



Building
cash
reserves

A must-have strategy for
nonprofit sustainability



HAVING CASH RESERVES ON HAND FOR A NONPROFIT IS NOT A NICE TO HAVE, IT IS A MUST-HAVE.

And it is not enough to have a cash reserve fund: a board must create a policy for when to use it and how to replenish it.

In order to carry out a nonprofit's stated mission, the executive director and board of directors must work together to ensure the longevity and sustainability of the nonprofit through a dedicated, regularly replenished cash reserve fund. This fund acts as a risk mitigation strategy against unforeseen events that could threaten the nonprofit's continued success.

INADEQUATE CASH RESERVES? YOUR NONPROFIT IS AT RISK.

All too often finances get tight and the staff of a nonprofit will use their precious cash reserves for daily operating costs or emergencies, without having a plan in place to replenish the fund. This leaves a nonprofit vulnerable to future emergencies and funding dips and is an all-too common way for a nonprofit to find itself closing its doors within a few years.

And that is if a nonprofit has a cash reserve to begin with.

The cost of inadequate cash reserves could be closure.

In a 2022 survey of the nonprofit sector by the Nonprofit Finance Fund 39% of all respondents stated they had less than three months of available cash, with some stating that they had only one month.¹

1. State of the Nonprofit Sector Survey, Nonprofit Finance Fund, 2022. https://nff.org/learn/survey?gclid=CjwKCAjwzJmlBhBBEi-wAEJyLu8jR9_5hl6RZzOeWujgzN852ovCLqDyPI_BqyPEXGGR-w8kBqu0jQxoC1lIQAvD_BwE

In a post-pandemic economy, the fragility of the nonprofit sector remains a significant concern as countless nonprofits have faced:


1. Increased demands for services, especially food, shelter, and basic human needs.
2. Changes to how the work gets done, from pivoting to remote workforces to service delivery models requiring virtual contacts, shuttered facilities, and significant reductions in volunteerism.
3. A sector-wide loss of 900,000 jobs, staff burnout, and pressure on nonprofits to increase staff pay and benefits to retain employees.
4. Dwindling sources of unrestricted cash that were accumulated throughout the pandemic crisis from generous donors, private foundations, and supportive government crisis funding.

As nonprofits find themselves managing operations beyond the pandemic which changed almost everything about how nonprofits deployed their business model, one truth has not changed: **everything has a cost**. Many nonprofits turn to using cash reserves to solve short-term problems like ongoing budget gaps, or the loss of a major grant or donor. But what if your organization does not have cash reserves to use? **The cost can be closure.**

As you continue to adapt to the current economic, social, and political environment, what financial resources does your organization have to support the foundation of your mission?

If “a three-to-six-month cash reserve fund” isn’t one of your answers, you should make it a priority at **your very next board meeting** to establish one.

More than 73% of nonprofits identified achieving long-term financial sustainability as one of their headline challenges.² Creating a cash reserve fund is the first step to doing this, and now is the time to start.



What financial resources does your organization have to support the foundation of your mission?

2. Ibid.



IS YOUR CURRENT CASH RESERVE STATUS WORKING FOR YOU?

Every nonprofit is unique, but the guiding rule in the industry is to have three-to-six months of operating expenses in a cash reserve fund.

If that is not you, it's time to ask yourself "why?"

And if you're one of the nonprofits who already operate with the three-to-six-month cash reserve fund, bravo — but do you have a written policy, adopted by the board, to manage that cash reserve fund?

That is the next level of safeguarding that reserve so that it can support your organization for years to come.

WHAT IS A CASH RESERVE FUND?

Cash reserve funds are intended to be a "rainy day fund" that can act as an internal line of credit when unexpected shortages in revenue or unforeseen expenses occur. The problem with cash reserves arises when nonprofits *repeatedly* use those reserves to solve short-term problems. If you are dipping into your cash reserves to cover ongoing budget gaps or the loss of a major donor months after the donations stopped, you're not operating on a line of credit; you're using the fund as repeat cash injections with no plan to pay it back.

