Determining an appropriate reserve level for nonprofit organizations

By RSM MUSE

Setting a financial reserve level is a key process for a nonprofit organization, providing necessary funding to continue operations during a host of potential challenges or taking advantage of strategic opportunities. However, many nonprofits do not have a defined process to establish reserves, exposing the organization to undue risks. In an environment of economic and political uncertainty, implementing an effective method to set reserves is critical to long-term organizational sustainability.

There are some rules of thumb for determining a reserve level, such as using three months of operating expenses, but this is generally arbitrary. Following a more rigid framework may not be truly effective either, as each organization is different with unique risks and opportunities based on the mission provided. Conversely, many nonprofits tend to wing it when creating a reserve level, but that method lacks transparency and can create concerns of not enough reserves or too much that can hinder day-to-day operations.

Your organization can begin to implement an effective reserve strategy by taking four key steps:

Know your environment

In order to determine an appropriate reserve level, you must evaluate your strategy, operations and mission and additionally consider external factors. Ask questions, including:

- **What external factors are relevant?** What is happening in the political, regulatory and economic climate that might affect the organization?
- **Is funding dependent on a few key donors or diversified?** Could your organization sustain the loss of one or a few key donors?
- **Could you tighten the belt if necessary?** Most nonprofit organizations operate fairly lean, but are further efficiencies possible if needed?
- **Are there important future initiatives that will affect risk or will require significant investment?** What future plans may require funds from existing reserves or may dictate a rise in reserve levels moving forward?
- **Is your mission urgent?** Has more importance been placed on your mission, requiring a dip into reserves for increased activities and outreach now rather than later?

Understand your risks

Many organizations know their risks, but do not implement a framework to determine how those risks translate to potential financial impact and ultimately influence reserves. This process should include several key elements, including:

- **Identify risks:** Conduct interviews with leadership and identify challenges by area and program.
- **Assign risk type:** Are your specific risks related to compliance, finances, operations, your reputation or strategy?
- **Assign risk probability:** How likely are each of these risks to occur?
- **Prioritize risks:** Designate a tier level to each of your risks.
- **Calculate potential financial impact and impact to reserves:** For each risk, detail how much each risk could affect overall finances and convert impact to financial reserves.

Listing and evaluating these risks can be valuable in tactical planning, providing additional transparency and justification when setting reserve ranges. In addition, this exercise could raise yellow or red flags for previously unseen risks and start the development of mitigation plans.

Benchmark against similar organizations

As mentioned earlier, all organizations are different and risks can differ significantly. However, understanding what similar organizations keep in reserve can provide some insight into building an effective strategy. Information on savings and temporary cash investments from peer organizations can be found within the Form 990.

Be objective where possible

Many parties in your organization will have interest in how reserves are set because having more or less cash directly affects mission delivery on a variety of fronts. While the finance department usually controls the process, you may want to consider an independent external advisor in order to create a more transparent, participative and objective process.

An external advisor can provide a new perspective on reserve levels and strategies at similar organizations, as well as proven frameworks to assess considerations for setting reserves and how your risk environment can influence reserves, in both the short-term and long term.

Case study

We recently worked with a large international organization that had some challenges when setting appropriate reserve levels. Some of the organization's board members felt the organization appeared to have sufficient reserves, but some board members felt that the reserves were not enough, given current political and economic uncertainty and the potential need to expand mission efforts. Ultimately, the organization faced a debate that many nonprofits contend with: whether the right path forward was spending more to deliver mission or fiduciary responsibility to conserve for the future.

The organization had not updated its reserve policy recently, so our team worked closely with stakeholders to develop a comprehensive method to set reserves. We evaluated the organization's unique considerations, and identified its specific risks to each committee from a strategic, operational and people perspective. In the end, we compiled a list of over 100 risks, and categorized and quantified them.

Utilizing this information, we recommended a range of reserves and a more specific level for the organization, providing a level of detail and transparency that it did not previously have. The insights gathered and shared represent a defined and strategically justifiable reference point that leadership could work from when making final decisions for setting reserves.

Conclusion

Developing a reserve strategy is a complex initiative, given the unique characteristics and risks for each organization. Selecting a proper reserve level is both an art and a science; you want to reduce subjectivity, but you also have to use judgment. You should implement a process that provides actionable data, but also considers how your reserves can withstand one—or even multiple—of your risks occurring, and how you would sustain operations.