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Reserves planning: A step-by-step approach for nonprofit organizations

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In a recent survey of not-for-profit finance executives, nearly 40% of respondents identified maintaining cash reserves and financial flexibility as their organization's primary financial objective for the upcoming fiscal year[1]. While there has been increased focus on reserves, many organizations are still unclear as to how to determine appropriate reserve levels or establish an effective reserves policy.

Based on insights we have gained from working with industry executives across the country and colleagues in Grant Thornton's Not-for-Profit practice, this white paper addresses the importance of reserves and shares our recommendations and industry best practices to enhance organizational practices. It is also designed to assist the industry as a whole as it transitions to a more sophisticated and standardized reserves planning methodology.

A focus on risk reserves

This white paper focuses on the concept of "risk reserves" — the amount of net assets that a nonprofit organization should have on hand in order to adequately protect itself against risks that may adversely impact the organization's bottom line.

While it is common wisdom within the industry that nonprofit organizations should seek to achieve standard reserve-level targets (e.g., three months, six months or one year of operating expenses in reserves), these generic thresholds underserve organizations and their constituents. Each organization has a unique business model, risk exposure and financial circumstances; therefore, the level of assets that are set aside to mitigate against risks should vary from organization to organization.

In this white paper, we recommend a methodology that not-for-profits can use to determine the appropriate level of risk reserves specific to their organization.

What are reserves?

Over time, the concept of reserves has come to mean different things to various nonprofit professionals. Some define reserves as an organization's assets in excess of its liabilities — the textbook definition of net assets. Others solely consider an organization's liquid net assets in their definition of reserves. While liquidity is an important consideration in determining whether an organization's assets can be deployed to offset risks, this definition is challenging because the entirety of an organization's liquid net assets need not be set aside as reserves.

Our definition of reserves digs down one layer further:

An organization's financial reserves are a discrete subset of its liquid net assets. They are a distinct pool of assets that an organization can access either to mitigate the impact of unbudgeted, undesirable financial events or pursue opportunities of strategic importance that may arise in the future.

Reserves can be used as a "rainy day fund" to help an organization navigate through the risks that may impact financial performance in the months and years ahead. Reserves thus act as an insurance policy to enable an organization to maintain financial solvency and mitigate risk. They can also serve as cash on hand to fund new activities and provide organizations with the financial flexibility and ability to take advantage of strategic opportunities in the marketplace.

[1] The Center on Philanthropy at Indiana University. *Financial Literacy and Knowledge in the Nonprofit Sector*. February 2012. Available at www.philanthropy.iupui.edu/files/research/2012financialliteracy.pdf.

4 reasons why your organization should establish appropriate levels of risk reserves

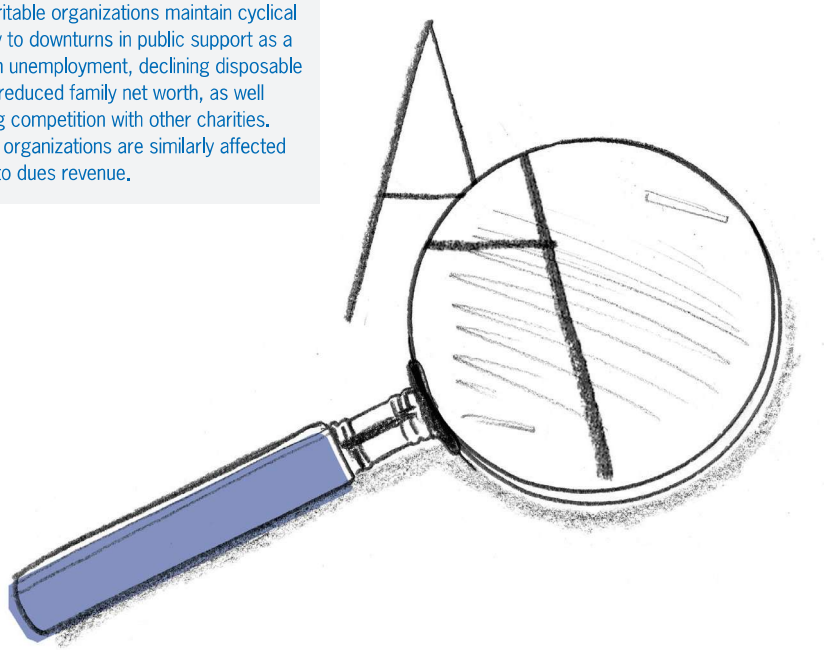
1. **Become self-sufficient.** Given the uncertainty of formerly stable revenue streams and budgetary belt-tightening at the national and local level, many nonprofits can't count on receiving funds that may have been previously considered a given. Many organizations have already experienced significant reductions on this front, and they should be prepared for potential new cuts.
2. **Be prepared for market-related risks.** When the S&P 500 plummeted from approximately 1,550 to below 700 in less than 18 months, nonprofits were reminded that the equities markets should not necessarily be relied upon as a form of annuitized income. Management and boards should continue to reassess their organizations' financial position and overall financial strategies.
3. **Avoid unplanned cost-reduction measures.** Throughout the fiscal crisis, due to solvency and liquidity issues, management of many nonprofits were forced to react in a relatively "knee-jerk" manner by undertaking staff reductions and program cuts. Unfortunately, without adequate reserves, many of these entities were forced to compromise their strategic trajectory and long-term attainment of their mission for the sake of near-term financial savings.
4. **Reduce the impact of industry-specific risks.** In addition to broad, systemic issues, every not-for-profit organization must establish reserves to mitigate against potential risks specific to their own unique sector, mission and business activities. For example, leadership at many advocacy and religious organizations are concerned about pending litigation costs that their organizations may encounter in the near future. Further, charitable organizations maintain cyclical susceptibility to downturns in public support as a result of high unemployment, declining disposable income and reduced family net worth, as well as increasing competition with other charities. Membership organizations are similarly affected with regard to dues revenue.

