

Operating Reserve: Why, How, and a Sample

Although most nonprofit organizations know that an Operating Reserve is essential, not everyone succeeds in building one and keeping it. This resource walks through the common obstacles to creating an Operating Reserve and lays out a clear path to achieve it.

Definition and Terminology

An Operating Reserve is an unrestricted fund balance that is set aside by a nonprofit to assist through unforeseen challenges, help with cash flow shortfalls, and take advantage of unexpected opportunities. In simpler terms, it is a type of savings.

An Operating Reserve is sometimes simply referred to as a Reserve Fund. Both of these names are correct. A Reserve Fund is the broader category. Reserve Funds may be split up and named differently on the Statement of Financial Position (Balance Sheet) based upon the intent of the Reserve, these could include Board Designate Reserve or an Opportunity Fund. For the purposes of this resource, we are using the term Operating Reserve due to its prevalence of use in the nonprofit field and the intended purpose of the fund. After an adequate Operating Reserve is built, other reserve funds can be added; see example in sample policy below. We will discuss different types of reserves further below.

Be careful not to confuse net assets with reserves. The balance in the bank accounts is not the same as the reserves. Those balances may include unspent grant money. **A reserve is made up of unrestricted funds only. It should be explicitly broken out in the equity section of the Statement of Financial Position**, separate from funds with donor restrictions.

Why Have an Operating Reserve?

Without a clear understanding of why an Operating Reserve benefits the organization, building the will and desire to create one is near impossible.

Without a clear understanding of why an Operating Reserve benefits the organization, building the will and desire to create one is near impossible.

ONE OF THE MAIN REASONS ORGANIZATIONS ARE UNABLE TO CREATE AN OPERATING RESERVE IS THAT THEY STRUGGLE TO CLARIFY WHY IT'S NECESSARY.

Sustainability

The mission nonprofits serve is vital. That's why they do the work they do day after day. That's why people fund their programs. Everyone knows it's essential. Therefore, as the fiduciary of these public funds, it's the organization's responsibility to ensure the programs continue running. Part of ensuring their sustainability is protecting against the risks addressed below. It's too risky not to have an Operating Reserve. It puts the programs at risk, which puts the mission at risk.

Unforeseen Challenges

Nonprofits do the best they can to predict income and expenses every year when creating the annual budget. But unexpected costs, lost revenue, and sudden obstacles cannot always be anticipated. It's the nature of running a nonprofit. Having an Operating Reserve allows the organization to persevere and even strengthen its position despite these unforeseen challenges.

These challenges may come in the form of a funding shortfall. The organization may have been 99% sure of a foundation grant that suddenly doesn't happen. A reliable major donor who committed to a substantial donation for the current year may have a life change and be unable to give this much-anticipated major gift. Even the most conservative revenue projections can be rendered inaccurate amidst unexpected shifts. Sometimes unforeseen challenges come in terms of an unexpected expense. The roof of the building collapses, and the insurance doesn't cover it. A complex legal issue develops. Staffing issues arise and require unplanned hiring expenses. Throughout the life of the nonprofit, any number of unexpected situations can occur.

Having an Operating Reserve allows the organization to withstand these unforeseen challenges. It provides an answer to unexpected events that could otherwise derail the organization's programs. With an Operating Reserve, the organization can keep its doors open and serve its mission while also addressing unexpected challenges.

Working Capital

An Operating Reserve can help cover short-term cash flow needs. Although the annual budget may contain a surplus, the timing of the funding and expenses don't always align. Especially for Federal and reimbursable grants, the organization may need to spend money before the funding arrives. Without cash on hand, this can create cash flow problems. Beware, however, to not label something a cashflow problem when it's really a budgeting problem.

Unforeseen Opportunities

As with unforeseen challenges, opportunities can sometimes arise that were unexpected. With an ample Operating Reserve, an organization has the flexibility to take advantage of these opportunities without sacrificing other programs.

For example, organizations doing conservation work may become aware of an unexpected opportunity to protect critical land nearby in a dramatic yet time-sensitive way. Perhaps a new program falls into their lap that is too aligned with their mission to pass up. Having an Operating Reserve allows the organization to invest strategically in mission-driven opportunities.

Concerns About Building an Operating Reserve

Even though it is widely agreed that building an Operating Reserve is vital for the sustainability of nonprofits, it can be difficult to rationalize. These are some of the more common questions, concerns, and reasons we hear from nonprofit organizations as to why they don't have an Operating Reserve.

