

Retooling Your Financial Reserves

by Ben Aase

It's an age-old question that many leaders are revisiting during these difficult economic times: "How much money should my organization have in reserves?"

There are plenty of arbitrary rules of thumb—for example, holding a minimum of three months' cash or setting aside 25 percent of your projected annual operating budget. Unfortunately, these "best practices" are not supported by thoughtful reasoning, nor do they reflect the business realities facing your unique organization.

Look to your industry

Being aware of financial trends in your industry can be a good way to start thinking about reserves. For example, governmental entities across the country are facing delayed payments due to projected federal and state budget deficits. As states delay or hold back payments to reduce their fiscal year appropriations, individual entities that rely on those revenue streams need to position themselves to shoulder these aid shifts. Governmental entities should also consider statutory requirements and the limitations that can be placed on financial reserves. And they should know what types of activities the funds can be reserved for, the appropriate mechanism for designating reserves, and any dollar amount limits.

Most industries' membership associations or trade publications also offer standards or benchmarks as guidance.

The "bottom up" method

If you want to move to an objectively informed reserve policy, a more nuanced approach is to use a "bottom up" method. This technique dissects your organization's business model and identifies the risks to your revenue and expense drivers (and assets and liabilities where appropriate). It then assigns dollar amounts and probabilities to those risks. The result gives an organization a range of acceptable reserve levels based on real scenarios that your organization could face, given your line of business and competitive environment.

In practical and general terms, this type of analysis addresses risks and associated reserve needs that are likely to fall under the following groupings:

- General operating: for ongoing operational expenses during interim periods of economic disruption (less than 12 months)
- Capital investment or improvement: for the repair, replacement, or expansion of major technological infrastructure and facility needs
- Business model: for operations over a three-year period during which your organization must make a significant change in its business model
- Uninsurable legal: for uninsurable costs associated with litigation
- Market volatility: for unanticipated investment losses caused by market volatility
- Initiative or opportunity: for business initiatives that require significant development or start-up costs

Putting the idea into practice

To illustrate the idea, take the instance of a large international association with a \$350 million operating budget. It used the "bottom up" method to move away from its previous "best practice" reserves policy requiring 50

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percent of the operating budget. And while the “bottom up” method did not provide right or wrong “answers” per se, it did provide an objective and data-driven framework and process. In the end, the organization’s trustees felt confident that their reserves policy was supported by a disciplined and reasoned approach that was predictable and consistent. Too often, reserve policies are treated as a one-time exercise, reflective of your organization at a snapshot in time but then left to sit idle. Your organization’s reserve policy should not be static. It should grow with your organization.

In today’s tight credit markets, you can’t afford to come up short on reserve funds when they are needed. And while organizations with reserves are often applauded for their conscientious behavior, a short-sighted and insufficient reserves policy can actually turn an organization’s rainy day fund into a risk. So ask yourself: what are our key risk areas at this stage, in this economy, in our field? And then evaluate your reserves.

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