How to determine the appropriate level of reserves for your organization

Regardless of your organization's financial position, determining an appropriate level of reserves should be a key focus for management. "Appropriate" is an important term since, over the years, some nonprofits have been criticized for maintaining insufficient liquid assets, while others have been under attack for carrying "excessive" reserves on their balance sheets.

Many standards are currently applied to the establishment of reserves in the nonprofit sector. Whether it's a set number of months' worth of operating expenses or a predetermined dollar amount, these generic rules of thumb are relatively arbitrary, not organization-specific, and cannot be "proven" to be adequate. Given today's economic realities, these relatively unsophisticated approaches are no longer satisfactory.

No two organizations' business operations and risk profiles are alike. Just as all organizations establish their own unique business plans and associated operating budgets, we recommend that every nonprofit adopt a unique reserves plan to meet its specific needs and circumstances.



Highlights from our four-step reserves planning process

1. **Develop a baseline long-term financial forecast.** Begin the reserves planning process by developing a five-year financial forecast for all aspects of the organization. This forecast will enable management to develop insights into key drivers and see trends that are not evident in annual budgets.
2. **Perform a detailed analysis of potential risks.** Identify, quantify and assign likelihoods to potential downside performance within the organization's short- and long-term financial plan.
3. **Quantify your average annual risk exposure.** Evaluate downside performance across all identified one-time or recurring budget line items, and apply probability-weighted, net present value-adjusted averages of risk exposure.
4. **Establish your target reserves level and funding approach.** In addition to establishing a reserves target, develop a funding plan in order to designate appropriate balance sheet assets to fund the organization's reserves.

Our four-step solution will enable you to better determine your nonprofit's target reserves level.

1. Develop a baseline long-term financial forecast.

Organizations that can most capably articulate a sound reserves plan typically maintain fairly robust long-term financial planning practices. If reserves are intended to mitigate against adverse financial consequences, it's important to understand what you are "insuring" against. We recommend beginning the reserves planning process by developing a five-year financial forecast for all aspects of the organization. This forecast will enable management to develop insight into key drivers and see trends that are not evident in annual budgets.

2. Perform a detailed analysis of potential risks.

Understanding the potential financial risks that your organization may encounter in the future is critical to building an appropriate reserves target. For this step, we recommend that management identifies, quantifies and assigns likelihoods to potential downside performance within the organization's short- and long-term financial plan.

Example of a financial planning exercise

Director of membership: With regard to our projected membership dues revenue for the upcoming fiscal years, I feel that our current five-year forecasts are quite ambitious. Given the realities of the marketplace and our recent performance, my belief is that it's:

- 25% likely that we will meet or exceed our forecasted performance (i.e., $10 million, $11 million, $12 million, $14 million and $16 million over the next five fiscal years);
- 15% likely to miss projections by 15% each year;
- 25% likely to miss projections by 10% each year; or
- 35% likely to miss projections by 5% each year.

Similar evaluations should be performed throughout your organization. In order to conduct a thorough and comprehensive bottom-up risk analysis, we suggest that your finance professionals collaborate with each department head, much like they would as part of the organization's annual budget cycle. An enterprise-wide assessment of financial risks requires a significant level of engagement from department heads because they are the ones closest to the organization's day-to-day activities and strategic initiatives.

