

## NONPROFIT OPERATING RESERVES AND POLICY EXAMPLES

### OPERATING RESERVES

An operating reserve is an unrestricted fund balance set aside to stabilize a nonprofit's finances by providing a cushion against unexpected events, losses of income, and large unbudgeted expenses. The most common trigger for use of operating reserves is on the income side, such as when a previously reliable source is reduced or withdrawn. Since operating reserves are most valuable if they are reliable, an important factor in using reserves is also having a realistic plan to replenish them. Operating reserves should not be used to cover a long-term or permanent income shortfall. Reserves can allow an organization to weather serious bumps in the road by buying time to implement new strategies. To be prudent, reserves should be used to solve temporary problems, not structural financial problems. In the worst case scenario, reserves can be used for an orderly shut down of the organization.

Operating reserves may be a part of the organization's unrestricted cash or working capital. Every nonprofit needs to have sufficient cash flow coming in from various income sources and going out to pay expenses and other obligations when they are due. Some organizations create reserves by setting aside cash in addition to the regular bank fund balances for use when regular cash flow is disrupted.

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

### Where Do Reserves Come From?

Occasionally, a nonprofit will receive a grant or contribution to create or add to an operating reserve fund. Usually, though, reserves are built up over time by generating an unrestricted surplus and intentionally designating a portion

of the excess cash as a reserve fund. Some organizations include a line item in the budget to add to reserves.

### How Much Should We Have?

While there are general guidelines for setting operating reserve goals, they should always be accompanied by "it depends." Most standards are based on a formula to have enough unrestricted cash to cover operating expenses for a number of months. A commonly used reserve goal is three to six months' expenses. At the high end, reserves should not exceed the amount of two years' budget. At the low end, reserves should be enough to cover at least one full payroll including taxes.

Keep in mind that generic target amounts for reserves don't take some important variables into account, such as the stability of the nonprofit's cash receipts. Organizations that have contracts or fees with regular and reliable payments don't need as much in reserves as organizations that rely on periodic grants, fundraising events or campaigns, or seasonal activities. Factor in these considerations when setting an operating reserve target. The goal for operating reserves will change, too, when income or expenses become less reliable or predictable because of internal or external changes.

### Why Policies Matter

To be a viable operating reserve, there should be a board agreement and policy about the purpose and use of operating reserves. The purpose of the policy is to define and set goals for reserves funds, clearly describe authorization for use of reserves, and outline requirements for reporting and monitoring. Without a policy and procedure, reserve funds tend to be gradually spent down over time and then are not available the next time the funds are really needed. When developing the policy, be sure to allow for some flexibility and ease of access. Reserves are there to help the organization operate programs and services, not to create an untouchable bank balance to admire. Two examples of policies are included at the end of this article.

## Other Kinds of Reserves

This discussion has been focused on operating reserves designated to manage cash flow or short-term cash shortfalls and unexpected expenses. There are other kinds of reserve funds that can be established to build up cash balances for specific purposes such as building repair and replacement reserves, program reserves to support program continuation if income is uncertain, and opportunity reserves to allow the nonprofit to provide seed funding for a new idea or innovation. Each type of reserve needs the same kind of planning and policy as described for operating reserves.

## DEVELOPING AN OPERATING RESERVES POLICY

Developing and adopting a written policy regarding a nonprofit's operating reserves is a valuable practice for any organization. The policy may be contained within the financial policies or may stand alone. Having a written and approved policy on operating reserves will help to ensure that the board of directors and staff leadership use consistent definitions and calculations and that the authority and operational guidelines for using funds in reserve are clear to all. In the absence of an adopted policy, staff and board members may have different assumptions that may or not be accurate or productive. If the idea of creating an operating reserves policy seems daunting, this basic example and guideline for policy development can be helpful.

### Five Essentials for Policies

The intent of the operating reserves policy is to describe and document the purpose, goals, and mechanics for maintaining and using operating reserve funds. In order to accomplish this, the operating reserve policy needs to address five areas:

1. Purpose of building and maintaining reserves
2. Definitions of the type of reserves, intended use, and calculation of target amounts
3. Assignment of authority for making use of each type of reserve fund, which may include delegation of some authority to staff leaders
4. Responsibilities for reporting reserve fund amounts and use of reserve funds
5. Any specific policies, if needed, about investment of reserve funds

## Developing and Approving a Policy

This article includes two examples of reserves policies. The first is for operating reserves only and will be useful for nonprofits with a single cash reserve that is primarily used for occasional unexpected shortfalls. The second policy example expands to include other types of reserves, such as building reserves. This example requires more discussion and customization for the nonprofit's particular situation and plans. Both of the example policies include a variety of components that may or may not fit the needs of any individual nonprofit organization. These examples are a starting point intended to help you address the essential questions and decisions. Some nonprofits develop more comprehensive and detailed policies that incorporate more specific responsibilities and add much more detail. The most important action is to create and adopt a policy that meets your organization's needs.

