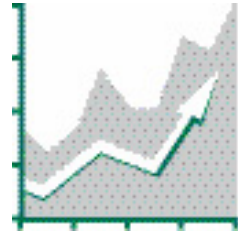


Financial Adviser



Operating Reserves Essential for Reducing Risk

Each nonprofit organization at one time or another has wished it had saved for rainy day. Saving for a rainy day sounds logical, but most organizations don't plan for or anticipate the need. Many organizations neglect to put aside funds that will help them preserve their capacity to deliver on their missions in the event of unforeseen financial shortages. A natural disaster that increases operating expenses, a budget impasse from a governmental organization, or an unexpected decrease in gifts from individual donors can put an organization without adequate operating reserves at risk.

Some nonprofits have negative reserves and are already at risk. To assess this locally, I performed a brief analysis of 25 nonprofits in the Erie region by accessing their 2009 Internal Revenue Service Form 990's from *GuideStar.org*. The annual expenses ranged from \$3.4 million to \$299 million for services that included health care, education and human services. Nine of the 25 had operating reserve ratios over 25 percent, and the other 16 actually had negative reserve ratios. This is by no means an exhaustive analysis; however, it does demonstrate the reality of this issue.

What is an Operating Reserve?

An operating reserve is the portion of "unrestricted net assets" that nonprofit boards maintain or designate for use in emergencies to sustain financial operations for unanticipated events. Accumulated unrestricted net assets increase or decrease from annual surpluses or deficits. Financial stability is attained by budgeting for, and actually achieving, yearly surpluses, which help meet operating reserve objectives. Unrestricted net assets should be further defined as "available," or that portion of net assets not attached to fixed assets, net of related debt.

For organizations interested in creating an operating reserve, it is recommended that nonprofit boards establish a minimum operating reserve ratio policy. A minimum operating reserve ratio can be calculated in terms of a percentage (operating reserves divided by the annual expense budget) or number of months (operating reserves divided by the average monthly expense budget).

Industry experts conclude that a board should establish, at a minimum, an operating reserve ratio of 25 percent or three months of the annual expense budget. The minimum is just that, a minimum. How much beyond the minimum can vary from organization to organization and is dependent on several other factors.

Establish a Reserve Policy

Whatever is decided, it is prudent that nonprofits establish an operating reserve policy regardless of the size of their annual budget. Establishing a policy is something that each nonprofit should do by evaluating what is adequate for them. This should be given serious consideration and not approached half-heartedly using a boiler-plate policy found on the Internet. It has to work for you! One final comment would be that operating reserves should be accumulated in advance of other Board-designated funds.

The key steps for any nonprofit creating a policy are to: 1) establish a minimum level for an operating reserve ratio; 2) define how the operating reserve will be calculated (use the above or something more specific to your organization); 3) define how reserves will be invested; 4) define frequency of measuring (monthly report to executive director and quarterly to the board); and, 5) identify how the operating reserve will be replenished if used.

One key element in the success of building an operating reserve is to overcome the stigma that nonprofits are not permitted to make a profit. Staff and boards of nonprofits, as well as contributors, need to understand and agree that it's OK to have anticipated annual surpluses to help build an operating reserve, but more importantly, it will help an organization achieve sustainability.

There is no "one size fits all" solution but there is a solution that will work for each organization if those who believe in the nonprofit take the time to define what will work best for them. That's why it's so critical for nonprofits to incorporate an operating reserve policy into their long-term plans.

For more information and questions regarding operating reserves, contact Shawn Emerson at McGill, Power, Bell & Associates, LLP at semerson@mpbcpa.com or 814/453-6594.

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