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Right-Sizing Long-Term Reserves

Selecting the Appropriate Long-Term Reserves Method Can Lead to a More Confident Investment Strategy

Nonprofit organizations face continuous pressure to achieve the goals set forth by their mission: they are expected to maximize the impact of the assets they've collected while minimizing costs and ensuring that prudent risk management strategies are in place. Often, when reserves on the balance sheet seem excessive, the organization's membership may request a dues holiday or ask the board to spend money on new initiatives as a way to soak up reserves that appear to be overfunded.

When members make these types of comments or recommendations about how to drive down an organization's operating reserves, they reveal two common misconceptions:

1. Nonprofits cannot be profitable.
2. A nonprofit's long-term reserves must be kept at a minimum to demonstrate that proper due diligence policies are in place.

Unfortunately, these misconceptions can lead nonprofits to make short-sighted decisions that put the long-term health of the organization at risk. When long-term reserves are properly allocated and left intact for optimum growth potential, they can strengthen an organization's ability to withstand unforeseen challenges, as well as maximize investment dollars for future mission-related activities.

Also offered are four methods on how to calculate the right amount of assets for your organization's long-term reserves. Understanding the pros and cons of each method will help you determine the best method for your nonprofit and help address critical questions from members about how assets are being allocated in pursuit of your organization's mission.

This paper is intended to help nonprofit volunteers and executives understand the relationship between operating reserves and long-term reserves, and to help them fund each bucket more effectively to not only protect their organization from risk, but maximize the growth potential of existing assets.

Protecting Your Organization From Risk

How long could your organization continue to fulfill its mission if there was an unexpected loss of income or a surge in demand for your services? This question was the key driver that compelled experienced nonprofit professionals to form a working group in 2008 that resulted in the development of the **Nonprofit Operating Reserves Initiative** (**NORI**).

The initiative had two key objectives:

1. define "operating reserves" and
2. establish guidelines to help nonprofit leaders determine benchmarks for financial stability specific to their organizations.[1]

The collaborative efforts of the working group resulted in an industry white paper, "Maintaining Nonprofit Operating Reserves," that was published in January 2009, and a toolkit released in September 2010. These documents have been endorsed by many prominent nonprofit organizations and businesses concerned with the well-being of the sector.

This white paper leverages much of the good work of these professionals and strives to move the conversation forward to guide nonprofit leaders in continuing to make smart decisions about the future of their organizations.

What Are Total Operating Reserves

One of the outcomes of the industry working group was to define operating reserves, which they determined were assets without external restrictions[2] (or perhaps with internal restrictions) that nonprofit boards maintain, formally designate or reserve for use in emergencies and long-term financial stability. These funds, in total, are to be used to sustain financial operations in the unanticipated event of a significant unbudgeted increase in operating expenses and/or losses in operating revenues.[3]

In essence, operating reserves increase an organization's ability to absorb or respond to unforeseen circumstances. The amount of accumulated net assets without donor or board restrictions is increased or decreased as the result of annual operating surpluses or deficits. Nonprofits pursue financial stability by budgeting for and then achieving reasonable, modest surpluses annually until they have met their operating reserves objectives.

Why Nonprofits Need Operating Reserves

Building and maintaining healthy operating reserves helps ensure sufficient funds are available to manage cash flow on a day-to-day basis and maintain financial flexibility. For example, operating reserves can enable an organization to accept government grants that reimburse expenses after the fact, since it can handle occasional delayed grant payments. The presence of operating reserves promotes public confidence that the organization is stable and that funds donated to the organization will have a lasting impact.

Many small- and mid-sized nonprofit organizations are founded by entrepreneurial-type visionaries who are, in many ways, similar to their for-profit counterparts. Nonprofits are, in essence, businesses whose profits (called surpluses) remain with the nonprofit.

It is important to dismiss the misconception that "nonprofit" means "no surplus allowed." Just as for-profit businesses need working capital to operate at peak performance, nonprofits need the equivalent in operating reserves. The distinction here is that nonprofits are exempt from paying most federal income taxes under Section 501(c) of the Internal Revenue Code.

Without operating reserves, nonprofits can be thrown into cash flow stress and become easily distracted from smart long-term decision-making or forced to make expensive short-term crisis-based decisions. In some cases, they could even be forced to discontinue the delivery of certain programs or initiatives. Organizations with no operating reserves are often forced to focus solely on the short term and are less likely to engage in responsible long-term planning.