Nonprofits in a Post-pandemic Environment

73%

said "achieving long-term financial sustainability" was their top challenge

39%

have 3 months or less of cash on hand

45%

have no emergency fund

92%

reported significant impacts related to the COVID-19 pandemic

71%

said demands on program services increased as a result of COVID

86%

anticipate service demands will continue to increase post-pandemic

67%

saw funding increases during the pandemic, but only 27% consider those increases likely to continue beyond 2022

WHY DON'T WE HAVE ONE?

If you do not have a fund at all, or it's a truly paltry one, you and your board need to ask yourselves “why?” Why do we have less than three-to-six months’ worth of cash? What is eating away at our cash reserves each month? What is missing in our budgeting process that isn’t allowing us to set aside money each month or each year?

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DOES EVERYONE UNDERSTAND THE RISKS OF NOT HAVING A CASH RESERVE FUND?

Perhaps you’ve taken for granted that you do have a cash reserve fund or glossed over the fact that you don’t have one at all. Either way, an important step in establishing and maintaining one is to make sure that everyone involved in budgeting and spending decisions knows what a cash reserve is and why it’s important. It might be time for a refresher for the entire team and putting together a list of risks to the nonprofit is a great place to start.



A properly maintained cash reserve fund should:

- Target an amount based on the organization’s unique risks
- Be a written policy (see example under “Get a policy in place,” page 9.) approved by the nonprofit’s Board of Directors
- Specify who has authority to use operating reserves and when
- Have guidelines on when withdrawals should be replenished
- Be part of the annual budgeting and forecasting process

POTENTIAL RISKS OF LOW/NO CASH RESERVE FUND

Here's a few risk factors and how to assess if they are risk factors for your organization:

Loss of a major donor. Has this already happened, or is there a more than a 50% chance it will happen? What percentage of overall revenue would this represent? How would you replace it or adjust your budget to compensate?

Downturn in the economy or continued inflation.

The economic horizon for the U.S. remains uncertain. Many economists are still predicting at least a mild recession by the end of 2023. Inflation has, and still is, having a dramatic impact on nonprofits as shown by these facts:


- 65% of nonprofits have increased wages and salaries to help their staff weather the impacts of inflation.
- 54% of nonprofits are actively pursuing operational efficiencies.
- 52% of nonprofits are increasing their fundraising efforts.
- and the number of U.S. households contributing to nonprofits has dropped to less than 50% for the first time in the last 20 year.³

Changes in where and how work is done. The reliance on many new technologies to fundraise, deliver program services, complete operational work, and access vast amounts of online data have exponentially increased the risks of fraud and cyberattacks on systems and data. A breach can be costly, in more ways than one.

The demand for services increased during the pandemic

Demand surges for services, increasing costs beyond budgets. Seventy-one percent of nonprofits reported that the demand for services increased during the pandemic, and 86% of nonprofits believe this increased demand will continue

The economic horizon for the U.S. remains uncertain.



You cannot rely on the same investment projections that you once did.

Investment losses. The markets for stocks, bonds, government securities, and money markets have experienced more than three years of great volatility – with no end clearly in sight. You cannot rely on the same investment projections that you once did.

Competition with other nonprofits. In an environment where nonprofits must stand out to garner the attention of donors and funders, many nonprofits see an expansion of programs into new areas to cast a broader net for harvesting revenue.

Membership declines. Historically low rates of memberships in local organizations results in lower dues revenue for those who rely on memberships.


Unexpected replacement of fixed assets. Nonprofits are finding it essential to keep upgrading their technology capabilities to remain competitive and relevant to their constituents and donors. The addition of new technology to weather the pandemic put a dent in many organizations' cash reserves.

Natural disasters. The effects of climate change are ushering in natural disasters with more severe outcomes, more widespread destruction, and deeper long-term impacts.

Key executive or development staff leave. When key staff leave a nonprofit, they often take with them vast institutional knowledge that can take significant investments in time and financial resources to rebuild. Today's rapidly shifting job market doesn't leave nonprofits untouched.

Your nonprofit likely has extensive exposure to all the above risks in today's climate. If you don't have a well-funded cash reserve, you're increasing your exposure even more.

