

Managing Operating Reserves

by Jim D. Rebenar, CPA, Audit Manager

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When the Financial Accounting Standards Board recently released [Accounting Standards Update No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*](#), most of the attention was given to the changes made in net asset classifications. Many organizations devoted minimal time to the Standard's other reporting updates, until it came time for their annual financial audit. Among the less heralded of the updates were various disclosure enhancements, one of which aimed to improve the usefulness of information needed to assess liquidity of financial assets. The new standard now called for qualitative information to help financial statement readers better evaluate a nonprofit's ability to manage its liquid resources.

As an auditor, the first instinct when trying to gain an understanding of how an organization manages a specific business operation is to look at what is in policy. In doing this, we routinely asked for the auditee's policies regarding operating reserves, and to our surprise, were answered with more than a few blank stares. This brought to question, why are cash reserves and financial flexibility such a low priority on many NPOs' list of strategic objectives? The answer likely lies in management's uncertainty of how to go about determining appropriate reserve levels and establishing a comprehensive reserve policy.

The intent of this article is to spark that discussion at your organization and provide resources that can aid in the adoption of an operating reserve policy tailored to your individual risks, operations and structure. Before going further, let's share the definition of an operating reserve as given by the AICPA, who defines it as an accumulation of resources

without donor restrictions, often resulting from surpluses, which are available for use at the discretion of the governing board.

Essentially, reserves are often considered a “rainy day fund” set aside to stabilize a nonprofit’s finances. Reserves should not be used to make up for income shortfalls, unless the organization has a plan to replace the income or reduce expenses in the near-term future. Reserves could also serve as cash on hand to fund new activities and provide an organization with financial flexibility to pursue strategic opportunities. Without an operating reserve, your organization could be thrown into cash flow stress and become distracted from good long-term decision making or forced to make expensive short-term crisis-based decisions, or worse; you may not have the resources to continue the delivery of your programs.

For these reasons, it should be apparent how critical the successful management of operating reserves is to any nonprofit. To help facilitate such management, a formal policy should be adopted by the board which addresses each of the following items:

- The purpose of building and maintaining the reserves
- A calculation of the target amount
- The intended use of the reserves
- Who will have the authority over use of the reserves
- How the reserve account will be monitored
- A plan for replenishing the reserve balance

The Association of International Certified Professional Accountants has made available a very helpful tool which contains sample elements that can be used in the creation of an operating reserve policy. The sample policy can be found [HERE](#), or accessed through the Not-for-Profit Governance & Management Resources webpage at aicpa.org.

As mentioned earlier, uncertainty in determining an appropriate reserve amount for your organization is often the largest hurdle when developing a reserve policy. Keep in mind no two nonprofit business operations are alike; therefore, a one-size-fits all level of reserves does not exist. Each nonprofit should set its own reserve goal based on its cash flows and expenses.

Effectively managing operating reserves requires discussion and decision-making with many parties, which at the minimum include management, the governing board and the finance committee. I hope this article can help get the ball rolling on these important discussions in your organization.

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