



OPERATING RESERVE POLICY TOOLKIT FOR NONPROFIT ORGANIZATIONS

FIRST EDITION
(SEPTEMBER 15, 2010)

Sponsored by the National Center for Charitable Statistics, Center on Nonprofits and Philanthropy at the Urban Institute, and United Way Worldwide

Link: http://www.nccs2.org/wiki/index.php?title=Nonprofit_Reserves_Workgroup

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PREFACE

After publishing its whitepaper titled *“Maintaining Nonprofit Operating Reserves”* in January 2009, some members of the Nonprofit Operating Reserves Initiative Workgroup formed the Operating Reserves Policy Toolkit Workgroup as a logical follow up. Members of the Toolkit Workgroup have compiled this “Operating Reserves Policy Toolkit” to serve as a technical reference for nonprofit board and staff policy committees, as well as their financial consultants and professionals, as they respond to the message of the whitepaper.

This Toolkit was created to provide a resource to:

- help to make a compelling case within the organization for the need to establish an operating reserve,
- provide factors to take into consideration in determining the size of the operating reserve for their organizations,
- suggest practices for managing the reserve and reporting its balance, and
- offer some tools with which to go about drafting a policy to record decisions.

This document also seeks to put forward common terminology for referring to operating reserves that, frankly, we hope will take hold among nonprofit organizations and their funders, donors, and financial professionals. And we hope that it will become commonly understood and accepted that nonprofits of all sizes need to have operating reserves at a level appropriate to their own circumstances.

The main body of this document defines an operating reserve, presents the rationale for creating one, and discusses a variety of issues that may affect the policy an organization ultimately creates to establish, build, manage, and maintain its operating reserve. The appendices are for the use of the person(s) leading the policy development project within the organization, so the process does not have to start from scratch. The appendices include policy outlines, sample policy language, worksheets to help in determining the appropriate ratio/size for the reserve, illustrations for how the operating reserve can be clearly shown in an organization’s internal and external financial reports, how an organization might consider investing its reserve funds, and references to several useful papers, articles and websites. The appendices also include a glossary, which we hope will encourage everyone to use consistent terminology in referring to operating reserves and reserve components.

Use these tools. Please. Copy, paste, customize. Give us your feedback and share tools with us that you have developed so we can continue to improve the web-based Operating Reserves Policy Toolkit and other training and implementation materials. **Register** with us so we can inform you of updates. Our mission is to spread the word and share the tools that will facilitate better long-term financial sustainability among the vital nonprofit organizations that save and enrich our lives.

Nonprofit Operating Reserves Initiative Workgroup (NORI)
September 15, 2010

EXECUTIVE SUMMARY & ACKNOWLEDGEMENTS

The Nonprofit Operating Reserves Initiative (NORI) white paper titled *“Maintaining Nonprofit Operating Reserves”* called for organizations to make maintaining an adequate level of operating reserves their top priority. While this may seem obvious, preliminary research indicates that many organizations neglect to put aside funds that will help them preserve their capacity to deliver on their missions in the event of unforeseen financial shortages.

The fact is numerous nonprofits have negative reserves and are already at risk. The NORI Work Group recognized that the current economic crisis threatens the very existence of thousands of nonprofit organizations. At a time when nonprofit organizations may be focused on survival, the thought of building reserves may seem a distant priority. But for organizations currently just hanging on that expect to survive this crisis, and those in relatively stable current financial condition that seek to fortify their position, the Work Group encourages including operating reserves in the planning process. Organizations that review their policies closely and devise plans for replenishing their operating reserves to an agreed upon adequate level will emerge from this current economic crisis in a stronger financial position, ready to withstand the next challenge that arises.

Briefly, the term “operating reserves” refers to the portion of “unrestricted net assets” that nonprofit boards maintain and/or formally designate or “reserve” for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. “Unrestricted net assets” is a required line item in the balance sheets of financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and IRS Forms 990 of nonprofit organizations.

The amount of accumulated unrestricted net assets 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 year after year until they have met their operating reserves objectives.

Nonprofits can ask the following two questions to facilitate internal discussions about adequate operating reserves for financial stability.

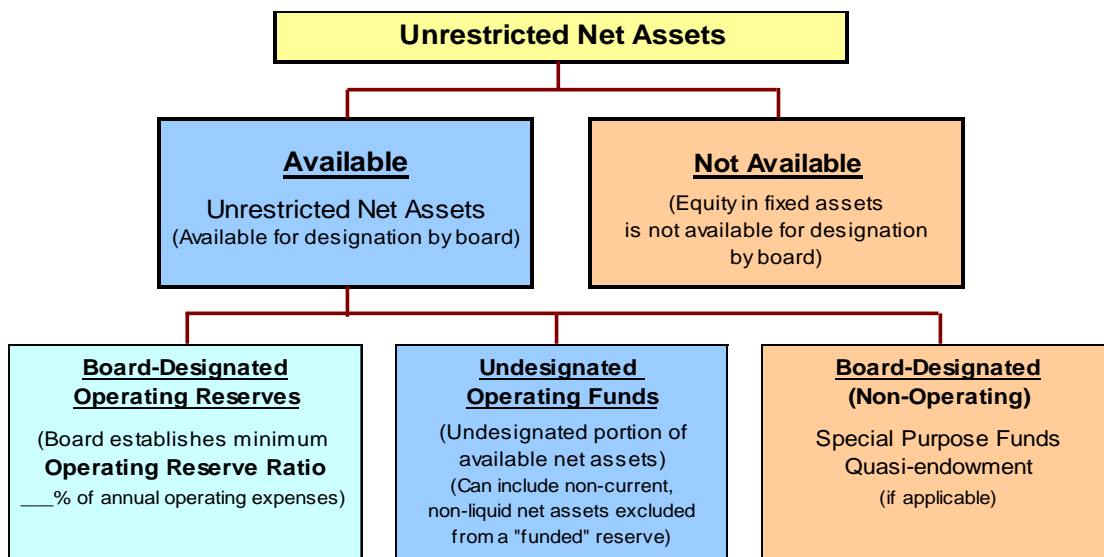
- 1. What does it mean to be financially stable?**
- 2. What are adequate operating reserves?**

According to Richard Larkin, CPA, National Technical Director of Not-for-Profit Accounting and Auditing, BDO USA, LLP, the answer is, “It depends.” Mr. Larkin goes on to say, “It is best to start by saying that, based on the literature available, there is simply no single correct solution for all organizations. Despite the importance of the issue there exists no agreed upon industry benchmark. To complicate matters further, such benchmarks as are commonly used must be viewed in the context of the particular organization to which they are being applied.”

The NORI Workgroup recommended that nonprofit boards establish a minimum operating reserve ratio policy. An organization’s *Operating Reserve Ratio* can be calculated in terms of a percentage (operating reserves divided by the annual expense budget) or number of months (operating reserves divided by the average monthly expense budget). The minimum operating reserve ratio at the lowest point during the year suggested by the Workgroup is 25 percent, or 3 months of the annual expense budget. The adequacy of operating reserves beyond the minimum is variable and depends on factors such as the reliability of operating revenues and impact of economic conditions among others. This Operating Reserves Policy Tool Kit is intended for use internally by nonprofit staff and boards, not by outside watchdog groups or other external evaluators.

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

“Available unrestricted net assets” are the portion of total unrestricted net assets, including operating reserves, that are available for designation by the board for various purposes. The definition for “available unrestricted net assets” is unrestricted net assets less the equity in fixed assets – i.e., fixed assets net of related long-term debt.



Some organizations go further and account for funded operating reserves as net assets and assets. They employ fund accounting methods where assets consisting of solely of liquid assets – i.e., cash and cash equivalents -- correspond to their board-designated operating reserves portion of net assets. In this way, board-designated operating reserves exclude (in addition to equity in fixed assets) other non-current assets, net of related liabilities, such as long-term receivables, inventory, prepaid expenses and deposits held by others. Thus, these non-current assets are excluded from the calculation of operating reserve ratios. See Figures C3 and C5 in Appendix C for illustrative statements of financial position (balance sheets) that reflect this practice.

In support of its call to action, the NORI formed a technical workgroup to draft guidance for nonprofit organizations to use in establishing operating reserves and operating reserve policies. Additionally, this guidance attempts to standardize the definition of terms used, identify the various types of reserves appropriate for various organization and offer what, in NORI's opinion, could be considered "best practice" for organizations.

In the winter of 2010, the workgroup presented, and NORI approved, this document as a guide for the nonprofit sector. This publication is the result of the dedicated efforts of both NORI and other leaders of the nonprofit financial community, representing both large and small organizations. Their insights and contributions to this publication helped to create a document appropriate for use by all nonprofits, regardless of size.

As noted above, this Operating Reserves Policy Tool Kit is intended for use internally by nonprofit staff and boards, not by outside watchdog groups or other external evaluators.

It is the hope of NORI that all organizations will consider the value of establishing and maintaining adequate levels of operating reserves in keeping with the spirit of good stewardship. To that end, we offer this guide as a starting point and encourage each organization to embrace its principles.

The Nonprofit Operating Reserve Policy Toolkit Workgroup

September 1, 2010

Nonprofit Operating Reserve Policy Toolkit Workgroup

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We also wish to acknowledge the contributions of the following Toolkit Sponsors:

Lead Sponsors (*The lead sponsors provided staff support, IT web services and other resources for the development of the tool kit.*)

- National Center for Charitable Statistics, a program of the Center on Nonprofits and Philanthropy at The Urban Institute
- United Way Worldwide, Membership & Financial Accountability Department

Supporting Sponsors (*Supporting sponsors endorse the Operating Reserve Policy Initiative and its mission “to help nonprofit organizations establish board-approved policies for maintaining operating reserves at levels adequate for achieving financial stability.”*)

- Association of Fundraising Professionals
- Better Business Bureau (BBB) Wise Giving Alliance
- BoardSource
- Greater Washington Society of CPAs
- GuideStar USA
- Merrill Lynch
- National Arts Strategies
- National Center on Nonprofit Enterprise
- National Council of Nonprofits
- National Grants Partnership
- National Human Services Assembly
- Not-for-Profit Banking Group, M&T Bank

FOREWORD: NONPROFITS AND SQUIRRELS

by Richard F. Larkin, C.P.A.
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Most of us have at least a few “squirrel” tendencies. It is comforting to have something put aside for the winter or the proverbial rainy day. In an organization, this stash is referred to as its “operating reserve;” it is what keeps the doors open during a temporary financial drought.

A frequent question in the nonprofit sector is, how much operating reserve should we have? However, the simple answer: as much as possible, is not really simple. Consider the following scenario: You graduated from a large private university, with total assets exceeding ten billion dollars (this describes several American universities.) You are, therefore, likely the recipient of an unending stream of appeals for you to contribute to their annual fundraising campaign. You consider your personal balance sheet; you look at their balance sheet, and – unless your name is Gates or Soros – you probably think, “They want *me* to send money to *them*???”

Being rich, in the nonprofit sector, is not an unmitigated blessing. Indeed, wealth allows you to avoid worrying about where the money is coming from to pay the next payroll, and to expand your services to the community. But it can cause headaches too, such as having to deal with a union representing your employees who understandably assume that with all that money in the bank, a large raise could easily be afforded. More than one university and orchestra – to name just two parts of the nonprofit sector – have faced this very real challenge.

Of course being poor is not the answer either. Then you do have to worry about keeping the doors open, and you are not able to offer all the community services you would like to offer.

But what is the right amount? How should nonprofit leaders go about deciding on an appropriate level of reserves for their organization, given that life is inherently uncertain?

First, recognize that this is partly a personal decision; there is no absolute answer. Some people (boards and managers) are not uncomfortable living on the edge, and trusting that resources will appear; others like that warm fuzzy feeling of knowing a cushion is there. Your board probably includes some of each type. I am reminded of the story of the three bears and the bowls of porridge; Goldilocks thought one bowl of porridge was too hot; another too cold, and the third just right. Of course, the porridge in all three bowls was actually the same temperature!

Second, realize 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 reserve goal. Similarly, organizations in different places may well need different reserves.

Next, consider who is interested in a nonprofit’s reserve level. Besides the obvious – management and the governing board, I suggest this list includes: donors, clients/customers, members (of an association), employees, the media, regulators, the general public.

People often ask, is there some IRS or other legal limit on how much a nonprofit can accumulate without jeopardizing its tax-exempt status? The answer is, no – as long as the accumulated assets are actually being used to further the organization’s exempt purpose. For many wealthy nonprofits, this is achieved by investing a large part of the assets – often in accordance with donor restrictions on endowment gifts, and using the income to help pay for operations. Most universities, orchestras, museums, and other nonprofits spend so much more on providing their services (education, concerts, exhibits, and so on) than they take in from tuition, ticket sales, admissions, etc., that, to stay solvent, they still need the additional money from annual giving. Also many nonprofits require sizable amounts of resources invested in property (classrooms, laboratories, dormitories, concert halls, collections, exhibit space); these resources are not available to pay today’s light bill or faculty salaries.

What is very important for organizations that appear wealthy (say, more than 12 months’ budget in the bank) is to be prepared to explain to prospective donors, parents paying their children’s tuition, concertgoers, the media, etc., why there is still a need for additional funds beyond what is often perceived as high tuition, ticket prices, etc. Inability to do that effectively will make it nearly impossible to attract the required resources.

Similarly, organizations that appear poor need to be able to convince, say, a prospective donor that a gift will not be wasted; that the organization will be around long enough to accomplish useful outcomes.

Now, why does an organization need operating reserves? To be able to handle uncertainties? What could happen?

- *Unexpected shortfall in revenue.* This could result from unexpected external events – September 11th comes to mind, as does a blizzard the day of your big annual gala fundraiser; general poor economic conditions – we have been seeing this recently; organizational problems generating unfavorable publicity which turns away customers and donors; overly-optimistic budgeting of anticipated revenue (very common); and many other reasons.
- *Unexpected demands on your resources.* Examples might again be September 11th – if you are the Red Cross of New York, the same blizzard – which causes your roof to collapse, or the university’s labor union gaining a wage increase.
- *Unanticipated opportunities.* Recently an extremely rare major dinosaur fossil became available at public auction. Museums knew that it would sell for a high price, and it did. If your museum wanted this for its collection, it had to have resources available to cover the cost. (In the real case, the winning bidder managed to quickly tap some large corporations to help, but still had to put up quite a bit of its own money.)
- *The inevitable instances of less than perfect judgment and foresight.* A project that everyone thought would succeed, didn’t. The foundation grant that you thought was in the bag, wasn’t.
- *A change in direction is called for.* A long-standing program just isn’t what’s best any more. Community needs have shifted. Resources are required to phase out the old and bring in the new. The parallel here is to seed capital in a business.

- *Normal day-to-day fluctuations in income and expenses.* Accountants refer to the reserves needed here as Working Capital. Payrolls have to be paid every payday. The electric company is likely to want cash, not a promise, to keep the power flowing. But income often comes in spurts, especially contributions.

Often there are seasonal factors. For example, many contributions probably arrive in December as donors do personal tax planning. Colleges collect tuition at the beginning of each semester, and then have to live off it until next semester. Orchestras sell season tickets in the spring to pay for concerts to be put on over the following winter. On the other side, utility costs are probably higher in the winter and summer (heating and air conditioning), but lower in between.

Every organization should plan for its operating reserves. Consider how the above uncertainties might affect you. Your board, with advice of management, should adopt a formal policy for the reserve level it wishes to maintain, and review that policy regularly. Of course you cannot just make reserves appear on command; it may take an extended period to accumulate the desired level.

Related to this is continuing tension between wanting to spend currently everything we possibly can – because the need for our services is great, vs. putting something aside for the future. (Squirrels must be well programmed to handle this, as there are always lots of squirrels still around at winter’s end.) That tension is part of every organization’s (and person’s) existence.

There should also be Plan B. For nonprofits this can be some combination of: cash on hand, surplus assets that can be sold, a bank line-of-credit, a local foundation that you know would help in a pinch, some individual donors who could be counted on if the going gets really rough, or a plan to cut expenses to a bare bones level for a while.

Ask yourself, which organization needs larger operating reserves: (1) the Los Angeles Red Cross – think major, immediate, unpredictable events, or (2) a local day care center that owns its building debt-free, has a full roster of clients and a waiting list, adequate insurance and a reliable funder that covers most of its operating budget? Now, where do you fall on that continuum?

OPERATING RESERVES AND OPERATING RESERVES POLICIES GUIDELINES FOR NONPROFIT ORGANIZATIONS

“Operating Reserves”: What are they and why have them?

The “what and why” of having **operating reserves** are intertwined and fundamental. In its very simplest concept, an operating reserve is a rainy day fund¹, and people have such funds because they provide shelter from the storm.

Operating reserves are essentially the accumulation of unrestricted surpluses that are available for use at the discretion of an organization’s board. The presence of an operating reserve increases an organization’s ability to absorb or respond to temporary changes in its environment or circumstances, for example the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. In volatile economic times, an operating reserve could sustain an organization through delayed payments or cutbacks in funding from government agencies or foundations.

Building and maintaining an operating reserve helps to ensure that sufficient funds are available to manage cash flow on a day-to-day basis and maintain financial flexibility. For example, an operating reserve could allow an organization to accept government grants and contracts that reimburse expenses after the fact because it could handle occasional delayed grant payments. The presence of an operating reserve promotes public and funder confidence that the organization is stable and that funds invested in the organization will have a lasting impact.