Evolving Operating Reserves for Better Outcomes

With the release of NORI's insights and toolkit nearly a decade ago, many nonprofits have accepted and implemented the strategies set forth by industry professionals. We recommend taking their guidelines one step further by distinguishing between current and long-term operating reserves:

CURRENT OPERATING RESERVES are the balance sheet assets reserved for use in emergencies during the current budget year. These reserves can be used for meeting commitments, obligations or other contingencies for day-to-day current operations. They can represent a percentage of total operating expenses or an equivalent amount of monthly expenses for a period of time, i.e., six months or one year. This amount is determined through the annual budgeting process.

LONG-TERM RESERVES are the balance sheet assets reserved for managing emergencies and long-term risks beyond the current year. These reserves protect the mission of the organization over the life of its purpose and cause. While long-term reserves can be considered as having a perpetual time horizon, we suggest using a 7 to 10-year span for investment planning and asset allocation modeling.

Expanding the scope of operating reserves to differentiate current from long-term reserves provides nonprofits with flexibility to invest their long-term reserves more effectively for the benefit of the organization. However, this added nuance makes striking the right balance between the current operating reserves and long-term reserves extremely important. It also dictates the amount of acceptable risk an organization's balance sheet can handle.

Taking Operating Reserves One Step Further

The accounting profession recently provided some guidance to better understand appropriate levels of operating reserves.

In August 2016, the Financial Accounting Standards Board issued Accounting Standards Update No. 2016-14, Presentation of Financial Statements for Not-for-Profit Entities.[4] As part of this new standard, nonprofits are now **required** to disclose both qualitative and quantitative information about liquidity and services in the footnotes to the financial statements:

The qualitative information describes how a nonprofit manages its liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date.

The quantitative information describes the availability of a nonprofit's financial assets to meet cash needs for general expenditures within one year of the balance sheet date.[5]

These are extremely useful guidelines in determining current and long-term reserves as nonprofits need to reduce the availability of liquid financial assets by

1. external limits imposed by donors, laws and contracts with others and
2. internal limits imposed by board decisions.

A formal policy needs to be developed and disclosed in the footnotes regarding managing the nonprofit's liquidity needs. It may also be appropriate to incorporate information about operating reserves into the nonprofit's Investment Policy Statement and review this information on an annual basis.

Key Considerations for Setting Long-Term Reserves

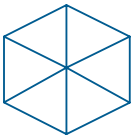
When determining the appropriate amount of long-term reserves for your organization, there are a number of important questions to consider:

WHAT IS THE PURPOSE OF THE LONG-TERM RESERVES? There is likely more than one answer for every organization, but managing long-term risk should be at the top of the list. Identifying what these risks are and assigning a value to them will help set the benchmark for how much to attribute to your long-term reserves. These risks include, but are not limited to, industry or economic slowdown, reduction in membership, an uninsured catastrophe or a catastrophe for which an insurance claim could be held up in the courts or negotiations for a long time, or simply depreciation of real estate.

WHAT FACTORS IMPACT THE SIZE OF THE RESERVES? It's important to recognize 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 reassess the reserves goal. For instance, a slower economy may reduce donor generosity for charitable contributions or your members' ability to pay dues.

WHO IS MOST INTERESTED IN THE SIZE OF THE RESERVES? Beyond the obvious interested parties — management and the governing board — this list may include donors, clients or customers, members of the association, employees, the media, regulators and the public. It's important for organizations that appear "wealthy" (e.g., more than 12 months of budget in the bank) to be prepared to explain to prospective donors, members and clients why there is still a need for additional funds beyond what is often perceived as high fees or dues or additional charitable contributions. Inability to do so effectively will make it very difficult to attract the right resources.

ARE THERE ANY LEGAL OR TAX RESTRICTIONS AS TO HOW MUCH A NONPROFIT CAN ACCUMULATE WITHOUT PUTTING ITS TAX-EXEMPT STATUS AT RISK? The answer is "no" as long as the accumulated assets are being used to further the organization's exempt purpose. For wealthier nonprofits, this is achieved by investing a large part of the assets in accordance with donor restrictions on gifts and using the income to help pay for operations.



Four Methods for Determining Long-Term Reserves

We believe every organization should have liquid, unrestricted assets available to mitigate risks or pursue opportunities of strategic importance to advancing the organization's mission. The challenge is determining the right amount that fits your organization's unique business model and associated risks.

Unfortunately, there is no simple answer. Despite its importance, there is no "one size fits all" formula or benchmark for determining the right amount to allocate to long-term reserves. The determination of which method to use depends on an individual organization's mission and its particular revenue and spending risk.

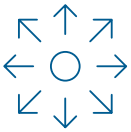
We've identified four common methods for determining long-term reserves, along with pros and cons for each method and key questions to help determine which method is most appropriate for your organization. We recommend that once a method is chosen, the leadership team should review the experience and process regularly, and at least every five years as part of the organization's overall risk assessment.

