise awareness that results in corrective behavior. The Workgroup will facilitate the creation of educational guides designed to help organizations establish policies and agree upon specific goals and objectives tailored to their unique situation that results in solution based action leading to financial sustainability.

Regarding at-risk organizations, 16 percent of the nonprofits in DC are at serious risk with negative Reserve Ratios and another 9 percent are at-risk with ratios of less than 5% of their annual expenses. Another 23 percent have Reserve Ratios under the suggested 25% minimum guideline and are somewhat at risk. [See Table 1, page 2.] This leaves about 50 percent of DC area nonprofits with sufficient available unrestricted net assets to have both board-designated operating reserves and additional board-designated funds for special, non-operating purposes.

Operating Reserve Ratio Definitions

The numerator and denominator for the **Operating Reserve Ratio** are consistent with those used in “*Reserves and Reserve Policies Guidelines for United Ways*,⁵” which is a resource and an illustrative reserve policy for the nonprofit reserves initiative. The numerator in the Operating Reserve Ratio excludes the non-operating, special purpose board-designated portion, if any, of unrestricted net assets.

Operating Reserve Ratio = **operating reserves** divided by
total operating expenses

Numerator for the Operating Reserve Ratio:

The Operating Reserve Ratio numerator – operating reserves - equals total unrestricted net assets minus fixed assets (net of related debt) and, when material, minus other non-current, non-liquid assets which are not readily available for use to cover operating expenses. Other board designated funds, if any, are also excluded.

For purposes of calculating *operating reserves* as used in the **Operating Reserve Ratio**, temporarily restricted and permanently restricted assets and liabilities are accounted for separately from unrestricted assets and liabilities.

Form 990 does not provide for calculating an **Operating Reserve Ratio** that excludes, if any exist, non-operating board designations of unrestricted net assets for special purposes. Therefore, in Forms 990, the numerator, *operating reserves*, are calculated by estimating the overall *available* portion of *unrestricted net assets*, using following formula: Line 67 (Unrestricted net assets) less fixed assets net of debt. Fixed assets net of debt equals Lines 55 and 57 (Land, buildings, and equipment -- i.e., fixed assets) minus Lines 64b (Mortgages and other notes payable).

A more precise and conservative definition of reserves and available unrestricted net assets for internal use by nonprofit organizations is provided in Appendix D. [See “A More Precise and Conservative Definition of Reserves” in *Determining Appropriate Levels of Reserves* by Dick Larkin, BDO Seidman, LLP (section B, Appendix D).]

Denominator for the Operating Reserve Ratio:

The Operating Reserve Ratio denominator -- total operating expenses – equals total annual expenses excluding depreciation, use of tangible in-kind, non-cash donations, intangible contributed services and donated use of facilities.

The Operating Reserve Ratio includes restricted fund expenses in the denominator because (a) this is a more conservative approach that results in larger operating reserve objectives, (b) the denominator needs to include the total payroll and personnel related budget and not just the unrestricted portion of personnel expenses, (c) this definition is consistent with those of BBB Wise Giving Alliance and United Way of America and (d) Form 990 does not distinguish between restricted and unrestricted expenses or include a line item for funds released from restrictions.

⁵ The United Way formula relates solely to unrestricted net assets, identifies board-designated unrestricted net assets and excludes these net assets from the numerator of the reserve calculation.

In Forms 990, *total operating expenses* are calculated as: Line 44 (Total functional expenses) less Line 42 (Depreciation) in Column A. Form 990 excludes contributed services and use of facilities from Line 44. However, in forms, tangible in-kind, non-cash donations are included in Line 44, but not reported separately, so they cannot be deducted from the denominator.

Applicability

The **Operating Reserve Ratio** and the suggested 25% minimum reserve percentage are generally for those organizations that depend on contributed and/or government income for a significant portion of their total operating expenses (e.g., 20 percent or more). Note that government grants and contracts are usually restricted. Organizations that receive most of their funding from government agencies need adequate reserves just like other nonprofits do. If they don't have adequate unrestricted revenues to build reserves, they need to be able to include distributions to reserves in their indirect cost rates.

Authoritative accounting references

Key accounting terms in this document are used in authoritative accounting literature.

The 1998 edition of the Blackbook contains extensive descriptions and GAAP guidance for “Board-Designated Funds,” “Quasi Endowment Fund,” operating reserves under the title “General/Operating Fund,” and “Unrestricted Fixed Assets Fund.” The term “Funds” is the same as the FASB Statement No. 117 term “net assets.” Board-designated funds include designations of a “portion of net assets to fund a certain program, activity, or purpose, e.g., disaster relief, AIDS education, a homeless project, research, etc.”⁶

FASB Statement No. 117 uses the term “board-designated” as follows: “An organization’s governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called funds functioning as endowment or quasi-endowment funds).”⁷

⁶ Pages 11 to 15 and 128 to 129, “Blackbook” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, 1998 edition. The “Blackbook” *Standards* are Level E authoritative accounting literature, sponsored by National Health Council, National Assembly and United Way of America.

⁷ Paragraph 168 (the glossary) of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.