### Considerations When You Start With a Policy Template

We offer this example of a financial policy to get you started, but keep in mind that no example will be an exact fit for your organization. Never adopt a policy without a thorough review and consideration of the risks, operations, and structure of the organization. In the example policies included here, some areas require customization. Bold, bracketed text should be **CUSTOMIZED** to meet your needs. We have included some options to assist you. Be sure to review these parts carefully to create the right policy for your organization.

## EXAMPLE 1 - OPERATING RESERVES SAMPLE OPERATING RESERVE POLICY

### PURPOSE

The purpose of the Operating Reserves policy for [NAME] is to ensure the stability of the mission, programs, employment, and ongoing operations of the organization. The Operating Reserve is intended to provide an internal source of funds for situations such as a sudden increase in expenses, one-time unbudgeted expenses, unanticipated loss in funding, or uninsured losses. The Reserve may also be used for one-time, nonrecurring expenses that will build long-term capacity, such as staff development, research and development, or investment in infrastructure. Operating Reserves are not intended to replace a permanent loss of funds or eliminate an ongoing budget gap. It is the intention of [NAME] for Operating Reserves to be used and replenished within a reasonably short period of time. The Operating Reserve policy will be implemented in concert with the other governance and financial policies of [NAME] and is intended to support the goals and strategies contained in these related policies and in strategic and operational plans.

### DEFINITIONS AND GOALS

The Operating Reserve Fund is defined as the designated fund set aside by action of the Board of Directors. The minimum amount to be designated as Operating Reserve will be established in an amount sufficient to maintain ongoing operations and programs for a set period of time, measured in months. The Operating Reserve serves a dynamic role and will be reviewed and adjusted in response to internal and external changes.

The target minimum Operating Reserve Fund is equal to [one/two/three/six] months of average operating costs. The calculation of average monthly operating costs includes all recurring, predictable expenses such as salaries and benefits, occupancy, office, travel, program, and ongoing professional services. Depreciation, in-kind, and other non-cash expenses are not included in the calculation. The calculation of average monthly expenses also excludes some expenses [CUSTOMIZE: examples are pass-through programs, one-time or unusual, capital purchases].

The amount of the Operating Reserve fund target minimum will be calculated each year after approval of the annual budget, reported to the Finance Committee/Board of Directors, and included in the regular financial reports.

### ACCOUNTING FOR RESERVES

The Operating Reserve Fund will be recorded in the financial records as Board-Designated Operating Reserve. The Fund will be funded and available in cash or cash equivalent funds. Operating Reserves [CUSTOMIZE: will be maintained in a segregated bank account or investment fund, in accordance with investment policies OR will be commingled with the general cash and investment accounts of the organization].

### FUNDING OF RESERVES

The Operating Reserve Fund will be funded with surplus unrestricted operating funds. The Board of Directors may from time to time direct that a specific source of revenue be set aside for Operating Reserves. Examples may include one-time gifts or bequests, special grants, or special appeals.

### USE OF RESERVES

Use of the Operating Reserves requires three steps:

#### 1. Identification of appropriate use of reserve funds.

The Executive Director and staff will identify the need for access to reserve funds and confirm that the use is consistent with the purpose of the reserves as described in this Policy. This step requires analysis of the reason for the shortfall, the availability of any other sources of funds before using reserves, and evaluation of the time period that the funds will be required and replenished.

#### 2. Authority to use operating reserves

**CUSTOMIZE:** This section must be customized to reflect the authority and process selected by the organization. Several possible approaches are included as examples.

- **Approach A:** The Executive Director will submit a request to use Operating Reserves to the Finance Committee of the Board of Directors. The request will include the analysis and determination of the use of funds and plans for replenishment. The organization's goal is to replenish the funds used within twelve months to restore the Operating Reserve Fund to the target

minimum amount. If the use of Operating Reserves will take longer than 12 months to replenish, the request will be scrutinized more carefully. The Finance Committee will approve or modify the request and authorize transfer from the fund. (OR, the Finance Committee will recommend the request to the Executive Committee or the Board of Directors).