Numerous small and midsized nonprofits are founded by entrepreneurial visionaries who are in many ways comparable to their counterpart for-profit business owners. Nonprofits are in fact businesses whose profits (surpluses) remain with the (nonprofit) corporation rather than going to individuals or shareholders as in the for-profit business model. Note: “not-for-profit” does not mean “no surplus allowed.” Just as for-profit businesses need working capital to function at peak capacity, so do nonprofits need the equivalent in operating reserves.

Without an operating reserve, an organization can be thrown into cash flow stress and become distracted from good long-term decision-making, or forced to make expensive short-term crisis-based decisions, or worse; it may not have the resources to continue delivery of its programs. Organizations with no operating reserves and limited or negative **operating funds** by necessity focus on the short term and are less likely to engage in responsible long-term planning.

¹ State Rainy Day Funds by **ELAINE MAAG, ALISON MCCARTHY**, TAX POLICY CENTER, THE URBAN INSTITUTE (2006); States use rainy day funds (RDFs), or budget stabilization funds, as a cushion against financial shocks.
www.urban.org/url.cfm?ID=1001024

OPERATING RESERVES DEFINED

“Operating Reserves” means the portion of **unrestricted net assets** that are available for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. This tool kit provides *three* definitions for operating reserves: Board-designated (recommended), undesignated (simplified, not recommended*) and available (simplest, not recommended*).

Definition I

Board-Designated Operating Reserves (recommended) are defined as the portion of “available unrestricted net assets” that the Board has *designated* for operating reserves. “Available unrestricted net assets” equals total unrestricted net assets less equity in fixed assets. Assets related to Board-designated operating reserves are typically invested in cash, near-cash or other low-risk investments. Access to these funds would require Board approval since they are Board-designated. The amounts of Board-designated operating reserves, **undesignated operating funds** and other unrestricted net asset funds can be calculated as follows:

Total Unrestricted Net Assets:	\$1,732,950
Less Equity in Fixed Assets:	<u><\$ 476,300></u>
Available Unrestricted Net Assets	\$1,256,650
Less Board-Designated Funds for Specific Purposes	<u><\$ 775,000></u>
Less Board-Designated Operating Reserves	<u><\$ 350,000></u>
Undesignated Operating Funds	\$ 131,650

See also Figure C2 in Appendix C – Illustrative Statements of Position.

Board-designated operating reserves can be used as an internal line of credit during the year when Undesignated Operating Funds are depleted. However, it would typically only be accessed according to Board-approved operating policy or Board action taken in response to the specific financial situation.

If Undesignated Operating Fund balances are negative at the end of the fiscal year, Board-Designated funds are adjusted downward as needed.

It is strongly recommended that organizations with **fund accounting** systems use a ***funded operating reserve***, where a Board-designated operating reserves *fund* is established consisting of specifically identified and segregated liquid assets and investments. Assets and net assets for this *fund* are accounted for *separately* from those of the Undesignated Operating Fund. This Board-Designated *Fund* may be presented in the asset and net asset sections of an annual audit’s statement of financial position – or only in the net asset section.

See Figures C1, C2 and C5 in Appendix C – Illustrative Statements of Position.

OPERATING RESERVES DEFINED – CONT'D

Definition II

Undesignated Operating Reserves (simplified, not recommended*) are defined as the portion of “available unrestricted net assets” that has *not* been designated by the Board for other specific purposes. This definition is not recommended because it combines operating reserves with day-to-day operating funds.

The amount of **undesignated operating reserves** can be calculated as follows:

Total Unrestricted Net Assets:	\$1,732,950
Less Equity in Fixed Assets:	<u><\$ 476,300></u>
Available Unrestricted Net Assets	\$1,256,650
Less Board-Designated Funds for Specific Purposes	<u><\$ 775,000></u>
Undesignated Operating Reserves	\$ 481,650

See also Figure C3 in Appendix C – Illustrative Statements of Position.

Definition III

Available for operating reserves (simplest, not recommended*) are defined as the available portion of total unrestricted net assets when organizations do not have any Board-designated funds. This definition is not recommended because it combines operating reserves with day-to-day operating funds.

The amount of **available operating reserves** can be calculated as follows:

Total Unrestricted Net Assets:	\$ 1,732,950
Less Equity in Fixed Assets:	<u><\$ 476,300></u>
Available For Operating Reserves	\$ 1,256,650

See also Figure C4 in Appendix C – Illustrative Statements of Position.

* While not recommended, undesignated and available operating reserves may be used by organizations that do not have the capacity, or whose Boards choose not to establish Board-designated operating reserves. Use of an undesignated or available operating reserve does not afford the same degree of availability or security as a Board-designated operating reserve. Therefore, use of either of these methods would require organizations to ensure sufficient liquid cash and investment balances to meet the organization’s operating and reserve requirements, such that the level of their undesignated or available operating reserves never falls below the targeted operating reserve minimum.

Without this level of oversight, the operating reserve may include non-current, non-liquid assets such as long-term pledges and other long-term receivables, inventory, prepaid expenses and deposits held by others that would not be readily available in the event of a cash shortage or crisis. It could give the appearance that an organization has adequate operating reserves when, in fact, liquid cash reserves can be very low or nonexistent, putting the organization at risk of experiencing serious financial viability issues in the event of an emergency.

What is a Board-Approved Operating Reserve Policy?

A board-approved operating reserve policy sets the goals for the reserve and terms and conditions for its use.

By consciously and proactively setting the financial goal of building an operating reserve (and potentially other non-operating specific-purpose funds) an organization's staff and board take responsibility for the long-term financial stability of the organization.

Setting a policy to maintain and carefully manage an operating reserve helps to ensure that sufficient funds are available to manage cash flow on a day-to-day basis. Building board-designated funds for non-operating special purposes, based on the particular needs of the organization, would position the organization to seize opportunities to enhance mission programs, to respond to spikes in demand for services, and to make planned capital purchases, among many other purposes.

Can we afford an operating reserve?

While it may seem obvious at this point that operating reserves are a necessary component of nonprofit success, preliminary research indicates that many organizations neglect to put aside funds that will help them preserve their capacity to deliver on their missions in the event of unforeseen financial shortages.

The fact is that numerous nonprofits have negative operating reserves and are already at risk. The current economic crisis or any crisis (e.g. fire, natural disaster, acts of terrorism, war, civil unrest, etc.) can threaten the very existence of thousands of nonprofit organizations. At a time when nonprofit organizations may be focused on survival, the thought of building operating reserves may seem a distant priority. But for those organizations that survive these difficult economic times, fortifying their position before the next crisis must include re-establishing or creating operating reserves. Organizations which review their policies now and begin to devise plans for replenishing their operating reserves to an agreed upon adequate level will emerge from this current economic crisis in a stronger financial position, positioned to withstand the next challenge that arises.

Thus, the real question is *"Can we afford not to have an Operating Reserve?"*

How much do organizations need to keep in operating reserves?

In order to answer this question, an organization needs to first ask itself the following two questions:

1. What does it mean to be financially stable?
2. What are adequate operating reserves?

The answer to each question is, “It depends.” Experience tells us that it is best to start by acknowledging there is simply no single correct solution for all organizations, one size does not fit all when it comes to operating reserves. Despite the importance of the issue there exists no simple formula or benchmark. To complicate matters further, the benchmarks that are commonly cited must always be applied in the context of the unique operational situation of the organization.

So to answer the question of “how much,” an organization must begin by examining the common factors at play in their operation. There are two main areas that create a risk of volatility for an organization, namely, revenue streams and spending levels.

Revenue Risk Factors: Common factors that impact the risk for volatility in revenue streams include, but are not limited to:

- Stability of donated revenue from 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

Spending Risk Factors: Common factors that influence the ability to adjust spending levels include, but are not limited to:

- The organization’s importance in community crisis situations (for example if the organization’s mission involves disaster relief)
- The extent to which economic downturns or other types of events may effect demand for services, either up or down
- The extent of funding commitments made for longer than one year
- Amount of unsecured debt carried by the organization
- Long-term leases with substantial penalties for cancelation
- Level of dependency of programs on stable, individual funding streams
- Ability to downsize operations quickly and still provide services to the community (e.g. staff have more than one essential duty)

In general, consideration of these and other factors (*See Appendix G - Other Considerations*) allow the organization to create a continuum of variables that will influence the definition of the appropriate operating reserve level for any given organization. The extent to which an organization finds itself

more or less subject to the variables will influence how far above the recommended minimum baseline the adequate or appropriate operating reserve level is set.

Recommended minimum Operating Reserve: This document recommends a minimum Operating Reserve ratio, at the lowest point during the year, of 25 percent or 3 months of the annual expense budget. This **Operating Reserve ratio** criteria is applicable whether an organization accounts for Operating Reserves as board-designated or undesignated.

An organization can apply an operating reserve ratio to calculate its operating reserve level in terms of a percentage – operating reserves divided by the annual expense budget, or number of months – operating reserves divided by the average monthly expense budget.

The greater the number or magnitude of risk factors an organization has (whether they are revenue risks or risks related to spending requirements), the greater the need for a higher operating reserve. For example, if an organization has two risk factors related to revenue volatility and seven risk factors related to spending requirements, the organization would be in the “easy come, easy go” category and should have an operating reserve of three to six months. If an organization has seven risk factors related to revenue volatility and two risk factors related to spending requirements, the organization would be in the “storm on the horizon” category and should have an operating reserve between three and six months. If an organization has several risk factors in both categories, it would be considered in “no time to waste” status and should have six months or greater set aside in operating reserves.



Examples of how to establish the appropriate balance for the operating reserve:

Example One:

Illustration: Organization A operates on an annual budget of \$15 million. The bulk of the funding comes from a variety of medium size foundations in the area and a number of substantial gifts from individual professionals, with no reliance on one specific foundation or individual. The community is growing and the number of young professionals relocating to the area is increasing. Job growth has been on a consistent rise for the past several years. The organization is not geographically located within a floodplain nor is it near the coast, making it unsusceptible to hurricanes. Operationally they have a very conservative approach to program service delivery and the organization does not commit to its clients beyond three month intervals. The overhead rate of this organization is 9% and, if necessary, the organization could be downsized.

Analysis: Based on the information listed, this organization has low risk in terms of its revenue stream. Spending requirements are also low as spending levels could be adjusted if necessary and the organization does not promise more than it could fund. Accordingly, this organization would be classified as a “Life is Good,” as its risk for revenue volatility and its spending requirements are both low. Therefore, its operating reserves could be as low as three months of operating and program expenses.

Example Two:

Illustration: Organization B operates on an annual budget of \$15 million. The bulk of its funding comes from two large foundations and significant number of small gifts from individuals. The organization is located along the Gulf Coast and is susceptible to hurricanes. The organization relies heavily on these two foundations to make their annual fundraising goal. Operationally, the organization commits to six months of service for each client. The overhead of the organization is 10% but the organization could be downsized if necessary.

Analysis: Based on the information listed, this organization has higher risk in terms of potential volatility in its revenue stream. However, spending levels could be adjusted if necessary so this organization does not appear to be over-committing its spending. Because this organization has higher risk for revenue volatility but lower risk in terms of spending requirements, it would be classified in the “storm on the horizon” category. As such, its operating reserves should be in the range of three to six months. Considering one natural disaster or one significant employer shut down could greatly alter the revenue stream, it would be prudent for this organization to take the more conservative position and have operating reserves closer to six months of operating and program expenses.

Example Three:

Illustration: Organization C is a large human service organization in a major metropolitan area. Among its programs is the provision of disaster relief to victims

of local disasters: fires, floods, earthquakes, and the like. This metropolitan area is in an active earthquake zone and has suffered major quakes in the past, but none very recently. Geologists say that the area is probably overdue for a major quake, but, while they are able to identify geographic areas where a quake is more likely to occur, so far all attempts to predict the time of such events with any degree of certainty have proved impossible.

Organization C's funding comes from a combination of small and large individual contributions and bequests, allocations from a local federated fundraising organization, a few foundation grants and earnings from its investments. It is the local chapter of a national parent organization.

Analysis: This organization is at high risk of volatility both in its revenue stream and in demand for its services. Therefore, it would fall into the "no time to waste" category. Given that the timing of the next major earthquake is completely unpredictable, they have to be well-prepared now. Being prepared will increase the likelihood that they can deal with the impact of a quake on their operations, donors and facilities, and still help others. One possible source of support would be the organization's national parent and its affiliates in other areas. These would presumably be willing and able to loan resources until the worst effects of the disaster have been addressed, but there would likely be logistical problems in physically getting the resources to where they are needed.

Due to the nature of this organization's work in disaster recovery, where crisis-oriented cash needs could be of such a magnitude as to exceed any routine level of need, this organization should maintain larger than average reserves – at least a years' worth of operating expenses and, possibly, two or three years worth may be more appropriate. Even then they may not have enough to meet all the needs after a major disaster, but a larger reserve could discourage donors from responding to appeals, based on a perception that the organization already has enough resources. Therefore its fundraising should always include an element of public education about the special circumstances faced by disaster recovery organizations in a high risk area.

Developing a Written Operating Reserve Policy

Every organization should have a board-approved policy on operating reserves.

A written Operating Reserve Policy should include the following elements:

- **Statement of Purpose** – The reason for establishing the operating reserve.
- **Policy** – The objective(s) to be achieved.
- **Definitions** – Descriptions of the meaning of key terms used in the policy. See Appendix A – Glossary of Terms.

- **Funding** – Beginning balance of operating reserve, if any, ultimate target amount for the fund and timeline for achieving it, including an annual increase in targets and strategies/sources for funding.
- **Procedures** – Details of how the policy is to be implemented, including the formula for calculating the operating reserve ratio, the amount of the operating reserve balance, whether or not the operating reserve should be formally board-designated, if it is to be a funded operating reserve and its relationship to the approved investment policy.
- **Uses** – Circumstances in which the operating reserves can be used.
- **Governance** – Procedures for approving the use of operating reserves, persons authorized to establish policies and oversee the operating reserve ratio and balance; provisions for recalculating the formula of the operating reserve balance and distributing the excess operating reserve balance, or funding operating reserve deficiencies.
- **Authorization of Drawdown from the Operating Reserve Fund** – Define terms and conditions for drawdown from the fund for operating purposes in the case of a financial emergency, including procedures for eventual replenishment

(See Appendix A for Sample policies)

Managing the Operating Reserve

What sources can fund the operating reserve balance?

The operating reserve can be funded with any available funds that are not temporarily or permanently restricted. Typical sources include:

- Unrestricted contributions from individuals or corporations. (Foundation grants tend to be restricted; one must look at the precise terms of the grant to determine if any of it can be used for funding an operating reserve.)
- The net surplus or “profit” from fees for goods or services. These fees include everything from hospital patient revenues, school tuition and theater ticket sales, to museum shop sales and much more. In some cases, net income from government fees may be used but, as with foundation grants, it will depend on the details of your government contract.
- Surpluses from annual operations of the organization
 - Planned (e.g. budgeted surplus earmarked for operating reserves)
 - Unplanned (e.g. surplus beyond budgeted surplus)
- Unrestricted Investment income in the form of interest and dividends or the sales of stocks and bonds.
- Unused and unrestricted reserves for uncollectible pledges (the losses are lower than expected).
- Unused and unrestricted **capital acquisition funding** included in the annual cash operating budget (may need board action to re-designate).

In addition to the unrestricted sources above, some foundations award grants for the specific purpose of creating or increasing an unrestricted board-designated reserve fund (typically referred to as cash reserve, working capital reserve, operating reserve, etc.)

Please note: grants given for reserves are very different from grants for permanently restricted endowments (see Permanently Restricted Net Assets in glossary) or board-designated quasi-endowments (see item in glossary).

What are appropriate uses of the operating reserve?

Operating reserves can be used for meeting commitments, obligations, or other contingencies for day-to-day operations. They would not, however, be used for non-operating expenses such as funding the purchase of a new building (barring the loss of an existing facility with insufficient insurance proceeds) or establishing an endowment.

Here are some examples of how organizations have used their operating reserves:

- Offset the negative impact of any of the following scenarios that may arise:
 - Sudden shutdown or decrease in size of major funder which could result in a significant decrease in anticipated revenue.
 - To maintain current program operations when government payments are delayed.
 - Community disaster – to respond to special community needs resulting from an unanticipated disaster, such as a hurricane.
- Provide a funding source for extraordinary or unplanned capital purchases as approved by the board (e.g. organizations should already have a plan for funding routine repair and replacement of capital assets rather than relying on the operating reserve for such expenditures). For example:
 - Replacement of your fully depreciated roof should be paid for via your reserve for replacement.
 - Replacement of your 5-year old roof due to uninsured damage could be paid for from the operating reserve.
- Make up the budget gap between anticipated and actual contributions when pledge losses are higher than expected.

How often should the operating reserve balance be reviewed?

It is recommended that, at a minimum, the operating reserve balance be reviewed as part of your board's annual budgeting process.

It is also recommended that management monitor the balance on an ongoing basis and report to the board any significant variations from the target balance as part of its regular financial reporting to the board (or designated committee).

It may be reviewed by the board (or designated committee) more often if events with major financial or operational implications are planned or expected.

How should the board respond to operating reserve surpluses and shortfalls?

The intent of sustaining operating reserves is to assure the mission of the organization continues to advance. It is a long-term approach, allowing those charged with carrying out the mission in the future have access to the needed level of financial resources.

Thus, we recommend looking at target variances (actual operating reserves versus targeted reserve levels) in a similar light, such as over a two or three-year time frame. We also recommend the adoption of an explicit policy on the use of surpluses to fund operating reserves such as the following:

“If the operating reserves exceed the targeted reserve level for three consecutive years, the excess [or x% of the excess] should be made available for current use.”