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Appendix A - Board-designated special-purpose funds

Board designated special-purpose funds are a sub-component of unrestricted net assets in the **net assets** section of a balance sheet (aka, Statement of Position).

The hierarchy of net assets is as follows:

Net assets

There are three categories of **net assets**:

unrestricted,
temporarily restricted, and
permanently restricted.

Unrestricted net assets consist of:

available unrestricted net assets and
fixed assets (net of related debt)

Available unrestricted net assets consist of:

Operating reserves and

**[in end of year external report, adjusted for annual operating surplus (deficit)
and annual new and revised board designations]**

Board-designated special-purpose funds

[adjusted for new and revised board designations in end of year external report]

Operating reserves, for internal monthly reporting purposes, consist of:

Operating fund surpluses (deficits) – year to date [adjusted to zero as of end of year]

Operating reserves – end of year

[reserves policy: minimum beginning of year = X% of annual expenses]

[end of year external report, adjusted for operating surplus (deficit)]

Board-designated special-purpose funds can be designated for:

Purchase of fixed assets (e.g., land, buildings, equipment, furniture, software)

Fixed asset replacement and maintenance

Sustainability of operations [major fluctuations]

Stabilization of support programs [e.g., assuring allocations for United Way agencies]

Quasi-endowments (e.g., endowed artistic position, scholarships)

Other specific purposes (that further program needs, goals and objectives)

Specific purposes for board-designated unrestricted net assets can include:

Disaster relief and other programmatic emergencies

Special projects

Unanticipated opportunities

It is recommended that boards establish reserve policies where board designations for non-operating special purposes do not result in reducing their **operating reserves ratio** below a board-designated minimum operating reserve goal.

Authoritative references

FASB Statement No. 117 uses the term “board-designated” as follows: “An organization’s governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called funds functioning as endowment or quasi-endowment funds).⁸”

The 1998 edition of the Blackbook contains descriptions and GAAP guidance for “Board-Designated Funds.”⁹ IRS Form 990 does not separate board designated funds from other unrestricted net assets.

Assumptions about board-designated special-purpose funds

1. If an organization does not have board-designated special purpose funds, all available unrestricted net assets are included in the operating reserve fund.
2. Nonprofits with negative available unrestricted net assets have no reserves and, therefore, are not able to have other board-designated special-purpose funds.
3. Special-purpose, non-operating board designations cannot result in negative *available unrestricted net assets*. For example, illustrative GAAP guidance for the balance sheet states: “The [operating] unrestricted net asset balance should not be reported to be in a deficit position as the result of [other] designations which exceed the total of available unrestricted net assets.¹⁰”
4. Nonprofits with available unrestricted net assets of less than 25% of annual operating expenses are not in a financial position to have significant, if any, non-operating board-designated special-purpose funds. Operating reserves (i.e., unrestricted net assets available for operations) need to be maintained at minimum levels by re-designating portions of board-designated special-purpose funds, if available, to operating reserve funds.

Intended use of board-designated special-purpose funds

Board-designated special-purpose funds are intended for uses other than general operations and are expected to be expended solely for special projects and purposes. Board-designated special-purpose funds are not intended for use to cover payroll for permanent employees, occupancy and other unavoidable operating expenses.

When to establish board-designated net assets

It is suggested that nonprofits with available unrestricted net assets under 25% of annual expenses would not have adequate unrestricted net assets to be able to maintain or establish board-designated special-purpose funds. In addition, organizations are encouraged not to establish board designated net assets that result in operating reserve funds of less than 25% of annual operating expenses. On the other hand, when operating reserve funds begin to exceed 25 percent, organizations can consider establishing board designated special-purpose funds. These organizations would, in addition to tracking their overall available unrestricted net assets as defined in this document, also track operating reserve funds and other board-designated funds.

⁸ Paragraph 168 (the glossary) of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.

⁹ Pages 11 to 15 and 128 to 129, “Blackbook” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, 1998 edition. The “Blackbook” *Standards* are Level E authoritative accounting literature, sponsored by the National Health Council, National Assembly and United Way of America.

¹⁰ Page 129, “Blackbook” *Standards*, 1998.

When to reverse board designated net assets

If operating reserve funds fall below the minimum level set by the board, the board can reverse portions of their unexpended, un-obligated board-designated special-purpose funds as needed to replenish their operating reserve funds to minimum levels. In other words, while board-designated special-purpose funds are not available -- or intended for use -- to cover any payroll or other general operating expenses, any un-obligated board-designated special-purpose funds can become operating reserve funds – as needed – when the operating reserve ratio is below minimum, e.g., under 25 percent.

Definitions

Board-designated special-purpose funds consist of *quasi-endowments* or net assets functioning as endowments and designations for *purchase of fixed assets*, *fixed asset maintenance and replacement*, *sustainability of operations*, *stabilization of support programs*, and *specific purposes*.

Quasi-endowments are board-designated net assets that function as permanent endowments. The principal of a quasi-endowment is maintained intact and only the income is spent either for general purposes or for purposes specified by the board¹¹.

