Determining Appropriate Levels of Reserves

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A. The Question: Among the single most popular questions historically asked by nonprofit CEO's and their boards is "What is an appropriate level of reserves for our organization?"

B. The Answer: It is best to start by saying that based on the literature available there is simply no single correct solution for all organizations. Despite the importance of the issue there exists no agreed upon industry benchmark. To complicate matters further, such benchmarks as are commonly used must be viewed in the context of the particular organization to which they are being applied.

C. The Problems: There are actually a variety of problems in trying to establish an industry standard benchmark.

1. The most important is that the term "reserve", while generally understood, is subject to a great variety of specific definitions. Later on we will discuss several of the more common definitions and calculations used, and discuss their strengths and weaknesses.
2. A close second in solving the problem is the variety of the potential contextual issues in which the organization finds itself. This is where we will begin.

D. Contextual Issues.

1. The initial contextual issue concerns the age of the organization. Simply put a young organization will not have had time to build a significant reserve. These organizations should have as their goal to create a positive change in net assets each year so that they can build a reserve. Such a goal should not be less than 3-5% of gross income and not more than 8-10%. While these numbers are not written in stone, they are logic driven: to take less will not allow the organization to aggregate a sufficient reserve, or perhaps even keep up with inflation; to take more would deprive the young organization from offering sufficient program services.
2. One of the most important contextual issues concerns the number and dependability of the organization's income streams. If an organization has three or more major revenue streams that are reasonably dependable, they are far more secure and thus need fewer funds available for a rainy day (i.e., reserves). On the other hand, an organization that has few or no highly reliable income streams might do quite well to have nine months or a year's worth of expenses in reserve.
3. Some organizations also need to maintain more reserves than others because of major planned expenditures such as the purchase of a building, or a major IT implementation. While borrowing is used as frequently as cash for expenditures of this type, it is nevertheless important for an organization when setting its current goals for reserves to do so with an eye toward potential major expenditures.

4. The fourth contextual issue is based on whether the organization is likely to confront ‘difficult to anticipate’ major contingencies. For example, the Red Cross must have very substantial reserves since it may face some years in which there are a multitude of devastating storms; a professional society is not likely to face similar contingencies.
5. The final contextual issue is one of absolute size. If an organization has one or two million dollars a year in expenditures, having a years’ worth of expenditures in reserves may make good sense. On the other hand, if an organization has a 50 million dollar budget it might well be considered poor stewardship to have a substantial percentage of that in reserve. The IRS is not likely to object; it is the donors or members who might question why so large a sum of “their” money is being held by the organization.

A. The most common calculations of reserves.

The variety of calculations of reserves used within the nonprofit industry is broad indeed. Among the many definitions organizations use for reserves are:

1. Total assets;
2. Total assets less total liabilities (or net assets);
3. Current assets plus investments minus current liabilities;
4. Or simply total cash and investments.

Two different definitions of reserves in common use are (neither of which is entirely valid, however popular they may be):

1. ‘Liquid reserves’ - which is defined as ‘cash and investments that can be quickly converted to cash.’ The problem with this definition is that it does not take into account such things as accounts payable and deferred revenue, and the like, which will be paid or consumed in the very near term.
In one survey of actual reserves held by associations the median reserve target reported on this basis was 33% of the organization’s annual operating budget. In common parlance this would be defined as ‘four months of expenses’ in reserve.

2. ‘Total net assets.’ The problem with this figure, which is self defining, is that it would include fixed assets, such as a building, computers, or furniture and fixtures – all of which are not available to be spent should the need arise. On the other hand , total net assets would have been potentially reduced by long term liabilities, such as mortgages, which do not need to be paid off, and thus do not require the use of cash, any time soon.

The same survey listed the median reserve target for this definition for ‘All Organizations’ to be 50%, or in common parlance, ‘six months of expenses’ in reserve.

B. A More Precise and Conservative Definition of Reserves:

Arguably, the best measure of what an organization has available to use in case of an urgent need for liquidity is based on the elements which define liquidity. Consider the following formula:

Current assets,
less:
receivables that are not fully expected to be collected within three months, and
inventory that is not fully expected to be sold for cash within three months
and less:
all prepaid expenses
and plus:
unrestricted investments not already included in current assets
and less:
current liabilities, except for deferred revenue
equals:
Available reserves

This formula essentially reduces the financial position of the organization to its ultimate measure of liquidity. Begin with all current assets, but take out accounts receivable and inventory which may or may not be converted to cash in the very short term, and also remove prepaid expenses which reduce certain future costs but have already been spent. Then add in the investments which the organization could spend if it had to – not those restricted to a particular use or time frame, and certainly not permanently restricted funds. Finally subtract out all the current liabilities except for amounts collected in advance of providing goods or services. What remains is an ultimate measure of liquidity and thus funds available to meet any emergency.

The formula is quite conservative. However, by itself it does not indicate what percent of a year's expenses the organization should have. To solve that dilemma the author would suggest that the ultimate "gold standard" for a successful mature organization is one year's expenses in reserve adjusted for the context that the organization finds itself in.