The Programs Are Too Critical

It's not uncommon for leaders to run their organization with a sense of urgency and, at times, even emergency. The programs they oversee are essential, and the needs within the programs can seem bottomless. When faced with a choice between expanding programs and reach or investing in building an Operating Reserve, leaders often choose where they see immediate needs and results. These organizations often operate with no Operating Reserve and can be in a constant state of financial vulnerability

THE PROGRAMS ARE TOO IMPORTANT TO RISK THEIR FUTURE BY NOT BUILDING AN OPERATING RESERVE.

Not Enough Money

Along the lines of scarcity for program funding, the most common reason for not building an Operating Reserve is that there's not enough money to do so. Some organizations stop their consideration here, but it's possible to create an Operating Reserve even when the financial situation is tight.

To build an Operating Reserve, the organization must start by adopting a surplus budget (more income than expenses). This may seem unlikely for some organizations, but it's possible to free up unrestricted dollars to build a reserve for even the most financially stressed organizations.

By creating a budget by program, an organization can see which programs have full funding and which are subsidized by the rest of the organization. For the underfunded programs that are core to the organization's mission, this highlights additional funding opportunities. For the underfunded programs that are not core, this is an opportunity to move staff and expenses to the funded programs and make cuts where necessary.

Nonprofits shouldn't let the phrase "We don't have enough money" be a stopping point. With strategic work, a plan can be created and enacted over time.

Donors Won't Want to Give If We Have Savings

For organizations that have been operating in emergency mode, they may worry about how funders will view having an Operating Reserve on the books. They may think that showing an Operating Reserve will make donors less interested in contributing to the organization. But the opposite is true. Foundations look for solvent organizations who are fiscally responsible and review the Operating Reserves when assessing organizations' financial sustainability. They don't want to give money to organizations that are at risk. They want to give to organizations that manage their money well and are positioned to thrive through challenging times.

We Can't Have Reserves Because We're a Nonprofit

This isn't heard as often these days, but some people assume that nonprofits can't retain funds from year to year. This is not true. Restricted funds must be spent in accordance with their restrictions, which may include time and program restrictions, but unrestricted funds do not have to be spent within anytime constraint. They can be invested in an Operating Reserve.

How to Build an Operating Reserve

Congratulations on your commitment to building a reserve! Once it's been decided that a reserve is right for your organization, know there is a clear path to get there.

1. Get Buy-In

Begin by getting buy-in from the leaders in the organization, including board members. Knowing why an Operating Reserve is essential from the beginning will help keep the commitment over the long haul. Use the sections above on Why Have an Operating Reserve and Concerns About Building an Operating Reserve as a guide for these discussions.

2. Make a Plan and Stick to It

In essence, building an Operating Reserve is as simple as adopting a surplus budget for a set number of years and putting the extra funds into your Operating Reserve Fund. However, in practice, it can be more challenging. That's why it's helpful to make a plan and stick to it.

Have the Board adopt a Board Designated Reserve Policy; see the sample below as a template. As part of this policy, include a clear plan on how to build the Reserve. For example, you may plan to budget for a 10% surplus for the next six years until you reach a six-month Operating Reserve. Other aspects of the policy should include when and how to use the Operating Reserve, how quickly to replenish the funds, and where to keep the money.

a. Measuring Reserves

Operating Reserves are often measured in terms of months of operating expenses. The goal is to have three to six (3- 6) months of Operating Reserves or 25-50% of your annual expenses.

3. Budget for a Surplus

As mentioned above, budgeting for a surplus year-over-year can seem daunting, but it's possible. By budgeting by program and seeing the underfunded programs that are both core and non-core, strategic budgeting decisions can be made to free up funds. See TREC's Resource Library for more in-depth resources on these topics.

| BUDGETING FOR A SURPLUS IS POSSIBLE ON EVEN THE TIGHTEST BUDGETS |

a. Accurate Budgeting

Sometimes a surplus budget is created and adopted, but by year-end, the budget is running a deficit. Things happen mid-year that are different from the budgeted numbers. Many budgeting pitfalls can lead to unexpected year-end deficits.

When budgeting income, it's essential that the income is budgeted conservatively. It's easy to create a surplus budget by increasing the income numbers, but this will lead to problems. Use several revenue projections methodologies to ensure accuracy.

Another common reason for inaccurate budgets is not enough detail in expense projections. Expenses should be projected with as much detail as possible and include the relevant staff in the budgeting process. Just copying last year's numbers can create inaccuracies. When this happens, the surplus can be drained quickly. By involving staff in the budgeting process and going into detail, you not only create a more accurate budget, but you help develop a cost-conscious organization.

See TREC's Resource Center for resources and toolkits on revenue forecasting and budgeting.

b. Only Unrestricted Dollars

An Operating Reserve can only consist of unrestricted dollars. It cannot include unspent grant money to be spent in a future period. Unspent grant money needs to be tracked closely and spent according to its restrictions. Sometimes an annual budget may show a total surplus, but that surplus number includes grant money received in one year that will be spent in the following year. By budgeting by program, the unrestricted surplus amount is known and not confused with carry-over grant funds.

