

OPERATING RESERVES: IS YOUR ORGANIZATION SAFEGUARDED?



COVID-19 brought to the forefront the necessity of having a strong balance sheet for nonprofits. Those organizations with limited liquidity and minimal reserves struggled mightily in fulfilling their missions. But those entities with ample resources not only survived but generally thrived.

Soup Kitchen A, whose leadership was proud to put every dollar raised into feeding the community for 20 years, found that at the time of greatest need it was forced to cut back on daily meals. Across the street, **Homeless Shelter B** had allocated a portion of each year's funding to building reserves and was able to expand its reach during the pandemic. In the early months of the crisis, its reserves allowed services to be maintained. And as time went on, donors rewarded their ability to deliver service by investing more deeply.

What are operating reserves?

An operating reserve is an unrestricted fund balance set aside to stabilize a nonprofit's finances by providing a cushion against unexpected events, losses of income and large unbudgeted expenses. Establishing adequate operating reserves is necessary to provide support to withstand unexpected financial shortfalls as they occur. The ability to draw on these reserves when unforeseen

circumstances arise, provides the organization a safety net so they can continue to focus on their programs and overall mission.

Many nonprofits have had to draw on their operating reserves to endure the economic outcome of the unexpected COVID-19 crisis. While many organizations wished they had maintained an operating reserve to draw upon during these extraordinary times, some organizations thrived by building up operating reserves from increased charitable giving and COVID-19 related federal funding received.

If your organization is considering an operating reserve or needs to replenish its reserves, now is the time to develop a plan for creating a policy and build up an initial operating reserve.

Why does my nonprofit need operating reserves?

Simply put, operating reserves offer protection. Having an appropriate level of operating reserves demonstrates sound financial responsibility to your stakeholders. These reserves also increase your odds for self-sufficiency, making you less vulnerable to unexpected events, loss of revenue, government funding cuts, large unbudgeted expenses and swings in investment income.

Operating reserves also can protect against staff or program reductions that would prevent you from achieving your mission. Reserves also can empower you to take advantage of sudden opportunities, such as the availability of new facilities or the ability to take on and staff a new program.

However, you generally shouldn't rely on reserves to make up for income shortfalls unless you have a realistic plan to quickly replenish the fund. Reserves are better applied to income-timing problems than to deficit issues.

How much do I need?

Every nonprofit organization's circumstances are different, so there is no single rule of thumb standard to follow when setting an ideal reserve level. At a minimum, it is suggested your organization should plan enough reserves to cover 3-6 months of operations, including payroll, fixed costs and other necessary

operating expenses.

Another suggested minimum is an operating reserve ratio of at least 25%.

OPERATING RESERVE RATIO = Operating Reserves ÷ Annual Expense Budget

When determining an ideal reserve level you should take into consideration important variables and factors that are specific to your organization such as:

- Organization's revenue streams and stability of receipts
- Dependency on government grants, donations or fundraising events
- Such funding can experience dramatic shifts due to political or economic changes
- The likelihood for unexpected opportunities requiring additional financial resources
- Organization's risks and threats
- Organization's mission, sector and geographic location
- Accuracy in the historical budgeting process and forecasting financial results
- Who's interested in your organization's operating reserve level?
- Donor's, clients and customers, the general public, regulators

Can I have too much in reserves?

Although it might sound counterintuitive, your operating reserves can become too large. At the high end, it is suggested that reserves should not exceed two years of your operating budget. Donors and sponsors want to see your organization using funds to achieve your mission and funding various program expenses, rather than accumulating excessive reserves of money. Charity watchdogs often monitor nonprofits' reserves and make this information easy for potential donors to view and assess. If your reserves are too high, donors may conclude that you don't need their money.

Building operating reserves

Budgeting and raising funds for the buildup the operating reserve takes time. In addition to designating annual operating surpluses to the reserve fund, other potential strategies include:

- An annual "addition to reserve" as a budgeted line item
- An option for gifting in a capital campaign and planned giving campaigns
- Designate a portion of annual board contributions
- Designate a percentage of one-time grants or gifts without donor restrictions
- Designate savings from temporary staff vacancies

Operating reserve policy

It is prudent for your organization to have an operating reserve policy in place. The policy should be reviewed and approved by management and the board of directors annually because what is appropriate today may be too much or too little for tomorrow. The size of your operating reserves is somewhat moot if your organization doesn't have a related policy in place.

A comprehensive operating reserve policy should include the following:

Statement of Purpose

- the reason your organization and board established the reserve
- what sources will be used to build the operating reserve
- budget surpluses, investment income, contributions without other restrictions

Usage Circumstances & Limitations

- how and when the funds can be drawn and used?
- minimum and maximum ideal reserve levels

Authorization for Use

- delegated authority(ies)
- role of the board or finance committee

Managing & Monitoring the Fund

- portion to be invested in low-risk, highly liquid
- process and timeframe for replenishment

The AICPA has a sample [nonprofit operating reserve policy](#), which is a good reference and starting point to utilize when developing your organization's own policy.

BMF's Nonprofit Team can help you determine the appropriate level of reserves and assist you with creating a reserve policy for your specific organization.