It is less disruptive for organizations to set aside funds for operating reserves from surpluses in years when revenues exceed expenses than to find new sources of funding when the organization is in desperate need. Thus, in the event operating reserves fall below the policy-stated target, planned measures should be taken to restore the balance to a more acceptable level before new needs arise.

A policy should be adopted by the board to deal with ongoing shortfalls in the level of operating reserves. It is important that the policy take into account what’s right for your organization in the environment in which it operates, and that this be a discussion between your executive and the board. Thus, these are examples only – the wording and policy choices for your organization should be customized based on the circumstances directly pertaining to your situation. This may contain language such as:

Policy for Operating Reserves Shortfall #1:

“If the operating reserve is and has been less than 75% of the targeted reserve level for two consecutive years, the Board of Directors, in the absence of any extraordinary circumstances, should adopt an operational budget that includes a projected surplus sufficient to rebuild operating reserves over the following two years back to its targeted reserve level.

Example #1a:

Excellent Charity (EC) operates on an annual Budget of \$1,000,000 and maintains a targeted reserve level of 3 months of operating costs (\$250,000). Due to Board-approved use of the reserves to maintain services during an economic downturn, reserves have fallen to 60% of the target level (\$150,000). The Board anticipates another year of economic challenge ahead and demand for EC’s services will continue to be at elevated levels.

Thus, based upon the operating reserve policy, they opt to take no action relative to replenishing reserves in the upcoming budget year (e.g. extraordinary circumstances dictate that the upcoming year will likely require continued draw-down of reserves rather than replenishment).

Example #1b:

Same facts as Example #1, except that the Board sees the economy improving and demand for EC's services falling back to more normal levels. Based upon the operating reserve policy, they budget for an annual operating surplus of \$50,000 (or 5% of operational budget) and plan for the same budgetary surplus the following year. With this budgeting, the operating reserve balance will reach a level of \$250,000 (or 100% of the target balance) within the next two years.

Policy for Operating Reserves Shortfall #2:

"If the operating reserve is less than 50% of the targeted reserve level for two consecutive years, the Board of Directors should adopt an operational budget with a projected surplus to rebuild operating reserves back to the targeted level over the following two-four years.

Example #2:

Excellent Charity (EC) operates on an annual Budget of \$1,000,000 and maintains a targeted reserve level of 3 months of operating costs (\$250,000). Due to Board-approved use of the reserves to maintain services during an economic downturn, reserves have fallen to 40% of the target level (\$100,000) over the last three years. Because the Board anticipated the current year was going to pose another economic challenge and demand for EC's services would continue to be at elevated levels, they opted to take no action to replenish reserves even though they were below 75% (e.g. extraordinary circumstances dictated that the upcoming year would likely require continued draw-down of reserves rather than replenishment). For the upcoming year, the economic outlook is for modest growth and funding levels are expected to stabilize, but demand for services will likely still be higher than before the economy turned bad. Based upon the operating reserve policy, the Board must set in motion a plan to rebuild reserves to the target balance (\$250,000) starting in the upcoming budget year, so the Board adopts a 4-year plan as follows:

- Year 1 = Budgeted surplus of \$15,000 (1.5% of operational budget)
- Year 2 = Budgeted surplus of \$30,000 (3% of operational budget)
- Year 3 = Budgeted surplus of \$45,000 (4.5% of operational budget)
- Year 4 = Budgeted surplus of \$60,000 (6% of operational budget)

Policy for Operating Reserves Shortfall #3:

"In the event operating reserves are less than the targeted reserve levels, this deficit must be eliminated in a minimum of three years, with one third of the deficit balance being required to be funded in the current operating budget, until the reserve is restored to the target balance."

Example #3:

Solid Charity (SC) operates on an annual Budget of \$2,000,000 and maintains a targeted reserve level of 4.5 months of operating costs (\$750,000). Due to Board-approved use of the reserves to fund recovery efforts from an earthquake last year, reserves have fallen to 70% of the target level (\$525,000). Thus, the Board of SC has adopted a 3-year budget plan that requires annual budget surpluses of no less than \$75,000 (3.75% of operational budget) per year.

Note: *There are a variety of other options available to the board for crafting such policies and the above should not be considered an exhaustive list of examples. Boards should consider the organization's individual circumstances and craft a policy that is most reasonable for their unique needs.*

How often should the operating reserve policy be reviewed?

The policy should be reviewed every three years by the board (or designated committee), or sooner if conditions warrant. Variables to consider when re-evaluating the policy include significant changes in operations, anticipated changes in community or other needs, significant changes in funding base, changes in the regulatory environment impacting charitable giving and the stability of the local economy. Any changes to the policy must be approved by the board.

Investment Considerations *(see Appendix F)*

Developing an investment strategy for any fund starts with answering the question, “What is the purpose of the fund?” This question is answered for us in the recommended definition of operating reserves found in this document:

Board-designated operating reserves are defined as the portion of “available unrestricted net assets” that the board has designated for operating reserves. “Available unrestricted net assets” equals total unrestricted net assets less equity in fixed assets. Assets related to board-designated operating reserves are typically invested in cash, near-cash or other low-risk investments. Access to these funds would require board approval since they are board-designated.

The next question to consider is related to the time-horizon for the investment, or “When is the money needed?” The nature of operating reserves makes the answer to this question uncertain. A better way to phrase the question is “When *might* we need the money?” The answer to this question is: “Soon.”

The nonprofit community is composed of diverse organizations, varying greatly by size, staff expertise and financial resources. Because of this diversity, there is no single “right” way to invest operating reserves. However, there is a process that is appropriate for all nonprofits: the development of an investment policy dealing with the cash management for the organization.

The cash management industry is changing. Once thought of as a safe and no-risk asset class, the cash market is now recognized as multi-faceted, complex and subject to risk. For nonprofit boards who have yet to establish, or have not recently evaluated their existing cash investment policies, now is the time. Under *Appendix F – Investment Considerations: Developing a Cash Investment Policy*, we examine the issues surrounding the **cash investment policy statement** and offer some suggestions and best practices for establishing, updating and/or maintaining this important roadmap for managing a nonprofit’s cash reserves.

Legal, Tax, and Accounting Implications

Does the operating reserve fall under Financial Accounting Standards Board Staff Position 117-1 (now codified as 958-205)?

An operating reserve does not automatically fall under FSP 117-1. FSP 117-1 deals with “endowments,” as defined in the document. Footnote 2 to paragraph 1 of the FSP defines endowment as:

An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment for a permanent source of income, or a term endowment for income for a specified period. An organization’s governing Board may earmark a portion of its unrestricted net assets as a Board-designated endowment (sometimes called, “funds functioning as endowment,” or “quasi-endowment funds”) to be invested to provide income for a long, but unspecified, period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets.

This FSP uses the term endowment to mean all of an organization’s endowment funds collectively, which encompasses both donor-restricted endowment funds and those established by Board designation (herein called Board-designated endowment funds). The latter are sometimes called “funds functioning as endowment,” or “quasi-endowment funds.”

Thus, whether or not some portion of an organization’s assets are covered by the FSP depends on the organization’s intention regarding the assets. Since operating reserves are normally not donor-restricted, the question becomes one of the intentions regarding any board-designated amounts. If the board has formally designated such reserves as endowment (or specifically for the long-term production of investment income, regardless of whether the word “endowment” is used), then they are covered by 117-1. If the purpose is expressly or implicitly for some other purpose – even though some income may incidentally be earned from temporary investment of the funds – then they would not be covered by 117-1.

Is a grant received for reserves considered unrestricted?

It depends. The particular guidelines for such grants may or may not be clear regarding whether the grant is to be considered restricted. Since a board designation can only be applied to unrestricted funds, it could be assumed that the grant will be unrestricted. It is best to work with your accountant and grant program officer to craft clear wording for the grant relative to the granting organization's intent for the funds to be unrestricted. The presence of an actual restriction in the grant documentation may have an impact on whether or not it can fall under the terms of your reserve policy.

NEXT STEPS

As noted in the preface, this “Operating Reserves Policy Toolkit” was created to help nonprofit leaders and the financial consultants who serve their organizations to:

- make a compelling case within their own organizations for the need to establish an operating reserve,
- provide factors to take into consideration in determining the operating reserve size/ratio that is appropriate for their particular organization,
- suggest practices for managing the reserve and reporting its balance, and
- offer some tools with which to go about drafting a policy to record their decisions and guide implementation.

The main body of this document has defined an operating reserve, presented the rationale for creating one, and discussed the many factors that would determine the size and management of one. The following appendices are for the use of the person or task force leading the policy development project within the organization. (Appendices A, B, and D are also available in their native Word or Excel formats at the same online location as the [Toolkit](#).)

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The Glossary is provided to encourage everyone to use consistent terminology in referring to operating reserves and reserve components that, frankly, we hope will take hold among nonprofit organizations and their funders, donors, and financial professionals. We hope that it will become commonly understood and accepted that nonprofits of all sizes need to have operating reserves at a level appropriate to their own circumstances.

We suggest a process that might follow this sequential scenario:

- 1) The case for the need for an operating reserve is made to the board of directors. In advance of the board meeting, a copy of the whitepaper “Maintaining an Operating Reserve” by the Nonprofit Operating Reserves Initiative Workgroup is provided to board members as background.
- 2) The board concurs with the case and asks the finance (or other) committee to create a reserve policy draft.
- 3) The finance committee and chief administrative and finance staff use tools from the “Operating Reserve Policy Toolkit” to determine a target amount for the reserve and to draft the actual policy document using outlines and sample language from the Toolkit.
- 4) The draft policy is presented to the board.
- 5) The board discusses and either approves the policy or requests changes based on discussion.
- 6) The policy is finalized and approved.
- 7) Implementation of the policy commences.

Use these tools. Please. Copy, paste, customize. Give us your feedback and share tools with us that you have developed so we can continue to improve the web-based Operating Reserves Policy Toolkit and other training and implementation materials. [Register](#) with us so we can inform you of updates. Our mission is to spread the word and share the tools that will facilitate better long-term financial sustainability among the vital nonprofit organizations that save and enrich our lives.

APPENDIX A - DEVELOPING A WRITTEN OPERATING RESERVE POLICY

SAMPLE 1

Outline for Development of Written Reserve Policies with Example Language

NAME OF ORGANIZATION

POLICY STATEMENT – BOARD-DESIGNATED FUNDS

OPERATING RESERVE FUND

BOARD-DESIGNATED OPERATING RESERVE FUND

I. **Statement of Purpose**

→ Define the purpose(s) and objective(s) of this organization's operating reserve.

[example:]

The ORG Board of Directors designated an OPERATING RESERVE FUND by resolution at its DATE Board meeting. The general purpose of the fund is to help to ensure the long-term financial stability of the organization and position it to respond to varying economic conditions and changes affecting the organization's financial position and the ability of the organization to continuously carry out its mission.

ORG will maintain a Board-Designated Operating Reserve Fund to achieve the following objective(s):

- 1. To enable the organization to sustain operations through delays in payments of committed funding and to accept reimbursable contracts and grants without jeopardizing ongoing operations;*
- 2. To promote public and funder confidence in the long-term sustainability of the organization by preventing chronic cash flow crises that can diminish its reputation and force its leaders to make expensive short-term, crisis-based decisions,*
- 3. To create an internal line of credit to manage cash flow and maintain financial flexibility.*

II. **Board-Designated Operating Reserve Fund Balance**

→ Describe the establishment of the fund. Include such details as:

- The ultimate goal amount for the fund and method / rationale for determining the amount.

- Current operating reserve fund balance, if any, or amount of existing funds to be designated.
- Planned additions to the reserve using identified grant money and, if applicable, whether any required matching money is to be designated as part of the reserve fund.
- The timeline and incremental plan for reaching the desired ultimate fund balance, if applicable.

[example:]

The target amount to be attained and maintained for the Board-Designated Operating Reserve Fund is \$200,000, representing approximately 25% of annual operating expenses of \$800,000, or about 3 months of expenses on average. To establish the Operating Reserve Fund, the ORG Board of Directors has designated \$20,000 of existing accumulated liquid net assets as the beginning balance of the fund. The next \$60,000 is to be funded by a special one-time grant from AGENCY NAME of \$30,000, along with the required 1-1 match of new or increased donations committed during the 20XX fiscal year. The remaining \$120,000 is to be funded over the next XX fiscal years in increments of \$XX,000, through funding strategies incorporated into ORG's annual fundraising plan and capital budget.

III. Use of the Board-Designated Operating Reserve Fund

→ Describe terms and use of the fund. Include such details as:

- Who may access the fund.
- What authorization is given or required.
- What communication methods are acceptable.
- The threshold (time and/or amount) requiring a higher level of authorization.
- The standard expectation for repayment of accessed funds.
- The notifications required regarding the status of repayments, including frequency and recipient(s) of the notifications.
- Describe the relationship between the reserve and a commercial line of credit (if applicable) i.e., which should be used first, etc. The choice of hierarchy of use depends on the particular circumstances of the organization.

[example:]

The Executive Director may access up to \$XX,000 for purposes as outlined above, as long as sufficient accounts or grants receivable are available to repay such usage within three months time. The Executive Director will notify the Treasurer in writing, and usage will be acknowledged in writing by the Treasurer. E-mail or fax shall be acceptable forms of notification and acknowledgement.

Any funds borrowed from the Operating Reserve Fund for greater than \$XX,000 and/or for longer than 90 days will be paid back through a prescribed repayment schedule/method. Approval of any such usage and the proposed repayment schedule shall be requested by the

Executive Director from either the Board or the Executive Committee. If approved by the Executive Committee, such disbursement shall be reported at the next full Board meeting. At any time that a borrowing from the Operating Reserve is outstanding, the status of the borrowing and payments made against the proposed repayment schedule will be reviewed at the regularly scheduled Board meetings.

[examples re: use of reserve relative to commercial line of credit:]

- A. *Use of the Operating Reserve Fund will be subsequent to fully depleting any existing commercial lines of credit.*
- OR
- B. *The Operating Reserve Fund will be fully depleted before use of the commercial line of credit*

[Note: management procedures, authorizations, etc. must be consistent with the choice of hierarchy.]

IV. Management of the Board-Designated Operating Reserve Fund

→ Describe the management of the fund. Include such details as:

- Who is responsible for managing the fund.
- Who may open and/or monitor bank accounts.
- Whether a separate bank account is required.
- Accounting procedures, reporting requirements, and disposition of any interest income.
- Liquidity requirements for funds comprising the reserve, and whether and how they can be invested.
- Which assets will be included or excluded in the formula for monitoring the reserve balance. For instance, excluding non-liquid or non-current line items such as prepaid expenses, inventories, and long-term receivables and deposits held by others produces a more conservative reading. The example below refers to a fund that is cash only.

[example:]

Under the direction of the Treasurer or the Finance Committee, the Executive Director will establish a separate bank account for the Board-Designated Operating Reserve Fund. Policies and procedures for handling deposits, reconciling statements, safeguarding access, etc. will be the same as established from time to time for any of the organization's other bank accounts. If feasible, the funds will be invested according to the guidelines set in the Operating Reserve Investment Policy.

The Operating Reserve Fund will be listed separately in the net assets section of the organization's statement of financial position as "Board-Designated Operating Reserve" and longer-term borrowings from the reserve will be shown as a liability – "Due to Operating Reserve" – in internal financial reports.

V. **Authorization of Draw-Down* from the Board-Designated Operating Reserve Fund**

- Define the terms and conditions for drawing down the fund for operating purposes in the case of a financial emergency, including procedures for eventual replenishment. (See also: “**Operating Reserve Shortfalls**” below.)

[example:]

A draw-down from the fund that will not or cannot be replaced with operating funds in the timeframe established in “Use of the Board-Designated Operating Reserve Fund” above, must be approved by a majority of the Board, either by a majority of the votes of a quorum present at a regular Board meeting, or by a 2/3 majority of the Board if such vote is conducted by other means. A record of any such action will be maintained and be made a part of the Board meeting minutes. Any such action would remove the Board designation of “reserves” from these funds.

*Note: this essentially decreases the fund from the established target level and is not recommended except under extraordinary circumstances.

VI. **Operating Reserve Shortfalls**

- Describe the Board’s policy for restoring its Board-Designated Operating Reserve to target level (once achieved) if the fund has been depleted to below the target level. Include time and amount thresholds for which the replenishment policy will become applicable.

[example 1:]

If the Operating Reserve is and has been less than 75% of the targeted reserve level for two consecutive years, the Board of Directors, in the absence of any extraordinary circumstances, will adopt an operational budget that includes a projected surplus sufficient to rebuild the Operating Reserve Fund to its targeted reserve level over the following two years.

[example 2:]

If the operating reserve is less than 50% of the targeted reserve level for two consecutive years, the Board of Directors will adopt an operational budget with a projected surplus to rebuild operating reserves over the following two-four years back to its targeted reserve level.

[example 3:]

In the event operating reserves are less than the targeted reserve levels, this deficit must be eliminated in a minimum of three years, with one third of the deficit balance being required to be funded in the current operating budget, until the reserve is restored to the target balance.

VII. Responsibilities of the Finance Committee

- Describe the responsibilities of the Finance Committee with regard to operating reserve and other board-designated funds oversight. How will the committee monitor the activity in the funds? How often and in what manner will they report to the Board about funds activity? How often will the Operating Reserve Policy be reviewed and updated?

