PLAN B: BUILDING CASH RESERVES & PLANNING FOR CONTINGENCIES

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By reading this white paper, you will learn:

- What the nonprofit industry standards are for reserve funds
- How to avoid fiscal jeopardy and cash shortfalls by being proactive
- How to create a proactive contingency plan using five steps
- Why you need a cash reserve policy, and what it should contain
- Three steps to grow cash reserves

Our Context

The annual Nonprofit Finance Fund's *State of the Sector Survey* has shown for more than seven years in a row that less than 25% percent of those nonprofits responding had more than six months of cash in reserve. In fact, the majority of the nonprofits responding reported that they had less than three months of operating reserves on hand. And close to 10% had less than thirty days of cash on hand. While this may be the reality for nonprofits, that does not mean it is optimal. The *State of the Nonprofit Sector Survey* is a widely cited barometer of U.S. nonprofits' programmatic, operational, and financial health.

Building cash reserves and securing capacity funding, and having contingency plans is a good offense and defense for emergencies. The two approaches go hand-in-hand. They are two sides of the same nonprofit coin.

To test your own situation, if you answer yes to one or more of these questions, then this white paper is for you:

- *Are you continuously juggling cash flow?*
- *Is your agency's credit line nonexistent or at its limit?*
- *Is your client base growing faster than your revenue?*
- *Have funders asked you for stronger program outcomes, but your quality assurance (Q/A) department is nonexistent or understaffed?*
- *Do you lack planning funds to pilot a new program before a full launch?*
- *Did you have to pass on a growth opportunity because you lacked the required seed capital?*
- *Is your equipment, facilities, and/or I/T capability not up to 21st-century demands?*

If your answer is YES to any of the above, consider rethinking your approach to cash reserves and contingency planning.

Generally, these situations drive the need for cash reserves and contingency plans: emergencies, unexpected expenses, spiking demand for services, projected cash shortfalls, capital repairs or maintenance, replacement of equipment or property, or the ability to take advantage of new opportunities.

DEFINITIONS

Operating reserves may be a part of your organization's unrestricted cash or working capital. Every nonprofit needs to have sufficient cash flow coming in from various income sources and going out to pay expenses and other obligations

"It is absolutely true that every nonprofit needs to have adequate cash balances available to support the timing of payroll and other expenses, as well as to pay for unanticipated costs or increases. It's a myth, however, that a single standard applies for all nonprofits."

Kate Barr, Executive Director, Nonprofits Assistance Fund when they are due. Some organizations create reserves by setting aside cash in addition to the regular bank fund balances for use when regular cash flow is disrupted.

Reserves vs. Restricted Funds: Reserves are different from restricted funds. Restricted funds are grants and contributions that have you've received for specific programs or projects. These funds are "restricted" for use according to the grant agreement or the donor's instructions. Sometimes this means that restricted funds sit idle in the bank for a while, and the nonprofit cannot use those funds for another purpose.

On the other hand, reserves are "unrestricted" funds that your nonprofit's management and board can use in any way they choose.

RESERVES EQUAL TO THREE YEARS

To resolve that issue, **The U.S. Better Business Bureau** allows nonprofits to have operating reserve funds up to three years of operating expenses. Yes, three years. So, if your organization's annual budget is $1 million, you can have unrestricted reserves of $3 million. The larger the nonprofit, the closer one should aim to have a significant reserve.

In contrast, The U.S. Better Business Bureau's Wise Giving Alliance, which assesses whether national organizations follow its **Standards for Charity Accountability**, states in those standards that charities should "avoid accumulating funds that could be used for current program activities." However, to meet that organization's standards, a nonprofit can't have operating reserves totaling more than three years of current operating expenses.

Four-steps to determine the reserves you need:

1. **Develop a baseline long-term financial forecast.** Begin the reserves planning process by developing a two to five-year financial forecast for all aspects of the organization. This forecast will enable management to develop insights into key drivers and see trends that are not evident in annual budgets. A key number to know is what your fixed expenses are, payroll and operating costs, for six months. That alone justifies a good reserve to set.

2. **Perform a detailed analysis of potential risks**. Identify, quantify, and assign likelihoods to potential downside performance within the organization's short- and long-term financial plan. It's important to fund the depreciation expenses on replacing equipment and property. So many nonprofits overlook that step. This means that you have to know the depreciation schedule for each item. Those schedules run for one year, five years, or twenty years.

3. **Quantify your average annual risk exposure**. Evaluate downside performance across all identified one-time or recurring budget line items, and apply probability-weighted, net present value-adjusted averages of risk exposure.

4. **Establish your target reserves level and funding approach**. In addition to establishing a reserves target, develop a funding plan to designate appropriate balance sheet assets to fund the organization's reserves. This funding plan is integral to your strategic plan. Your organizational strategic plan must contain growth projected budgets, which can be used to determine the size of the reserves you need for the future.

You'll Need A Cash Reserves Policy

Your board of directors should adopt a "reserve policy as recommended by the CEO and the CFO. When developing an appropriate policy for your nonprofit, consider including guidance on these issues:

(i) how much money your nonprofit will set aside at all times,

(ii) defining the types of circumstances that will result in assets in reserve being used,

(iii) the process the nonprofit will go through to determine whether or not to dip into reserves,

(iv) the process and timeframe for repayment into the reserve account, and

(v) whether there should be any directions, restrictions, or limitations on what the money held in reserve may be used for.