Board designations for *purchase of fixed assets* and for *fixed asset maintenance and replacement* are intended to be spent on land, buildings, furniture, equipment, works of art, software or other fixed assets. Once the fixed assets are purchased, maintained or replaced the amounts are transferred from board-designated net assets to fixed net assets.

Board designations for *sustainability of operations* serve as supplemental reserves to be made available for operations in unusual or emergency situations such as moving to new facilities, CEO turn over or unexpected disruptions in operations and services.

Board designations for *stabilization of financial support programs* are intended to enable nonprofits that make grants and allocations (e.g., to United Way agencies) to other nonprofits or provide financial support directly to individuals to continue these financial support activities during periods of declining revenues.

Board designations for *specific purposes* are intended to be a “portion of [unrestricted] net assets to fund a certain program, activity, or purpose, e.g., disaster relief, AIDS education, a homeless project, research, etc.”¹²

¹¹ Page 18, “Blackbook” *Standards*, 1998.

¹² Page 14, “Blackbook” *Standards*, 1998.

Reserve Workgroup comments regarding board designations

Comment A¹³: Board designated special-purpose funds are set separate from operating reserve funds in conjunction with an organization's strategic plan -- along with related funding strategies for each. For instance, an organization may need to create additional board designated special-purpose funds for:

A Building & Equipment Maintenance & Replacement Fund that might be funded by allocation of non-cash depreciation expense;

Or a Human Resources Capacity Building Fund to set aside an amount equivalent to 1.5 FTE at mid-management level as they ramp up fundraising staff whose ROI will not be evident until the following 12-18 months; or the fund could be to support leadership succession;

Or a "Carpe Diem" or "Artistic Venture Capital" or "Opportunity" Fund set aside by the board to position its entrepreneurial artistic director to launch a new project or seize a timely opportunity that would otherwise destabilize the organization financially or have to be forfeited. Etc.

Comment B¹⁴: Board-designated funds provide financial flexibility and adequate funding for expected major expenditures.

Infrastructure Fund. The purpose of the Infrastructure Fund is to set aside funds that will provide for major technology and facility needs.

Business Development Fund. The purpose of the Business Development Fund is to set aside funds that will be available for major business initiatives or opportunities requiring significant development or start-up costs.

Scholarship Fund. The purpose of the Scholarship Fund is to provide self-sustaining financial support for the Scholarship Program apart from the annual operating budget.

¹³ Illustration A is from Workgroup member Bess Foley's emailed comments.

¹⁴ Illustration B is an example of a "Reserve Policy" from the American Association of Critical Care Nurses revised July 2003 – available from the ASAE website. The policy memo is available on request to James_Schmutz@ml.com.

Appendix B - Balance sheet hierarchy and checklist -- illustrative

Assets

- Cash
- Receivables
- Loans
- Inventories
- Investments in marketable securities - at market
- Prepaid expenses and deferred charges
- Fixed assets net of depreciation -- at cost or market
- Other long-term and non-current assets

Liabilities

- Accounts payable
- Accrued expenses
- Refundable advances and other deferred revenue
- Mortgages and other loans secured by fixed assets
- Other liabilities

Net assets

- Unrestricted
- Fixed assets net of debt

Available

- Operating reserve funds – available for operations [general fluctuations]
- Board-designated for: [see also Attachment A]
 - Specific purposes [see also Attachment A]
 - Disaster relief
 - Emergencies
 - Special project
 - Unanticipated opportunity
 - Purchase of fixed assets
 - Fixed asset replacement and maintenance
 - Sustainability of operations [major fluctuations]
 - Stabilization [e.g., United Way funds for agencies]
 - Quasi endowments
 - Endowed artistic position
 - Scholarships

Temporarily restricted

- Purpose

- Time

Permanently restricted

- Unrestricted income endowments

- Restricted income endowments

- Scholarship endowments

- Endowed staff positions

Liabilities and net assets

For purposes of calculating available unrestricted net assets for use in **Operating Reserve Ratios**, temporarily restricted and permanently restricted assets and liabilities are accounted for separately from unrestricted assets and liabilities.

Appendix C – “It Depends”

FACTORS TO BE CONSIDERED IN DECIDING WHAT AMOUNT OF RESERVES AN ORGANIZATION WILL PLAN TO MAINTAIN

Factors to be considered in deciding (a) what amount of reserves are needed for sustainability and (b) what amount of board designations are needed for mission accomplishment. This “It Depends” document is to be used, for example:

1. By Staff and Board to assess “their” organization
 2. When demand is greater than available funds
 3. During difficult economic times
 4. In transition – executive or other key leadership turnover
- Every organization should plan for its reserves. Consider how the factors below might affect you. Your board, with advice of management, should adopt a formal policy for the reserve level it wishes to maintain, and review that policy regularly. Of course you cannot just make reserves appear on command; it may take an extended period to accumulate the desired level.
 - Following is a list of factors to be considered by nonprofit organizations in making that decision. In many cases, no one of these factors will be determinative by itself; all applicable factors should be considered together.

