Operating Reserves: Not Just for Disaster Recovery

By Jim Hagestad

Do you need an operating reserve? If so, how big should it be?

Litigation, an economic downturn, the loss of a major donor — such events can catch your organization off guard and unprepared for the financial impact. The good news is that you can manage such situations if you have an operating reserve.

> "Your reserve needs can change from year to year."

Benefits of Operating Reserves

The chief benefit of an operating reserve is financial protection from unexpected revenue shortfalls or increased expenses. Added benefits include:

- **improved management** of risks
- **flexibility** to invest in new opportunities
- **better strategic** decision-making.

Determining the Right Amount

The board establishes an operating reserve to maintain a specific balance for operating purposes. How much is enough? There's no one formula that works for everyone. To determine an appropriate amount for your organization:

- **Identify potential risks** to your organization's financial health.
- **Estimate how long it might take** to manage each risk.
- **Quantify the potential revenue lost or expense incurred** by the risk.

Depending on your organization's circumstances, your reserve needs can change from year to year. For example, a nonprofit with a large donor base and a growing investment portfolio might decide that a three-month reserve is enough. However, if that same organization plans to construct a new building and obtain a loan to finance the project, a suitable reserve might be six months or more.

Therefore, you should also consider the factors below when determining an appropriate operating reserve amount:

Planned events. Future plans that involve large financial commitments will limit your operating flexibility. Even if the planned event doesn't occur for several years, you need time to build up a reserve beforehand.

Existing financing. An available line of credit gives your organization the ability to weather short-term fluctuations in cash flow. However, a line of credit that's in use for an extended period may indicate other cash flow difficulties. Principal and interest payments on long-term debt require cash for the life of the loan, reducing operating flexibility.

Sources and concentrations of revenue. Revenue derived from a small donor base can be more susceptible to

> Revenue derived from a small donor base can be more susceptible to competition.

competition from other nonprofit organizations and economic factors. In addition, if you derive most of your revenue from one or two grants, you're at risk should those grants be curtailed in future years.

Take time to analyze your financial risks, evaluate your weaknesses, and consider what might go wrong in the future. Then establish and maintain an operating reserve to help you weather those risks. By planning ahead, you'll be prepared to manage a potential financial crisis — and take advantage of future opportunities.

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Resources

Barr, Kate, "The Yin & Yang of Operating Reserves: What You Need to Know," *Nonprofit World*, Vol. 27, No. 1.

Cutt, James et al., "Do You Have Enough Cost Information to Make Good Decisions?", *Nonprofit World*, Vol. 15, No. 6.

These resources are available at NonprofitWorld.org/members.

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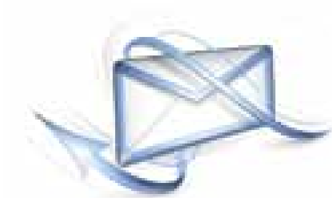

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