

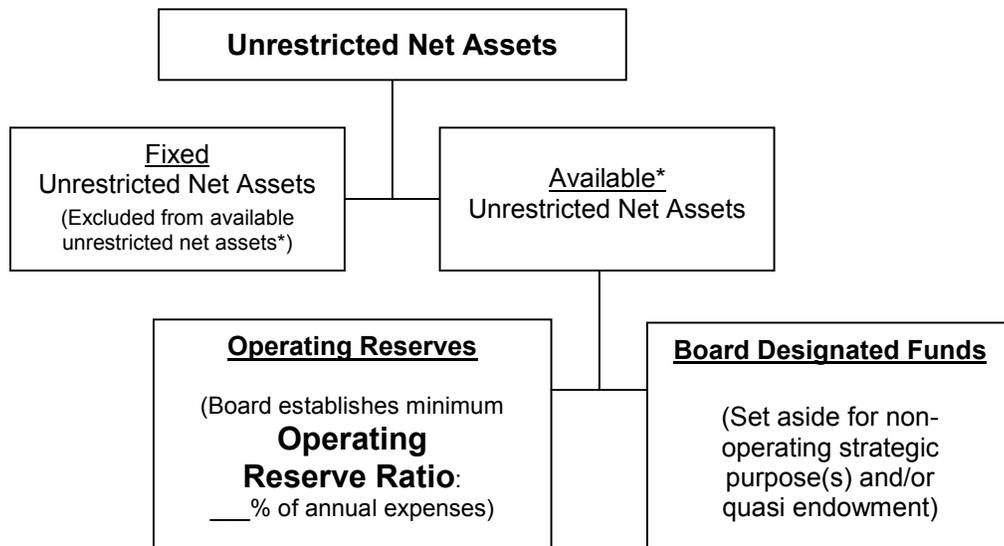
Nonprofit Operating Reserve¹ Ratio

by Nonprofit Reserves Workgroup, NCCS/CNP, The Urban Institute; 9-19-08

$$\text{Operating reserve ratio} = \frac{\text{operating reserves}}{\text{annual operating expenses}}$$

As used here, “operating reserves” means the portion of *unrestricted net assets* that are available for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues.

Figure 1 -- Suggested balance sheet net asset terms presented in an illustration that all nonprofit CEOs and boards need to understand



* Available unrestricted net assets could also exclude other non-current, non-liquid assets such as receivables, inventory, prepaid expenses and deposits held by others

A board approved Reserves Policy establishes a minimum Operating Reserve Ratio in terms of a percentage, or number of months of the prior year annual expenses or current year expense budget. The Reserves Policy can also include Board Designated funds that are set aside for non-operating strategic purposes and/ or quasi endowment.

Since Board Designated Funds, if any, would be for non-operating purposes, they would not be available for operations. However, portions or all of Board Designated Funds can be undesignated by board action and become available for operations if financial conditions change – e.g., the Operating Reserve Ratio falls below the minimum level set by the board..

¹ While “reserves” is a popular term for referencing financial strength, it is not used with consistent meaning and is not described or found extensively in not-for-profit authoritative accounting literature. When it is used in various articles and documents on nonprofit reserves, it can refer to all available unrestricted net assets, which would include all board-designated funds, or be limited to the portion of available unrestricted net assets designated for operating reserves. Further, the term “reserve” can also be used in an entirely different accounting context – in the insurance industry for example.

The basic premise is that many nonprofits do not have adequate **operating reserves**, and an initiative is needed to help them improve their financial condition by increasing their reserves. An organization without adequate **operating reserves** facing chronic cash shortages can be distracted from long range planning or prevented from taking advantage of unexpected opportunities.

As a general rule, a minimum **Operating Reserve Ratio** of 25 percent – or three months of annual operating expenses or budget – is the Nonprofit Reserve Workgroup’s suggested minimum goal. However, the *adequacy* of **Operating Reserve Ratios** over 25 percent is variable and *depends* on a number of factors such as reliability of operating revenues, impact of changes in economic conditions, potential for CEO turnover, or need to move to new facilities in near future, for example.

Once an “adequate” **operating reserve**, as determined by each organization’s board according to its particular circumstances and financial position, has been acquired, available unrestricted net assets in excess of this amount can be designated by the board for strategic purposes and/or quasi endowment. The Workgroup recommends that maintaining the minimum **Operating Reserve Ratio** established by the board be the first priority over potential board designations of available unrestricted net assets for non-operating special purposes.

Operating reserves can serve as an internal line of credit when needed to cover the normal fluctuations of day-to-day operations – temporarily bringing the Operating Reserve Ratio below the required minimum. Funds ‘borrowed’ from **operating reserves** would be ‘repaid’ when, for example, anticipated revenues are received.

According to a preliminary analysis of IRS Form 990 data (2003), 1,516 or nearly fifty percent of the 3,154 nonprofits located in Washington, DC had **operating reserve ratios** below the suggested minimum of 25 percent:

- 362 nonprofits (11%) had negative reserve ratios of minus 5 percent or worse,
- 258 nonprofits (5%) had negative reserve ratios of zero to minus 5%,
- 271 nonprofits (9%) had reserves of zero to +5 percent, and
- 725 nonprofits (23%) had reserves of 5 to 25 percent;

For a total of 1,516 nonprofits (48%) with less than 25 percent.

Using Form 990, **operating reserves** consist of Line 67 (Unrestricted net assets) less fixed assets net of debt. Fixed assets net of debt equals Lines 55 and 57 (Land, buildings, and equipment -- i.e., fixed assets) minus Lines 64b (Mortgages and other notes payable). **Annual expenses** consist of Line 44 (Total functional expenses) less Line 42 (Depreciation) in Column A.²

² The link to the 2007 IRS Form 990 is <http://www.irs.gov/pub/irs-pdf/f990.pdf>