Factors whose presence would indicate that the organization probably should try to maintain a higher* level of reserves

Operating funds **[for financial sustainability]**

Our main sources of expendable revenue may be subject to large unexpected negative fluctuations.¹

The nature of our activities is such that there is a high risk of there being significant unpredictable demands on our resources.²

Our regular day-to-day fluctuations in income and expenses are significant.³

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. While the organization may never have faced an event requiring the extended use of our reserves, the board considers this a fundamentally sound financial management practice

Our planning and budgeting processes have historically proved to be less accurate in forecasting financial results.⁴

Factors whose presence would indicate that the organization can likely get along with a lower* level of reserves

Our main sources of revenue are generally not subject to large unexpected negative fluctuations.

It is less likely that significant unexpected demands on our resources will occur.

Our regular day-to-day fluctuations are relatively minor.

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 is generally willing to live ‘day-to-day’ and trust that resources will be available when needed. The 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.

Factors whose presence would indicate that the organization probably should try to maintain a higher* level of reserves

Adequate backup sources of resources are not in sight.

We are dependent on one or a few funding sources.

We may have to replace our CEO in the near future.

We are a young organization and will need time to build up our reserves..

When the economy declines, our revenues tend to decline while the need for our services increases.

Factors whose presence would indicate that the organization can likely get along with a lower* level of reserves

We are confident that adequate backup sources of resources are likely to be available in a pinch.⁵

We have numerous funding sources and are not dependent on one or a few large funding sources.

We are confident that our CEO will be with us for a long time.

We are an old, established organization and have been building reserves steadily for years..

Our revenues and the demand for our serves are not impacted by declines in the economy..

Board-designated funds
[for optimal mission accomplishment]

The nature of our activities is such that there is a high likelihood that unexpected opportunities will come our way, requiring additional (available) resources to take advantage of these opportunities.⁶

There is a sense that a change in organizational direction may be considered desirable in the not-so-distant future.⁷

The nature of our activities is such it is not very likely that such opportunities will come our way requiring additional (available) resources.

There is no change in organizational direction anticipated any time soon.

* - No attempt is made here to quantify ‘higher’ and ‘lower.’ That has to be done individually by each organization, considering all its circumstances. A reserve level that would be considered high for one organization may be completely inadequate for another.

Notes:

1. Examples might include: ‘September 11th’-type events that affect your charitable giving and fee income, a blizzard the day of your big annual gala fundraiser; general poor economic conditions; organizational problems generating unfavorable publicity which turns away customers and donors; overly-optimistic budgeting of anticipated revenue (very common); many other reasons.

2. Examples might again include: September 11th – if you are the Red Cross of New York; every day – if you are the Red Cross of Los Angeles; the same blizzard - which causes your roof to collapse; the organization’s labor union gains a major wage increase.

3. Payrolls have to be paid every payday. The electric company is likely to want cash, not a promise, to keep the power flowing. But income often comes in spurts, especially contributions. Also there may be seasonal factors. For example, many contributions probably arrive in December as donors do personal tax planning. Colleges collect tuition at the beginning of each semester, and then have to live off it until

next semester. Orchestras sell season tickets in the spring to pay for concerts to be put on over the following winter. On the other side, utility costs are probably higher in the winter and summer (heating and air conditioning), but lower in between. Expenses of our annual conference will be bunched around the time of the conference.

4. For example, you have had numerous instances of situations such as cost overruns, or, ‘The project that everyone thought would succeed, didn’t.’ ‘The foundation grant that you thought was in the bag, wasn’t.’ ‘The big fundraising event failed to meet expectations.’

5. This is your Plan B. For nonprofits this can be some combination of: cash on hand, investments and surplus assets that can be sold, a bank line-of-credit, a foundation or other institutional funder that you know would help if asked, some individual donors who could be counted on if the going gets really rough, a plan to cut expenses to a bare bones level for a while. If an organization uses this to justify not establishing a reserve, the organization should define in writing this “Plan B” which names sources (to include: held assets, organizations and individuals) from which funds would come.

6. For example, recently an extremely rare major dinosaur fossil became available at public auction. Museums knew that it would sell for a high price, and it did. If your museum wanted this for its collection, it had to have resources available to cover the cost. (In the real case, the winning bidder managed to quickly tap some large corporations to help, but still had to put up quite a bit of its own money.)

7. A long-standing program just isn’t what’s best any more. Community needs have shifted. Resources will be required to phase out the old and bring in the new. The parallel here is to seed capital in a business.

Appendix D

Determining Appropriate Levels of Reserves

Richard F. Larkin, CPA,
National Technical Director of Not-for-Profit Accounting and Auditing
BDO Seidman, LLP, Bethesda, Maryland

