# <u>Nonprofits and Squirrels</u>
**or, How big a reserve do *you* need?**

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Most of us have at least a few "squirrel" tendencies. It is comforting to have something put aside for the winter or the proverbial rainy day. In an organization, this stash is referred to as its "operating reserve;" it is what keeps the doors open during a temporary financial drought.

A frequent question in the nonprofit sector is, how much reserve should we have? However, the simple answer: as much as possible, is not really simple. Consider the following scenario: You graduated from a large private university, with total assets exceeding ten billion dollars (this describes several American universities.) You are, therefore, likely the recipient of an unending stream of appeals for you to contribute to their annual fundraising campaign. You consider your personal balance sheet; you look at their balance sheet, and – unless your name is Gates or Soros – you probably think, "They want *me* to send money to *them*???"

Being rich, in the nonprofit sector, is not an unmitigated blessing. Indeed, wealth allows you to avoid worrying about where the money is coming from to pay the next payroll, and to expand your services to the community. But it can cause headaches too, such as having to deal with a union representing your employees who understandably assume that with all that money in the bank, a large raise could easily be afforded. More than one university, and orchestra – to name just two parts of the nonprofit sector – has faced this very real challenge.

Of course being poor is not the answer either. Then you do have to worry about keeping the doors open, and you are not able to offer all the community services you would like to.

But what is the right amount? How should nonprofit leaders go about deciding on an appropriate level of reserves for their organization, given that life is inherently uncertain?

First, recognize that this is partly a personal decision; there is no absolute answer. Some people (boards and managers) are not uncomfortable living on the edge, and trusting that resources will appear; others like that warm fuzzy feeling of knowing a cushion is there. Your board probably includes some of each type. I am reminded of the three bears and the bowls of porridge; one bear thought his porridge was too hot; another too cold, and the third just right. Of course, the porridge in all three bowls was actually the same temperature!

Second, realize that the world changes over time. What was appropriate yesterday may be too much today, but too little tomorrow. Changing economic, demographic, political, cultural, and other circumstances make it vital to regularly re-assess the reserve goal. Similarly, organizations in different places may well need different reserves.

Next, consider who is interested in a nonprofit's reserve level. Besides the obvious – management and the governing board, I suggest this list includes: donors, clients/customers, members (of an association), employees, the media, regulators, the general public.

People often ask, is there some IRS or other legal limit on how much a nonprofit can accumulate without jeopardizing its tax-exempt status? The answer is, no - as long as the accumulated assets are actually being used to further the organization's exempt purpose. For many wealthy nonprofits, this is achieved by investing a large part of the assets – often in accordance with donor restrictions on endowment gifts, and using the income to help pay for operations. Most universities, orchestras, museums, and other nonprofits spend so much more on providing their services (education, concerts, exhibits, and so on) than they take in from tuition, ticket sales, admissions, etc., that, to stay solvent, they still need the additional money from annual giving. Also many nonprofits require sizable amounts of resources invested in property (classrooms, laboratories, dormitories, concert halls, collections, exhibit space); these resources are not available to pay today's light bill or faculty salaries.

What is very important for organizations that appear wealthy (say, more than 12 months' budget in the bank) is to be prepared to explain to prospective donors, parents paying their children's tuition, concertgoers, the media, etc., why there is still a need for additional funds beyond what is often perceived as high tuition, ticket prices, etc. Inability to do that effectively will make it nearly impossible to attract the required resources.

Similarly, organizations that appear poor need to be able to convince, say, a prospective donor that a gift will not be wasted; that the organization will be around long enough to accomplish useful outcomes.

Now, why does an organization need reserves? To be able to handle uncertainties. What could happen?

- *Unexpected shortfall in revenue*. This could result from unexpected external events – September 11$^{th}$ comes to mind, as does a blizzard the day of your big annual gala fundraiser; general poor economic conditions – we have been seeing this recently; organizational problems generating unfavorable publicity which turns away customers and donors; overly-optimistic budgeting of anticipated revenue (very common); and many other reasons.
- *Unexpected demands on your resources*. Examples might again be September 11$^{th}$ – if you are the Red Cross of New York, the same blizzard - which causes your roof to collapse, or the university's labor union gaining a wage increase.
- *Unanticipated opportunities*. Recently an extremely rare major dinosaur fossil became available at public auction. Museums knew that it would sell for a high price, and it did. If your museum wanted this for its collection, it had to have resources available to cover the cost. (In the real case, the winning bidder managed to quickly tap some large corporations to help, but still had to put up quite a bit of its own money.)
- *The inevitable instances of less than perfect judgment and foresight*. A project that everyone thought would succeed, didn't. The foundation grant that you thought was in the bag, wasn't.
- *A change in direction is called for*. A long-standing program just isn't what's best any more. Community needs have shifted. Resources are required to phase out the old and bring in the new. The parallel here is to seed capital in a business.
- *Normal day-to-day fluctuations in income and expenses*. Accountants refer to the reserves needed here as Working Capital. Payrolls have to be paid every payday. The electric company is likely to want cash, not a promise, to keep the power flowing. But income often comes in spurts, especially contributions.

  Often there are seasonal factors. For example, many contributions probably arrive in December as donors do personal tax planning. Colleges collect tuition at the beginning of each semester, and then have to live off it until next semester. Orchestras sell season tickets in the spring to pay for concerts to be put on over the following winter. On the other side, utility costs are probably higher in the winter and summer (heating and air conditioning), but lower in between.

Every organization should plan for its operating reserves. Consider how the above uncertainties might affect you. Your board, with advice of management, should adopt a formal policy for the reserve level it wishes to maintain, and review that policy regularly. Of course you cannot just make reserves appear on command; it may take an extended period to accumulate the desired level.

Related to this is continuing tension between wanting to spend currently everything we possibly can – because the need for our services is great, vs. putting something aside for the future. (Squirrels must be well programmed to handle this, as there are always lots of squirrels still around at winter's end.) That tension is part of every organization's (and person's) existence.

There should also be Plan B. For nonprofits this can be some combination of: cash on hand, surplus assets that can be sold, a bank line-of-credit, a local foundation that you know would help in a pinch, some individual donors who could be counted on if the going gets really rough, a plan to cut expenses to a bare bones level for a while.

Ask yourself, which organization needs larger operating reserves: (1) the Los Angeles Red Cross – think major, immediate, unpredictable events, or (2) a local day care center which owns its building debt-free, has a full roster of clients and a waiting list, adequate insurance, and a reliable funder which covers most of its operating budget? Now, where do you fall on that continuum?