CONTINGENCY PLANNING

Contingency planning helps nonprofit leaders plan for and react to projected challenges and crises, and/or opportunities that may arise. They enable your nonprofit to ask and answer the question, *"What would we do if...?"* for various circumstances, taking time to consider strategic implications, identify and weigh options, and agree on trade-offs.

Contingency plans are not just for a financial crisis. They also can include Emergency Management Planning, Special Events Management, Fire Risk Assessments, Workplace Health and Safety, Construction Safety for Capital Projects.

Scenario planning enables leaders to explore and prepare for hypothetical circumstances and environments (e.g., economic downturn vs. recovery, government funding cuts vs. growth, or a public health emergency). Contingency planning is a form of scenario planning focused on navigating worst-case scenarios (e.g., loss of primary funding, sudden loss of leadership, programmatic failure, adverse policy change, a spike in need).

Follow These Steps
To undertake scenario or contingency planning, you must have a clear understanding of your current strategy and operations, and key drivers of success.

1. **Identify the key factors**: Identifying factors that are critical to your success yet may be uncertain or unpredictable (e.g., a government funding stream that might get cut, a new merger that might take place, an ambitious hiring target). Naturally, much about the future is unpredictable, so focus on the factors that would most significantly affect the organization's ability to reach its goals.
2. **Determine possible outcomes and implications**: For each of the key factors, identify the likely range of outcome scenarios for a given element of strategy (e.g., the merger occurs in February, the merger is delayed until August, merger falls through) and, if practical, try to assign at least rough probabilities for each. Then, systematically think through how the organization would be affected by each outcome, including how each scenario would affect operations, growth, outcomes, and finances.
3. **Analyze and identify the best path**: Next, determine the options for how you could respond to the various scenarios, making appropriate adjustments to its tactics or even its strategy. Weigh the pros and cons of multiple responses—which path will be most likely to achieve the organization's mission and goals? Think carefully about which investments, initiatives, or programs must be prioritized and protected and which ones could be postponed, reduced, or eliminated.
4. **Codify the triggers and scenarios**: Decide what circumstances will lead you to take the potential changes. For example, "If revenues fall by 10-percent, we will do X, and if they fall by 20-percent, we will also do Y and Z." Determine what indicators you should track and how those indicators trigger the action that you should take.

5. **Monitor environment and implement scenarios:** As it moves forward, the organization should monitor key indicators to select the right scenario for achieving the greatest impact under the circumstances.

THE FUNDRAISING STEPS

I am often asked, "I don't know where to start! How do I build reserves?" Here are three steps. You'll need all three!

1. **Accumulate funds from your operating surplus** and build your reserves gradually. You must budget for the reserves that you will need.
2. **Fund depreciation expenses**. We all know that depreciation is the recognition, by recording an expense, of the decrease in value of a fixed asset over its expected physical or economic life. Well, the opposite is also true. You will also need to replace that item, so fund the amount of depreciation within the annual budget you are setting and fundraising for it.
3. **Private Fundraising**: Have you funded contingencies and emergencies from your general fund? If so, you're missing an opportunity to fundraise. To raise unrestricted support and provide additional funding to build infrastructure capacity, a Cash Reserve & Capacity Campaign, in the tradition of Capital Campaigns, is recommended. The campaign is time-limited, lasting 36 to 60 months on average, and seeks special gifts, **challenge gifts,** and major gifts from your most loyal funders and individual donors, as well as from new value-aligned donors that we identify through prospect research. These gifts are secured through personal meetings, presentations, and special funder appeals.

To begin a cash reserve campaign, LAPA Fundraising would possibly conduct a feasibility study, including interviewing your stakeholders and donors without attribution of who says what. The process could also include an **audit** of your development and communications programs and/or your staffing structure. We use those findings to develop a comprehensive plan for the advancement program unique to your agency. Our Cash Reserve Campaigns include advanced prospect research to develop new donor constituencies. We also research and write smart business plans if needed.

We will also write a cash reserve policy to fit your agency and for the board to authorize how the cash reserves should be used. We also prepare a state of the art **Case for Support** that drives home the urgency of your mission. The case for support will show your prospective donors how increasing your capacity and improving infrastructure can make your programs more robust, more reliable, and flexible to changing needs; however, the Case may not be called "A Case for Reserve Funds." That would not have the emotional resonance we're seeking to convey. Instead, we find the powerful impact you intend to achieve because of donors and funders investing in your agency.

We also aim to boost your Annual Fund (annual revenue and expenses) through advanced prospect research, moves management, and donor-centered communication.

One of the approaches our clients like the best is that we include fundraising costs in the fundraising goal so that your fundraising costs are paid for in the end.

At the end of a successful process, your nonprofit will have a new or expanded **cash reserve fund**. You can use these funds to increase your Quality Assurance program, improve your physical plant, expand I/T and other support functions, and especially have a stronger development program.

Are your cash reserves at the level they should be? Please share what your needs are with me, either on our blog or email me privately. I look forward to hearing from you.

To learn more about the context for advanced fundraising, please read Laurence's book**, Fundraising 401: Masterclasses in Nonprofit Fundraising That Would Make Peter Drucker Proud**, $10 available for purchase online.

LAPA seeks to positively change the way nonprofit executives and their boards think about fundraising. We provide the models, the tools, and the expertise to empower our clients to significantly increase their revenues.

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