



**Making a Case for Reserve Funds
In the Nonprofit Sector**

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1. Defining Operating and Capital Reserve Funds

When researching the various definitions and explanations that abound on the Internet today, operating and capital reserve funds are typically described as, “Monies set aside for use in the event of financial emergency or in the event that there is an interruption of cash flow.” For a capital reserve fund, the money may be designated for specific projects and improvements in the future. These are commonly known as “rainy day funds” or “reserve funds.”

This rainy day fund, or reserve fund, is specifically designed to keep an organization afloat in the event of some unforeseen circumstances that disrupt the flow of cash into the organization or to provide it with much needed funds when improvements have to be made.

Sometimes when thinking about a reserve fund, you need to play the *what if* game. *What if* a significant contributor pulls its support? *What if* a competing nonprofit distracts some of your best supports? *What if* we need a new roof? *What if* there is a serious interruption to the organization, such as the death of the Executive Director/CEO? In each of these unexpected *what if* scenarios, the immediate impact would be much worse if there was no contingency plan - especially one that includes alternative sources of cash during the emergency.

Human beings are not the only ones who practice prudence regarding reserve funds. There are many instances that can be readily observed in nature that indicate that the concept is instinctual. No one has to tell the busy squirrel that acorns should be gathered during the summer season when they abound to store away for the winter season when there will surely be scarcity.

The principle underlying the establishment of reserve funds is to ensure continuity in much the same way for nonprofit organizations as it is for the squirrel stashing away nuts today to ensure some security in the future. For various reasons that will be discussed herein, a reserve fund is critically important for the success (and sometimes survival) of a nonprofit.

The importance of having a reserve fund cannot be overstated. Throughout this paper we will explore the differences between establishing reserve funds for nonprofit organizations versus reserve funds in “for profit” companies. We will also use this platform to make the case for establishing such a fund and discuss how much money should be placed in it. Because each organization and association is different, with its own goals and objectives, there is a certain amount of customization that is applied to the equation for calculating the amount that comprises the reserve fund.

2. The Unique Challenges of the Nonprofit Environment

In recent years there has been a significant increase in the number of tax-exempt organizations operating in the United States. This expansion has caused a greater scrutiny of nonprofit and social service organizations than ever before. **These groups are, for the first time, being held accountable for their actions and are being expected to adopt many of the best practices that are commonly applied within the for-profit community.**

Having “tax-exempt” status is no longer an alibi, nor is it an excuse, for an organization behaving in an unprofessional fashion. Standards are being applied to the nonprofit organizations in the same manner that they have always been adhered to amongst for profit companies.

However, one of the greatest challenges facing nonprofits is that, while they are being asked to comply with professional benchmarks, in most cases they do not have the capability to do so. In a survey conducted in 2006 by the United Way of the Bay Area, entitled the *Nonprofit Pulse Survey*, most of the respondents said they lack resources to tackle critical business issues.

In that survey, which was sent to 1,788 nonprofits in the Bay area, results revealed that more organizations are not maintaining reserve funds. 31% of the respondents said they did not maintain reserves in 2005, up from 23% in 2003. In addition, one in three - or 32% of the organizations that do maintain reserves reported that it had tapped or depleted those funds in 2005. The most common reasons cited for tapping reserves were increased costs of doing business, spending more money on fundraising or because of cash flow problems.

“The importance of maintaining a reserve fund is not new to nonprofits, but it has become top of mind in the wake of recent natural disasters and terrorist threats, coupled with ebbs and flows of government spending,” noted GERALYNE MAHONEY at Burr, Pilger & Mayer LLP.

As nonprofits struggle to embrace the management and operational functions of the for profit world they will have to become more comfortable with many of the procedures that are most critical for success. Despite the survey’s findings, nonprofits today will find themselves developing a clearly stated mission, vision, strategic plan and budget. These are the elements that supply the blue print for the success of the organization and give it the guidelines it needs to reach its goals.

Budgeting and cash flow forecasting are extremely important because cash pays the bills. That means that the organization’s cash position is always critical and that having a surplus provides a great advantage and a better financial position in the long run. Without a surplus, nonprofits may not have enough working capital in the short run. This surplus fund becomes even more important as the

organization grows in size and sophistication. As the organization matures and moves from one developmental stage to the next, it will require additional capacity and an expanding infrastructure to support its activities. A surplus in the form of cash reserves can help the organization continue to grow by providing resources for the future.

