

Not-for-profit Cash Reserves

NFP Insight



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Australia is home to an estimated 600,000 Not-for-profit (NFP) entities¹, including approximately 56,000 charities, making its charity sector roughly equivalent in size to the Australian retail sector.² It is the second largest employer industry in Australia and also deploys over 4.5 million volunteers. New Zealand, meanwhile, has approximately 115,000 NFPs, including more than 27,000 charities – more charities per capita than any other nation in the world.³ In this CA ANZ Business Insight, we will refer to NFPs as charities are a subgroup of this broader sector.

Like their for-profit counterparts in sectors such as retail, NFPs must carefully consider how much cash to maintain as an operating reserve. Yet there is often extra pressure on charities and NFPs to justify their cash balances. Too much in the coffers can cause people to question as to why the charity or NFP needs additional resources. Too little, places organisations in a difficult position with respect to sustainability. More than any other sector, NFPs face a financial balancing act when it comes to cash reserves.

This CA ANZ Business Insight explores how appropriate it is for a NFP to post a surplus, before exploring:

- How to determine the best reserve policy for your organisation, and
- How to communicate that decision.

To assist in this discussion, it is appropriate to clarify the terms that are used in the discussion.

- **Surplus**

A surplus or profit, arises when the income exceeds the expenses for accounting purposes. This should be distinguished from the cash flows. A number of items such as depreciation, asset acquisitions and asset disposals can cause there to be a difference between the result for accounting purposes and the result from a cash flow perspective.

- **Cash**

Generally this will include cash at bank and on deposit. This may also include assets that are able to be easily converted to cash such as receivables and marketable securities held for sale.

- **Reserves**

The term reserve is generally used to describe an amount of accumulated surplus that is set aside for a particular purpose.

However, when used in the context of cash reserves the term suggests amounts of cash, deposits and similar liquid assets that are held available for use by the NFP to support its operations in the event of unexpected circumstances.

How appropriate is making a surplus?

To people who are unfamiliar with the NFP sector, the idea of making a surplus can appear inappropriate.

However, it is vital that NFPs generate surpluses in order to be sustainable in any market economy like those in Australia and New Zealand. Accumulating funds can enable NFPs to achieve better outcomes over a longer period, by investing in people, assets, innovation and growth.

It is also important to look beyond the headline number in order to understand the source of the surplus. Did the surplus arise from the day-to-day activities of the NFP or was the source a non-recurring event?

By way of example, a NFP that receives a capital grant to construct/acquire an asset will generally need to record the grant as income and the asset under non-current fixed assets. The capital income of the grant may create a false impression of the income from the activities that are the core focus of the NFP.

¹ Australian Charities and Not-for-profits Commission (2019), Australian Charities Report, A Report of the ACNC, Melbourne.

² Strengthening for Purpose: The Australian Charities and Not-for-profits Commission Legislation Review 2018, p16.

³ Understanding the sector in which we operate, Project Periscope, 2018.

Cash reserves

Cash reserves are generally understood to include all unrestricted funds, being the cash balance which is not allocated to a specific purpose, available to the organisation to allocate at their discretion. They do not include land or other tangible assets such as building and equipment. Nor do they include funds that have been received specifically for a designated project or purpose such as grant funds or tied funds.

However, cash balances may include amounts that need to be set aside by the NFP to cover such future outgoings or commitments such as the payment of employee entitlements.

Cash reserves can also include those balances that support the ongoing operations of the NFP, being available to meet unexpected outgoings, and allow the NFP to meet its financial obligations.

Maintaining at least minimum levels of cash reserves is necessary to risk management, and other changes as part of remaining viable.

In New Zealand smaller Charities falling under Tier 3 standards are finding it beneficial to ring fence a reserve for 3-6 months of expenses as an “operating reserve”. This sends a clear signal to funders that they have sufficient reserves in the event that some of their grants or contracts are not renewed.

How much is enough?

The question then is: what’s a prudent and responsible amount to set aside as your NFP’s reserves?

Too high...

