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FINANCE

Clear the Fuzzy Thinking About Nonprofit Reserves

Kate Barr | July 15, 2015

When I want to push nonprofit leaders to think about finances more comprehensively than their annual budget, I have a simple exercise that I use:

Imagine that a surprise gift arrives at your organization from a loyal and honorable donor, with no restrictions or strings attached, equal to 20% of your annual budget. What would you do with this windfall?

After the initial smiles and laughs about fantasyland, the answers start coming. I've heard a wide variety, but the most common response is: "Put it in a reserve fund." My next question is, "Why?" These answers are often pretty vague: "In case something happens,'" or, "To give me some elbow room." I believe that fuzzy thinking about reserves is one of the barriers to building reserves. If we're not clear about why a nonprofit needs reserves, or how reserves will be beneficial for the community, then why bother?

In our discussions with nonprofits about the concept of capital structure, described in general in this post from a few months ago, we dig deeply into the topic of reserve funds. For most nonprofits, there are three primary purposes for having reserves:

Repair and replacement of fixed assets: to maintain and preserve productive long term assets. Things break and need to be upgraded, from computer networks to furniture to roofs and heating systems. Building funds, or Repair and Replacement reserves, are a tool for accumulating cash for non-routine maintenance or replacement of fixed assets. Some of these expenditures can be planned by developing a systems replacement plan, whole others are unexpected. Cash is needed in either case.

Unexpected external problems: to protect and stabilize the nonprofit in case of unexpected, often external, problems. This is the classic rainy day fund, or operating reserve. Scenarios would include the sudden loss of a previously reliable funding source, unexpected delays in the timing of grants or revenue, or an unusual decrease in special event or earned revenue.

Invest for the future: to prepare for and respond to long term changes in organizational strategy or in the community or market. Opportunity reserves allows a nonprofit to invest in program redesign or to pilot an expansion, seed fund an innovation, test out new marketing or development ideas, or bring on staff capacity that will pay off in the future. More than anything, having internal reserves for opportunities makes a nonprofit an investor in its future.

How much does an organization need in these three reserve buckets? I resist the standard rules of thumb metrics because I recognize the vast differences among nonprofits. Clarifying the different purposes of reserves makes the idea of a single "best practice" questionable anyway. If a nonprofit has reserves that equal 90 days of their operating budget, when and how would they use it? Organizations have different obligations and commitments. There is a spectrum of risks. Some organizations are more likely to take on a big new opportunity than others.

The first step in developing useful nonprofit reserves is to clear the fuzzy thinking and ask "why," "when" and "what if" questions. What buckets does your organization need, why do you need them, and how would reserves maintain, protect, stabilize, and prepare the organizations to achieve mission in the community?

If you're ready to dig into these questions about reserves for your organization, check out this article and example policies from Propel Nonprofits' Resource Library.

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One Main Street SE, Suite 600
Minneapolis, MN 55414

612.249.6700

info@propelnonprofits.org

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