

Defining the Operating Reserve Ratio

Supplement to: *What are Adequate Nonprofit Reserves for Financial Stability? – “It Depends”*
A White Paper by Nonprofit Reserves Workgroup,¹ which can be found at:
http://www.nccs2.org/wiki/index.php?title=Nonprofit_Reserves_Workgroup

The classification of unrestricted net assets in the balance sheet, as depicted in Figure 1, is critical to developing a clear and accurate snapshot of an organization’s financial position.

1. We begin by defining the “available unrestricted net assets” box in Figure 1. “Available unrestricted net assets” are the portion of total unrestricted net assets that are available for use. A *simple* definition for “available unrestricted net assets” is unrestricted net assets less fixed assets net of related long-term debt, as shown in Figure 1.

A *more conservative* definition of “available unrestricted net assets” would exclude other non-current assets and non-liquid current assets such as receivables, sales inventory, prepaid expenses and/or deposits held by others, as footnoted in Figure 1. Each organization needs to determine if the *simple* definition can be used reliably for measuring Operating Reserves or if it needs to use a *more conservative* definition.

2. “Operating Reserves” are that portion of “available unrestricted net assets” that an organization maintains – or it’s board has formally designated or “reserved” -- to cover significant unbudgeted increases in operating expenses or losses in revenues. Operating Reserves can serve as an internal line of credit when needed to cover the normal fluctuations of day-to-day operations.

3. The Operating Reserve Ratio = Operating Reserves divided by Total Operating Expenses.

The Operating Reserve Ratio can be calculated in terms of a percentage (operating reserves divided by annual expenses) or number of months (operating reserves divided by average monthly expenses).

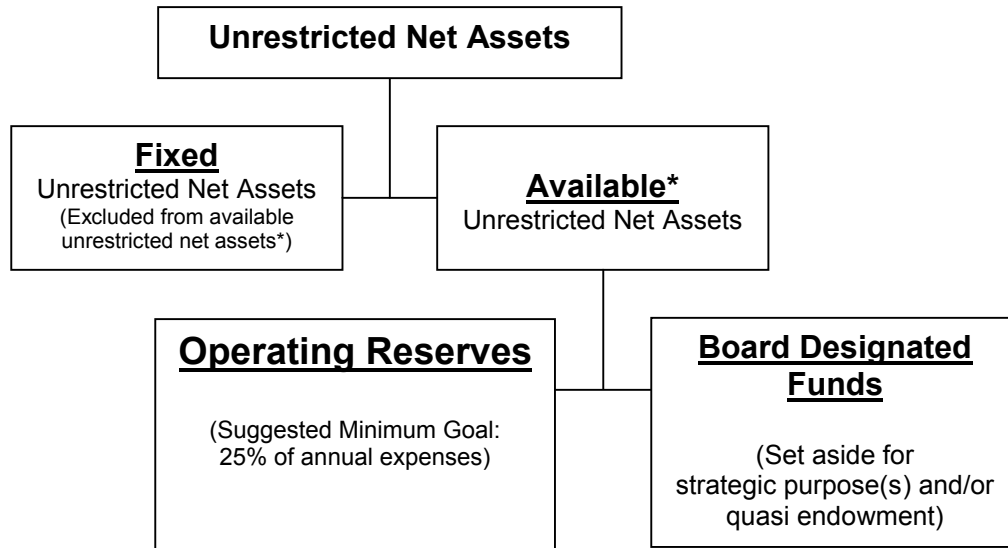
The Workgroup concluded that the Form 990 provides a good tool for illustrating the content of the Operating Reserve Ratio. Using the 2007 Form 990, Operating Reserves consist of Line 67 (Unrestricted net assets) less fixed assets net of debt. Fixed assets net of debt equals Lines 55 and 57 (Land, buildings, and equipment -- i.e., fixed assets) minus Lines 64b (Mortgages and other notes payable). Annual expenses consist of Line 44 (Total functional expenses) less Line 42 (Depreciation) in Column A.²

4. If the board designates a portion of available unrestricted net assets for non-operating purposes (i.e., board designated funds), “Operating Reserves” are not to be classified or treated as the *undesignated* portion of available unrestricted net assets or “what’s left over to work with that the board hasn’t designated”. Rather, “Operating Reserves” need to be classified as *the portion of available unrestricted net assets formally designated by the board specifically as “Operating Reserves.”* That is, as a general rule, building an adequate *operating reserve* is viewed as the first priority over *other* board designated funds.

¹ The views, recommendations and suggestions expressed in this paper are those of the Nonprofit Reserve Workgroup and have been established by the Workgroup on a consensus basis. Some members may disagree on some points. Workgroup members represent themselves and not their affiliations. This paper is not the product of the Center on Nonprofits and Philanthropy at The Urban Institute, which serves as secretariat for the Workgroup.

² The link to the 2007 IRS Form 990 is <http://www.irs.gov/pub/irs-pdf/f990.pdf>

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

Non-Operating Board Designated Funds for Optimal Mission Accomplishment

5. Once an adequate operating reserve, as determined by each organization’s board according to its particular circumstances and financial position, has been acquired, boards and CEOs can focus on designating additional funds for strategic purposes and optimal mission accomplishment (see board designated funds, Figure 1). These non-operating funds are designated for purchase of fixed assets, development of new programs, taking advantage of unexpected opportunities, investment in quasi endowment and other specific purposes. These board designated funds are for non-operating purposes and are not available for operations without board approval. However, board designated funds can be re-designated as operating reserves by board action if financial conditions change.