- Accumulating a high level of reserves can have a negative impact on public perception. The Australian Charities and Not-for-profits Commission (ACNC) report there has been a 13% decline in public trust and confidence in charities since 2013⁴. New Zealand saw a decline of 11% between 2008 and 2019⁵. Any belief (no matter how mistaken) that an NFP is stockpiling funds may erode faith in that entity.
- Similarly, donors and funding providers may be deterred by significant bank balances. Funders (and future funders) may see cash reserves as an indication that lesser or no additional funding is needed or that services are not being fully provided.
- Where a NFP maintains a significant level of cash reserves it is in the interest of that NFP to include in its financial statements an explanation of how those reserves are to be applied. An example would be a NFP that employs a lot of

assets in the delivery of its services and puts aside the cash amounts equivalent to the depreciation charge in order to fund the asset replacement. Another example would be a NFP that has a strategy to acquire a significant asset and holds the cash balances as it accumulates the funds to acquire that particular asset.

In these cases the NFP would be well advised to include an explanation in the financial statements of the purposes for which the cash balances are held so the reader of the financial statements does not misinterpret the financial statements. Being transparent about the purpose of accumulations can assist a NFP in demonstrating its stability and effectiveness to funders, other key stakeholders and the public.

- Sustaining a high level of cash reserves can also put the organisation’s income tax exemption at risk. Under the *Income Tax Assessment Act 1997* (Cth), Australian NFPs can accumulate income and still remain income tax exempt. However, there are restrictions on the accumulation of income without any identified purpose.
- Division 50 of the *Income Tax Assessment Act 1997* requires a NFP to apply all of its assets solely to the objects of the NFP. Each NFP should be able to evidence how the retention of cash balances is directed towards the achievement of its objects.
- The Tax Working Group in New Zealand has also been considering possible taxation changes regarding charities, particularly private foundations, that are seen to be accumulating rather than applying their income to their purpose.

Too low...

- Running the cash reserves of a NFP down poses many potential risks. The continued operations of the NFP can come under threat of insolvency if funds run too low.
- A low reserve can also be of concern to investors, donors and funders. Low reserves may be misinterpreted to be a sign of financial mismanagement or may create the question of whether the NFP has the financial capability to deliver its services. Funders are increasingly looking to fund fewer NFPs but more deeply and over longer periods. Assessing the outcomes delivered by a NFP and its commitment to financial stability and longevity are core considerations for funders.
- Low reserves means a NFP is more vulnerable to funding shocks, sudden changes in government policy, changes in service delivery models and changing economic conditions.
- Low available funds can also leave a NFP unable to respond to new opportunities to deliver services, apply for grants that require a co-investment or to withstand unforeseen situations such as funding cuts.

⁴ Ibid, p18.

⁵ www.charities.govt.nz/charities-in-new-zealand/public-trust-and-confidence-in-charities/

Is there a right level of cash reserves?

In a single word – no.

There is no hard and fast rule when it comes to determining the right level of reserves for any one organisation. Each NFP needs to consider the circumstances that are particular to that organisation and its strategy.

The need for cash reserves will vary with factors including:

- organisation size and sector/industry in which it operates;
- the outlook for that sector including changes that may be happening in the future (the Australian National Disability Insurance Scheme is a good example);
- the nature and scale of current operations, and where the NFP needs to be to maximise efficiencies;
- the identification of significant needs within the NFP's objects;
- the mode of service delivery contracts including term, likelihood of renewal;
- where funding for services is from particular contracts, in the event that the contract renewal is delayed or may not happen, how long is the NFP prepared to continue to deliver those services whilst the NFP secures an alternate source of funding or seeks to advocate for the restoration of that funding;
- the types and sources of other funding received;
- access to support, financial and otherwise, from associated organisations;
- the asset infrastructure needs, both immediate and aspirational;
- the risk appetite of the organisation as managed by the board and leadership team; and
- the broader economic climate.

ACNC Checklist: How do I determine the right level of reserves?

The ACNC provides the following checklist to help determine an appropriate level of reserves:

- 1 What liabilities (current and future) does the NFP have? What are the likely levels of liabilities to be if strategic goals or prospective policy changes are implemented?
- 2 What staff entitlements (current and potential) exist? What staff leave policies do you have in place to manage leave liabilities and what is the experience of your organisation regarding staff leave habits?
- 3 What changes in the funding or political landscape may affect current and future income streams?
- 4 What external trends may affect the public's willingness to give to the NFP (both in time and money)?
- 5 If volunteers do not come forward in numbers required, is there a financial impact and should that impact be considered in the context of reserve estimates?
- 6 What external events may affect the NFP's service (such as natural disasters—especially on-the-ground recovery NFPs)?
- 7 What compliance issues (current or potential) need to be addressed?
- 8 Are there any potential legal claims that could be brought that will not be covered by insurance policies?
- 9 What upcoming repairs or upgrades are needed (such as property, equipment, IT systems, etc.)? To this list could be added the question regarding asset replacement /upgrade for those NFP's that are capital intensive
- 10 What are the asset replacement strategies and requirements?