Even if the task of establishing a cash reserve fund seems impossible, now is the time to start.



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DETERMINE YOUR SPECIFIC LEVEL OF RISK.

The three-to-six months of operating expenses guideline is a start, but the individual amount each nonprofit should have in cash reserves will vary. A nonprofit with stable grants and contracts will have less risk, but one that relies heavily on fundraising events can have much greater risk. It's important to study and know your nonprofit's budget, history, and forecasts as you determine the ideal amount of cash to have on hand in a reserve fund.

Know your numbers.

Examine your budget and actual expenditures over the past two to three years to determine where shortfalls have routinely occurred. This will help to determine if the issue is overspending, a lack of funding, or a bit of both.

Look ahead.

Where is the market going? What does your budget forecast look like for the next three-to-five years? This is tough in a swiftly changing economic climate, but it's an essential exercise for nonprofits that only budget on a year-to-year basis to help avoid massive budget shortfalls that will eat away at a hard-won cash reserve fund.

Identify your potential risks.

Look at the "Potential Risks" list on pages 6 and 7. Get everyone possible to participate in this exercise. Not just the executive director, but the board and department heads and employees who have been with the organization a long time. Try to get as full of a picture as you can.

It's important to study and know your nonprofit's budget, history, and forecasts...

Quantify your risk.

Once you know what your potential risks are, you can see what dollar amounts might cause severe cash flow shortages. There are two different types of risk analysis an organization can use: simplified analysis or probability-weighted analysis.

Simplified analysis is taking the largest risk item and comparing it to average monthly expenses (see the calculation formula below). An organization then sets its reserve equal to that many months of expense.

Probability-weighted analysis is a net present value-adjusted calculation, often used by larger organizations. For an in-depth example, see “Reserves planning: A step-by-step approach for nonprofit organizations.”⁴

How to calculate your operating cash

Formula:

$$\frac{(\text{CASH ON HAND} + \text{CASH EQUIVALENTS})}{(\text{ANNUAL OPERATING EXPENSES} / 365)}$$

The result will be the number of days of operating cash your organization has available

Important: the calculation for cash and cash equivalents SHOULD NOT include any restricted funds.

GET A POLICY IN PLACE.

Whether or not you already have a cash reserve policy in place, now is a great time to review what is there and update it to reflect the current economic and market conditions. And if you don't have one, the list below is a great template to help build your policy from scratch.

Keep in mind that this should be a written document, approved by the nonprofit's board of directors, and updated annually.

4. Klein, Paul, et al. "Reserves Planning: A Step-by-Step Approach for Nonprofit Organizations." Grant Thornton LLP. 2013. Accessed July, 6, 2023. https://na.eventscloud.com/file_uploads/97ee4b6aa2bf931481119c4922c4b7fb_ReservesPlanningfor-NonprofitsfromGrantThornton.pdf Ac



ESSENTIAL ELEMENTS OF A CASH RESERVE POLICY:

Purpose and objectives. A written statement of what your cash reserve fund is meant to do will help future boards understand why it exists – and help them to keep it intact.

Target amount. Updated annually – or as market conditions change rapidly enough to warrant review – you should have a written target amount that you are working toward as an initial amount or as a floor for future replenishments.

Initial funding plan. If this is a new fund, there should be a written plan for how to build it. There is a list of potential funding sources on page 13 to get you started.

Relationship to the organization's budget. Where in your priority list does adding to your cash reserve fund fall? How much of your budget will you allocate each month/quarter/year?

Appropriate conditions for use of funds. When can funds be used? On what kinds of things? Is there a blanket approval for up to certain amounts, or must each use involve a board vote?

Authority of management or board to use funds. Establish the executive director as the only staff member with authority to draw on cash reserve funds and set a limit on how much the executive director can draw without board approval. A written policy outlining an approval process will be necessary for any sum above that amount

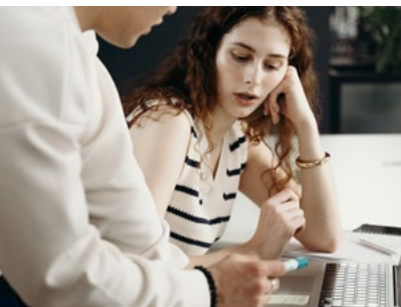
Guidelines on replenishing funds. How quickly will you aim to replenish funds? From what revenue sources?