Looking into the future is difficult - even with a dependable crystal ball, it requires a good amount of guess work and, at best, is far from accurate! Since we agree that no one can really predict what is coming, it is best to be prepared for any eventuality. Having enough cash in reserve in case of emergency situations is one of the practices of leading edge for profit and nonprofits alike, but it is more difficult for nonprofits. This is, in part, because they have an obligation to have financial security while also managing the public's perception of the group's accumulated wealth. There is a fine line between having the right amount of cash in reserve (to survive when it is time to add new programs or sites, face a crisis or engage in a capital improvement) and having the nonprofit appear to be inappropriately stockpiling too much capital. There are, of course, ways for nonprofits to get the message out to their board, their grantors, donors and investors and their recipients about the prudent way that they are managing their cash flow and reserve funds. But it is an area that requires the ability to demonstrate fiscal strength without fiscal irresponsibility.

There are two key areas that are typically impacted by the presence or lack of presence of a reserve fund. We will examine both here.

Cash Flow Shortages

There are several factors that can cause cash flow shortages in a nonprofit organization. There may be expected seasonality issues, unpredictability of service delivery, unexpected emergencies or general cutbacks in federal, state or local funding, grants and donations.

As we review the various conditions that can impact cash flow, and validate the importance of a reserve fund, it is also important to point out the 'down side' of a reserve fund. Because having a fund to cover emergency situations can lead to complacency – this is something that the leadership of every nonprofit organization needs to be aware of so they do not inadvertently fall into this trap!

Seasonality can be anticipated and dealt with once the cash begins to flow again. This is often seen in programs that only run during certain seasons, like a summer theater group. However, unpredictability of service cannot be foreseen. If the organization has been established to help the homeless and suddenly victims of three major floods in a row create an excess of the homeless, the situation can easily grow out of control if the organization cannot accommodate all the newly homeless at once. An unexpected emergency such as the loss of a major donor and supporter can temporarily throw the entire organization into a tailspin. In any or all of these situations, cash flow will be impacted and an

operating reserve fund can help to smooth the immediate situation until a more permanent solution is found. Lastly, general funding cutbacks must also be acknowledged in any realistic cash flow analysis. Even as demands for nonprofit services have increased since 2001, organizations have been trimming back their budgets in response to declining revenues due to government funding cuts and a slow economic recovery, according to the *Minnesota Nonprofit Economy Report* published by the Minnesota Council of Nonprofits. This observation is supported by a survey performed by the Johns Hopkins Center for Civil Society and the Nonprofit Listening Post Project. Their findings amongst 1,000 nonprofits across the country were that nearly two thirds are feeling the financial stress from recent government funding cuts and that the cuts are seen as a very significant challenge. Alan Abramson, Director of the Nonprofit Sector and Philanthropy program at the Aspen Institute, concurs. "Even as nonprofits shoulder a large part of the burden of meeting human needs in this country and around the world, this nation's nonprofit organizations will soon begin to feel the impact of federal spending cuts enacted in the recently completed fiscal year 2006 appropriations process and will likely face additional funding cuts in the fiscal year 2007 budget cycle."

Capital Purchases

Although the amount needed for major capital betterments or future capital purchases varies from group to group depending on their needs, the process of establishing such a fund is consistent across any group. If an organization can predict a future need for computer equipment, new office space, a new roof, or the hiring of a professional consultant for a limited project, then it will be easier to determine the appropriate amount necessary for the property and equipment reserve fund. Looking forward (these funds are NEVER designated to pay old debt) an organization needs to be able to forecast what issues may arise and plan for them accordingly by placing cash in a separate fund.

What's Expected Ahead?

The outlook for 2003 through 2010 is seen as gloomy according to the participants in a workshop hosted by McKinsey & Company. At least in the short term, the likely continuation of stagnation in the economy, policy trends and state and local deficits will lead to continued funding cuts for community based organizations. "This is much worse than the recession of the early 1990s. There isn't a window we can look through and see that if we just tighten our belts, we will get through it. We're much more scared than we've ever been," said Beatriz Otero, Executive Director of the Calvary Bilingual Multicultural Learning Center in Washington, DC.

While the nonprofit organizations and social service associations do have distinctive challenges and obstacles, it is essential to note that they also have distinctive advantages. These include the passion for doing good that infuses their staff, their board and their donors. It also includes the pride they can feel when they are able to solve a problem in the community or contribute to a

solution. While “good will” may be considered an intangible asset, it has a very positive, tangible effect on the world of nonprofits. Where there is a willingness, talent and desire to help others, these powerful forces can work together to enable the nonprofits to have the energy to deal with some of their more serious issues.