- A. The Question: Among the single most popular questions historically asked by nonprofit CEO's and their boards is "What is an appropriate level of reserves for our organization?"
- B. The Answer: It is best to start by saying that based on the literature available there is simply no single correct solution for all organizations. Despite the importance of the issue there exists no agreed upon industry benchmark. To complicate matters further, such benchmarks as are commonly used must be viewed in the context of the particular organization to which they are being applied.
- C. The Problems: There are actually a variety of problems in trying to establish an industry standard benchmark.
 - 1. The most important is that the term "reserve", while generally understood, is subject to a great variety of specific definitions. Later on we will discuss several of the more common definitions and calculations used, and discuss their strengths and weaknesses.
 - 2. A close second in solving the problem is the variety of the potential contextual issues in which the organization finds itself. This is where we will begin.
- D. Contextual Issues.
 - 1. The initial contextual issue concerns the age of the organization. Simply put a young organization will not have had time to build a significant reserve. These organizations should have as their goal to create a positive change in net assets each year so that they can build a reserve. Such a goal should not be less than 3-5% of gross income and not more than 8-10%. While these numbers are not written in stone, they are logic driven: to take less will not allow the organization to aggregate a sufficient reserve, or perhaps even keep up with inflation; to take more would deprive the young organization from offering sufficient program services.
 - 2. One of the most important contextual issues concerns the number and dependability of the organization's income streams. If an organization has three or more major revenue streams that are reasonably dependable, they are far more secure and thus need fewer funds available for a rainy day (i.e., reserves). On the other hand, an organization that has few or no highly reliable income streams might do quite well to have nine months or a year's worth of expenses in reserve.
 - 3. Some organizations also need to maintain more reserves than others because of major planned expenditures such as the purchase of a building, or a major IT implementation. While borrowing is used as frequently as cash for expenditures of this type, it is nevertheless important for an organization when setting its current goals for reserves to do so with an eye toward potential major expenditures.

4. The fourth contextual issue is based on whether the organization is likely to confront 'difficult to anticipate' major contingencies. For example, the Red Cross must have very substantial reserves since it may face some years in which there are a multitude of devastating storms; a professional society is not likely to face similar contingencies.
5. The final contextual issue is one of absolute size. If an organization has one or two million dollars a year in expenditures, having a years' worth of expenditures in reserves may make good sense. On the other hand, if an organization has a 50 million dollar budget it might well be considered poor stewardship to have a substantial percentage of that in reserve. The IRS is not likely to object; it is the donors or members who might question why so large a sum of "their" money is being held by the organization.

A. The most common calculations of reserves.

The variety of calculations of reserves used within the nonprofit industry is broad indeed. Among the many definitions organizations use for reserves are:

1. Total assets;
2. Total assets less total liabilities (or net assets);
3. Current assets plus investments minus current liabilities;
4. Or simply total cash and investments.

Two different definitions of reserves in common use are (neither of which is entirely valid, however popular they may be):

1. 'Liquid reserves' - which is defined as 'cash and investments that can be quickly converted to cash.' The problem with this definition is that it does not take into account such things as accounts payable and deferred revenue, and the like, which will be paid or consumed in the very near term.

In one survey of actual reserves held by associations the median reserve target reported on this basis was 33% of the organization's annual operating budget. In common parlance this would be defined as 'four months of expenses' in reserve.

2. 'Total net assets.' The problem with this figure, which is self defining, is that it would include fixed assets, such as a building, computers, or furniture and fixtures – all of which are not available to be spent should the need arise. On the other hand, total net assets would have been potentially reduced by long term liabilities, such as mortgages, which do not need to be paid off, and thus do not require the use of cash, any time soon.

The same survey listed the median reserve target for this definition for 'All Organizations' to be 50%, or in common parlance, 'six months of expenses' in reserve.

B. A More Precise and Conservative Definition of Reserves:

Arguably, the best measure of what an organization has available to use in case of an urgent need for liquidity is based on the elements which define liquidity. Consider the following formula:

Current assets,
 less:
 receivables that are not fully expected to be collected within three months, and
 inventory that is not fully expected to be sold for cash within three months
 and less:
 all prepaid expenses
 and plus:
 unrestricted investments not already included in current assets
 and less:
 current liabilities, except for deferred revenue
 equals:
 Available reserves

This formula essentially reduces the financial position of the organization to its ultimate measure of liquidity. Begin with all current assets, but take out accounts receivable and inventory which may or may not be converted to cash in the very short term, and also remove prepaid expenses which reduce certain future costs but have already been spent. Then add in the investments which the organization could spend if it had to – not those restricted to a particular use or time frame, and certainly not permanently restricted funds. Finally subtract out all the current liabilities except for amounts collected in advance of providing goods or services. What remains is an ultimate measure of liquidity and thus funds available to meet any emergency.

The formula is quite conservative. However, by itself it does not indicate what percent of a year's expenses the organization should have. To solve that dilemma the author would suggest that the ultimate "gold standard" for a successful mature organization is one year's expenses in reserve adjusted for the context that the organization finds itself in.

Nonprofits and Squirrels
or, How big a reserve do *you* need?

by Richard F. Larkin, C.P.A.
Institute for Nonprofit Excellence, BDO Seidman, LLP

Most of us have at least a few “squirrel” tendencies. It is comforting to have something put aside for the winter or the proverbial rainy day. In an organization, this stash is referred to as its “operating reserve;” it is what keeps the doors open during a temporary financial drought.

A frequent question in the nonprofit sector is, how much reserve should we have? However, the simple answer: as much as possible, is not really simple. Consider the following scenario: You graduated from a large private university, with total assets exceeding ten billion dollars (this describes several American universities.) You are, therefore, likely the recipient of an unending stream of appeals for you to contribute to their annual fundraising campaign. You consider your personal balance sheet; you look at their balance sheet, and – unless your name is Gates or Soros – you probably think, “They want *me* to send money to *them*???”

