How much should we have in cash reserves?

One of the vexed questions for boards of not-for-profit entities is what level of reserves the entity should hold as operational insurance. For many entities this issue is one that has been getting a fair bit of airtime in audit committees and governing body meetings.

So what should a prudent organisation do?

Tomorrow vs. today

Should we use the funds now or ensure we have some funds set aside for a rainy day? This issue highlights the natural tension between a board being prudent to protect their operational capability against unexpected future funding cuts, and not wishing to be perceived as "storing" funds.

The issue, or perception, of "storing" funds can have some strong impacts. Generally, these are in two main areas:

1. In membership based organisations such as incorporated societies we have seen it cause dissatisfaction amongst the members and other stakeholders who believe that the organisation should be using its resources for current operations and members.
2. Funding - Some organisations have also struggled with funders and potential funders not providing ongoing funding due to the perception that the NFP "appears rich". i.e. the NFP doesn't need funding due to their levels of reserves held.

Interestingly, this latter view is often more of a fear held by the NFP organisation concerned, rather than a reality of the view held by the funder. However, there are some funders who do use this very basic (some would say crude) financial statement approach to culling funding applications. Hence sadly the legend continues.

Disclosure is the key!

No matter what level of reserves are held we think that appropriate disclosure in the financial statements around the level of reserves being held, or aimed for, is critical. Good disclosure, clearly explaining the reserves and reason for them, will help contextualise and hopefully remove misperceptions or overly simplistic conclusions being jumped to. Some organisations make this even more explicit by making allocations between distinctive reserves within their overall equity pool.

New Zealand's recent radical change in financial reporting requirements for charities and other public benefit entities also specifically attempts to address this issue. A large part of the policy rationale behind requiring PBEs to provide entity and service performance information is to ensure there is better context to the financial information. i.e. a reader should firstly be clear about what an entity is, what it set out to do, and how well it delivered on this before they read the financial statements.

Unlike a profit seeking company where its annual profit and cash reserves are much more of a scorecard of its success, the annual surplus or deficit of a PBE and its cash reserves don't tell stakeholders how well it has delivered on its purpose. Sure, such financial reporting is important hygiene information but it is only useful if you also understand the context. That is; how much and how well the entity is delivering on its purpose.

Understanding this policy rationale of requiring all PBEs to report entity and service performance information, it should also come as no great surprise that this information is required to be disclosed up front in the annual performance report before the annual financial information. Understand the context….and then read the numbers.

The appropriate level of reserves will differ between organisations

Key factors to be taken into account include:

- the nature and scale of the entity's operations – specifically how structurally difficult it is to change size rapidly (especially in a downwards direction) if needed e.g.:
  - → Service delivery contracts locked into and for how long?
  - → Nexus between funding and delivery of service contracts – are these funded directly or is a portion of funding required from general funds?
  - → Nature of workforce relationships – are entity team members' employment contracts linked to specific funded service contracts or just generally with the organisation, and what contractual financial impacts are there if they had to downsize rapidly?
  - → What other operating commitments is the entity locked into and for how long? E.g. property and equipment leases
- the main types of funding received – the issue here is primarily the level of certainty and security of these income streams
- the existence and level of any other funds or saleable investments that the organisation can call on should a major downturn occur
- access to other external funding sources. For example, is the entity able to raise a commercial loan if needed, secured over fixed assets such as a building?
- the board's view on the current economic climate and medium term prospects – generally the less certain and more negative the outlook the greater the reserve.
- the risk appetite of the board and their organisation - generally, boards with a greater appetite for risk will accept lower levels of reserves.

What is becoming the norm?

A very hard question to answer due to the very wide variety of entities in the sector. However, as auditors we often still get pushed to "give us a number based on what you see in the sector".

In many prudent New Zealand NFP or charitable organisations we are seeing the level of reserves held is generally between 3 and 6 months of operating expenditure depending upon the relevant mix of factors above. The logic is that this is the minimum length of time needed practically to restructure the organisation in a planned manner, if required.

However, we stress that there is no magic number and the most appropriate level will depend upon the specific nature of the entity and consideration of the factors above.

In some organisations their target level of cash reserves is aspirational. However, if it is aspirational it is more important than ever to clearly disclose this fact so that readers are not fooled into thinking that the organisation already has that level of funds specifically set aside.

Summary - Communicate clearly

Of key importance is for organisations to clearly communicate to their stakeholders. Whatever your organisation decides and does; it is very important to disclose the reason for any reserve and the governing body's logic in aiming to build up a prudent reserve.

This is normally done via a clear note to the annual financial statements as regards their management of, and setting aside, any funds and their logic behind this so that readers are well communicated to and appropriately informed.

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