[example:]

The Finance Committee will receive reports on the Board-Designated Operating Reserve Fund at its regular meetings and shall be charged with assuring that the funds are invested prudently in accordance with the guidelines stated above and that the organization receives a reasonable rate of return considering the size of the reserve fund, the instruments in which it is invested and other relevant factors.

The Treasurer will report the status of the Board-Designated Operating Reserve Fund to the Board as part of the regular Treasurer's report.

The Finance Committee will review the Operating Reserve Policy every three years, or sooner if conditions warrant, and put forward any necessary changes for Board approval.

OPTIONAL:

Funds Designated for Other Special Purposes

- Per the above outline, describe the policy and process the Board will follow to create/designate other special purpose funds relevant to identified objectives of a strategic plan, etc., for example, Equipment Maintenance & Replacement, Human Resource Capacity Building, New Program Initiative, pursuit of unforeseen opportunities, etc.

Sample 2

Funded Board-Designated Operating Reserve

I. Philosophy

The establishment and maintenance of a funded Board-Designated Operating Reserve is a high priority. This will enable _____ to support strategic business practices and to:

- Manage cash flow interruptions.
- Minimize the need for working capital borrowing.
- Meet commitments, obligations or other contingencies.
- Generate investment income.

II. Policy

The purpose of this policy is to establish and maintain a funded Board-Designated Operating Reserve, unencumbered and uncommitted, at a level relative to the annual program funding and the costs of operating and maintaining the organization.

The Operating Reserve is intended to serve a dynamic role and is available to be utilized as needed rather than being static, devoted only to generating interest income.

III. Definitions

- **Board-Designated Operating Reserves** – Amounts reported in the Unrestricted Net Assets section of the balance sheet and identified as Board-Designated Operating Reserves.
- **Program Funding** – Undesignated allocations to Agencies and Initiatives. It does not include expenses funded by grants.
- **Costs of Operating and Maintaining the Organization** – _____ net expenses for Program Services, Fundraising & Administration
- **Funded Board-Designated Operating Reserve** – A fund consisting of liquid assets and investments accounted for separately from **Undesignated Operating Funds** in the asset section of a balance sheet. Liquid assets are those that may be converted to cash quickly and easily. It is not required that Board-Designated Operating Reserves be physically segregated in a separate bank account although _____ may decide to do so.

IV. Strategies and Procedures

- A. Board-Designated Operating Reserves shall be accounted for separate and apart from Undesignated Operating Funds.
- B. The Investment Committee will have the responsibility for developing and recommending policies and guidelines for the investment of the Operating Reserve assets and the Finance Committee will approve such policies and guidelines.
- C. The Operating Reserve goal will be to achieve and maintain between three and six months of Program Funding and Operating Costs as defined in Section III.

V. Sources

Assets for the **Board-Designated Operating Reserve** accounts will come from the Annual Campaign, unrestricted Legacies/Bequests/Memorials, earnings on investments, recapture of undistributed Allocations/Initiatives, Special Grants and other sources the Executive Committee may deem to be appropriate.

VI. Uses

- A. Internal line of credit for use to financially operate the organization.
- B. Funds to stabilize a level of allocations or a level of increased allocation when events affect the source and application of funds.
- C. Funds to meet unfunded and unexpected organization needs.
- D. Funds for emergency and emerging needs of Agencies.
- E. Funds to make up a deficiency in the Campaign, either in results or collection experience.

VII. Governance

The procedure for approving use of the Operating Reserve Funds will be as follows:

1. Request submitted to Finance Committee.
2. Action taken by Finance Committee.
3. Recommendation to the Executive Committee by the Finance Committee
4. Approval by the Executive Committee.
5. Notification of action taken to the Board of Directors.

VIII. Maintenance

The status of the funded **Board-Designated Operating Reserve** will be calculated at the end of each fiscal year based upon audited financial results.

Operating Reserve Ratio Calculation

The calculation formula will be based upon amounts defined in Section III as follows:

$$\frac{\text{Unrestricted, Board-Designated Operating Reserve as of 12/31}}{[\text{Budgeted Annual Operating Expenses} + \text{Program Funding}]} \times 1/12 = \text{No. of Months}$$

The Operating Reserve Ratio Calculation will be presented to the Executive Committee at their meeting following approval of the financial audit results by the Audit Committee. The Committee will consider the adequacy of the Operating Reserve amount and will recommend any changes as deemed necessary.

IX. Policy Review

This policy will be reviewed every three years by the Finance Committee or sooner if conditions warrant. Any changes thereto will be reviewed by the Executive Committee and approved by the Board of Directors.

**APPENDIX B: SAMPLE TEXT FOR AUDIT FOOTNOTES
AND IRS FORM 990 DISCLOSURE**

Because Generally Accepted Accounting Principles do not require footnote disclosure of the composition of Unrestricted Net Assets, organizations should have a discussion with their auditors relative to inclusion of a note regarding the operating reserve. Your auditor will want the note to tie to the balance sheet presentation and may need to test the balances as part of the audit procedures.

Sample 1: The organization defines Board-Designated Operating Reserves as the portion of “unrestricted net assets” that the Board has designated for use in emergencies to sustain financial operations in the event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. The amount of accumulated “unrestricted net assets” is increased or decreased as the result of annual operating surpluses or deficits. The organization pursues financial stability by budgeting for – and then achieving reasonable, modest surpluses year after year in order to met their *operating reserves* objectives.

The Board has established a goal of maintaining a minimum operating reserve of two months of operating costs (\$350,000) and a maximum of five months operating costs (\$875,000)

The balance of Board-Designated Operating Reserve held by the organization at 12/31/09 is calculated as follows:

Total Unrestricted Net Assets		\$1,732,950
Less Equity in Fixed Assets		<u><\$ 476,300></u>
Unrestricted Net Assets Available for Designation		\$1,256,650
Less Board Designated Amounts for:		
Operating Reserves	<\$350,000>	
Replacement of Fixed Assets	<\$175,000>	
New Program Seeding	<\$100,000>	
Quasi-Endowment	<u><\$500,000></u>	<u><\$ 1,125,000></u>
Undesignated Operating Funds		\$ 131,650

Sample 2: Board-Designated Operating Reserves are a portion of the accumulation of unrestricted surpluses that are available for use at the discretion of an organization’s board. The presence of a board-designated operating reserve increases an organization’s ability to absorb or respond to temporary changes in its environment or circumstances, for example the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues.

The organization maintains an Operating Reserve Policy that requires the Board set aside a portion of Available Unrestricted Net assets at the end of each fiscal year to fund a Board-Designated Operating Reserve. The policy also establishes a goal for the Board-Designated Operating Reserve of a minimum target balance equal to two months of operating expenses (\$300,000) and a maximum balance of five months operating expenses (\$750,000).

Available Unrestricted Net Assets are defined as the portion of total unrestricted net assets that are available for designation by the Board for operating reserves and non-operational special purposes or Board-designated quasi-endowment that further the mission of the organization.

Available Unrestricted Net Assets at 12/31/09 are:

Total Unrestricted Net Assets	\$967,450
Less Equity in Fixed Assets	<\$ 75,300>
Less Board-Designated Operating Reserve	<\$330,000>
Less Board-Designated for Special Initiatives	<\$ 50,000>
Less Board-Designated Quasi-Endowment	<u><\$375,000></u>
Undesignated Operating Funds	\$137,150

The Board of the organization has established a target of \$350,000 (2.3 months of operating costs) of Unrestricted Net Assets as an operating reserve in accordance with the policy.

APPENDIX C: ILLUSTRATIVE STATEMENTS OF FINANCIAL POSITION

There are *four* illustrative statements of financial position (balance sheets) referring to three definitions noted in the “Operating Reserves Defined” sidebar on pages 12-13.

Definition I

Board-Designated Operating Reserves (recommended) are the portion of available unrestricted net assets that the Board has designated for Operating Reserves. “Available unrestricted net assets” equals total unrestricted net assets less equity in fixed assets.

Figure C1 - Board-Designated Operating Reserve [displayed under assets and under net assets].

Figure C1 displays "Operating Reserve" in the asset section of the balance sheet (classified as noncurrent) and displays "Board-Designated Operating Reserve" in the Unrestricted Net Asset section.

Figure C2 - Board-Designated Operating Reserve [displayed under Net Assets only].

Figure C2 displays only "Board-Designated Operating Reserve" in the Unrestricted Net Asset section of the balance sheet.

Note to Definition I: Organizations that use **fund accounting** establish a Board-Designated Operating Reserves Fund consisting of both liquid assets and unrestricted net assets that are accounted for separately from assets and unrestricted net assets related to their Undesignated Operating Funds¹. Figure C5 provides an illustrative fund accounting balance sheet. Organizations that do not use fund accounting cannot use Figure C1, which displays Operating Reserves in the asset section, because they cannot account for assets related to their Board-Designated Operating Reserves.

Definition II

Figure C3 - Undesignated Operating Reserves² (simplified, not recommended) are the portion of “Available Unrestricted Net Assets” that has not been designated by the Board for other specific purposes. Figure C3 is not recommended because it combines Operating Reserves with day-to-day Operating Funds.

Definition III

Figure C4 - Available For Operating Reserves³ (simplest, not recommended), are the available portion of total unrestricted net assets when organizations do not have any board-designated funds. Figure C4 is similar to Figure C3 – Undesignated Operating Reserves except that the term “undesignated” is not applicable when organizations do not have any “board-designated” funds. Therefore, Figure 4 excludes the \$90,000 board-designated equipment fund that is included in Figures 1 to 3. Figure C4 is not recommended because it combines operating reserves with day-to-day operating funds.

¹ The **Board-Designated Operating Reserve FUND** is the 2007 UWW guide’s “Funded Reserve” option.

² **Undesignated Operating Reserves** is the 2007 UWW guide’s primary definition where reserves consist of “undesignated” unrestricted net assets.

³ **Available For Operating Reserves** is the only definition that can be used with IRS Form 990 data.

Internal financial management report

Figure C5 - Board-Designated Operating Reserves

(Suggested columnar display for internal use)

The columnar fund-accounting format in Figure 5, while quite detailed, can a very useful internal financial management report, presenting a clear picture of an organization's financial position including the status of its board-designated operating reserve fund in relation to other funds.

Figure C1⁴

Operating reserve ratio:		Statement of Financial Position	
Operating Reserves		Board-Designated Operating Reserve	
= -----		[Displayed under assets and under net assets]	
Annual operating expense budget			
	125,000	Current	Prior
	-----	Year	Year
	500,000		
	25.00%		
ASSETS			
Current Assets			
Checking/Savings	64,000		82,000
Receivables	35,000		45,000
Short Term Investments	98,000		150,000
Other Current Assets	9,000		16,000
Total Current Assets	206,000		293,000
Operating Reserve			
Checking/Savings	125,000		125,000
Fixed Assets			
Buildings & Equipment	475,000		410,000
Accum. Depreciation & Amort.	(52,000)		(47,000)
Total Fixed Assets	423,000		363,000
TOTAL ASSETS	754,000		781,000
LIABILITIES & NET ASSETS			
LIABILITIES			
Short-Term Liabilities	30,000		27,000
Long-Term Liabilities/Mortgage	75,000		80,000
TOTAL LIABILITIES	105,000		107,000
NET ASSETS			
Unrestricted			
Equity in Fixed Assets	348,000		283,000
Board Designated Equip Fund	90,000		150,000
Board Designated Ops Reserve	125,000		125,000
Undesignated Operating Funds	24,000		21,000
Total Unrestricted	587,000		579,000
Temporarily Restricted	62,000		95,000
TOTAL NET ASSETS	649,000		674,000
TOTAL LIABILITIES & NET ASSETS	754,000		781,000

⁴ This format is consistent with the UWW 2007 Reserve Policy Guide's "Funded Reserve" option.

Figure C2

Operating reserve ratio:		Statement of Financial Position	
Operating Reserves		Board-Designated Operating Reserve	
= -----	Annual operating expense budget	[Displayed Under Net Assets Only]	
=	125,000	Current	Prior
=	500,000	Year	Year
=	25.00%		
ASSETS			
Checking/Savings	189,000		207,000
Receivables	35,000		45,000
Short Term Investments	98,000		150,000
Other Assets	9,000		16,000
Fixed Assets			
Buildings & Equipment	475,000		410,000
Accum. Depreciation & Amort.	(52,000)		(47,000)
Total Fixed Assets	423,000		363,000
TOTAL ASSETS	754,000		781,000
LIABILITIES & NET ASSETS			
LIABILITIES			
Short-Term Liabilities	30,000		27,000
Long-Term Liabilities/Mortgage	75,000		80,000
TOTAL LIABILITIES	105,000		107,000
NET ASSETS			
Unrestricted			
Equity in Fixed Assets	348,000		283,000
Board Designated Equip Fund	90,000		150,000
Board Designated Ops Reserve	125,000		125,000
Undesignated Operating Funds	24,000		21,000
Total Unrestricted	587,000		579,000
Temporarily Restricted	62,000		95,000
TOTAL NET ASSETS	649,000		674,000
TOTAL LIABILITIES & NET ASSETS	754,000		781,000

Figure C3

Operating reserve ratio:		Statement of Financial Position	
Operating Reserves		Undesignated Operating Reserve	
=	-----		
Annual operating expense budget			
	149,000	Current Year	Prior Year
=	-----		
	500,000		
=	29.80%		
ASSETS			
Current Assets			
Checking/Savings	189,000		207,000
Receivables	35,000		45,000
Short Term Investments	98,000		150,000
Other Current Assets	9,000		16,000
Total Current Assets	331,000		418,000
Fixed Assets			
Buildings & Equipment	475,000		410,000
Accum. Depreciation & Amort.	(52,000)		(47,000)
Total Fixed Assets	423,000		363,000
TOTAL ASSETS	754,000		781,000
LIABILITIES & NET ASSETS			
LIABILITIES			
Short-Term Liabilities	30,000		27,000
Long-Term Liabilities/Mortgage	75,000		80,000
TOTAL LIABILITIES	105,000		107,000
NET ASSETS			
Unrestricted			
Equity in Fixed Assets	348,000		283,000
Board Designated Equip Fund	90,000		150,000
Undesignated Operating Reserve	149,000		146,000
Total Unrestricted	587,000		579,000
Temporarily Restricted	62,000		95,000
TOTAL NET ASSETS	649,000		674,000
TOTAL LIABILITIES & NET ASSETS	754,000		781,000

<-- Includes
Operating
Funds

Figure C4

Statement of Financial Position

Available For Operating Reserves

[Includes operating funds; not applicable with board-designated funds*]

Operating reserve ratio:			
	Operating Reserves		
=	-----		
	Annual operating expense budget		
	239,000		
=	-----		
	500,000	Current	Prior
=	47.80%	Year	Year
		Total	Total
ASSETS			
Checking/Savings	189,000	207,000	
Receivables	35,000	45,000	
Other assets	17,000	16,000	
Fixed Assets (net of depreciation)	<u>423,000</u>	<u>363,000</u>	
TOTAL ASSETS	<u>664,000</u>	<u>631,000</u>	
LIABILITIES & NET ASSETS			
LIABILITIES			
Short-Term liabilities	30,000	27,000	
Long-Term Liabilities/Mortgage	<u>75,000</u>	<u>80,000</u>	
TOTAL LIABILITIES	<u>105,000</u>	<u>107,000</u>	
NET ASSETS			
Unrestricted			
Equity in Fixed Assets	348,000	283,000	
Available For Operating Reserves	<u>239,000</u>	<u>296,000</u>	<--- Includes
Total Unrestricted	<u>587,000</u>	<u>579,000</u>	Operating Funds
Temporarily Restricted	<u>62,000</u>	<u>95,000</u>	
TOTAL NET ASSETS	<u>649,000</u>	<u>674,000</u>	
TOTAL LIABILITIES & NET ASSETS	<u>754,000</u>	<u>781,000</u>	

Figure C5

Statement of Financial Position

Board-Designated Operating Reserve [Suggested Columnar Display for Internal Use]

Operating reserve ratio:	
Operating Reserves	= -----
Annual expense budget	= -----
125,000	= -----
500,000 *	= -----
25.00%	= -----

	Current Year					Temp Restr'd Total	Prior Year TOTAL
	----- Unrestricted -----				Operating Funds		
	TOTAL	Fixed Assets	---- Board Designated ---- Equip. Fund	Operating Reserve			
ASSETS							
Current Assets							
Checking/Savings	189,000			125,000	22,000	42,000	207,000
Receivables	35,000				15,000	20,000	45,000
Short Term Investments	98,000		90,000		8,000		150,000
Other Current Assets	9,000				9,000	-	16,000
Total Current Assets	331,000		90,000	125,000	54,000	62,000	418,000
Fixed Assets							
Buildings & Equipment	475,000	475,000					410,000
Accum. Depreciation & Amort.	(52,000)	(52,000)				-	(47,000)
Total Fixed Assets	423,000	423,000	-			-	363,000
TOTAL ASSETS	754,000	423,000	90,000	125,000	54,000	62,000	781,000
LIABILITIES & NET ASSETS							
LIABILITIES							
Short-Term Liabilities	30,000				30,000		27,000
Long-Term Liabilities/Mortgage	75,000	75,000					80,000
TOTAL LIABILITIES	105,000	75,000	-	-	30,000	-	107,000
NET ASSETS							
Unrestricted							
Equity in Fixed Assets	348,000	348,000					283,000
Board Designated Equip Fund	90,000		90,000				150,000
Board Designated Ops Reserve	125,000			125,000			125,000
Undesignated Operating Funds	24,000				24,000		21,000
Total Unrestricted	587,000	348,000	90,000	125,000	24,000		579,000
Temporarily Restricted	62,000					62,000	95,000
TOTAL NET ASSETS	649,000	348,000	90,000	125,000	24,000	62,000	674,000
TOTAL LIABILITIES & NET ASSETS	754,000	423,000	90,000	125,000	54,000	62,000	781,000

APPENDIX D: OPERATING RESERVE NEEDS ANALYSIS

Operating Reserves Risk Analysis

Instructions: Erase the contents of the yellow cells and complete with data for your organization. Results are in red at bottom of sheet.

