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Reserve Funds: The Basics

A Whitepaper for Nonprofits

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What is a Reserve Fund?

The common conception of what exactly "reserves" means can vary across the industry. Sometimes reserves are viewed as an organization's assets over its liabilities. Other times they are considered an organization's liquid net assets in their definition of reserves. These definitions can be challenging because, despite liquidity's importance in a reserve policy, the entirety of an organization's liquid net assets may not necessarily be best used as reserves.

Rather, an organization's financial reserves are a component of its liquid net assets. They are assets that an organization can access either to lessen unbudgeted, undesirable financial events' impact or pursue future strategic opportunities.

Reserves, often referred to as a "rainy day fund," can help an organization handle the risks that may impact future financial performance. Reserves can act as a safety net to enable an organization to maintain financial stability and adequate downside protection. They can also, given their liquidity, fund initiatives and provide organizations with the financial flexibility and independence to take advantage of strategic opportunities in the marketplace.

Reserves' Importance

Everyone will at some point face unexpected costs. Nonprofit organizations are no exception to this. Although, unfortunately, the organizations that have the appropriate reserves to comfortably handle these unexpected costs can be an exception. Having sufficient reserve funds can solve these unexpected timing issues.

A reserve fund can help preserve assets. Equipment breaks and needs to be upgraded, be it computers, telephones, furniture, roofs, or air conditioning, to name only a few. Building reserves to serve as easily accessible funds on-hand for non-routine maintenance costs can save an organization from needing to find external funds in a panic. Some expenditures can be planned while others are unexpected, but, either way, funds will be needed.

Reserves can also protect and stabilize in the case of unforeseen, external issues. This is where the classic "rainy day fund" label is produced. Scenarios would include the sudden loss of a funding source, unexpected delays in grants or revenue, or a decrease in special event revenue. Sometimes organizations may not even know what their revenue for a given fiscal year will be until a single grant or revenue stream arrives. Such heavy reliance on a single event risks leaving an organization in a very difficult position. Reserves can buffer the impact of an event's nonoccurrence.

As an organization grows, reserve funds can allow an organization to prepare for and adapt to long-term organizational changes in strategy or in the market. Reserves can allow an organization to invest in new programs, expand the organization's own reach, fund innovation within, or outside of, the organization, test out new development ideas, or grow internally. Ultimately, having sufficient liquid reserve funds makes a nonprofit a potential future investor, in either itself or other ventures.

The Benefits of Reserve Funds

A. Financial Independence: One aim of a nonprofit organization should be financial independence. Given the possible uncertainties that can come with revenue streams and budgetary restraints, many organizations may be left unable to count on receiving funds that may have been previously considered guaranteed. As nonprofit organizations' market changes, many can experience significant reductions in funding and may need to proactively address the possibility of even more.

B. Markets: When markets plummeted approximately 50% in 2008, organizations were reminded of the importance of diversification within their reserves. Those whose reserves were solely in equities faced a harsh reality. Management and boards should continually reassess their organization's financial position and overall financial strategies to ensure prudent levels of downside protection are always implemented.

C. Avoid Cost-Cutting: Nonprofit organizations are not immune to economic downturns. During previous economic crises, many nonprofits were forced to react by cutting staff and programs due to a lack of solvency and liquidity. Unfortunately, without adequate reserves, organizations were put in a position of having to salvage short-term financials at the cost of their long-term initiatives.

D. Mitigate Industry Risks.

In addition to macro-level issues, every nonprofit organization must establish reserves to protect against potential risks specific to their sector and business activities. Charitable organizations are susceptible to downturns in support. High unemployment, declining disposable income, and reduced family net worth for charitable giving, as well as competition amongst charities, can all result in reduced funding for an organization. Membership organizations are similarly affected regarding revenue from membership dues. Establishing reserve funds can mitigate the impact any of these downturns may have on an organization by closing the resulting financial gaps.

How Much is Enough?

It is recommended across 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), but these thresholds vary based on each organization's unique circumstances. Each organization has a unique business model, risk exposure, and financial circumstances. Therefore, the level of assets that are set aside to mitigate risks will vary among organizations. Generally, abide by a three-, six-, or twelve-month level of operating expenses, but an organization's specific circumstances will affect this.

A cash flow study could shed light on what amount may be appropriate for an organization's specific circumstances. Also, an organization's time horizon will help in assessing its risk profile and how much it could afford to leave in reserve funds. It's common to recommend placing funds into reserves that are not anticipated to be needed within the next five years. Knowing cash flow needs will help reasonably identify what expenditures may be incurred during a given timeframe, and thus how much could be left as reserve funds.

This will lead to how the reserve funds are possibly invested. The longer an organization allows for reserve funds to grow without anticipating tapping into the funds, the more risk-tolerant that organization may be.

As a result, budgeting and forecasting cash flows is critical to determine what amount an organization may require in reserves. For example, if an organization adopts a more conservative budgeting and forecasting approach, it could place more into a reserve fund and focus it on long-term growth. Conversely, if budgeting and forecasting are more aggressive and reliant on grants or revenues, the organization may have a greater need for highly liquid funds that remain more stable in value in case grants or revenues cease. This is a simple example of how two otherwise similar organizations could have different reserve fund needs.

Finally, don't be concerned about what other organizations may be doing. Reserve levels within other organizations (a frequent request by organizations when planning a strategy for reserve funds) don't provide the answer when determining an appropriate level for reserve funds. While it's not a bad thing to understand other organizations' reserve levels, it does very little in terms of shedding light on whether a particular organization's level of reserves is appropriate. Nonprofit organizations have an array of business models, demands and risk profiles, and thus what works for one organization does not necessarily translate perfectly for another.

Long-Term Financial Stability with a Reserve Fund

The accelerating change and uncertainty in today's world requires nonprofit organizations to be proactive, flexible, and financially prepared. Maintaining sufficient reserves enables nonprofit organizations to maintain long-term financial health, while providing stability and continuity in the near future.

About MEDIQUS' Institutional Funds Management

MEDIQUS Asset Advisors, Inc.'s Institutional Funds Management division serves the investment advisory needs of almost 60 nonprofit organizations. These organizations come to MEDIQUS for expertise regarding the current issues and challenges they face relative to their reserve fund strategy and its implementation — establishing strategy, refining the necessary governance tools, risk tolerance, cash flow needs, changes in strategy, communications, and keeping the long term in perspective despite a changing economic environment.

We look to address our clients' unique issues and circumstances, drawing upon our years of experience.