



How Much in Reserve Funds Should Your Nonprofit Have?

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In an earlier article, I suggested that there are no limits on how big a reserve or endowment fund might be as long as the amount is credible relative to the mission of the nonprofit. A more relevant question for most of us is “what is the minimum cash reserve fund we should have set aside”?

What We Have Learned From Our Clients

In the mid 1990’s the large public accounting firms suggested that nonprofits have 3 to 6 months of budgeted expenses as “reserves” depending on the situation of an individual nonprofit. Certainly the simplicity of this has appeal. For smaller nonprofits that have steady cash flows and cash based accounting, this seems to be a good approach.

It also has limitations. We were working with a large Head Start provider that was responsible for maintenance of their facility, an aging former public school. Their accounting firm deemed 3 months’ expenses adequate since the agency had a reliable revenue stream from the state. They struggled to keep 3 months of budgeted expenses and continually faced cash flow problems. The state funds, while predictable, were not always timely. A roof repair or replacement of kitchen equipment, which happened with some regularity, could equal a month’s budgeted expenses. Our recommendation was for them to build a minimum of 6 months’ operating expenses plus an additional fund for facilities maintenance emergencies.

We did a more sophisticated analysis for a second client whose primary source of revenue was an annual walk. They understood the relationship between the weather and the fundraising income from this event. They wanted to determine the amount of reserves which would make it very probable they could fully fund their work given the uncertainties of weather. We were able to work with them to build a statistical model to determine the appropriate reserve.

For a third client, a monthly cash flow analysis revealed a seasonal cash flow valley that added to the need for reserves. This is typical of summer camps, which can be flush with cash from advance deposits in the spring, but can run short of cash by the last payroll of the season. The easiest way to identify seasonal cash needs is to look



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back at two or three years of cash balances to see if there are seasonal peaks and valleys.

Often arts organizations, such as theaters have complex cash flows. They may benefit from advance ticket sales, or may face a cash crunch when required to make advance payments to secure the services of entertainers.

Rapidly growing nonprofits can be “profitable”, yet still face a cash flow bind. We analyzed the cash flow of an agency that provided homemakers and home health aides to help seniors remain in their homes. The agency had to front the training costs for new employees. It was only after the new employees completed their training and their first month of delivering service that the agency could bill for their work. Collecting on the billing took another month. All told the agency had to carry cash reserves to cover 3 months of a new employees’ salary, before they received any income. The faster they grew the more employees they hired, and the bigger the cash flow deficit.

Reliance on a single large funder can create a need for more reserves. We are aware of more than one situation where the anticipated 2nd or 3rd year of a program was not funded by a foundation as had been expected. In one case a large state contract that supported almost half of an agency’s budget was discontinued with 90 days notice. A cash cushion might have helped bridge the situation and saved some of the services and the attendant jobs.

For a small nonprofit, an Executive Director transition can lead to extra costs, but more importantly result in a break in grantwriting or cultivating important donors. The attendant lapse can seriously impact the initial success of the new Executive Director and the future of the agency. Again, a reserve cushion buys time and flexibility to get back on track.

On a more positive note, a reserve cushion can serve as an opportunity fund to meet new needs or capitalize on new opportunities that many arise.

The point is, if the cash flow varies or is subject to items that are unpredictable this needs to be analyzed and take into account when determining target reserve levels.

A National Authority Weighs In

One source of guidance is Charity Navigator which was founded in 2001 as arbiter of financial ratings for larger nonprofits that raise significant sums from the general public. They calculate a Working Capital Ratio to evaluate the adequacy of cash reserves. This determines how long, in years, a charity could sustain itself using only its net liquid assets. The Working Capital ratio is defined as:

*(Short Term Assets – Short Term Liabilities) / 12 Months Expenses **



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In order to garner the most points toward a top rating by Charity Navigator, most nonprofits would need a ratio greater than 1. This is the equivalent of 12 months or more of Working Capital. Food Banks and Humanitarian Relief Supplies can get by with less, while Museums and other nonprofits that have lots of “bricks and mortar” need much more according to Charity Navigator.

While this is a laudable goal, this is national data for large nonprofits that have had decades to build their financial strength. The 2010 data on the Charity Navigator web site shows a national average of .75 years or 9 months. Even in this elite group of large nonprofits most have a ratio of less than a year of working capital reserves.

The Operating Reserves Policy Toolkit for Nonprofit Organizations

Beginning in 2008 The Nonprofit Operating Reserves Initiative Workgroup, which included representatives of nonprofits, accountants, academics, and the watchdogs, began a two year effort leading to the publishing of *The Operating Reserves Policy Toolkit for Nonprofit Organizations*. This group found that all nonprofits should have at least 3 months of Operating Reserves, at the **lowest level during a fiscal year**. From that baseline they should increase the number of months of reserves to six months based on risks to revenue and risk in controlling expenses. The list of possible risks was so inclusive that virtually all nonprofits would need 6 months of Operating Reserves. Here is a link to that study:

http://www.nccs2.org/wiki/images/b/b4/Operating_Reserves_Policy_Toolkit_1st_Ed_2010-09-16.pdf

What Should You Do?

Nonprofits should analyze their cash flow for seasonal factors, potential opportunities, and the stability and predictability of cash flow items. For nonprofits that have less than 6 months of Working Capital at the low point in the year, we suggest an intermediate term goal to increase reserves to 6 months plus an additional amount to cover factors such as seasonality, rapid growth, or unpredictability of revenues or expenses.

* **Working Capital Ratio:** Determines how long a charity could sustain its level of spending using its net available assets, or working capital, as reported on its most recently filed Form 990. We include in a charity's working capital unrestricted and temporarily restricted net assets, and exclude permanently restricted net assets. Dividing these net available assets by a charity's total expenses for the most recent fiscal year, yields the working capital ratio.

For other articles including “*Can Nonprofits Have Too Much in Reserve Funds?*” go to www.nonprofit-consultants.org/escarticles.htm