Current Finances

Operating reserves	100,000	
Annual budget	1,000,000	
Current operating reserves (# of months)	1.2	
Total revenue	1,000,000	
Revenue sources (%)	<u>Dollar Value</u>	<u>Percent Value</u>
Earned income	\$ 400,000	40%
Charitable donations & grants	\$ 500,000	50%
Investment & other income	\$ 100,000	10%

What's your target ratio? Complete the following...

What is the likelihood of following events occurring in next 3 years?

	<u>OR</u>	<u>OR</u>	<u>OR</u>	<u>OR</u>	<u>OR</u>
	Major natural or manmade disaster	Economic recession (5% GDP decline)	Major capital expense (new roof on office?) INCLUDE???	Open new program INCLUDE???	Gov't funder 3 month later than usual paying (earned income=\$0)
Additional reserves needed	585,000	0	0	90,000	0
Likelihood of occurring in next 3 years	50%	30%	10%	10%	50%
Impact on earned income (12 month period)	-25%	-5%	0%	15%	0%
Impact on donations	-15%	-10%	0%	0%	0%
Impact on investments	-10%	-20%	0%	0%	0%
Impact on demand for your goods and services	50%	-10%	0%	20%	0%
Short-term impact on cash flow and costs	0%	0%	5%	5%	10%
Projected earned income	300,000	380,000	400,000	460,000	400,000
Projected charitable donations & grants	425,000	450,000	500,000	500,000	500,000
Projected investment and other income	90,000	80,000	100,000	100,000	100,000
Projected revenue	815,000	910,000	1,000,000	1,060,000	1,000,000
Projected expenses	1,500,000	900,000	1,050,000	1,250,000	1,100,000
Net income if event occurs	(685,000)	10,000	(50,000)	(190,000)	(100,000)

(If negative, this is the amount that operating reserves should cover)

APPENDIX E: ILLUSTRATIVE OPERATING RESERVE POLICY AMENDMENT

For an organization that had to make its first operating reserve draw-down to meet the revenue shortfall incurred in fiscal year ending 2007-2008. The amount of this draw-down is not to exceed \$390,000 or 21% of the then existing reserve fund balance.

Accordingly, members of the Finance Committee agreed that more specific language addressing maintenance of the operating reserve be adopted. It is with that objective in mind that the Finance Committee recommends the following Operating Reserve Policy language be amended as follows:

Excerpt:

B. Maintenance

Once the targeted “Operating Reserve” level is achieved, the Finance Committee will make a recommendation annually to the Board of Directors for appropriate maintenance of the adjustment to the Operating Reserve. In a crisis situation, when significant funds are dispersed from the Operating Reserve, the Board of Directors must approve a plan to replenish the Operating Reserve. The recommended adjustment to replenish the Operating Reserve will be calculated based on 25% of the “Total Budgeted Operating Expenses and Program Funding” for the next fiscal year, compared to the projected balance in the Operating Reserve account for the current fiscal year-end and will be built into the budget for that year. This will occur at the 4th Quarter Board of Directors’ meeting when the operating budget for the next fiscal year is approved.

New Language:

“In the event there exists a deficit between the Operating Reserve account balance as required under the [organization’s] Operating Reserve Policy (25% of budgeted annual operating expenses), and the amount actually in the Operating Reserve (based on audited financial results), every effort should be made to eliminate the deficit in a minimum of three years, with one third of the deficit balance being funded in the current operating budget, until the Operating Reserve is restored to the minimum required balance. In the event the annual operating budgeted expenses result in a reduction in the required balance, no additional funding may be required. The objective of ensuring that the Operating Reserve balance meets or exceeds the required amount can be achieved through a combination of lowering budgeted expenses or increasing the amount invested in the Operating Reserve account. In the event operating expenses are budgeted to increase resulting in an Operating Reserve deficiency, the Board will budget to fund the required Operating Reserve balance.”

APPENDIX F - INVESTMENT CONSIDERATIONS: DEVELOPING A CASH INVESTMENT POLICY

(Note: This section is based on material from “The Cash Investment Policy Statement: Developing, Documenting and Maintaining a Cash Management Plan,” a paper published by BlackRock®. The original article has been modified for nonprofit organizations).

What is a Cash Investment Policy Statement (IPS)?

Having a documented policy for the administration of the nonprofit’s cash is among the most effective means of risk management, serving as a clear and constant reminder of the organization’s goals and ability to tolerate risk for its short-term funds. We believe the IPS should be part of every nonprofit’s risk management protocol, incorporated into an annual board review process and updated on a regular basis.

The cash IPS can be incorporated as part of the overall investment policy, which includes long-term funds as well as cash management, or be a separate document. A separate document will have the advantage of giving cash management a level of attention that may be lost when it is combined with more complex investments appropriate for long-term funds, such as endowments or quasi-endowments.

According to the Chartered Financial Analyst (“CFA”) Institute, an IPS “addresses the client’s risk tolerance, return requirements and all investment constraints (including time horizon, liquidity needs, legal and regulatory factors, and unique circumstances). ...The IPS also should identify and describe the roles and responsibilities of the parties to the advisory relationship and investment process, as well as schedules for review

A cash IPS will be important to determine:

- How the policy will be reviewed and modified on an ongoing basis,
- Who should be involved in that review process,
- Who has ultimate decision-making authority, and
- The frequency and timeframe for such a review (annually, semiannually).

In short, an effective cash IPS provides a means for communicating the objectives for and permitted level of risk in, a nonprofit’s cash portfolio. The IPS should provide guidelines for those responsible for managing the nonprofit’s cash, whether that is an internal or external manager.

Getting Started

Before developing a cash IPS, it is important to conduct a thorough evaluation of the nonprofit’s cash needs, including organization budgets and strategic plans. It is also important to pinpoint its risk profile. Effective forecasting of liquidity needs and assessment of risk tolerance allows for the best opportunity to achieve optimal returns within a cash portfolio.

If an investment manager is used for the management of operating reserve assets, then the nonprofit needs to share their cash flow forecasts and establish formal communication and reporting guidelines with that manager.

As an initial step, the appropriate staff should inventory the nonprofit’s cash flow forecasts. This process serves to quantify

how much cash is available for strategic investment. Additionally, staff should consider whether there are any organization-specific or unique restrictions to be factored into the cash IPS.

Second, it is important to assess the nonprofit’s priorities. To that end, ask the questions: “What is the general course of the nonprofit,” and “Where is cash likely to be deployed?” Answering these questions can help to ensure that the nonprofit’s finance staff and/or Finance Committee, which are typically responsible for overseeing the cash strategy, are sharply attuned to the broader objectives of the organization. Of equal importance is obtaining a good understanding of the nonprofit’s outlook, taking into account the organization’s view of the economy and the effect this will have on the organization’s revenue streams. When constructing a cash portfolio, it is important to understand how and when the nonprofit may potentially need cash. Forward knowledge of a cash need—be it months, weeks or just days ahead—can have a beneficial impact on expected returns. Having a thorough grasp of expected liquidity needs often can provide more opportunity for excess returns with less risk than a broader set of allowable investments in longer or lower-rated securities, but with uncertain needs.

From there, finance staff is better equipped to judge the overall makeup of the organization’s cash, a central concept that every nonprofit needs to understand when developing an IPS. In fairly simplistic terms, a nonprofit’s cash can fall into three distinct categories:

	Operating Cash	Core Cash	Strategic Cash
Investment Horizon	0-6 months	6-12 months	12-24 months
Liquidity Needs	Regular access to cash	Occasional access to a portion of cash	Varies; accessibility determined prior to investments
Investment Focus	Liquidity	Low-risk, Incremental return	Optimization of returns

Important Considerations

Each nonprofit organization’s cash investment policy will be as unique as the nonprofit itself, factoring in the organization’s liquidity needs, any risks to its revenue stream, broader economic trends and the size of the cash pool. The nonprofit’s specific situation will dictate the policy constraints and benchmark for the cash portfolio.

While an individual nonprofit’s investment policy ultimately should be customized, there are several important factors that all nonprofits should take into account when developing a policy. Each of them – risk tolerance, portfolio objective and benchmark – is described here.

Risk Tolerance

Risk tolerance is arguably the most important criterion upon which to begin building a cash investment policy. As a first step, the board must determine if the key priority is preservation of capital or maximization of returns. This determination may be made for cash as an asset class or for each category of cash the nonprofit maintains (i.e., operating, core and strategic). As a next step, consider whether, within each category, there is an ability to weather any deterioration in liquidity.

Risk can come in many forms – for example, short-term volatility, technical pressures (supply/demand) or **headline risk**⁵, to name just a few. The impact on the nonprofit’s cash portfolio can differ based on the ability to navigate these variables.

Types of Risk		
Primary Risks	Definition	Factors
Credit Risk	Risk that a security’s value will change due to a ratings downgrade or, in the case of a distressed security, default.	<ul style="list-style-type: none"> ▪ Ratings downgrade ▪ Default
Interest Rate Risk	Risk that a security’s value will change due to a change in interest rates or the shape of the yield curve.	<ul style="list-style-type: none"> ▪ Change in the level of interest rates ▪ Change in the shape of the yield curve
Liquidity Risk	Risk that arises from the difficulty of selling an asset: security cannot be bought or sold quickly enough to prevent or minimize a loss.	<ul style="list-style-type: none"> ▪ Secondary market bid availability
Spread Risk	Risk of change in value of a security due to a change in the relative spreads in the market.	<ul style="list-style-type: none"> ▪ Hybrid of credit and liquidity risk

Conventional investment wisdom suggests that higher returns are accompanied by higher levels of risk. However, as noted above, there are different types of risks to consider, some of which may be more tolerable than others given the potential reward. Quantifying such variables can be a difficult task, but considering these questions can help nonprofits frame their risk tolerance:

- What types of risk are acceptable? Can the nonprofit cope with lack of liquidity for a short or extended period of time? Is there ever a circumstance where loss of principal is acceptable?

⁵ “Headline risk” is defined as the risk that a major event or story will spread throughout various media/publications, and will negatively impact a company’s publicly-traded security prices. The risk is due to the harmful nature of the story, even if the news is not justifiable. For example, news about a corporate scandal at the executive level may apply downward pressure onto a security, even if there is no truth behind the allegation.

- Is the nonprofit prepared to weather volatility in returns? If so, how much is acceptable – monthly, quarterly or only annual bouts of volatility?
- How do different economic cycles effect the nonprofit’s revenue streams?
- How much diversification of investments is desired? It is not uncommon for a policy to incorporate parameters that do little to contain risk-taking, but do limit the portfolio in terms of diversification. Does the nonprofit have the means to access and manage a diverse mix of investments?

According to the CFA Institute, “The investment profession has long recognized that the combination of several investments is likely to provide a more acceptable level of risk exposure than having all assets in a single investment. The unique characteristics (or risks) of an individual investment may be partially or entirely neutralized when combined with other investments within a portfolio. Some reasonable amount of diversification is the norm for many portfolios, **especially those managed by individuals or institutions that have some degree of fiduciary responsibility.**”

The dialogue surrounding these questions can help ensure that the board is aware of the risks associated with their cash investment policies and the potential consequences of market or industry events.

Portfolio Objective

Based on the nonprofit organization’s risk tolerance, market views and liquidity needs, investment committees and boards are faced with the task of establishing objectives for their organization’s cash portfolios. A portfolio objective can be quantitative (e.g., seek returns that exceed a defined market hurdle) or qualitative (e.g., focus on safety and liquidity). In either case, the objective should be specific enough to guide the organization’s choice of investments, but flexible enough to allow the organization to take advantage of tactical opportunities that the cash and fixed income markets might present.

This is not to say that a nonprofit must establish a single objective for the management of its cash. In fact, multiple objectives are often warranted. Ultimately, these objectives will guide portfolio construction and help the nonprofit to appropriately divide its cash assets into operating, core and strategic buckets. Following are some common examples of cash portfolio objectives:

- Preserve principal.
- Meet forecasted cash flow needs.
- Provide income/yield.
- Deliver prudent, risk-managed total return.
- Seek above-benchmark returns.

Importantly, any given nonprofit might have multiple cash pools, each with a distinct purpose, such as those noted above. It is possible, and often more efficient to manage multiple pools within a single portfolio; however, it is necessary to identify the purpose of and to establish

an appropriate investment objective and risk profile for each pool within the context of the overall portfolio.

Ideally, the portfolio objective(s) also should address the question of **duration**⁶ or maturity structure or both. Specifically, portfolio objectives need to indicate whether the duration or average maturity should be actively adjusted to remain within a stated range or whether a buy-and-hold strategy is preferred. Typically, targeting a specific duration or average maturity is better suited to a total return objective, while buy and hold is more often associated with capital preservation. There are ramifications to either approach, as outlined in “The Question of Duration/Average Maturity” below.

The Question of Duration/Average Maturity

Every investment policy statement should factor in the desired duration or average maturity strategy for the nonprofit’s cash portfolio. Most often, this will be a choice between targeting a specific duration/average maturity or a buy-and-hold approach:

- **Target Duration or Average Maturity:** Making adjustments to target a specific duration or average maturity can expose a portfolio to high turnover. This can be a concern if the nonprofit’s management arrangement is such that costs are incurred per trade. In addition, trades to bring a portfolio in line with its benchmark could be subject to interest rate risk if the yield curve shifts up unexpectedly. That said, the effect of a change in interest rates or a shift in the yield curve should also be reflected in the composition of the portfolio’s benchmark. For a longer-dated portfolio, a total return strategy measured against an appropriate benchmark is the best tool for measuring the effectiveness of the investment strategy, serving to accurately evaluate both the principal value and income portions of performance.
- **Buy-and-Hold:** A buy-and-hold strategy is usually more appropriate for a capital

Of final note, when establishing an objective for cash accounts, consider the accounting associated with capital gains and losses. In most cases, a total return strategy will require more frequent portfolio turnover. This will equate to more accounting entries. In addition, if the nonprofit is working with a broker who is paid on a per-trade basis, higher turnover will result in an incremental increase in management costs.

Benchmark

A benchmark offers a means for comparing and measuring portfolio performance and risk. Importantly, a performance target is not a benchmark. While a cash portfolio may seek to match the return of a specific industry or peer group average, such as those for money market mutual funds, that alone does not constitute a benchmark. Generally speaking, every

⁶ “Duration” is defined as the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. The larger the duration number, the greater the interest-rate risk or reward for bond prices. Two main risks can affect a bond’s investment value: credit risk (default) and interest rate risk (rate fluctuations). The duration indicator addresses the latter issue.

benchmark should be transparent and measurable, meaning it should be comprised of well-defined securities with readily available prices quoted on a daily basis. By definition, a benchmark must exhibit a certain level of comparability with the portfolio’s makeup (in terms of type of securities held, asset allocation and duration) in order to effectively convey risk.

When choosing a benchmark, consider the impact of your decision on future performance comparisons. Because of the custom constraints and guidelines typically imposed on a nonprofit’s cash portfolio, most will often sacrifice yield-enhancement opportunities in favor of ensuring that the nonprofit’s large goals of capital preservation and liquidity are maintained. In contrast, most fixed income credit indices are total return-oriented and may have components that would be inappropriate for a cash portfolio. For that reason, the indices will often generate returns that exceed those of a more conservative cash portfolio. Considering the impact of your liquidity and risk objectives relative to the benchmark is an essential part of evaluating performance. In most cases, a blended benchmark containing elements that closely resemble the cash portfolio’s expected allocation may be beneficial. This allows you to better match those portions of the portfolio that are intended to be more liquid.

Components of an IPS Document

Each cash IPS will be unique in its details. However, the basic components are likely to be very similar across organizations. It is important to carefully evaluate each component of the IPS to rule out the possibility that related guidelines may contradict one another. In addition, boards should identify the particular risks they are seeking to control, and determine how to evaluate those risks, in constructing specific guidelines. The following is intended to illustrate the composition of a typical cash IPS.

Components of a Typical Cash Investment Policy Statement		
<p>1. Definition of Portfolio</p> <ul style="list-style-type: none"> Who is managing the portfolio <p>2. Investment Objective</p> <ul style="list-style-type: none"> Qualitative Quantitative <p>3. Benchmark</p> <ul style="list-style-type: none"> Performance target Risk target <p>4. Maturity/Duration Guidelines</p> <ul style="list-style-type: none"> Maximum maturity (may differ across sectors) Average duration for portfolio Weighted average life for asset-and mortgage-backed securities 	<p>5. Asset Guidelines</p> <ul style="list-style-type: none"> Specifically define allowable investment types and sectors <p>6. Asset Allocation</p> <ul style="list-style-type: none"> Define issuer and sector limitations <p>7. Credit Criteria</p> <ul style="list-style-type: none"> Short-term vs. long-term Quality (may differ by sector/asset class, e.g. only AAA-rated AGBS, but A-rated corporates) <p>8. Other Investment Practices</p> <ul style="list-style-type: none"> Repurchase agreement guidelines 	<p>9. Reinvestment of Income</p> <p>10. Custodian</p> <ul style="list-style-type: none"> Determined by the nonprofit <p>11. Accounting Agent</p> <ul style="list-style-type: none"> Your investment manager’s reports are to be used only for reconciliation and performance purposes Your custodian and/or accounting agent is the official record keeper for the portfolio <p>12. Other Vendors</p> <ul style="list-style-type: none"> Investment consultant Treasury consultant Compliance/reporting systems

Conclusion

The importance of a well-documented and up-to-date cash investment policy cannot be overstated. The IPS serves as a critical roadmap for nonprofit organizations and investment managers charged with navigating today's increasingly complex cash and fixed income markets. By ensuring that all parties understand and observe the same objectives and guidelines, the IPS paves the way for successful administration of a nonprofit's operating reserves.