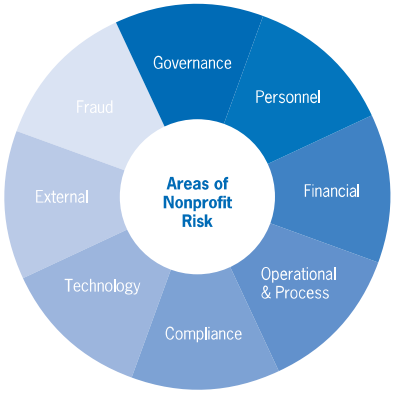
Any foreseeable shortfalls to your organization's long-term forecast should be documented, including those that are due to:

- factors beyond management's control within the organization's operating environment,
- forward-looking predictions regarding the organization's ability to execute against its operating plan, and
- external influences.

This type of financial exercise should be conducted for all key budget line items (i.e., revenues and expenses) where variance from plan may have a material impact on the organization's overall financial performance. Any type of risk that may financially affect the organization's bottom line should be included within the assessment — from governance to financial to technology. Recurring (e.g., member/donor income), multiyear (e.g., product/service revenues) and one-time risks (e.g., litigation) should also be inventoried.

Building consensus among management on organizational risks and their impact ensures buy-in and integrity within the overall reserves planning process, and creates a shared perspective on the enterprise's long-term direction and operations.

Risks to consider in order to identify potential downside financial scenarios



3. Quantify your average annual risk exposure.

Once the risk universe has been identified based on the various inputs collected from across the organization, the finance function should synthesize this information relative to the organization's long-range financial plan. This can be accomplished by evaluating downside performance across all identified one-time or recurring budget line items, and applying probability-weighted, net present value-adjusted averages of risk exposure.

Here's an example that illustrates how this approach would work based on the previously mentioned director of membership's concerns:

Membership dues revenue (USD, millions)						
	Likelihood	Year 1	Year 2	Year 3	Year 4	Year 5
Baseline performance *Perform to plan*	25%	10.00	11.00	12.00	14.00	16.00
Downside scenario 1 *Off 15% per year*	15%	8.50	9.35	10.20	11.90	13.60
Downside scenario 2 *Off by 10% per year*	25%	9.00	9.90	10.80	12.60	14.40
Downside scenario 3 *Off by 5% per year*	35%	9.50	10.45	11.40	13.30	15.20
Probability-adjusted outcome for each year		9.35	10.29	11.22	13.09	14.96
Variance from forecast		(0.65)	(0.71)	(0.78)	(0.91)	(1.04)
Net present value of risk (Using a 7% discount rate.)		(3.30)				
Net present value of risk per year		(0.66)				

In summary:

- $3.3 million is the amount of funding that the organization would need to set aside today in order to protect itself against dues-related risks within the upcoming five fiscal years, and
- $660,000 is the average annual amount in today's dollars of dues-related risks.

As noted, the same calculation should be performed for all organizational risks that management identifies in order to understand the five-year and average annual amounts required to protect the organization against potential risks. Despite the fact that each individual risk may have a nominal margin of error associated with its underlying assumptions, this probabilistic, "basket-of-risks" approach is reliable in the aggregate and enables the organization to establish an appropriate level of funding.

Through a "portfolio approach" to risk analysis, management will have a clear understanding of the various factors that may inhibit the organization from achieving its annual budget and the average annual financial resources that are needed to mitigate against organizational risks.

4. Establish your target reserves level and funding approach.

In addition to knowing your organization's risks and their financial impact, management must ultimately determine its target reserve level, as well as its approach to setting aside funds for the determined amount.

The five-year and annualized net present value calculations that we have described above are a starting point; however, each organization will have different reserves planning practices depending on its own unique situation. Determining the reserves target may vary based on leadership's risk appetite and management's expectations regarding the organization's ability to react to change. For example, if an organization does not feel confident that it can reduce its expenses or enhance revenues in the face of realized risk, then it should adopt a more conservative approach towards reserves planning. Accordingly, while some organizations may elect to establish an institutional target of funding risks for the next five years, others may be more conservative and aspire to fund their risks for a noticeably longer duration.

In addition to establishing a reserves target, your institution must also designate appropriate balance sheet assets to fund its reserves. Some organizations have adequate liquid assets on hand to fully fund their reserves target at the outset. Others need to develop a funding plan, which can often be accomplished by taking measured steps to manage the bottom line (and/or relying on investment income) to improve their funding position. Since reserves are a prudent and critical aspect of sustaining ongoing viability, if you don't have the means to either access cash on hand or generate sufficient operating margin, it's critical to make difficult current spending decisions to generate the necessary funds. Further, by instituting improved controls, modifying business plans (e.g., getting out of risky investments or business ventures) or mitigating risk through procurement of insurance policies, organizations can alter their risk profiles and thereby reduce their reserves targets.