Being rich, in the nonprofit sector, is not an unmitigated blessing. Indeed, wealth allows you to avoid worrying about where the money is coming from to pay the next payroll, and to expand your services to the community. But it can cause headaches too, such as having to deal with a union representing your employees who understandably assume that with all that money in the bank, a large raise could easily be afforded. More than one university, and orchestra – to name just two parts of the nonprofit sector – has faced this very real challenge.

Of course being poor is not the answer either. Then you do have to worry about keeping the doors open, and you are not able to offer all the community services you would like to.

But what is the right amount? How should nonprofit leaders go about deciding on an appropriate level of reserves for their organization, given that life is inherently uncertain?

First, recognize that this is partly a personal decision; there is no absolute answer. Some people (boards and managers) are not uncomfortable living on the edge, and trusting that resources will appear; others like that warm fuzzy feeling of knowing a cushion is there. Your board probably includes some of each type. I am reminded of the three bears and the bowls of porridge; one bear thought his porridge was too hot; another too cold, and the third just right. Of course, the porridge in all three bowls was actually the same temperature!

Second, realize that the world changes over time. What was appropriate yesterday may be too much today, but too little tomorrow. Changing economic, demographic, political, cultural, and other circumstances make it vital to regularly re-assess the

reserve goal. Similarly, organizations in different places may well need different reserves.

Next, consider who is interested in a nonprofit's reserve level. Besides the obvious – management and the governing board, I suggest this list includes: donors, clients/customers, members (of an association), employees, the media, regulators, the general public.

People often ask, is there some IRS or other legal limit on how much a nonprofit can accumulate without jeopardizing its tax-exempt status? The answer is, no - as long as the accumulated assets are actually being used to further the organization's exempt purpose. For many wealthy nonprofits, this is achieved by investing a large part of the assets – often in accordance with donor restrictions on endowment gifts, and using the income to help pay for operations. Most universities, orchestras, museums, and other nonprofits spend so much more on providing their services (education, concerts, exhibits, and so on) than they take in from tuition, ticket sales, admissions, etc., that, to stay solvent, they still need the additional money from annual giving. Also many nonprofits require sizable amounts of resources invested in property (classrooms, laboratories, dormitories, concert halls, collections, exhibit space); these resources are not available to pay today's light bill or faculty salaries.

What is very important for organizations that appear wealthy (say, more than 12 months' budget in the bank) is to be prepared to explain to prospective donors, parents paying their children's tuition, concertgoers, the media, etc., why there is still a need for additional funds beyond what is often perceived as high tuition, ticket prices, etc. Inability to do that effectively will make it nearly impossible to attract the required resources.

Similarly, organizations that appear poor need to be able to convince, say, a prospective donor that a gift will not be wasted; that the organization will be around long enough to accomplish useful outcomes.

Now, why does an organization need reserves? To be able to handle uncertainties. What could happen?

- *Unexpected shortfall in revenue.* This could result from unexpected external events – September 11th comes to mind, as does a blizzard the day of your big annual gala fundraiser; general poor economic conditions – we have been seeing this recently; organizational problems generating unfavorable publicity which turns away customers and donors; overly-optimistic budgeting of anticipated revenue (very common); and many other reasons.
- *Unexpected demands on your resources.* Examples might again be September 11th – if you are the Red Cross of New York, the same blizzard - which causes your roof to collapse, or the university's labor union gaining a wage increase.
- *Unanticipated opportunities.* Recently an extremely rare major dinosaur fossil became available at public auction. Museums knew that it would sell for a high price, and it did. If your museum wanted this for its collection, it

had to have resources available to cover the cost. (In the real case, the winning bidder managed to quickly tap some large corporations to help, but still had to put up quite a bit of its own money.)

- *The inevitable instances of less than perfect judgment and foresight.* A project that everyone thought would succeed, didn't. The foundation grant that you thought was in the bag, wasn't.
- *A change in direction is called for.* A long-standing program just isn't what's best any more. Community needs have shifted. Resources are required to phase out the old and bring in the new. The parallel here is to seed capital in a business.
- *Normal day-to-day fluctuations in income and expenses.* Accountants refer to the reserves needed here as Working Capital. Payrolls have to be paid every payday. The electric company is likely to want cash, not a promise, to keep the power flowing. But income often comes in spurts, especially contributions.

Often there are seasonal factors. For example, many contributions probably arrive in December as donors do personal tax planning. Colleges collect tuition at the beginning of each semester, and then have to live off it until next semester. Orchestras sell season tickets in the spring to pay for concerts to be put on over the following winter. On the other side, utility costs are probably higher in the winter and summer (heating and air conditioning), but lower in between.

Every organization should plan for its operating reserves. Consider how the above uncertainties might affect you. Your board, with advice of management, should adopt a formal policy for the reserve level it wishes to maintain, and review that policy regularly. Of course you cannot just make reserves appear on command; it may take an extended period to accumulate the desired level.