APPENDIX G: OTHER CONSIDERATIONS

Selected comments from various readers of an earlier draft of the Toolkit:

Comment 1

Our organization maintains a “Fiscal Standard” policy which is similar in ways to NORI’s operating reserve. This policy speaks to operating reserves at three levels:

1. Spending – generally limited to revenue and support, but may exceed where excess net assets are present.
2. Net asset floor and ceiling – the floor ensures that the organization maintains adequate reserves; the ceiling serves as a trigger for avoiding unnecessary net asset accumulations.
3. Liquidity – ensures the organization’s ability to meet its current obligations.

If an organization’s net assets are less than the net asset floor, they would need to budget to raise the level of net assets back to the floor level. If they exceed the ceiling, they would budget to spend down their net assets back to within the ceiling level. These indicators should be monitored at least annually, more often if necessary.

Further, during particularly difficult economic times, it is often useful to define liquidity at two levels:

1. To meet rainy day needs, and
2. For longer-term investment.

During tough economic times organizations tend to spend down excess net assets at the same time that the economy is heading south, but they are not transferring long-term invested funds into cash or short-term funds. As a result, they walk a tightrope – in effect borrowing money short-term while waiting for the most appropriate time to liquidate funds invested in stocks.

Comment 2

Using the annual operating expense budget as the denominator for the operating reserve ratio might be inadequate for a growing organization with the need to finance other balance sheet growth, such as capital expenditures, gift shop or other inventories, and prepaid expenses.

Comment 3

Since many nonprofits do not have sufficient operating reserves, some respondents suggested that it might be helpful to provide some additional guidance on how to accumulate them via budgeting, long-range planning or other ways, including how to deal with the political demands that might prioritize “putting money toward the fight” over saving for that rainy day.

Comment 4

For those organizations fortunate enough to have excess reserves, some respondents suggested that the document advise them on how to and not to spend those down. For example, advising them against hiring more staff (long-term commitment) to spend down a short-term excess.

APPENDIX H: GLOSSARY OF TERMS

By Consensus of the Nonprofit Operating Reserves Initiative Workgroup
NCCS/CNP, The Urban Institute

A top priority for nonprofit leaders needs to be maintaining operating reserves at levels adequate for achieving **financial stability**⁷. Financial stability of nonprofit organizations includes maintaining operating reserve ratios at levels adequate for preserving the capacity of nonprofit organizations to deliver on their missions for a reasonable period of time in the event of unforeseen financial shortages.

The definitions in this glossary are intended to be consistent with IRS Form 990 instructions, “Blackbook” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, and *Financial Statements of Not-for-Profit Organizations* (SFAS 117)⁸. SFAS 117 is issued by the Financial Accounting Standards Board and provides standards for external financial statements certified by an independent accountant for certain types of nonprofit organizations.⁹

One-size-fits-all standards for what it means to be financially stable are not feasible. However, there can be common terminology and definitions so that we can have a consistent way of talking about nonprofit financial stability, operating reserves, board-designated funds and **reserve policies**. The following terms are described first, and then defined alphabetically in this glossary.

Annual operating expense budget
Annual operating surpluses or deficits
Available for operating reserves
Available unrestricted net assets
Board-designated funds
Board-designated operating reserves
Board-designated quasi-endowment funds
Board-designated special purpose funds
Capital acquisition funding
Depreciation
Equity in fixed assets
Financial stability
Fund accounting

Funded operating reserve
Net assets
Not available (see equity in fixed assets)
Operating funds
Operating reserve policy
Operating reserve ratio
Operating reserves
Permanently restricted net assets
Temporarily restricted net assets
Undesignated operating funds
Undesignated operating reserves
Unrestricted net assets

⁷ *Maintaining Nonprofit Operating Reserves*, 2008. A White Paper by the Nonprofit Reserves Initiative Workgroup that can be found at: http://www.nccs2.org/wiki/index.php?title=Nonprofit_Reserves_Workgroup

⁸ SFAS No. 117 can be found at: <http://www.fasb.org/pdf/fas117.pdf>

⁹ Users of this glossary are expected to be familiar with SFAS No. 117’s net asset concepts, which are not described in detail in this document.

Description of Terms and Phrases

The operating reserve ratio is the centerpiece of the Nonprofit Operating Reserves Initiative.

$$\text{Operating Reserve Ratio} = \frac{\text{Operating Reserves}}{\text{Annual Operating Expense Budget}}$$

An organization's operating reserve ratio can be calculated in terms of a percentage:

→ operating reserves divided by annual operating expense budget

Or number of months:

→ operating reserves divided by 1/12th of the annual operating expense budget

Minimum operating reserve ratio at lowest point during the year suggested by the Nonprofit Operating Reserves Initiative Workgroup is 25 percent or 3 months of the annual operating expense budget.

For example, an organization with an operating reserve of \$250,000 and an annual operating expense budget of \$1,000,000 would have an operating reserve ratio of 25 percent or three months.

As used here, "operating reserves" means the portion of unrestricted net assets that is available for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. Unrestricted net assets is a required line item in the net assets section of balance sheets of financial statements prepared in accordance with generally accepted accounting principles (GAAP) and IRS Forms 990 of not-for-profit organizations.

Unrestricted net assets, including operating reserves, are generated through a series of annual surpluses of unrestricted revenue over expenses. Likewise, unrestricted net assets and operating reserves are depleted through annual deficits of unrestricted revenue over expenses. The unused portion of capital acquisition funding and unused reserves for uncollectible pledges (when losses are lower than expected) may be used to fund operating reserves.

A board-approved reserves policy establishes a minimum operating reserve ratio in terms of a percentage, or number of months of the prior year annual expenses or current year expense budget. The reserves policy can also include board-designated funds that are set aside for non-operating special purposes and/or quasi endowment.

Board-designated funds consist of board-designated operating reserves, board-designated special purpose funds and board-designated quasi-endowment funds. Board-designated special purpose and quasi-endowment funds, by definition, are not available for general operations. However, portions or all of these board-designated funds can be undesignated by board action and become available for operations if financial conditions change – e.g., when the operating reserve ratio falls below the minimum level set by the board.

Three definitions for operating reserves

There are three definitions for Operating Reserves: board-designated (recommended), undesignated (simplified, not recommended*) and available (simplest, not recommended*).

Definition I - Board-Designated Operating Reserves (recommended) are defined as the portion of “available unrestricted net assets” that the board has *designated* for Operating Reserves (See Figure 1 below and Figures C1, C2 and C5, Appendix C).

“Available unrestricted net assets” equals total unrestricted net assets less equity in fixed assets.

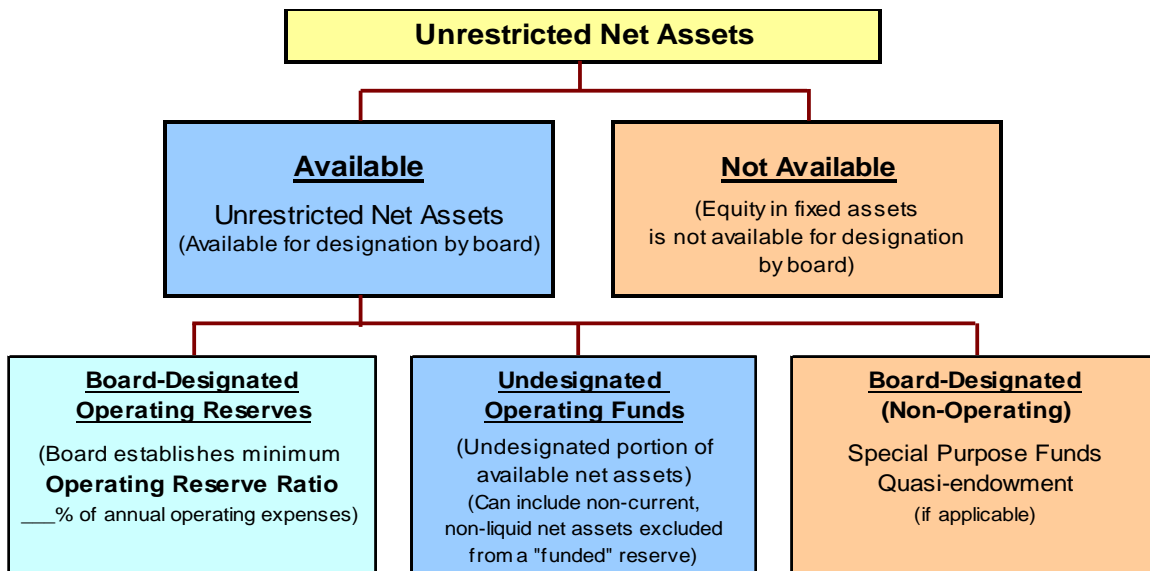
Use of a *Funded* Operating Reserve is strongly recommended where a Board-Designated Operating Reserves *fund* (using a fund accounting method) is established consisting of liquid assets and accounted for in the asset section of the balance sheet *separately* from Undesignated Operating Funds. (See Figures C1, C2 and C5, Appendix C)

Definition II - Undesignated Operating Reserves (simplified, not recommended*) are defined as the portion of “available unrestricted net assets” that the board has *not* designated for specific purposes (See Figure 2 below and Figure C3, Appendix C).

Definition III – Available For Operating Reserves (simplest, not recommended*) are defined as the *available* portion of total unrestricted net assets when organizations do not have any board-designated funds (See Figure 3 below and Figure C4, Appendix C).

* While *not recommended*, undesignated and available definitions may be used by organizations that do not have the capacity, or chose not, to account separately for both Board-Designated Operating Reserves and Undesignated Operating Funds. Undesignated and available definitions are *not recommended* because they do not provide for balance sheet accounts for operating reserves, separate from day-to-day operating funds accounts. Undesignated and available for operating reserves include non-current, non-liquid assets such as pledge and other receivables, inventory, prepaid expenses and deposits held by others. It can appear that an organization has adequate operating reserves when, in fact, liquid cash reserves can be very low or nonexistent, putting the organization at risk of experiencing serious financial viability issues in the event of an emergency.

Figure 1 – Hierarchy of a balance sheet’s unrestricted net asset terms presented in an illustration of the Recommended *Board-Designated* Operating Reserves.



Illustrative net assets hierarchy with Board-Designated Operating Reserves

[As used in the “net asset” section of a Statement of Financial Position (aka, Balance Sheet)]
(See Figures C1, C2, and C5, Appendix C)

Net assets (*)

Unrestricted net assets

Equity in fixed assets (**)

Board-designated operating reserves (***)

Board-designated special purpose funds

Board-designated quasi-endowment funds

Undesignated operating funds (****)

Temporarily restricted net assets

Permanently restricted net assets

Total net assets

(*) *Net* assets = assets *net* of liabilities or excess of assets over liabilities – similar to fund balances.¹⁰ FASB Statement No. 117 “requires that all not-for-profit organizations provide a Statement of Financial Position” [balance sheet] that includes “amounts for the organization’s total assets, liabilities and net assets.” FAS 117 “also requires classification of an organization’s net assets based on the existence or absence of donor-imposed restrictions” and “requires that amounts for each of three classes of net assets (permanently restricted, temporarily restricted and unrestricted) be displayed in a Statement of Financial Position”¹¹.

(**) Equity in fixed assets is reported in the net asset section of a balance sheet, net of mortgages and notes that are secured by such assets. They are not available for designation by the board. They are excluded from the calculation of operating reserve ratios.

(***) Organizations maintain separate unrestricted net asset accounts (line items) for board-designated operating reserves. Board-designated operating reserves can serve as an internal line of credit with board specified terms of use and replenishment. Funds “borrowed” from board-designated operating reserves would be “repaid” when, for example, anticipated revenues are received.

(****) Undesignated operating funds is a line item reported in the unrestricted net asset section of a balance sheet that fluctuates up or down according to day-to-day changes in normal cash flow activity. Note that undesignated funds should not be in a deficit position in the statement of financial position of an annual audited general purpose financial report.¹² Undesignated funds are classified as “Undesignated – available for general activities” in the 1988 Black Book’s illustrative balance sheet.¹³

The above breakdown of unrestricted net assets is not required in general purpose external financial reports, but may be included in the net asset section of the statement of financial position or in the notes, at the organization’s request.

¹⁰ The generally understood terms “assets,” “liabilities” and “fund balances” are not defined in this glossary.

¹¹ FAS 117 Summary, FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.

¹² Page 76, Black Book, *Standards of Accounting & Financial Reporting*, 1988

¹³ Page 87, Black Book, *Standards of Accounting & Financial Reporting*, 1988

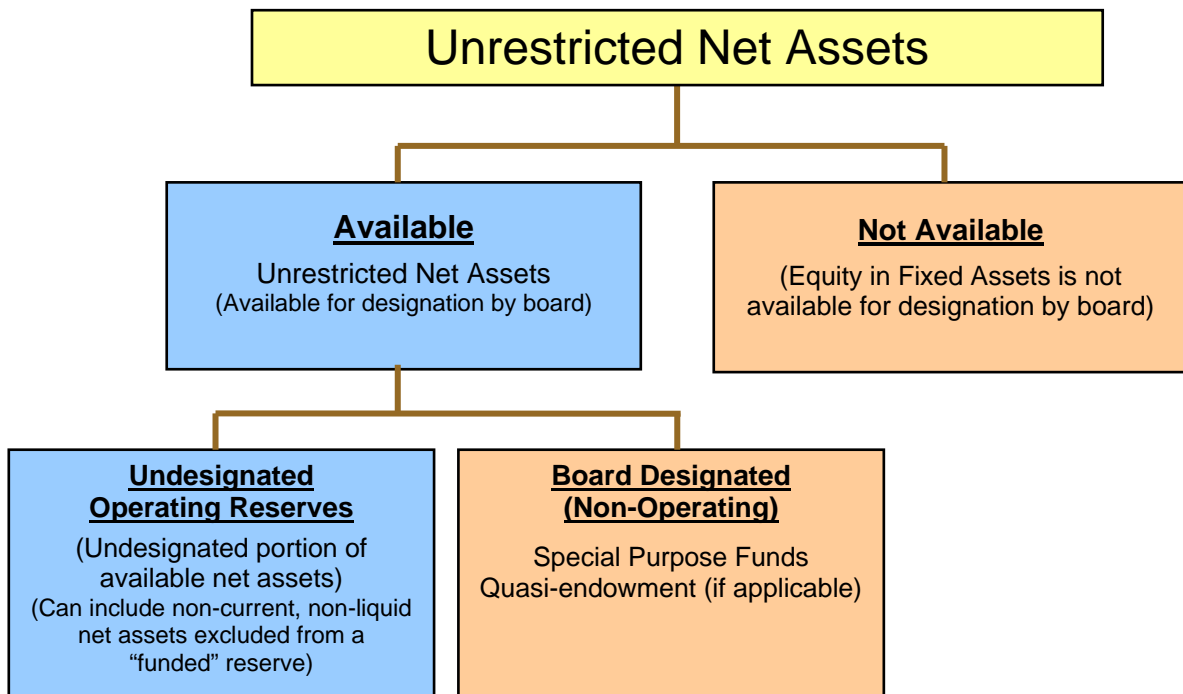
Accounting for funded operating reserves as net assets and assets

(See Figure C5, Appendix C)

In addition to maintaining separate unrestricted net asset accounts (line items) for board-designated operating reserves, organizations that employ fund accounting methods have assets that correspond to their board-designated operating reserves.

Some organizations go further and classify operating reserves as non-current asset accounts consisting of solely of liquid assets – i.e., cash and cash equivalents. In this way, board-designated operating reserves exclude (in addition to equity in fixed assets) other non-current assets, net of related liabilities, such as long-term receivables, inventory, prepaid expenses and deposits held by others. Thus, these non-current assets are excluded from the calculation of operating reserve ratios. See Figure C3 in Appendix C for an illustrative statement of financial position (balance sheets) that reflects this practice.

Figure 2 – Hierarchy of a balance sheet’s unrestricted net asset terms presented in an illustration of Undesignated Operating Reserves (not recommended).



* Equity in fixed assets is reported in the net asset section of a balance sheet, net of mortgages and notes that are secured by such assets. They are not available for designation by the board. They are excluded from the calculation of operating reserve ratios.

** The use of Undesignated Operating Reserves is *not recommended* because it does not provide for balance sheet accounts for operating reserves, separate from day-to-day operating funds accounts. Further, Undesignated Operating Reserves include non-current, non-liquid assets such as pledge and other receivables, inventory, prepaid expenses and deposits held by others.