- **Approach B:** Authority for use of Operating Reserves is delegated to the Executive Director in consultation with the Treasurer and/or Chair of the Finance Committee. The use of Operating Reserves will be reported to the Executive Committee/Board of Directors at their next scheduled meeting, accompanied by a description of the analysis and determination of the use of funds and plans for replenishment to restore the Operating Reserve fund to the target minimum amount. The Executive Director must receive prior approval from the Executive Committee/Board of Directors if the Operating Reserves will take longer than 12 months to replenish.
- **Approach C:** Authority for use [of up to \$xx,xxx] of Operating Reserves is delegated to the Executive Director in consultation with the Treasurer and/or Chair of the Finance Committee. The use of Operating Reserves will be reported to the Executive Committee/Board of Directors at their next scheduled meeting, accompanied by a description of the analysis and determination of the use of funds and plans for replenishment to restore the Operating Reserve fund to the target minimum amount. The Executive Director must receive prior approval from the Executive Committee/Board of Directors for use of Operating Reserves in excess of [\$xx,xxx].

### **3. Reporting and monitoring.**

The Executive Director is responsible for ensuring that the Operating Reserve Fund is maintained and used only as described in this Policy. Upon approval for the use of Operating Reserve funds, the Executive Director will maintain records of the use of funds and plan for replenishment. He/she will provide regular reports to the Finance Committee/Board of Directors of progress to restore the fund to the target minimum amount.

### **RELATIONSHIP TO OTHER POLICIES**

[NAME] shall maintain the following board-approved policies, which may contain provisions that affect the creation, sufficiency, and management of the Operating Reserve fund.

### **CUSTOMIZE:**

- **Financial Policy**
- **Budget Policy**
- **Contingency or Disaster Preparedness Plan**
- **Investment Policy**

### **REVIEW OF POLICY**

This Policy will be reviewed every other year, at minimum, by the Finance Committee, or sooner if warranted by internal or external events or changes. Changes to the Policy will be recommended by the Finance Committee to the Board of Director.

## EXAMPLE 2 - MULTIPLE TYPES OF RESERVES SAMPLE RESERVES POLICY

### PURPOSE

The purpose of the Reserves policy for [NAME] is to ensure the stability of the mission, programs, employment, and ongoing operations of the organization and to provide a source of internal funds for organizational priorities such as building repair and improvement, program opportunity, and capacity building.

The Reserves policy will be implemented in concert with the other governance and financial policies of [NAME] and is intended to support the goals and strategies contained in these related policies and in strategic and operational plans.

### DEFINITIONS AND GOALS

#### Operating Reserve

The Operating Reserve is intended to provide an internal source of funds for situations such as a sudden increase in expenses, one-time unbudgeted expenses, unanticipated loss in funding, or uninsured losses. Operating Reserves are not intended to replace a permanent loss of funds or eliminate an ongoing budget gap. It is the intention of [NAME] for Operating Reserves to be used and replenished within a reasonably short period of time. The Operating Reserve Fund is defined as the designated fund set aside by action of the Board of Directors. The minimum amount to be designated as Operating Reserve will be established in an amount sufficient to maintain ongoing operations and programs measured for a set period of time, measured in months. The Operating Reserve serves a dynamic role and will be reviewed and adjusted in response to both internal and external changes.

The target minimum Operating Reserve Fund is equal to **[one/two/three/six]** months of average operating costs. The calculation of average monthly operating costs includes all recurring, predictable expenses such as salaries and benefits, occupancy, office, travel, program, and ongoing professional services. Depreciation, in-kind, and other non-cash expenses are not included in the calculation. The calculation of average monthly expenses also excludes expenses **[CUSTOMIZE: examples are pass-through programs, one-time or unusual, capital purchases]**.

The amount of the Operating Reserve fund target minimum will be calculated each year after approval of the annual

budget, reported to the Finance Committee/Board of Directors, and included in the regular financial reports.

#### Building and Capital Asset Reserve

The Building and Capital Asset Reserve is intended to provide a ready source of funds for repair or acquisition of buildings, leaseholds, furniture, fixtures, and equipment necessary for the effective operation of the organization and programs.

The target amount of the Building and Capital Asset Reserve will be determined by **[CUSTOMIZE]**.

