The Yin & Yang of Operating Reserves: What You Need to Know

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

By Kate Barr

If cash is king, as the adage says, many nonprofits feel more like paupers than royalty. Even when the budget is balanced and programs well supported, cash isn't always there when it's needed. Whether it's because of the timing of grants and seasonal income, or cash outlays for programs and computer purchases, cash balances are often volatile and can be difficult to manage. That's where operating reserves come in.

What are operating reserves?

You can think of an operating reserve as a sort of rainy-day savings account. It's an unrestricted fund balance set aside to stabilize a nonprofit's finances by providing a cushion against cash flow ebbs and flows. You can use reserves to pay unexpected and unbudgeted expenses like building repairs or for increases in budgeted costs like utilities or insurance. You shouldn't use reserves to make up for income shortfalls unless you have a plan to replace the income or reduce expenses.

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> You can establish opportunity reserves to provide seed funding for a new idea or innovation.

Sometimes reserves can help an organization weather a major funding reduction by buying time to implement new strategies. To be prudent, reserves should be used to solve timing problems, not systemic financial problems that will never be resolved.

Reserves are different from restricted funds. Restricted funds are grants and contributions that have been received for specific programs or projects. These funds are "restricted" for use according to the grant agreement or donor's instructions. Sometimes this means that restricted funds sit idle in the bank for a while and the nonprofit cannot use those funds for some other purpose. Reserves, on the other hand, are "unrestricted" funds that can be used in any way that the nonprofit's management and board chooses.

Where do reserves come from?

Occasionally, a nonprofit will receive a grant or contribution to create or add to an operating reserve fund. Usually, though, reserves are built up over time by generating a surplus and intentionally designating a portion of the excess cash as a reserve. The funds may or may not be set aside in a segregated account.

The board should create a policy describing when reserve funds can be used, who can use them, and how this use should be reported to the board. Some organizations note it as a "board designated reserve" on their financial statements.

Without such a policy, reserve funds tend to be gradually spent down over time, and aren't available when they're really needed.

When developing the policy, be sure to allow for some flexibility and ease of access. Reserves are there to help you operate programs and services, not to create an untouchable bank balance to admire.

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How big a reserve do you need?

While there are some rules of thumb for setting operating-reserve goals, they should always be accompanied by "it depends." Most standards are based on a formula that provides the organization enough cash to cover operating expenses for three to six months. At the high end, reserves shouldn't exceed the amount of two years' budget. At the low end, reserves should be enough to cover at least one full payroll, including taxes.

Keep in mind that standard calculations don't take some important variables into account, like the stability of the nonprofit's cash receipts. Organizations that have contracts or fees with regular and reliable payments don't need as much in cash reserves as organizations that rely on periodic grants, fundraising events, or seasonal activities.

When setting a target, consider the factors in Table 1. However, before you set a policy calling for a three or six month reserve, do some calculation to find out how much cash is involved, and whether it's an attainable goal.

For an example, consider a hypothetical agency that provides mental health services with a $2 million annual budget. A three-month reserve is $500,000. If the organization currently has $100,000 in unrestricted cash accounts, it will need to generate a $400,000 surplus to set aside enough to meet the policy. This is probably unattainable in the near future, and it may be far more cash than this agency needs. If the mental health services are paid for by third-party insurance payments and government contracts, cash flow may be stable enough that one month in operating cash, or $165,000, will be enough. If this agency set aside $500,000 in operating reserves, it would probably never use the funds, and protecting the balance could mean forgoing opportunities to improve programs, invest in staff development, and serve its mission in other ways. Many small organizations may never build up three months' worth of reserves, but they might access a short-term line of credit or manage expenses closely.

Table 1. What to Consider when Deciding How Big a Reserve You Need

Income characteristics	Reserves needed
Stable, reliable income and cash receipts such as ongoing government contracts and regular earned income	One or two months
Stable income with unreliable timing such as established grant sources, earned income with large but uneven receipts	Two to four months, based on cash flow projections
Seasonal income and receipts such as summer programs, special events, and large year-end fundraising	Six months, based on cash flow projections
Uncertain income sources and timing such as reliance on new grants or projects	Flexibility with expense levels is more realistic; six months' reserves would be ideal

What other kinds of reserves exist?

This discussion has focused on operating reserves designated to manage cash flow or short-term cash shortfalls and unexpected expenses. You can establish other kinds of reserve funds to build up cash balances for specific purposes. Examples include:

- facility reserves
- repair and replacement reserves
- program reserves (to support program continuation if income is uncertain)
- opportunity reserves (to provide seed funding for a new idea or innovation).

Each type of reserve needs the same kind of planning and policy as described for operating reserves. ■

Resources

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

Robinson, Bridget, "Financial Stability: An Impossible Dream?", *Nonprofit World*, Vol. 15, No. 3.

Robinson, Jean Hardy, "Monitoring Your Organization's Financial Health: A CEO's Guide," *Nonprofit World*, Vol. 14, No. 6.

Ruiz, Rosemarie, "Are You Fulfilling Your Financial Trust?", *Nonprofit World*, Vol. 17. No. 1.

These resources are available at www.snpo.org/members.

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