Whether a separate bank or investment is required. Be sure to spread the organization's financial risk across different banks/investments if your cash reserve fund nears or exceeds FDIC insurance levels.

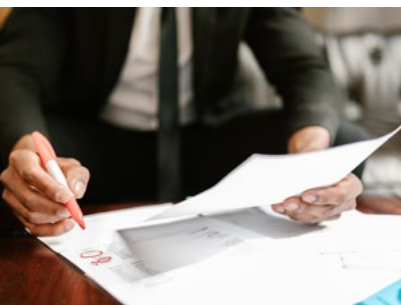
Investment policy for the cash reserve. Identify which sources of investment will be liquid enough to respond quickly in an emergency, but that will still earn as much interest as possible while your (hopefully large) sum of funds sits in waiting.

Roles and responsibilities of nonprofit management and finance

committee. There should be a requirement of management to provide regular reporting to the finance committee or the full board to summarize the status of the cash reserve fund, how much and why draws were taken, and how and when the funds will be replenished. The finance committee members are, in essence, the fund managers and will have a duty to ensure the policy is followed.



Guidelines for periodic review of the cash reserve policy. When will you look at the policy again? Are there “triggering events” that might make you look sooner than otherwise stated? What system will help you remember to do so? Who oversees calling attention to this?



Your cash reserve policy can be an internal document, but your nonprofit should also consider public disclosure to stakeholders as it would an annual update. This creates transparency with donors and the public, reassuring them that the organization is taking all steps possible to protect itself for unexpected future events.

REVIEW AND UPDATE WHAT IS ALREADY THERE.

Review as soon as possible what current policies you have in place, making sure to review them with the board, department heads, and other stakeholders. Take the time to educate this group on the risks involved in having no policy at all, or in not keeping it up to date. Make sure each person understands what a cash reserve fund is, does, and what it insures for your organization, so that the commitment to create and fund one is a universally accepted priority.

CREATE AND POLISH FOR THE FUTURE.

If you are starting from scratch, start now. Educate, educate, educate. Keep the project on your agenda until it is completed; do not set it aside for when the board is “less busy” — it will never happen.

This is also the time to formalize any processes and documentation regarding your cash reserve fund. We keep using the word “written” for good reason — cash reserve policies that aren’t in writing aren’t likely to survive a board changeover.

Make sure to review any compliance or auditing requirements for your organization. Is there anything special that needs to be considered for your specific nonprofit?

Make sure each person understands what a cash reserve fund is, does, and insures for your organization, so that the commitment to create and fund one is a universally accepted priority.

If you’re starting from scratch, start now. Keep the project on your agenda until it is completed...

Is there someone you need to consult with (perhaps your Fractional CFO at Veracity Pros?) in order to ensure the policy aligns with previously stated financial goals?

Once you’ve got policies in place to create and maintain a cash reserve fund, the next step is to line up your funding sources.



FUND YOUR CASH RESERVE.

A few nonprofits will be well-funded enough to immediately set aside their targeted cash reserve, but most will likely have to set up a funding plan that builds over a period of months or even years. It can be discouraging to think about but persevere: the discipline of budgeting to grow a fund can be severe, but so is the cost of never doing it at all.

HERE ARE A FEW WAYS TO FUND YOUR CASH RESERVE:

Here are some ideas to help you fund your initial cash reserve, or build your reserves toward a targeted amount:

Solicit a donor(s) to support the reserve. Nonprofits should look to leverage the relationships they have established with key donors, communicating the importance of ensuring a legacy for the organization via a cash reserve fund. This could include board members, donors with significant wealth, or donors who have a demonstrated passion or connection to the nonprofit's mission in the past.

