

# Accounting & Audit Advisor

## Nonprofit's strength depends on its operating reserves

By Guest Columnist Amy Boland, CPA, with Gelman, Rosenberg & Freedman, a CPAmerica International member firm

What is an operating reserve, and why does every nonprofit need to address this issue?

Nonprofit reserves are more important now than ever in today's economy. It is a common misunderstanding that nonprofit organizations should not make a profit.

In fact, the goal should be to build a solid base for the organization by accumulating unrestricted net asset balances and investing them in the organization's programs. Accordingly, the greater the unrestricted net asset balance, the greater the organization's ability to enhance and expand current programs and further promote the organization's tax-exempt purpose.

Operating reserves are the portion of unrestricted net assets that are designated for use in emergencies. The reserves sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses or reductions of operating revenues.

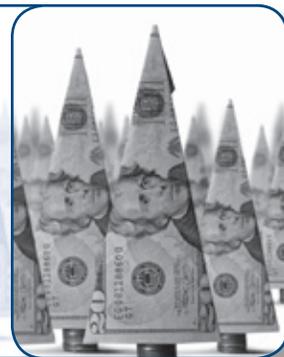
These reserves should not be confused with the unrestricted board-designated funds that are set aside for special projects or future ventures. They should also be separate from the undesignated, unrestricted net asset balances that are primarily made up of noncurrent, nonliquid net assets.

The operating reserves may be the difference that allows the organization to continue when faced with unexpected situations – such as the economic downturn. Reserves can carry nonprofits through tumultuous periods to those of greater stability

when anticipated revenue is received or important decisions are made based on the new circumstances facing the nonprofit.

Despite the importance of operating reserves, studies show that many nonprofits have insufficient or negative reserves, putting them at serious risk. Most nonprofits are aware they do not have reserves, but many have not addressed the issue.

**Having a healthy operating reserve may be perceived as evidence that the nonprofit has a well-thought-out sustainability plan, which can be attractive to potential funders.**



The question most nonprofits struggle with is: "What is the appropriate amount to be set aside in an operating reserve?"

Unfortunately, no single set benchmark applies to all nonprofit organizations. Each nonprofit organization is different. Therefore, the appropriate operating reserve balances differ for each one.

Key members of management and the board of directors must evaluate the internal and external factors that could potentially affect their organization. The factors may include stability of revenue and expenses, the maturity of the organization and future plans of the organization, which may include new ventures, new programs, etc.

The rule of thumb suggested by the Nonprofit Operating Reserves Initiative Workgroup is a minimum reserve of 25 percent or three months of the annual operating expense budget. Many organizations strive to increase that reserve to six months once

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## Operating reserves *continued from front*

the three-month reserve is achieved. This may be dependent on the factors identified in the previous paragraph.

Many organizations have not yet analyzed what the balance in their operating reserves should be. And even those that have determined the appropriate balance may find it difficult to obtain sufficient funding to build their reserves. This should not prevent the nonprofit from performing the exercise of identifying the optimal reserve balance.

Some nonprofits have inadequate unrestricted net assets. Others have been using restricted funds to cover current operating expenses. Using the funds in this way can be very serious for an organization since the funds are restricted for a different purpose. This situation will affect cash flow because ultimately the “borrowed” funds will have to be paid back to the restricted net asset accounts, or the organization will run the risk of defaulting on donor wishes.

Recurring deficits that result in negative or insignificant unrestricted net asset balances may raise red flags to existing or potential donors. Conversely, having a healthy operating reserve may be perceived as evidence that the nonprofit has

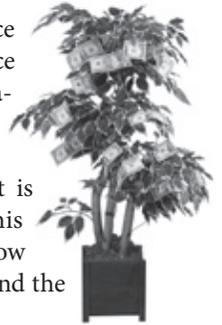
a well-thought-out sustainability plan, which can be attractive to potential funders.

Once an optimal balance has been established, the next step is to develop a plan for starting to build the operating reserve balance. Some organizations decide beforehand that a percentage of each year’s excess will be set aside until the goal has been achieved. Other nonprofits wait until the end of the year to decide what they can set aside based on how well the organization performed that year.

More fortunate nonprofits that already have significant unrestricted net assets just need to formally segregate these funds from the undesignated funds and internally designate the segregated funds for the operating reserve.

Finally, an appropriate operating reserve balance may be a moving target. The adequate reserve balance can vary from year to year, depending on the organization and its strategic goals.

The operating reserve balance should be evaluated on an annual basis to ensure the nonprofit is properly safeguarded from the unexpected. This should be a priority for all nonprofits, especially now when most have experienced losses and felt firsthand the effects of the recent economic downturn. ■



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