Adopting and communicating a reserves policy

Establishing and documenting a formal reserves policy is a best practice that should be adopted by all not-for-profits. In fact, some institutions have elected to explicitly communicate their reserves policies to constituents via their publicly visible websites. The proactive and transparent sharing of an organization's finances and financial planning practices gives its constituents a greater sense of comfort regarding the nonprofit's financial management. It also offers a clear justification for management's decision-making and the level of balance sheet assets.

If an organization simply seeks to set aside reserves for six months or a year of operating expenses based on a general rule of thumb, it can be challenging for management to defend these reserve levels amidst programmatic needs. However, if reserves are based on projections of risks that probabilistically will happen to the organization, management can more easily justify the allocation of assets for this purpose.

Further, communicating the reserves policy and its underlying rationale to an organization's board and management enhances leadership's understanding of and support for the new approach to reserves. As with all major initiatives, appropriate communication planning and change management are critical when successfully launching a new reserves policy.

Your organization should also determine the frequency of its risk profile evaluation (e.g., annually or biennially) and formalize this concept within the policy. Reserves policies also commonly specify how and when you should take corrective steps to improve the funding level (e.g., the adoption of reserves replenishment plans) if certain triggers or funding thresholds are reached. Additionally, the policy should identify the people who are responsible for establishing and funding reserve levels, as well as defining processes needed to use reserve funds when risk events occur.

Reserves policies versus reserves planning

A reserves policy in and of itself doesn't enable you to address the challenges associated with underfunded reserves. Based on our experience with finance professionals across the nonprofit sector, few executives consider their organization to be "well-funded"; in fact, most believe that their reserves are significantly underfunded. In such instances, management should work through its budgeting and financial planning processes to make certain that a clear and well-communicated reserves funding plan is established and implemented to attain the reserves target level.

It is typically challenging to fully fund reserves in the short term; however, many organizations have overcome this obstacle through thoughtful, multiyear planning and a commitment to improving the organization's financial well-being.

A sound reserves policy means financial health

The ever-increasing pace of change and general uncertainty in today's operating environment requires nonprofit organizations to be proactive, nimble and financially astute. Maintaining sufficient balance sheet health, vis-à-vis an organization-specific designated pool of reserves, enables nonprofits to be prepared for the future, while providing stability and continuity in day-to-day operations.

4 reserves planning considerations to keep in mind

1. **Your budgeting process impacts reserves.** Your long-range financial plan is the baseline for assessing the organization's risk profile. As a result, management's approach to budgeting and forecasting may significantly affect the specific reserves that an organization may require. For example, if your institution develops very conservative forecasts, it will have a lower financial exposure. Similarly, if it develops more "aspirational" budgets, the institution will inherently face a higher number of potential downside scenarios and a greater likelihood of missing its forecast. This is a simple example of how two otherwise similar organizations would adopt completely different reserves targets to meet their needs.
2. **Benchmarking provides little value.** If you choose to research reserves levels within other organizations (a very common request by management and boards when undergoing a reserves planning exercise), we recommend that you perform this benchmarking exercise only for political or change management purposes. While it's not a bad thing to understand other organizations' reserve levels, benchmarking is inherently limited, as "more or less" does not necessarily equate to "better or worse." Different nonprofit institutions have different business models, constituent demands and risk profiles, and as such should not necessarily have the same amount of reserves on hand. Therefore, benchmarking gives you limited value when determining appropriate reserve levels for your organization.
3. **Drawing upon your reserves should be expected.** Our methodology recommends that organizations draw upon reserves to address deviations from budget. As a result, a nonprofit expecting to generate a surplus (with the intent of using it in subsequent year activities) would effectively achieve its budgeted results regardless of actual performance by tapping its risk reserves pool. In contrast, regarding reserves as a means to backfill operating deficits is a less sophisticated approach to reserves planning.
4. **Reserves are a subset of your organization's overall liquidity.** Beyond setting aside liquid assets to mitigate against potential risk events, management must also ensure that it's maintaining adequate cash on hand and liquidity to fund day-to-day operations. Further, organizations should consider what additional discretionary funds should be set aside to pursue key strategic priorities or capital improvement projects. Determining an appropriate level for these needs tends to be a more qualitative exercise as compared to establishing a risk-based reserves pool, but it's an important process nevertheless.

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