Related to this is continuing tension between wanting to spend currently everything we possibly can – because the need for our services is great, vs. putting something aside for the future. (Squirrels must be well programmed to handle this, as there are always lots of squirrels still around at winter's end.) That tension is part of every organization's (and person's) existence.

There should also be Plan B. For nonprofits this can be some combination of: cash on hand, surplus assets that can be sold, a bank line-of-credit, a local foundation that you know would help in a pinch, some individual donors who could be counted on if the going gets really rough, a plan to cut expenses to a bare bones level for a while.

Ask yourself, which organization needs larger operating reserves: (1) the Los Angeles Red Cross – think major, immediate, unpredictable events, or (2) a local day care center which owns its building debt-free, has a full roster of clients and a waiting list, adequate insurance, and a reliable funder which covers most of its operating budget? Now, where do you fall on that continuum?

Appendix F

Illustrative Guidelines for Developing a Reserve Policy [Taken from UWA Reserve Policy Guidelines]

Developing a Written Reserve Policy

Every United Way needs to have a Board approved policy on reserves.

A written reserve policy includes the following elements:

- **Statement of Purpose** - The reason for establishing the operating reserve.
- **Policy** – The objective to be achieved.
- **Definitions** – Descriptions of the meaning of key terms used in the policy.
- **Procedures** – Details of how the policy is to be implemented including the sources for the reserves, how reserves are to be invested and the formula for calculating the amount of the reserve balance.
- **Uses** – Circumstances in which the reserves can be used.
- **Governance** – Procedures for approving the use of reserves; persons authorized to establish policies and oversee the reserve balance; provisions for recalculating the formula of the reserve balance and distributing the excess reserve balance or funding reserve deficiencies.

Sample Reserve Policy

I. Philosophy

The establishment and maintenance of a funded reserve is a high priority. This will enable United Way to support strategic business practices and to:

- Manage cash flow interruptions
- Minimize the need for working capital borrowing
- Meet commitments, obligations or other contingencies
- Provide flexibility for new organizational priorities
- Generate investment income

II. Policy

To establish and maintain a funded reserve unencumbered and uncommitted at a level relative to the annual program funding and the costs of operating and maintaining the organization.

The reserve is intended to serve a dynamic role and is available to be utilized as needed rather than being static, devoted only to generating interest income.

III. Definitions

- **Unrestricted Operating Reserves** – Amounts reported in the Unrestricted Net Assets section of the balance sheet and identified as operating reserve funds.
- **Program Funding** – Undesignated allocations to Agencies and Initiatives. It does not include expenses funded by grants.
- **Costs of Operating and Maintaining the Organization** – United Way net expenses for Program Services, Fund Raising & Administration and United Way of America membership fees
- **Funded Reserve** - A fund consisting of liquid assets and investments accounted for separately from operating funds. Liquid assets are those that may be converted to cash quickly and easily. It is not required that reserves be physically segregated in a separate account although a local United Way may decide to do so.

IV. Strategies and Procedures

- A. Reserves shall be accounted for separate and apart from Operating Funds.
- B. The Investment Committee will have the responsibility for developing and recommending policies and guidelines for the investment of the reserve assets and the Finance Committee will approve such policies and guidelines.
- C. The reserve goal shall be to achieve and maintain between three and six months of Program Funding and Operating Costs as defined in Section III.

V. Sources

Assets for the reserve accounts shall come from the Annual Campaign, undesignated Legacies/Bequests/Memorials, earnings on investments, recapture of undistributed Allocations/Initiatives, Special Grants and other sources the Executive Committee may deem to be appropriate.

VI. Uses

- A. Working funds to financially operate the organization
- B. Funds to stabilize a level of allocations or a level of increased allocation when events affect the source and application of funds
- C. Funds to meet unfunded and unexpected organization needs
- D. Funds for emergency and emerging needs of Agencies
- E. Funds to make up a deficiency in the Campaign, either in results or collection experience

VII. Governance

The procedure for approving use of the reserve funds will be as follows:

1. Request submitted to Finance Committee
2. Action taken by Finance Committee
3. Recommendation to the Executive Committee by the Finance Committee
4. Approval by the Executive Committee
5. Notification of action taken to the Board of Directors

VIII. Maintenance

The status of the funded reserve will be calculated at the end of each fiscal year based upon audited financial results.

Reserve Calculation

The calculation formula will be based upon amounts defined in Section III as follows:

$$\frac{\text{Unrestricted, Undesignated Net Assets as of 12/31}}{\text{Months [Budgeted Annual Operating Expenses + Program Funding]}} = \text{No. of Months} \times 1/12$$

The Reserve Calculation will be presented to the Executive Committee at their meeting following approval of the financial audit results by the Audit Committee. The Committee will consider the adequacy of the reserve amount and will recommend any changes as deemed necessary.

IX. Policy Review

This policy will be reviewed every three years by the Finance Committee or sooner if conditions warrant. Any changes thereto will be reviewed by the Executive Committee and approved by the Board of Directors.