#### Opportunity Reserve

The Opportunity Reserve is intended to provide funds to meet special targets of opportunity or need that further the mission of the organization which may or may not have specific expectation of incremental or long-term increased income. The Opportunity Reserve is also intended as a source of internal funds for organizational capacity building such as staff development, research and development, or investment in infrastructure that will build long-term capacity.

The target amount of the Opportunity Reserve will be determined by **[CUSTOMIZE]**.

### ACCOUNTING FOR RESERVES

The Reserve Funds will be recorded in the financial records as Board Designated **[XXXX]** Reserve. The Fund will be funded and available in cash or cash equivalent funds. Reserves **[CUSTOMIZE: will be maintained in a segregated bank account or investment fund, in accordance with investment policies OR will be commingled with the general cash and investment accounts of the organization]**.

### FUNDING OF RESERVES

The Operating Reserve fund will be funded with surplus unrestricted operating funds. The Board of Directors may from time to time direct that a specific source of revenue be set aside for Operating Reserves. Examples could include one-time gifts or bequests, special grants, or special appeals.

The Building and Capital Assets Reserve will be funded by [CUSTOMIZE: setting aside funds received from any capital campaigns or similar appeals (OR) setting aside the equivalent amount of cash equal to XX% of depreciation in the annual budget (OR) other calculations].

The Opportunity Reserve fund will be funded with occasional special designations made by the Board of Directors.

## USE OF RESERVES

Use of the Operating Reserves requires three steps:

### 1. Identification of appropriate use of reserve funds.

The Executive Director and staff will identify the need for access reserve funds and confirm that the use is consistent with the purpose of the reserves as described in this Policy. This step requires analysis of the reason for the shortfall, the availability of any other sources of funds before using reserves, and evaluation of the time period that the funds will be needed and replenished.

### 2. Authority to use reserves.

**CUSTOMIZE:** This section must be customized to reflect the authority and process selected by the organization. Each type of Reserve may require a different structure and process for authorization. Several possible approaches are included in the example.

- **Approach A:** The Executive Director will submit a request to use Reserves to the Finance Committee of the Board of Directors. The request will include the analysis and determination of the use of funds and plans for replenishment. The organization's goal is to replenish the funds used within twelve months to restore the Reserve Fund to the target minimum amount. If the use of Reserves will take longer than 12 months to replenish, the request will be scrutinized more carefully. The Finance Committee will approve or modify the request and authorize transfer from the fund. (OR, the Finance Committee will recommend the request to the Executive Committee or the Board of Directors).
- **Approach B:** Authority for use of Reserves is delegated to the Executive Director in consultation with the Treasurer and/or Chair of the Finance Committee. The use of Reserves will be reported to the Executive Committee/Board of Directors at their next scheduled meeting, accompanied by a description of the analysis and determination of the use of funds and plans for replenishment to restore the Reserve Fund to the target

minimum amount. The Executive Director must receive prior approval from the Executive Committee/Board of Directors if the Reserves will take longer than 12 months to replenish.

- **Approach C:** Authority for use [of up to \$xx,xxx] of Reserves is delegated to the Executive Director in consultation with the Treasurer and/or Chair of the Finance Committee. The use of Reserves will be reported to the Executive Committee/Board of Directors at their next scheduled meeting, accompanied by a description of the analysis and determination of the use of funds and plans for replenishment to restore the Reserve Fund to the target minimum amount. The Executive Director must receive prior approval from the Executive Committee/Board of Directors for use of Reserves in excess of [\$xx,xxx].

### 3. Reporting and monitoring.

The Executive Director is responsible for assuring that the Reserve funds are maintained and used only as described in this Policy. Upon approval for the use of Reserve funds, the Executive Director will maintain records of the use of funds and plan for replenishment, if required. He/she will provide regular reports to the Finance Committee/Board of Directors of progress to restore the fund to the target minimum amount, if required.

## RELATIONSHIP TO OTHER POLICIES

[NAME] shall maintain the following board-approved policies, which may contain provisions that affect the creation, sufficiency, and management of the Reserve Fund.

### CUSTOMIZE:

- Financial Policy
- Budget Policy
- Contingency or Disaster Preparedness Plan
- Investment Policy

## REVIEW OF POLICY

This Policy will be reviewed every other year, at minimum, by the Finance Committee, or sooner if warranted by internal or external events or changes. Changes to the Policy will be recommended by the Finance Committee to the Board of Director.