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"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 conception, an operating reserve is a rainy day fund, and people have such funds because they provide shelter from the storm.

Operating reserves are essentially the accumulation of unrestricted surpluses that are liquid (as opposed to invested in fixed assets) and thus available for use at the discretion of an organization's board. The presence of an operating reserve increases an organization's ability to take mission-related risks and to absorb or respond to temporary changes in its environment or circumstances, such as the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues.

Numerous small and mid-sized 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 limited or negative working capital by necessity focus on the short term and are less likely to engage in responsible long-term planning.

What is a Board Designated Operating Reserve?

By consciously and proactively setting the financial goal of building an operating reserve (and potentially other specific-purpose reserves) an organization's staff and board take responsibility for the long-term financial stability of the organization, preserving its continued capacity to deliver its mission programs and services.

Building and maintaining a board designated 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 reimbursable grants because it could handle occasional delayed grant payments. Building additional purpose-designated reserves, based on the particular needs of the organization, would position the organization to seize opportunities to enhance mission programs, respond to spikes in demand for services, or to sudden decreases in demand, and to make planned capital purchases, among many other purposes.

What level of Operating Reserves is appropriate?

In spring 2008, a Nonprofit Operating Reserves Initiative Workgroup comprising experienced individuals representing multiple facets of the nonprofit sector was convened with the objective of defining an "Operating Reserve Ratio" and using the ratio to focus attention on the importance of nonprofit financial stability.

The workgroup also reached a conclusion on what constitutes adequate operating reserves. Workgroup member Richard Larkin had previously concluded and written that the answer is: "it depends." Drawing on

Mr. Larkin's insight and experience the workgroup concluded, there is no one size fits all ratio or benchmark. However, 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.

Precisely because "it depends," the Nonprofit Operating Reserves Initiative Workgroup recommends that every nonprofit organization have a written Reserve Policy that defines its own "adequate" operating reserve level, defines how its operating reserves are calculated and provides the rationale that led staff and board to this conclusion. In general, for calculating the Operating Reserve Ratio, the Workgroup is strongly biased toward the simplest and most widely applicable formula. The group also felt that operating reserves in an amount determined by an organization's board to be "adequate" should be accumulated in advance of other board designated funds.

Final note: The Operating Reserve Ratio is one of a number of important and useful financial viability indicators that address various aspects of financial health.

For more information regarding establishing a reserve and related policies for its use and replenishment, please see the Nonprofit Operating Reserves Initiative (NORI) [Operating Reserves and Reserves Policy Toolkit](#), released September 15, 2010, and the whitepaper *Maintaining Nonprofit Operating Reserves, An Organizational Imperative for Nonprofit Financial Stability*, December 2008, by the **Nonprofit Operating Reserves Initiative Workgroup**, a collaborative effort of the [Nonprofit Operating Reserves Initiative Workgroup](#). NCCS/Center on Nonprofits and Philanthropy at The Urban Institute serves as secretariat to the Workgroup.

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

See also:

Nonprofits Imperiled By Low Reserves

In Tight Times, Lack of Cushion Can Mean Failure

By Megan Greenwell, Washington Post Staff Writer, Wednesday, June 24, 2009

<http://www.washingtonpost.com/wp-dyn/content/article/2009/06/23/AR2009062303405.html?referrer=emailarticle>

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