1. Percentage of Total Annual Operating Budget

DESCRIPTION:
This method uses a fixed percentage that is applied to the annual operating budget. Benchmarks suggest a minimum of 25% (or three months of operating expenses); however, some research suggests a level of 50-100%[6], depending on the types of funds needed in the reserve, as well as the risk of an organization's revenue flow and expense volatility.

PROS:
- Simplest method to determine reserves level
- Favored by many nonprofit organizations due to simplicity

CONS:
- Doesn't specify what the reserves are intended to cover
- May result in reserves that are either too high or too low, usually too high after investment appreciation
- If operating budget increases, so too do the reserves, which may result in being overfunded



2. Designated Funds for Specific Purposes

DESCRIPTION:
This method identifies specific "buckets" for how the reserves will be used. Each bucket can have its own calculation. These buckets could be for legal contingencies, building and maintenance reserves or for designated long-term goals or projects.

PROS:
- Allows leadership team to make strategic decisions about how funds will be used
- Applies a "bottom's up" approach to building each bucket

CONS:
- Requires an investment of time by the leadership team
- Requires some type of strategic plan to enable leadership team to identify each bucket and how much to set aside for each bucket
- Could lead to being over-reserved if not monitored as volunteer governance changes and goals change, which changes the time horizon of invested dollars

3. Risk-Based Analysis

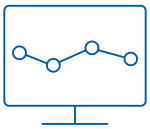
DESCRIPTION:
This method considers the likelihood of all risks for the organization over the next seven to 10 years and calculates a discrete amount for each one identified. The individual amounts are then added together to arrive at the estimated reserve target over a longer time horizon than the operating reserve. Recently, this approach has become popular in reassessing long-term reserves.

PROS:
- Targets are based on historical data, prior experience and future projections
- Assigns assets to specific high-risk areas of concern
- Allows leadership team to prioritize, or tier, each risk
- Helps determine future risks in contracted obligations

CONS:
- Requires an investment of time by the leadership team or hiring an experienced consultant
- Internal departments may not have information or understanding of risks
- Requires an assignment of probability, which could be over or understated
- Requires time potentially for internal departments to determine their risk to roll up for senior leadership to assess
- Presumes many unknowns and predicting unintended consequences
- Provides extra analysis of keen exposure in contracted obligations

Risk-Based Analysis Example

		% Probability	Total Exposure	Weighted Exposure
Department A	Risk 1	80%	$2,000,000	$1,600,000
Department B	Risk 2	60%	$5,000,000	$3,000,000
Department C	Risk 3	40%	$7,000,000	$2,800,000
Department D	Risk 4	20%	$12,000,000	$2,400,000
Department E	Risk 5	10%	$15,000,000	$1,500,000
Long-Term Reserves				$11,300,000