4. Add the Operating Reserve to Your Statement of Financial Position

The Equity section of your Statement of Financial Position (Balance Sheet) is where you'll see your Operating Reserve. You'll see this amount increase as your surplus of unrestricted funds are added to this balance year over year according to your plan. By presenting the Operating Reserve clearly in the Equity section, it shows up as clearly separate from your restricted funds' balance and other equity accounts.

5. Continue According to Plan

As the Operating Reserve is built, you can engage with these funds as needed according to the adopted Operating Fund Policy. If and when funds are spent, they are then built back up according to the policy.

6. Other Types of Reserve Funds

Once the Operating Reserve is in place, the organization may decide to continue building reserves or divide reserves into different types of funds on the balance sheet. For example, you may have a three-month Operating Reserve and a three to twelve-month additional reserve, which could be labeled as an Opportunity Fund. This shows funders that you are saving with a strategic focus. Nine months of Operating Reserves for an emergency may seem like too much, but splitting it into an Operating Reserve for emergencies and an Opportunity Fund for new and unfunded initiatives is more understandable.

Conclusion

With a clear understanding of how an Operating Reserve serves your mission, the commitment to build one is easier. Understanding the common concerns people have may make it easier to navigate conversations with your stakeholders when discussing an Operating Reserve. Even though it may feel daunting, there is a clear path to achieving a substantial Operating Reserve goal. With a plan in place and the budgeting tools to get there, every organization can succeed.

Sample: Board Designated Reserve Fund Policy

Date

Organization

Board-Designated Reserve Fund Policy

The Board directs the Executive Director to establish an operating reserve fund in accordance with the principles described below.

Purpose

The purpose of the Reserve Fund is to provide an internal source of operating funds in the following circumstances:

- 1. Stabilization funding.** A portion of the Reserve Fund will be available only for the purpose of stabilizing operations in the event of a sudden and unanticipated increase in expenses, the occurrence of a significant one-time expense or liability, or the unanticipated loss of a significant amount of budgeted revenue; or
- 2. Opportunity funding.** Any surplus in the Reserve Fund above the stabilization funding amount may be used to build the organization's capacity to generate revenue or take advantage of unanticipated program opportunities.

The Reserve Fund shall not be used to eliminate an ongoing budget gap or to replace a permanent loss of revenue.

Budget Targets

The target minimum for the Reserve Fund is three (3) months of average monthly operating expenses. The target maximum is six (6) months of average monthly operating expenses.

The first three (3) months of funding shall be available only for stabilization funding, as described above. Any excess over three (3) months of funding may be used for opportunity funding, as described above. "Average monthly operating expense" includes all recurring, predictable expenses like salaries and benefits, rent, travel, and program expenses. It does not include depreciation or other non-cash expenses, pass-through expenses, or unusual one-time expenses.

Funding the Reserve

The Reserve Fund will be funded with unrestricted operating funds.

The Board shall place a high priority on achieving the minimum Reserve target. Until the minimum target is reached, the Board will only approve budgets that allocate funding to the Reserve. Thereafter the Board will consider opportunities to achieve the maximum target. From time to time, the Board may direct that a specific source of revenue be allocated to the Reserve Fund. Examples may include unrestricted one-time gifts or windfalls, special grants, or special appeals.



Accounting and Reporting

The Reserve Fund shall be recorded in the organization’s financial records as the “Board-designated Reserve Fund.” It will be funded and available in cash or cash-equivalent funds. The Reserve Fund will be kept in a separate Money Market account that is FDIC insured.

The Executive Director is responsible for assuring that the Reserve funds are maintained and only used as described in this policy. The Executive Director shall provide regular reports to the Board about the status of the fund.

Use and Replenishment of Reserves

The Board must approve any request to use the Reserve Fund for stabilization purposes. To apply for the funds, the Executive Director shall submit a written request to the Board describing the amount needed, the reason for the need, and a plan to replenish the Reserve Fund within a reasonable period of time not to exceed 12 months. The Board may approve the request subject to conditions.

Once every 12 months, the Executive Director may use up to half of the Reserve Fund’s opportunity portion subject to prior consultation with the Executive Committee. In its discretion, the Executive Committee may require Board approval. The Board must approve any other expenditure of the opportunity portion of the Reserve Fund. Our goal is to replenish the Reserve Fund’s opportunity portion within a reasonable period of time, not to exceed 18 months.

Reserve Fund Policy ADOPTED:

Signature

Title

Printed name

Date adopted