Appendix G -- Personal financial situation versus nonprofit financial situation

Status	Personal financial situation	Nonprofit financial situation
Crisis	Your checking account is over drawn , credit cards all maxed out Savings = 0	Creditors calling and payables 90-120 days behind , can't make payroll, negative Operating Reserve Ratio = -15%
Urgent	Waiting until your payroll check clears before mailing monthly bill payments, large credit card debt, savings = 0	Coordinating paying bills , payroll with daily bank deposits, payables 60 days behind , negative Oper. Reserve Ratio = -5%
Very Low	Lowest checking bank balance during month = one average month expenses . Savings account = 0	Just making payroll , Payables 60 days behind , Operating Reserve Ratio = 0
Low	Lowest checking bank balance during month = one average month expenses. Savings account = one month expenses	Making payroll , Payables 30 days behind, Operating Reserve Ratio = 10%, 1 month
Fair	Lowest checking bank balance during month = one average month expenses. Savings = three month expenses	Making payroll, payables on time . Operating Reserve Ratio = 25%, 3 months
Adequate	Lowest checking bank balance during month = one average month expenses. Savings = three month expenses plus funds for vacation, recreation, Christmas, etc,	Making payroll, payables on time Operating Reserve Ratio = 25%, 3 months Plus some board-designated, special-purpose funds
Healthy	Lowest checking bank balance during month = one average month expenses. Savings = three months expenses plus funds for vacation, Christmas, etc. and new car, furniture, home improvements, etc.	Making payroll, payables on time Operating Reserve Ratio = 50%, 6 months Plus more board-designated. special-purpose funds Plus investments in securities
Very Healthy	Lowest checking bank balance during month = one average month expenses. Savings = three months expenses plus funds for vacation, Christmas, car, furniture, home improvements, etc. Plus, Mutual fund monthly contributions toward retirement fund	Making payroll, payables on time Operating Reserve Ratio = 100%, 12 months Plus board-designated funds Including quasi endowment Plus investments in securities

Appendix H

Guidelines for Long-Term Investment Planning and Policies

[under development]

Appendix I - Nonprofit Reserve Workgroup [as of 8-7-08]

Workgroup members represent themselves and not their affiliations. Positions on recommendations and issues are established on a consensus basis; some members may disagree on some points.

Rob Batarla, National Recreation and
Park Association
Wendy Batkin, Child Welfare League of America
Elizabeth Boris, Center Director, CNP,
The Urban Institute
Mary Buszuwski, ANA
Gale Case, Rothstein Kass
Glenda Cognevich, DC Central Kitchen
Gail Crider, National Arts Strategies
Cami Cumblidge, Nebraska Council of
School Administrators
Mary Ann de Barbieri, de Barbieri and Associates
Keith Danos, Jewish Federation for Group Homes
Rick Dorman, GWSCPA
Phylis Edans, American College of
Emergency Physicians
Ken Euwema, United Way of America
Bess Foley, Nonprofit Finance &
Accounting Consultant
Flo Greene, California Association of Nonprofits
Bill Hamm, Foundation for Independent
Higher Education
Bob Hawkins, former COO, Special Olympics
Marge Heitbrink, Wise Giving Alliance, CBBB
George Hergenbahn, Special Olympics, Maryland
Deborah Hickox, Goodwill of Greater Washington
Maria-Nelly Johnson, Special Olympics,
District of Columbia
Lisa Junker, ASAE
Dick Larkin, BDO Seidman
(*) Bill Levis, Senior Associate, NCCS,
The Urban Institute [Co-host meeting]
Elaine Lynch, American
Dawn Mancuso, Association of Air Medical Services
Christine Manor, QuickBooks for NPOs
Jan Masaoka, Blue Avocado
Corey McIntyre, National Association of
Independent Schools

Chuck McLean, VP Research and
Data Quality, Guidestar
Rick Moyers, Meyer Foundation
Patty O'Malley, Rubino & McGeehan
Tom Pollak, Program Director,
NCCS, Urban Institute
Dennis Ramprashad, MillerMusmar,
[Chair, GWSCPA QR Task Force]
Celeste Regan, National Park Foundation
Sally Rudney, The Montgomery County
Community Foundation
Daniel Saat, Tides Foundation
Susan Sanow, Center for
Nonprofit Advancement
(*) Jim Schmutz, Merrill Lynch
[Co-host meeting]
Jeff Schragg, Argy, Witse & Robinson
Cathy Stegmaier, Alliance of Cambridge Advisors
Suzanne Stone, Society for Women's
Health Research
Janette Stout, Southeastern Univ. Research Assn
Alan Strand, California Association of Nonprofits
Russy Sumariwalla, Global Philanthropy &
Nonprofits
Russell Willis Taylor, National Arts Strategies
A Irene Tongelidis, Accounting and
Consulting Services
Tim Walters, Association for Small Foundations
Bennett Weiner, BBB Wise Giving Alliance
Yonas Weldemariam,, Society for Women's
Health Research
Brian Williams, Step Afrika!
Jack Ziegler, Movement Advancement
Project/LGBT
Joe Zillo, Defenders of Wildlife
Steve Zimmerman, Spectrum Nonprofit
Services LLC

Others are being invited to join the workgroup. Workgroup members are encouraged to invite others to join.

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