Illustrative net assets hierarchy with undesignated operating reserves

[As used in the “net asset” section of a Statement of Financial Position (aka, Balance Sheet)]

(See Figure C3, Appendix C)

Net assets

Unrestricted net assets

Equity in fixed assets

Board-designated special purpose funds

Board-designated quasi-endowment funds

Undesignated operating reserves (*)

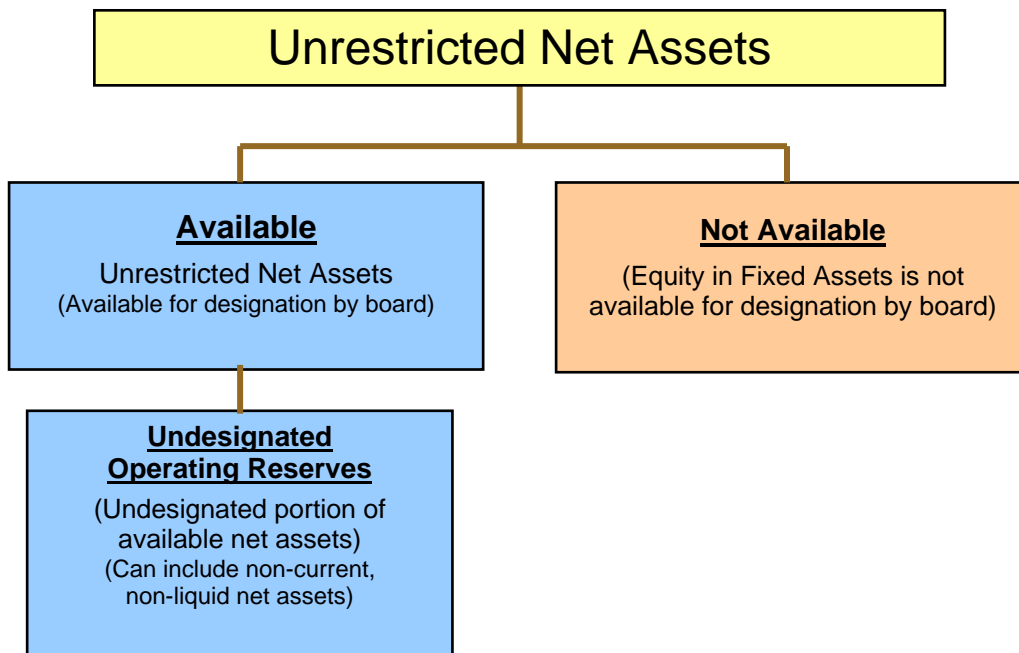
Temporarily restricted net assets

Permanently restricted net assets

Total net assets

(*) Undesignated operating reserves fluctuate up or down according to day-to-day changes in normal cash flow activity.

Figure 3 – Hierarchy of a balance sheet’s unrestricted net asset terms presented in an illustration of **Available For Operating Reserves** (not recommended).



* Equity in fixed assets is reported in the net asset section of a balance sheet, net of mortgages and notes that are secured by such assets. They are not available for designation by the board. They are excluded from the calculation of operating reserve ratios.

** The use of the Available For Operating Reserves method is *not recommended* because it does not provide for balance sheet accounts for operating reserves, separate from day-to-day operating funds accounts. Further, the Available For Operating Reserves method may include non-current, non-liquid assets such as pledge and other receivables, inventory, prepaid expenses and deposits held by others.

Illustrative net assets hierarchy with Available For Operating Reserves

[As used in the “net asset” section of a Statement of Financial Position (aka, Balance Sheet)]

(See Figure C4, Appendix C)

Net assets

Unrestricted net assets

Equity in fixed assets

Available for operating reserves (*)

Temporarily restricted net assets

Permanently restricted net assets

Total net assets

(*) Undesignated **operating** reserves fluctuate up or down according to day-to-day changes in normal cash flow activity.

Operating reserve policy

An operating reserve policy includes policies on operating reserves adequate for financial stability. An operating reserve policy can also include policies on board-designated funds that further the mission of the organization, even though some nonprofits do not classify board-designated funds as reserves¹⁴.

An operating reserve policy can be the operating reserves and other board-designated funds sections in a written, board-approved *financial management policy*. In addition to policies covering operating reserves and board-designated funds. *Financial management policies* can also include policies on financial planning, budgeting, internal controls and accounting procedures, internal and external reporting, auditing, and investments. In addition to an operating reserve policy, it is useful for nonprofits to have budgeting and other financial management *practices* in place that first build, and then maintain adequate operating reserves and, when needed, board-designated funds that specifically support mission.

For purposes of calculating annual operating expense budgets for use in operating reserve ratios, projections of expenses related to restricted funds are included. For example, operating reserve ratio denominators include the organization’s total payroll and personnel related budgets.

Annual operating expense budgets used in calculating operating reserve ratios need to exclude budgets for capital acquisition funding, depreciation, contributed services and donated use of facilities. Note that contributed services and use of facilities would be included if they are only temporary and would soon need to be replaced with cash expenditures. Annual operating expense budgets can also exclude use of tangible in-kind, non-cash donations if loss of such donations would not need to be replaced with cash expenditures.

Annual operating expenses for the prior year can be used as an alternative denominator to annual operating expense budgets. Actual operating expenses can be easier to calculate than expense budgets, especially when restricted funds are involved.

¹⁴ For example, United Way Worldwide’s reserve policy guide does not classify **Board-designated funds** as reserves. It does use a definition for reserves that is consistent with the definition for **undesignated operating reserves** in this glossary. “Reserves and Reserve Policies Guidelines for United Ways” can be found at: <http://www.nccs2.org/wiki/images/a/ad/UWA-ReservesandReservePolicies%284-17-07%29.pdf>.

Accounting references

Key accounting terms in this document are used in nonprofit accounting literature. For example, the 1998 edition of the Blackbook contains extensive descriptions and guidance for “Board-Designated Funds,” “Quasi Endowment Fund,” operating reserves under the title “General/Operating Fund,” and “Unrestricted Fixed Assets Fund.” The term “Funds” is the same as the FASB Statement No. 117 term “net assets.” Board-designated funds include designations of a “portion of net assets to fund a certain program, activity, or purpose, e.g., disaster relief, AIDS education, a homeless project, research, etc.”¹⁵

¹⁵ Pages 11 to 15 and 128 to 129, “Blackbook” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, 1998 edition. The “Blackbook” *Standards* are sponsored by National Health Council and National Human Services Assembly.

Definitions

In alphabetical order. Key phrases and sentences in the “Description of Terms and Phrases” section (pages 2 to 4) of this glossary are intentionally repeated in this “Definitions” section as appropriate.

Annual operating expense budgets

Annual operating expense budgets are the denominators used in operating reserve ratios.

Annual operating expense budgets equal total annual expense budget less budget for purchase of fixed assets and other non-operating expenses.

For purposes of calculating annual operating expense budgets for use in operating reserve ratios, projections of expenses related to restricted funds are *included*. For example, operating reserve ratio denominators include the organization’s total payroll and other personnel related budgets.

Annual operating expense budgets used in operating reserve ratios can *exclude* budgets for depreciation, contributed services and donated use of facilities. Note that contributed services and use of facilities would be included if they are only temporary and would soon need to be replaced with cash expenditures. Annual operating expense budgets can also *exclude* use of tangible in-kind, non-cash donations if loss of such donations would not need to be replaced with cash expenditures.

Actual annual operating expenses for the prior year can be used as an alternative denominator to the annual operating expense budgets. Actual operating expenses can be easier to calculate than expense budgets, especially when restricted funds are involved.

Annual operating surpluses or deficits

Unrestricted net assets, including board-designated operating reserves, are generated through annual surpluses of unrestricted revenues over expenses. Likewise, unrestricted net assets and operating reserves are depleted through annual deficits of unrestricted revenues over expenses.

Available for operating reserves

Available For Operating Reserves (simplest, not recommended*) are equal to available unrestricted net asset – i.e., the available portion of total unrestricted net assets after deducting equity in fixed assets -- when organizations do not have any Board-Designated Funds. [See Appendix C, Figure C4 for an illustrative statement of financial position.]

* While not recommended, the available for operating reserves option may be used by organizations that do not have the capacity, or chose not, to account separately for both Board-Designated Operating Reserves and Undesignated Operating Funds. Use of the available for operating reserves option is not recommended because it does not provide for balance sheet accounts for operating reserves, separate from day-to-day operating funds accounts. Available for operating reserves include non-current, non-liquid assets such as pledge and other receivables, inventory, prepaid expenses and deposits held by others. It can appear that an organization has adequate operating reserves when, in fact, liquid cash reserves can be very low or nonexistent, putting the organization at risk of experiencing serious financial viability issues in the event of an emergency.

Available unrestricted net assets

Available unrestricted net assets are the portion of total unrestricted net assets that are available for board-designated operating reserves and for non-operational board-designated special purpose funds and board-designated quasi-endowment funds that further the mission of the organization.

A simple definition for available unrestricted net assets is unrestricted net assets less equity in fixed assets, which is fixed assets net of related long-term debt.

Board-designated funds

Board-designated funds consist of board-designated operating reserves, board-designated special purpose funds and board-designated quasi endowment funds.

FASB Statement No. 117 uses the term “board-designated” as follows: “An organization’s governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called funds functioning as endowment or quasi-endowment funds)”¹⁶

The 1998 edition of the Blackbook contains the following guidance for board-designated funds: “Funds specifically designated by board action for a particular purpose are board-designated. Board-designated funds are included in unrestricted net assets because the board has discretionary control over the assets. The word ‘restricted’ should not be used to describe such funds. The fund balance for board-designated funds must be included in ‘Total Unrestricted Net Assets’ on the balance sheet. Additionally, net changes to board-designated funds must be incorporated in ‘Changes in Unrestricted Net Assets’ on the Statement of Activities.”¹⁷

As a general rule, building adequate board-designated operating reserves is viewed as the first priority over other, non-operating board designated funds. Non-operating Board Designated Funds are for optimal mission accomplishment while board-designated operating reserves are for financial stability.

Once an adequate board-designated 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. 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, non-operating board- designated funds can be re-designated as operating reserves by board action if financial conditions change.

When to establish board-designated quasi-endowment funds? It is suggested that nonprofits with available unrestricted net assets under 25% of their annual expense budgets would not have adequate available unrestricted net assets to be able to maintain or establish board-designated special-purpose funds or board-designated quasi-endowment funds. In addition, organizations are encouraged not to establish board-designated special purpose or quasi-endowment funds that result in operating reserves of less than the minimum percentage of their annual operating expense budgets set by the organization’s board. On the other hand, when operating reserves begin to exceed the minimum level set by the board, organizations can consider establishing other board-designated funds.

¹⁶ Paragraph 168 (the glossary), FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

¹⁷ Pages 11 to 15 and 128 to 129, “Blackbook” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, 1998 edition.

When to reverse *non-operating* board-designated funds? If board-designated operating reserves fall below the minimum level set by the board, the board can reverse portions of their unexpended board-designated special-purpose and/or quasi-endowment funds as needed to replenish their operating reserves to minimum levels. In other words, while these *non-operating* board-designated funds are not available -- or intended for use -- to cover any payroll or other general operating expenses, any un-obligated board-designated funds can become operating reserves – as needed – when the operating reserve ratio falls below minimum, e.g., under 25 percent.

Board-designated operating reserves

The board-designated operating reserves unrestricted net asset account (line item) shows the portion of available unrestricted net assets that the board has designated for use in unusual or unforeseen financial emergencies, separate from the Undesignated Operating Funds account. [See Appendix C, Figures C1 and C2 for an illustrative statements of financial position.]

This unrestricted net asset account can serve as an internal line of credit with board specified terms of use and replenishment, to draw down from when needed to cover the normal fluctuations of day-to-day operations. Funds “borrowed” from board-designated operating reserves can be “repaid” when, for example, anticipated revenues are received.

Recommendation: the Funded Operating Reserve option. In addition to maintaining separate unrestricted net asset accounts (line items) for board-designated operating reserves and Undesignated Operating Funds, it is strongly recommended that organizations go further and employ fund accounting methods that segregate *assets* related to board-designated operating reserve as separate operating reserves accounts (line items) in the *assets* section of their balance sheets. Some organizations go even further and classify board-designated operating reserves as *non-current* asset accounts consisting of solely of liquid assets – i.e., cash and cash equivalents. In this way, board-designated operating reserves exclude (in addition to equity in fixed assets) other non-current assets, net of related liabilities, such as long-term receivables, inventory, prepaid expenses and deposits held by others. Thus, these non-current assets are excluded from the calculation of operating reserve ratios. See Appendix C, Figure C5 for an illustrative statement of financial position (balance sheets) that reflects this fund accounting method.

Board-designated quasi-endowment funds

Board-designated quasi-endowment funds are board-designated unrestricted net assets that function as permanent endowments. The principal of a quasi-endowment is maintained intact and only the income is spent either for general purposes or for purposes specified by the board .

The 1998 edition of the Blackbook contains the following guidance: “The corpus of a quasi-endowment is classified as an unrestricted net asset because there are no donor imposed restrictions, but an organizational designation. These funds are under the control of the governing board and management. They are available for general use at the discretion of the board.”¹⁸.

FASB’s SFAS No. 117 describes “board-designated endowment funds” as follows: “An organization’s governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called funds functioning as endowment or quasi-endowment funds).”¹⁹

¹⁸ Page 14, “Blackbook” *Standards*, 1998.

¹⁹ Paragraph 168 (the glossary), FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

FASB Statement No. 117 also defines “endowment fund” as follows: “An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted.”²⁰

Endowed artistic positions and scholarship funds are a typical forms of board-designated quasi-endowment funds. The purpose of a scholarship fund is to provide self-sustaining financial support for the scholarship program apart from the annual operating budget.

Board-designated special purpose funds

Board-designated special-purpose funds are the “portion of unrestricted net assets to fund a certain program, activity, or purpose, e.g., disaster relief, AIDS education, a homeless project, research, etc. These funds are under the control of the governing board and management. They are available for use at the discretion of the board.”²¹

These non-operating board-designated funds further programmatic and organizational goals, objectives and special needs.

Once organizations reach the board-designated goal for operating reserves, they can then establish board-designated special-purpose funds for programmatic and/or organizational and infrastructure needs. The following are examples.

Programmatic:

- Disaster relief funds and other programmatic emergencies
- Special projects
- Stabilization of support programs [e.g., assuring allocations for United Way agencies]. Board designations for stabilization of financial support programs are intended to enable nonprofits that make grants and allocations to other nonprofits or provide financial support directly to individuals, to continue these financial support activities during periods of declining revenues.
- Unanticipated programmatic opportunities. For example, a "Carpe Diem" or "Artistic Venture Capital" or "Opportunity" Fund set aside by the board to position its entrepreneurial artistic director to launch a new project or seize a timely opportunity that would otherwise destabilize the organization financially or have to be forfeited.
- A Program Development Fund set aside by the board to be available for major program initiatives or opportunities requiring significant development or start-up costs.

²⁰ See more detailed definition in Paragraph 168 (the glossary), FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

²¹ The “Blackbook” uses the term “Program Fund (Unrestricted portion)” rather than **Board-designated special purpose funds**; *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, 1998 edition.

Organizational and infrastructure:

- Infrastructure Fund established by the board for purchase of fixed assets (e.g., land, buildings, equipment, furniture, other facilities, software, technology). An Infrastructure Fund can be generated using a capital acquisition funding line item in the annual cash operating budget.
- A Fixed Asset Building & Equipment Maintenance & Replacement Fund, which might be funded in part by including a capital acquisition funding line item in the annual cash operating budget or by allocation of funded non-cash depreciation expense.
- Sustainability of operations [major fluctuations] fund for organizational emergencies, unusual or emergency situations such as moving to new facilities, CEO turn over or similar unexpected disruptions in operations and services
- A Human Resources Capacity Building Fund set aside by the board as the organization hires additional fundraising staff whose return on investment (ROI) will not be evident until the following 12-18 months; or the fund could be to support leadership succession.

Board designations for *purchase of fixed assets* and for *fixed asset maintenance and replacement* are intended to be spent on land, buildings, furniture, equipment, works of art, software or other fixed assets. Once the fixed assets are purchased, maintained or replaced, the amounts are transferred from board-designated net assets to equity in fixed assets. The target balance for these funds would then need to be re-evaluated, and the funds replenished over a set timeline if appropriate.

Board-designated special-purpose funds are intended for uses other than general operations and are expected to be expended solely for special projects and purposes. Board-designated special-purpose funds are not intended for use to cover payroll for permanent employees, occupancy and other unavoidable operating expenses.

Capital acquisition funding

Capital acquisition funding can be one or more line items included in the annual cash operating budget used to fund *purchase of fixed assets* (e.g., land, buildings, equipment, furniture, other facilities, software, technology).

The unused portion of capital acquisition funding can be used to fund board-designated operating reserves.

Depreciation

Depreciation is a natural expense category in a statement of functional expenses. Depreciation accounting is the amortization of fixed assets, such as plant and equipment, in order to allocate the cost over its useful life. It is a process of cost allocation and not valuation. Depreciation increases expenses but does not reduce cash. Depreciation is recorded by debiting depreciation expense and crediting accumulated depreciation.²²

²² Definition of **depreciation** is from [Dictionary of Accounting Terms](http://www.allbusiness.com/glossaries/depreciation-accounting/4953023-1.html), found at <http://www.allbusiness.com/glossaries/depreciation-accounting/4953023-1.html>

Equity in fixed assets²³

Equity in fixed assets are usually unrestricted and are therefore reported in the unrestricted net asset section of a balance sheet, net of mortgages and notes that are secured by such assets. However, portions of *equity in fixed assets* can be temporarily restricted and/or permanently restricted if this is a requirement specified by a donor.