3. How to Develop a Reserve Fund

In a recently conducted survey by Guidestar, two-thirds of nonprofits polled reported decreased or stagnant contributions when comparing donations in 2002 to the year before. At the same time, the need for services has, of course, increased. That is backed up by the Washington Grantmakers poll in June 2002 which showed 82% of surveyed nonprofits reported increased demand for services over the past twelve months.

The convergence of the demand for more services with the potential for less revenue only serves to confirm that building and maintaining an operating or capital reserve fund is of critical importance for the nonprofit organization. Having a reserve fund requires having some surplus cash. Even nonprofits are legally entitled to show an operating surplus as long as it is used to promote the organization's designated mission.

Each group will have to go through the exercise of asking themselves some tough questions that will include:

- How will we explain to donors how much we still need their contributions when we have a surplus from previous years?
- How much is enough to guard against an unforeseen emergency?
- How much will we need to invest in new programs or projects this year?
- How much do we need to have in a fund in case we have to make capital improvements?
- Can we effectively forecast our cash flow throughout the year so we see how much smoothing out we will do?
- What is our plan of action in the event of a reduction or loss in revenue?

The budgeting and reserve process is managed differently by each organization, but the objective remains consistent. The goal for all is to effectively manage an organization, enabling it to remain financially strong in order to keep its promises to its constituency. In order to accomplish this, the organization has to rely on thorough planning and control. First of all, the nonprofit organization needs to carefully analyze the revenue and expense items in order to be able to balance its cash inflows and cash outflows. But in addition to the annual operating expenses, the organization must include reserve accounts for long term capital expenditures and deferred maintenance as well as a "rainy day fund" for short term emergencies.

At this point, once the decision has been reached to create a reserve fund, the question arises as to how much should be put in reserve. While the maximum amount acceptable to the National Charities Information Bureau is up to two years worth of expenses, there are varying opinions on how much is the right amount and how much is too much to set aside.

The range of suggestions from nonprofit executive directors polled across the country included:

- A flat sum of anywhere from \$10,000 – \$40,000
- One year's annual revenue
- A reasonable percentage of the annual budget
- Three months of expenses
- Six months of expenses
- Two years net expenses
- 5% of the budget
- Use whatever you can accumulate in a start-up fund, especially if you have a supporter who will help you

The final comment from one director was, "We do not actually have a reserve. We do carry money over from one year to the next. We have not yet determined what the threshold for a reserve might look like."

Using Common Sense

At Sobel & Co., Ron Matan, the Member in Charge of the Nonprofit and Social Services Group, has encouraged clients on the importance of sustaining a reserve fund, for all the reasons stated within this paper.

In helping them build and maintain a reserve fund at an appropriate level, Ron has provided his nonprofit clients with the following advice:

- Nonprofit and social service organizations cannot and should not continue to operate in crisis mode. Simply stated, if cash is not received in a timely manner, the organization is forced to react. All too often the majority of the time these are knee jerk reactions; in other words, they are unplanned reactions to crisis situations involving cash flow.
- Obviously, if a nonprofit receives funds or grant monies that were not earned or fees for unperformed services, such funds have to be returned to the appropriate funding source.
- One solution to an unplanned cash flow crisis might be to have available an open Line of Credit (LOC) for an appropriate amount to help weather an unforeseen storm.
- Recently, the President/Chief Executive Officer of a board returned from an executive management course held at Southern California University. The program emphasized that the President/CEO's task, or mission, is to design a plan for the organization to begin to build its reserves. Currently, the organization is cash flow strapped and has tapped out its LOC. A reserve plan was formulated and the President/CEO returned rejuvenated and more enthusiastic than ever.

- New Jersey's immediate past Governor Richard Codey recognized the need for nonprofit and social service organizations to have reserve funds. In fact, on January 13, 2006, he signed into law Executive Order #77. This order recognized that there is much to be done in fostering improvements to the current system and assisting the nonprofit providers in developing sufficient reserves or working capital to assist nonprofit providers in such endeavors as upgrading or replacing infrastructure, or defraying short term liabilities. The order directed the Department of Human Services - Division of Mental Health Services (DMHS) to enact a pilot program that would provide operational incentives for its DMHS contracts as follows:

-The operational incentives pilot program applies to all DMHS nonprofit, non-hospital and non-governmental agencies with cost reimbursement contracts. Fixed price and fixed rate contracts are not included, nor are contracts with hospital-based or governmental organizations.

-The contract provider earns an operational incentive when the provider's final contract expenditure report indicates that a net contract surplus exists. Providers can retain 100% of the current contracts net savings identified from contract deficiencies. There are reasonable restrictions and limits on the earned incentives, including an annual cap and a provision restricting federal funds. The operational incentives shall be utilized by provider agencies as a savings reserve, available to meet cash flow needs as working capital for assisting provider agencies in meeting their missions. Providers are prohibited from utilizing operational incentive funds to expand programming that would require ongoing funding, thereby creating obligations for future budget cycles. Additionally, providers cannot utilize incentive funds for executive management staff bonuses.