Establish a targeted fundraising campaign. Create a named fundraising initiative specifically for the purpose of funding the organization's cash reserve fund. Be sure to "sell" the idea of how cash reserves will help the nonprofit's ability to respond to crisis needs and to build long-term sustainability.

Open a line of credit. While having a line of credit does provide a source of working capital for your nonprofit in the event of a cash crisis, this should not be relied upon as your only cash crisis funding source. A line of credit is a loan and will have to be repaid with interest.

Build it into the annual budget for several years. It is a false narrative that nonprofits must operate from a balanced-to-zero budget each year. The truth is that a nonprofit that is not budgeting to have a surplus at their fiscal year end is failing to plan for its long-term sustainability or growth.

Designate a portion of operating surplus to cash reserves at the end of each year. This establishes the discipline of putting away some surplus into savings, making it a habit year after year.

Direct a portion of investment gains to the cash reserve.

Look at it as a reinvestment in your organization's future.

Sell non-current assets and use proceeds for the cash reserve. In the post-pandemic environment, many nonprofits have discovered the changes in the way we work means some fixtures, equipment, and maybe even buildings are no longer needed. Do not sit on those items if they will not be used again — sell them and build a cash reserve now.

Adjust the current budget/rethink program offerings. A nonprofit can, and should, re-evaluate its current budget often, asking itself if changes could be made immediately to free up cash. Are there opportunities to ask vendors for discounts, extended terms, or providing goods or services as a contribution? Can contracts be renegotiated? There are likely many possibilities to consider, but make sure cost-cutting decisions are not negatively impacting the delivery of your core mission.

Review previous cash fund raids and reallocate into those categories.

If there's a line item that habitually pulled funds from the cash reserve in the past, make sure to adequately fund that line item, starting now.



If your organization has extremely low cash reserves, such as less than a month or two of operating cash, your funding of the reserve takes on a more urgent tone.

If your organization has extremely low cash reserves, such as less than a month or two of operating cash, your funding of the reserve takes on a more urgent tone. Consider making real cuts in operating expenses or otherwise modifying your risk in order to fund the cash reserve to your target level. It will be a tough decision, but it is an absolutely necessary one.

MONITOR YOUR CASH RESERVE.

Once you have a cash reserve policy in place and have begun to fund it, the nonprofit can move to a maintenance mode in keeping it running. Regular record keeping and review of funds going in and out should become part of the financial section of the board packet at each board meeting. This will ensure adherence to the cash reserve policy and enable board members to monitor whether the organization is meeting its target amounts of contributions to the fund throughout the year, allowing them to course correct as necessary before the organization falls too far behind.

Set in place a policy and procedure for an annual review of all internal and external risk factors to the organization. Changes in risk may necessitate changes to the written policy and/or the targeted funding level. Likewise, market conditions change and will also affect the cash reserve fund wherever it is invested.



A checklist of what to cover with your board as you establish a cash reserve fund:

- Why a cash reserve fund is essential
- What you currently have in cash reserves
- What you should have in cash reserves, based on risk analysis
- A sample policy for creating and maintaining a cash reserve
- Sources of funding to explore to help build a cash reserve
- A schedule for an annual review of your cash reserve policy

CREATE A SUSTAINABLE FUTURE FOR YOUR NONPROFIT.

As we gain distance from the pandemic and the extraordinary levels of funding received by nonprofits during the crisis, it will be of utmost importance for nonprofits to build sustainable levels of cash reserves as they move forward in delivering on their mission.

The work of creating and building a cash reserve fund is not for the faint of heart — but neither is running a nonprofit. The trust that the public puts in nonprofits is a vulnerable trust, one that nonprofits are asked to steward with wisdom and foresight, lest it be easily lost. In creating and sustaining a strategic cash reserve fund, a nonprofit board can fulfill its fiduciary duty, helping to carry an organization through to the next crisis — and beyond.

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All In One Accounting. We are your strategic accounting team. We advise entrepreneurs on profitable growth and help nonprofit leaders amplify their impact. We deliver complete flexibility in how businesses and nonprofits use our services because we can manage every aspect of their accounting operations, so they can focus on growing their business and impact.