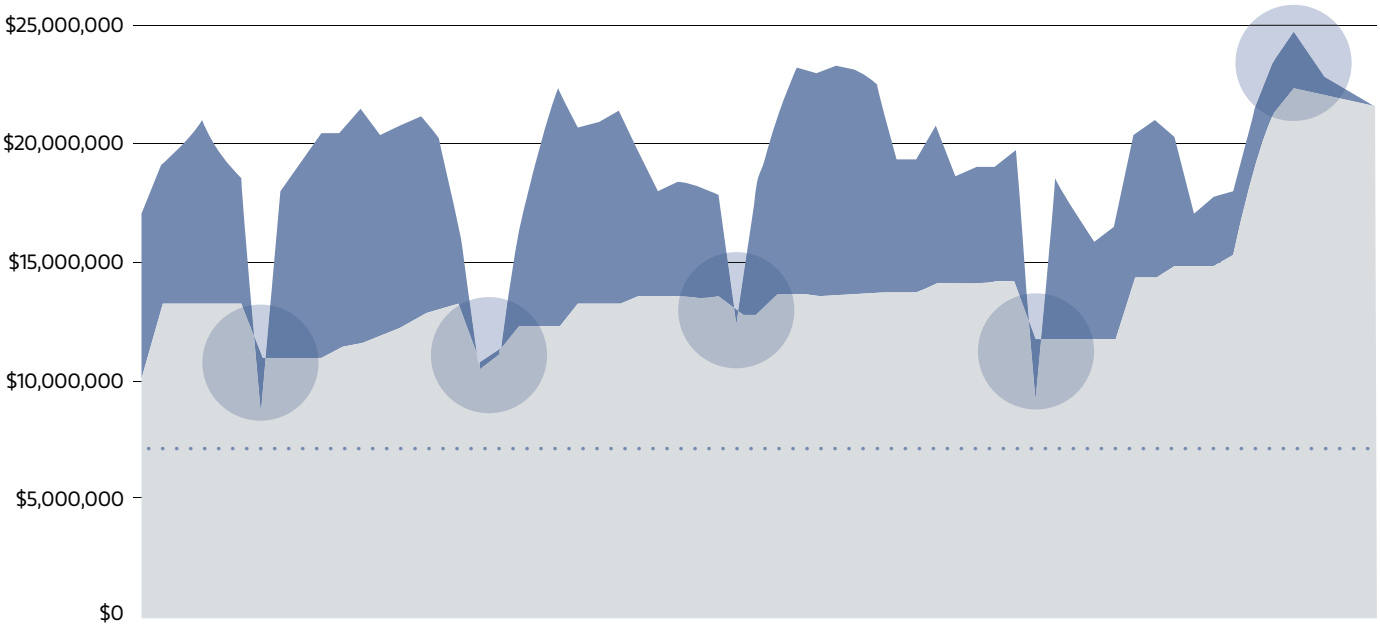
4. Quick Ratio on the Balance Sheet

DESCRIPTION:
Organizations determine this ratio by analyzing three to five years of data to determine the annual high and low balance of their total liquid assets. The value of the liquid assets at the lowest balance level is designated as long-term reserves. The remaining assets are considered operating reserves. This method can be quick and easy for organizations with steady and predictable member dues cycles or revenue.

PROS:
- Easy to calculate and update the reserves amount annually
- Useful for nonfinancial volunteers to visualize cash flow and weigh in on how much should be in long-term reserves

CONS:
- Only based on historical asset performance and accumulation.
- Uses historical data and is not forward-looking to anticipate changes in revenue or external factors

Quick Ratio on the Balance Sheet Example



Operating Reserves Long-Term Investment Portfolio

FOR ILLUSTRATIVE PURPOSES ONLY

Key Risk Factors to Consider When Determining Your Long-Term Reserves

When developing your current operating reserves and long-term reserves, begin by examining common factors at play within your organization. There are two main areas that create a risk of volatility: factors that impact revenue and factors that impact spending. Here are some core issues that impact both.

REVENUE RISK FACTORS

- Stability of donated revenue for primary sources
- Predictability of pledge collections
- Reliability of government grants and contracts
- Level of dependence on one or two major donors
- Foundation policies on overhead and annual support
- Economic health of the community
- Timing of funding commitments to agencies
- Likelihood of natural disasters, such as floods, hurricanes or earthquakes, especially if the organization's mission involves disaster relief
- Publicity that could adversely affect current or future revenues
- Certain regulatory changes, including tax law changes
- Negative tax or regulatory issues, which affect member expenses and potentially dues
- Industry consolidation and attrition reducing the revenue base
- Concentration of revenue sources, i.e., trade show or too few large members
- Market forces and/or industry disruptors, i.e., publishing

SPENDING RISK FACTORS

- The extent to which economic downturns or other types of events may affect demand for services, either up or down
- The extent of funding commitments made for longer than a year
- Amount of unsecured debt carried by the organization
- Long-term leases with substantial penalties for cancellation
- Level of dependency of programs on stable, individual funding streams
- Ability to downsize operations quickly and still provide services to the community, clients or members
- The need to fund crisis communications on a major or national level
- Negative tax or regulatory issues, which increase spending for lobbying, policy advocacy and research
- The need to fund litigation to protect the industry or members

Source: Operating Reserve Policy Toolkit for Nonprofit Organizations. First Edition, September 15, 2010.

Conclusion

Current operating reserves and long-term reserves are critical to supporting an organization's fiscal operations and ultimate longevity. We consider the funds to be mutually exclusive, with the long-term reserves rarely accessed for emergency situations or policy matters unforeseen during the annual budgeting process and the current operating reserves more regularly accessed for day-to-day unanticipated operations. Having a formal process and method for determining the amount allocated to long-term reserves will enable the organization's leadership team to address questions from members and donors about the size or purpose of the reserves. It also enables the board to invest the reserves more effectively, knowing they will only be tapped in case of a long-term emergency to allow for the continuation of their mission. This strategy potentially allows for more optimal investment performance results as the reserves can be invested using investment strategies that are designed specifically for the long-term growth of the organization and/or more strategic spending over a longer time horizon, such as seven to 10 years.

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[1] The Urban Institute, the Nonprofit Operating Reserve Initiative, page 1, updated June 2016.

[2] Effective July 1, 2019, the new term to be used is "net assets without donor restrictions." Financial Accounting Standards Board, 2016-14. https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168381847&acceptedDisclaimer=true.

[3] Operating Reserve Policy Toolkit for Nonprofit Organizations. First Edition, September 15, 2010.

[4, 5] Financial Accounting Standards Board, 2016-14. https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168381847&acceptedDisclaimer=true.

[6] Association Operating Ratio Report, 15th edition

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