Impact of Inadequate Operating Reserves

Supplement to: *What are Adequate Nonprofit Reserves for Financial Stability? – "It Depends"*
A White Paper by Nonprofit Reserves Workgroup,[1] which can be found at:
http://www.nccs2.org/wiki/index.php?title=Nonprofit_Reserves_Workgroup

The **status** of an organization's financial stability -- in terms of inadequacy of *operating reserves* -- falls into one of the following three categories based on the *Operating Reserve Ratio*.

An organization's *Operating Reserve Ratio* can be calculated in terms of a percentage (*operating reserves* divided by annual expenses) or number of months (*operating reserves* divided by average monthly expenses). The *minimum* operating reserve ratio, suggested by the Workgroup, is 25 percent or 3 months of annual expenses. See White Paper supplement: *Defining the Operating Reserve Ratio*.

Status 1 – No operating reserves

Operating reserve ratio range: less than 0%. **Months** of reserves: none

Impact: If the **Operating Reserve Ratio** is zero or less (i.e., a deficit in *unrestricted net assets available for operations*), the organization is in a very poor financial situation and may even be fiscally irresponsible.

It can be experiencing a serious, disruptive financial crisis. For example, it may be having difficulty meeting payrolls, and/or it may be seriously behind in paying its bills. It is likely operating hand-to-mouth -- disbursing funds as soon as they are deposited -- and could not operate for more than a few weeks without income. The staff and members of the board are devoting a disproportional amount of time on day-to-day financial management, resulting in a reduction in the delivery of program services. In some cases, staff may be asked to forego all or portions of their salaries. And, some staff members may leave for a more stable environment or may be subject to furloughs or layoffs. Internal controls may be ignored with less staff to do more work. .

Organizations with significant temporarily or permanently restricted net assets may be borrowing from those funds to cover deficits in unrestricted net assets available for operations. This is a very serious financial management problem since it violates the organization's fiduciary responsibility to assure that restricted funds are used only for purposes designated by the donors. Note that the numerator of the **Operating Reserve Ratio** includes only unrestricted net assets and excludes all restricted net assets.

Organizations with an **Operating Reserve Ratio** of zero or less would not be able to meet all of its financial obligations if it were to go out of business, unless liquidation of their non-current assets would cover the deficit.

[1] The views, recommendations and suggestions expressed in this paper are those of the Nonprofit Reserve Workgroup and have been established by the Workgroup on a consensus basis. Some members may disagree on some points. Workgroup members represent themselves and not their affiliations. This paper is not the product of the Center on Nonprofits and Philanthropy at The Urban Institute, which serves as secretariat for the Workgroup. Other Workgroup papers can be found at http://WikiHome>NCCS Core Activities>Nonprofit Reserves Workgroup.

Status 2 – <u>Low reserve</u>

Operating reserve ratio range: 0% to 25%. **Months** of reserve: none to 3 months

<u>Impact:</u> If the **Operating Reserve Ratio** is at or above zero but less than 25%, the organization can be in a weak financial situation. The nearer to zero the **Reserve Ratio** is, the weaker the financial situation becomes. A ratio of less than 25% indicates unrestricted net assets available for operations are only sufficient to cover less than three months operating expenses. The need is for action to avoid a serious financial situation should there be an unexpected downturn in revenue or increase in expenses**.** The need is to bring this ratio up to 25% (assuming this is the fiscal objective set by the board) within a reasonable time period (e.g., over a 6 to 48 month period).

Status 3 – <u>Adequacy: it depends</u>

Reserve range: 25% or more. **Months** of reserve: 3 months or more.

<u>Impact:</u> If the **Operating Reserve Ratio** is at or above 25%, the organization's financial situation <u>*may*</u> be considered **adequate** – <u>*depending*</u> on factors such as age, size, environment, revenue sources, type of programs. See White Paper supplement: *It Depends*.

<u>Operating within a proper budget is essential to financial sustainability</u>

In response to the question of how to get from status 1 - no operating reserves or status 2 – low operating reserves to status 3 – adequate operating reserves, some have suggested: "Teach them how to budget in a way that builds adequate operating reserves."

The basic concept is that nonprofits with below minimum operating reserves need to revise and improve their budgeting and other financial management practices to first grow, and then maintain adequate operating reserves. Reserves are generated through a series of annual surpluses of income less expenses. Likewise, reserves are depleted through a series of deficits of income less expenses.

For nonprofits experiencing annual deficits of income less expenses and/or negative or below minimum operating reserves, the key is to budget their revenues and expenses for annual surpluses that will grow their reserves to some minimum level over a period of years. The minimum level for their organization is set by the board in a formal reserve policy. The annual revenue budgets need to be realistic. That is, revenue budgets need to be estimates based on prior revenue generation adjusted for any projected changes that would reduce revenues in some revenue categories. Revenue goals can be significantly higher than revenue budgets, which need to be conservative with reasonable expectations that they can be achieved.

Nonprofits need to have financial management practices in place that enable them to operate, year after year, within their expense budgets and to be prepared to adjust expenses downward if and when actual revenues and/or revised revenue projections fall below budgeted amounts.

A 5 percent average annual surplus of revenues over expenses can improve an operating reserve ratio of minus 10 percent to the suggested minimum 25 percent in 7 years.