-Should a provider terminate the contractual relationship with DMHS, or dissolve the provider's corporate entity, the provider shall refund all remaining funds in the operational incentives reserve fund to the state.

-Such operational incentives reserve account is to be clearly labeled and presented separately on the provider's statement of financial position.

4. Conclusions

The purpose of this paper was threefold.

- The first goal was to clearly and succinctly define what a reserve fund is and how it functions within the nonprofit sector.
- The second objective was to identify the unique business, financial and professional proposition that exists in the world of nonprofit organizations.
- Lastly, it was our goal to demonstrate not only why, but how, a nonprofit can establish a reserve fund as one means of protection for a “rainy day.”

Based on current research and a depth of experience within the nonprofit sector, it is clear that a reserve fund is important to a nonprofit because it protects the organization in the face of an unexpected disaster, provides opportunities for growth and expansion and is an essential component of the organization’s infrastructure. As the trend in the nonprofit sector to adopt a more professional, formal approach grows stronger, organizations will find themselves embracing infrastructures that include corporate elements such as reserve funds.

Reserve funds will help ensure that nonprofit organizations begin to operate outside of crisis mode, which is fundamentally critical for the continued long term survival of nonprofit organizations.

Working in tandem with their Certified Public Accountant, an organization’s most trusted advisor, careful planning and preparation can help the leadership of the nonprofit accomplish the goals associated with its reserve fund.

5. About Sobel & Co.'s Nonprofit and Social Services Group

Sobel & Co. is a regional accounting and consulting firm with headquarters in Livingston, New Jersey. The firm has been providing nonprofit and social service organizations in the metropolitan area of New York / New Jersey with audit, accounting, tax and advisory services since its inception in 1956.

As a result of our expertise and highly regarded reputation in the nonprofit sector, we are proud to say that we are currently serving more than 95 nonprofit organizations with revenues ranging from \$100,000 to \$50,000,000. We offer these clients a wide range of services from audit and tax to strategic consulting and grant writing along with a variety of educational programs throughout the year including an annual symposium, webinars and roundtables.

About the Author

Ron Matan, CPA, is the Member in Charge of Sobel & Co.'s Nonprofit and Social Services Group. In this role he is responsible for the oversight of all clients in this sector. He is actively involved in the planning and direction of the services we provide to our clients as well as the supervision of the Sobel & Co. professional staff. He is always available during the conduct of every engagement, reviewing work of assistants, providing technical expertise and ensuring the project runs smoothly. Ron has many years experience with nonprofit organizations, and he draws on his experience to bring our clients the highest quality technical service combined with industry expertise and a focus on establishing a strong relationship with their organizations.

Ron is a member of the PKF North America Network's Nonprofit Committee, the New Jersey State CPA Society's Nonprofit Interest Group and serves on the NJSCPA Peer Review Executive Committee. He also serves on the boards of three local nonprofit organizations - First Occupational Center, Plainfield Neighborhood Health Center, and the Union County Educational Services Foundation.

If you have any questions or would like to talk about your reserve fund, please contact Ron Matan at 973-994-9494 or via e-mail at Ron.Matan@sobel-cpa.com. Your comments and feedback are very welcome!

For information about the complimentary nonprofit programs hosted by Sobel & Co., please contact Sally Glick, Chief marketing Officer, at 973-994-9494 or via e-mail at sally.glick@sobel-cpa.com.

6. Research Notes and Acknowledgements

In writing this white paper a good amount of external research was conducted by the author. Various books, documents, web sites and personal “blogs” were reviewed, many of which were rich in information that led to the final work presented here.

We would like to acknowledge and thank the following sources for the insights and ideas that they made public and which added great value to this document:

www.findarticles.com

www.earthwise.sep.state.pa.us

www.hafoundation.org/donor

www.npgoodpractice.org

www.answers.com

www.leg.state.or.us

www.uwba.org

www.fieldtsonealliance.org

www.compasspoint.org

www.managementhelp.org

www.nptimes.com/enews

www.jhu.edu/listeningpost

www.mckinsey.com/client-service/nonprofit/resources

Additional information was provided by:

- “Nonprofit Agendas, Developing a Reserve Policy that May Help You Survive the Next Crisis” published by Goodman & Co., CPAs. April/May 2005.
- Venture Philanthropy Partners, June 2003.