“Fixed assets are unrestricted when they are either purchased with unrestricted funds or contributed without restriction as to use or disposition. Unrestricted fixed assets are recorded at cost less depreciation, and are offset by associated liabilities such as mortgage notes, bonds or capital leases in the unrestricted net asset class on the balance sheet.”²⁴

Equity in fixed assets may include land, buildings, equipment, furniture, leasehold improvements, works of art and other assets with a useful life of 1-year or more and that exceed an organizations capitalization threshold. *Fixed assets* are reported net of depreciation in the asset section of a balance sheet. Only the unrestricted portion of *equity in fixed assets* is included in the calculation of what comprises available unrestricted net assets – i.e., total unrestricted net assets less unrestricted equity in fixed assets. `

Financial stability

Financial stability of nonprofit organizations includes maintaining operating reserve ratios at levels adequate for preserving the capacity of nonprofit organizations to deliver on their missions for a reasonable period of time in the event of unforeseen financial shortages.

Fund accounting

Fund accounting methods are required in order to implement the recommendation that organizations segregate *assets* related to Board-Designated Operating Reserve and Undesignated Operating Funds as separate accounts (line items) in the *assets* section of their balance sheets. See Appendix C, Figure C2 for an illustrative statement of financial position (balance sheet) that reflects this method.

Wikipedia: “**Fund Accounting** is an accounting system often used by nonprofit organizations and by the public sector. According to StartHereGoPlaces, fund accounting is a “[m]ethod of accounting and presentation whereby assets and liabilities are grouped according to the purpose for which they are to be used.” “It is the unique nature in which nonprofit organizations and the public sector operate that has made fund accounting a useful system for financial reporting to meet the needs of financial statement users. To that end, the accounting profession has recognized this need and continues to support the use of fund accounting by providing extensive standards and principles in this area.”²⁵

Blackbook (1988)²⁶: “A Fund is a separate accounting entity with a self-balancing set of accounts for recording assets, liabilities, fund balance, and changes in fund balance.” “When a columnar format is used [in a balance sheet] to present the financial statements, the undesignated and board-designated portions of the Current Unrestricted Fund may be presented side by side provided a total Unrestricted Fund column

²³ Users of this glossary are expected to be familiar with the term ‘fixed assets,’ which are not described in detail in this document.

²⁴ Page 14, “Blackbook” *Standards*, 1998

²⁵ http://en.wikipedia.org/wiki/Fund_Accounting

²⁶ Page 8, Black Book, *Standards of Accounting & Financial Reporting*, 1988

is also presented.” [FASB’s FAS No. 117 uses “classes of net assets” in place of “Funds” and “fund balances.”]

FASB: “The [FASB] Board decided to permit but not require not-for-profit organizations to disaggregate and report assets and liabilities by donor-restriction and unrestricted classes or fund groups.”²⁷

Funded operating reserve

With the use of a *Funded* Operating Reserve, which is strongly recommended, a Board-Designated Operating Reserves *fund* (using a fund accounting method) is established consisting of liquid assets and accounted for in the asset section of the balance sheet *separately* from Undesignated Operating Funds.²⁸

Net assets²⁹

Net assets = assets *net* of liabilities or excess of assets over liabilities – similar to equity or fund balances.³⁰

FASB’s SFAS No. 117 standards³¹ and IRS Form 990 instructions³² for reporting net assets apply.

FASB Statement No. 117 “requires that all not-for-profit organizations provide a statement of financial position” [balance sheet] that includes “amounts for the organization’s total assets, liabilities and net assets” [excess of assets over liabilities – similar to fund balances]. FAS 117 “also requires classification of an organization’s net assets based on the existence or absence of donor-imposed restrictions” and “requires that the amounts for each of three classes of net assets – permanently restricted, temporarily restricted and unrestricted – be displayed in a Statement of Financial Position”³³.

Form 990 instructions for Part X, lines X-27 through X-29—Net assets [2008 IRS Form 990]

“The Financial Accounting Standards Board issued *Financial Statements of Not-for-Profit Organizations* (SFAS 117). SFAS 117 provides standards for external financial statements certified by an independent accountant for certain types of nonprofit organizations. If the organization follows SFAS 117, report net assets in three groups—unrestricted, temporarily restricted, and permanently restricted—based on the existence or absence of donor-imposed restrictions and the nature of those restrictions. Show the sum of the three classes of net assets on line X-33.”

Not available [see equity in fixed assets]

²⁷ Paragraph 94, FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

²⁸ For example, the United Way Worldwide’s reserve policy guide proposes the use of ‘funded reserves.’ “*Reserves and Reserve Policies Guidelines for United Ways*” can be found at: <http://www.nccs2.org/wiki/images/a/ad/UWA-ReservesandReservePolicies%284-17-07%29.pdf>.

²⁹ Users of this glossary are expected to be familiar with the term ‘net assets,’ which is not described in detail in this document.

³⁰ The generally understood terms ‘assets,’ ‘liabilities’ and “fund balances’ are not defined in this glossary.

³¹ SFAS No. 117 can be found at: <http://www.fasb.org/pdf/fas117.pdf>

³² The link to the 2008 IRS Form 990 is <http://www.irs.gov/pub/irs-tege/f990rcore.pdf>.

³³ FAS 117 Summary, FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

Operating funds [See also Undesignated operating funds]

When a funded operating reserve employing a fund accounting method is maintained, assets and liabilities related to day-to-day operations are accounted for in a separate operating fund. A corresponding unrestricted net asset account (line item) is also established, which is referred to in this tool kit as undesignated operating reserves.

Operating reserve policy

An operating reserve policy includes policies on board-designated operating reserves adequate for financial stability.

An operating reserve policy can also include policies on other board-designated funds that further the mission of the organization, even though some nonprofits do not classify these *non-operating* board-designated funds as “reserves.”³⁴

An operating reserve policy can be the board-designated operating reserves and other board-designated funds sections in a written, board-approved *financial management policy*. In addition to policies covering board-designated funds, *financial management policies* can also include policies on financial planning, budgeting, internal controls and accounting procedures, internal and external reporting, auditing, and investments. In addition to an operating reserve policy, it is useful for nonprofits to have budgeting and other financial management *practices* in place that first build, and then maintain adequate board-designated operating reserves and, when needed, other board-designated funds.

Operating reserve ratio

The Centerpiece of the Nonprofit Operating Reserves Initiative

Operating reserve ratio = operating reserves divided by annual operating expense budget

An organization’s operating reserve ratio can be calculated in terms of a *percentage*:

→ *operating reserves divided by annual operating expense budget*

Or *number of months*:

→ *operating reserves divided by 1/12th of the annual operating expense budget*

The operating reserve ratio is an indicator of whether or not the organization has enough operating reserves available to meet operating costs including payroll and other personnel related expenses for a reasonable period (*) if it were to receive no revenue during that period.

(*) The *minimum* operating reserve ratio at the lowest point during the year suggested by the Nonprofit Operating Reserves Initiative Workgroup is 25 percent or 3 months of the annual operating expense budget. Regarding what level of nonprofit

³⁴ For example, United Way Worldwide’s reserve policy guide does not classify **Board-designated funds** as reserves. It does use a definition for reserves that is consistent with the definition for **operating reserves** in this glossary. “Reserves and Reserve Policies Guidelines for United Ways” can be found at: <http://www.nccs2.org/wiki/images/a/ad/UWA-ReservesandReservePolicies%284-17-07%29.pdf>

operating reserves above this minimum might be *adequate* for financial stability, the Workgroup reached the conclusion that “it depends,” i.e., there is no one size fits all operating reserves ratio or benchmark.³⁵

All *three* types of Operating Reserves can serve as the numerator in the Operating Reserve Ratio: board-designated (recommended), undesignated (simplified, not recommended) and available (simplest, not recommended).

Operating reserves³⁶

Operating reserves are elements of unrestricted net assets in statements of position as well as numerators used in calculating operating reserve ratios.

Operating reserves are that portion of unrestricted net assets that nonprofit organizations maintain, or their boards have designated or “reserved” for use in emergencies to sustain financial operations for a reasonable period in the event of significant and unanticipated, unbudgeted increases in operating expenses and/or losses in operating revenues.

A board may find it useful for internal accounting and reporting during the year to divide operating reserves into two unrestricted net asset accounts: board-designated operating reserves and operating funds.

There are *three* types of Operating Reserves: board-designated (recommended), undesignated (simplified, not recommended) and available (simplest, not recommended). [See definitions for each type in this Glossary.]

Operating reserves are generated through annual surpluses of unrestricted revenue over expenses. Likewise, operating reserves are depleted through annual deficits of unrestricted revenue over expenses. To illustrate, a 5 percent average annual surplus of revenues over expenses can improve an operating reserve of minus 10 percent to 25 percent in 7 years. The unused portion of capital acquisition funding and unused reserves for uncollectible pledges (when losses are lower than expected) can also be used to fund operating reserves.

Permanently restricted net assets

Permanently restricted net assets is a required line item – if present -- in the statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) and IRS Forms 990 of not-for-profit organizations.

³⁵ See “IT DEPENDS,” Factors to Be Considered in Deciding What Amount of Reserves an Organization Will Plan to Maintain, By Richard F. Larkin, C.P.A., BDO USA, LLP; Appendix A - in the Whitepaper: *MAINTAINING NONPROFIT OPERATING RESERVE, An Organizational Imperative for Nonprofit Financial Stability, December 2008* by the Nonprofit Reserves Initiative Workgroup that can be found at: http://www.nccs2.org/wiki/index.php?title=Nonprofit_Reserves_Workgroup.

³⁶ This glossary uses the term “operating reserves” because, while “reserves” is a popular term for referencing financial strength, it is not used with consistent meaning and is not described or found extensively in not-for-profit authoritative accounting literature. When it is used in various articles and documents on nonprofit reserves, it can refer to all available unrestricted net assets, which would include all board-designated funds, or be limited to the portion of available unrestricted net assets designated for operating reserves. Further, the term “reserve” can also be used in an entirely different accounting context – in the insurance industry for example.

FASB Statement No. 117. “Permanently restricted net assets: The part of the net assets of a not-for-profit organization resulting (a) from contributions or other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.”³⁷

2008 IRS Form 990 Part X, line 29 (formerly line 69) — Permanently restricted.

“Enter the total of the balances for the permanently restricted class of net assets. Permanently restricted net assets are (a) assets, such as land or works of art, donated with stipulations that they be used for a specified purpose, be preserved, and not be sold or (b) assets donated with stipulations that they be invested to provide a permanent source of income. The latter result from gifts and bequests that create permanent endowment funds.”

Temporarily restricted net assets

Temporarily restricted net assets is a required line item – when present -- in the statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) and IRS Forms 990 of not-for-profit organizations.

FASB Statement No. 117. “Temporarily restricted net assets: The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the pursuant to those stipulations.”³⁸

2008 IRS Form 990 Part X, line 28 (formerly line 68) — Temporarily restricted.

“Enter the balance per books for the temporarily restricted class of net assets. Donors' temporary restrictions may require that resources be used in a later period or after a specified date (time restrictions), or that resources be used for a specified purpose (purpose restrictions), or both.”³⁹

Undesignated operating funds

Undesignated operating funds is a line item reported in the unrestricted net asset section of a balance sheet that fluctuates up or down according to day-to-day changes in normal cash flow activity.

When fund accounting methods are employed that segregate *liquid assets* related to board-designated operating reserve and undesignated operating funds as separate accounts (line items) in the *assets* section of their balance sheets, the undesignated operating funds account includes non-current assets such as long-term receivables, inventory, prepaid expenses and deposits held by others. In this way, these non-

³⁷ Paragraph 168 (the glossary), FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

³⁸ Paragraph 168 (the glossary), FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*; <http://www.fasb.org/pdf/fas117.pdf>.

³⁹ 2008 IRS Form 990 instructions, link: <http://www.irs.gov/pub/irs-tege/f990core.pdf>

current assets are excluded from the calculation of operating reserve ratios. See Appendix C, Figure C2 for an illustrative statement of financial position (balance sheet) that reflects this fund accounting method.

Note that undesignated operating funds should not be in a deficit position in the net asset section in the statement of financial position of an annual audited general purpose financial report.⁴⁰ Undesignated operating funds are classified as “Undesignated – available for general activities” in the 1988 Black Book’s illustrative balance sheet.⁴¹

This breakdown of board-designated operating reserves and undesignated operating funds can be for internal accounting and reporting purposes and could also be included in general purpose external financial reports.

Undesignated operating reserves

Undesignated Operating Reserves (simplest, not recommended*) are equal to available unrestricted net asset – i.e., the available portion of total unrestricted net assets after deducting equity in fixed assets -- that the board has not designated for specific purposes. [See Appendix C, Figure C3 for an illustrative statement of financial position.]

* While not recommended, the undesignated operating reserves option may be used by organizations that do not have the capacity, or chose not, to account separately for both Board-Designated Operating Reserves and Undesignated Operating Funds. Use of the undesignated operating reserves option is not recommended because it does not provide for balance sheet accounts for operating reserves, separate from day-to-day operating funds accounts. Available operating reserves include non-current, non-liquid assets such as pledge and other receivables, inventory, prepaid expenses and deposits held by others. It can appear that an organization has adequate operating reserves when, in fact, liquid cash reserves can be very low or nonexistent, putting the organization at risk of experiencing serious financial viability issues in the event of an emergency.

Unrestricted net assets

Unrestricted net assets is a required line item in the statement of financial position prepared in accordance with generally accepted accounting principles (GAAP) and IRS Forms 990 of not-for-profit organizations.

FASB Statement No. 117. “The part of the net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.”⁴²

2008 IRS Form 990 Part X, line 28 (formerly line 68) — Unrestricted.

“Enter the balances per books of the unrestricted class of net assets. Unrestricted net assets are neither permanently restricted nor temporarily restricted by donor-imposed stipulations. All funds without donor-imposed restrictions must be classified as unrestricted, regardless of the existence of any board designations or appropriations.”⁴³

Unrestricted net assets are created through annual surpluses – i.e., excesses in unrestricted revenues and releases of temporarily restricted net assets over expenses.

⁴⁰ Page 76, Black Book, *Standards of Accounting & Financial Reporting*, 1988

⁴¹ Page 87, Black Book, *Standards of Accounting & Financial Reporting*, 1988

⁴² Paragraph 168 (the glossary), FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, link: <http://www.fasb.org/pdf/fas117.pdf>

⁴³ 2008 IRS Form 990 instructions, link: <http://www.irs.gov/pub/irs-tege/f990rcore.pdf> .

APPENDIX I: OTHER REFERENCE MATERIALS

- **A Whitepaper: Maintaining Nonprofit Operating Reserves**
<http://www.nccs2.org/wiki/images/3/3c/OperatingReservesWhitePaper2009.pdf>
- **Reserves and Reserve Policies – Guidelines for United Ways**
<http://www.nccs2.org/wiki/images/a/ad/UWA-ReservesandReservePolicies%284-17-07%29.pdf>
- **Determining Appropriate Levels of Reserves, and Nonprofits and Squirrels or, How big a reserve do you need?** *By Richard Larkin, CPA, National Technical Director of Not-for-Profit Accounting and Auditing, BDO USA, LLP, Bethesda Maryland*
http://www.nccs2.org/wiki/images/7/73/Determining_Appropriate_Levels_of_Reserves.pdf
- **Washington-Area Nonprofit Operating Reserves** *by Amy Blackwood and Tom Pollak, National Center for Charitable Statistics, Center on Nonprofits and Philanthropy, The Urban Institute*
<http://www.urban.org/url.cfm?ID=411913>
- **Operating Reserves resources** *from the Nonprofits Assistance Fund at*
http://www.nonprofitsassistancefund.org/pages/Resources_Reserves and
http://www.nonprofitsassistancefund.org/files/MNAF/Updated_Resources/Operating_Reserves.pdf
- **Learning from the Community: Effective Financial Management Practices in the Arts**, *a National Arts Strategies publication: Jim Rosenberg, Principal Author; Russell Willis Taylor, Editor*
http://www.artstrategies.org/downloads/Effective_Management_Practices_in_the_Arts.pdf
- **Hidden in Plain Sight: Understanding Nonprofit Capital Structure** *by Clara Miller, 2003*
http://www.nonprofitfinancefund.org/docs/Miller_Capital_Structure.pdf
- **The Grasshopper or the Ant: A Review of Endowment Giving Policy Options**
By Russell Willis Taylor for the Doris Duke Charitable Foundation Arts Program, 2006
http://www.ddcf.org/Global/doris_duke_files/download_files/GrasshopperortheAnt.pdf
- **Survey: No Cash On Hand At 12% of Charities** *An article from NPT Weekly, a publication of The NonProfit Times, March 22,2010*
<http://www.nptimes.com/10Mar/news-100322-1.html>.
- **Cash Investment Policy Statement – Developing, Documenting and Maintaining a Cash Management Plan**, *published by BlackRock, 2009,*
copies available from Enver Majid at enver_majid@ml.com
- **A Whitepaper: Maintaining sufficient reserves to protect your not-for-profit organization**
by Grant Thornton LLP, 2010
http://www.gt.com/staticfiles/GTCom/Not-for-profit%20organizations/NotForProfit%20files/NFP_Sufficient-Reserves_WP.pdf
- **Organizational Slack (or Goldilocks and the Three Budgets)** *by Woods Bowman*
http://www.thecentrepoint.ca/email_brdcasts/centrepoint_focus/fall_2007/organizational_slack.pdf
- **Operating Reserves** – *NonprofitAccountingBasics.org website sponsored by the Greater Washington Society of CPAs Educational Foundation*
<http://www.nonprofitaccountingbasics.org/internal-reporting-good-management/financial-management/operating-reserves>