Source: 'Charity Reserves: Finance Stability and Sustainability', ACNC.⁶

(Note: This list is not exhaustive and it is relevant equally to NFPs more broadly.)

Context is key

When it comes to cash reserves, the real risk isn't setting your reserves level too high or too low. The greatest mistake is failing to adequately explain your decision. Remember: you must *contextualise* your cash reserves.

All too often stakeholders see a surplus (or lack thereof) and immediately jump to conclusions. Too much money in reserve and your organisation might be seen as stockpiling.

⁶ 'Charity Reserves: Financial Stability and Sustainability', published by ACNC, 2016.

Not enough and it might be seen as mismanaging the funds. Additionally, not holding reserves can reinforce misconceptions held by some stakeholders that NFPs would not be viable and should not hold cash. There is a need for NFPs to educate their stakeholders with respect to the finances of their organisation and what financial sustainability looks like.

A large amount held in reserve, for instance, may actually reflect years of prudent saving by the organisation in order to carry out a long-term project. An example in NZ is iwi (Māori) entities and post-settlement governance entities where limited settlements require the iwi entities to take a long-term and inter-generational view.

Similarly, an annual deficit may not be a sign of inefficient operations. It may simply mean that services are reaching those beneficiaries the NFP was set up to support. Moreover, the financial results of *any* organisation (NFP or otherwise) should only be viewed as a one-year snapshot to be considered in a long-term context.

There is also the fact that NFPs, like all other businesses, face unavoidable costs. Employment law, health and safety law, and various other compliance obligations. NFPs are subject to the same sorts of legislative requirements – and therefore costs – as their for-profit counterparts, and yet people often overlook this. Operational expenses are as much a consideration for a NFP as they are for any other organisation, and their financial statements should be expected to reflect this. Further, governance and assurance processes are equally if not more important for NFPs and these also require resources in order to be implemented.

NFPs are, by very definition, established for a purpose, not for a profit. In fact, the term “not-for-profit” does not relate to the organisation itself but, rather, it refers to the fact that members are unable to derive a monetary benefit from their involvement—either during its operations or upon wind up. As such, there is no restriction on NFPs making money but, rather, on what they do with it.

These organisations exist to support or benefit society in some way – to relieve poverty, or improve education standards, or fund health advancements, run sporting or other clubs for instance. As such, the effectiveness of a NFP’s operations cannot be completely captured in their financial statements. Any surplus (or deficit) they post, while a useful indicator of financial health, should not be read as a single, comprehensive assessment of their success.

Time and time again, a NFP’s bottom line is mistaken for the top priority. Rather, we must assess a NFP’s effectiveness in light of what it is they set out to do. Their outcomes.

Whether they have made an impact. *Their mission as an organisation.* Only then can we tell if they’re stacking up against expectation.

Therefore, the challenge for NFPs is to provide context and reasoning around their level of reserves, along with other messages and to communicate this context and reasoning to stakeholders.

How can this be achieved?

Developing a reserves policy

There’s no shortage of reporting requirements for NFPs to fulfil. In Australia, if a charity is a reporting entity it must prepare (and file) general purpose financial statements (GPFS) that comply with [NFP entity requirements in Australian Accounting Standards](#), including standards for the presentation, measurement and disclosure of financial statements. If an NFP is a charity but not a reporting entity, it still needs to meet the requirements of the ACNC financial reporting regulations which include meeting the requirements of some standards.

In New Zealand, all charities are required by law to prepare general purpose financial reports (GPFR) that comply with the External Reporting Board’s (XRB) PBE Accounting Standards. Charities in tiers 1, 2 and 3 are required to report annually on the funds they have accumulated over their lives and are also required to state their reserves and describe the restrictions and/or purposes of their reserves.

More specifically regarding reserves, the Australian Taxation Office clarified in [Taxation Ruling 2015/1](#):

31. To satisfy the income and assets condition, an entity that accumulates most of its income over a number of years will need to show on a year by year basis that the accumulation is consistent with the purpose for which the entity is established.

Most organisations will disclose their reserves level via a note to the annual financial statements. Some will explicitly state what reserve allocations will be used for. It is best to fully explain any reserves rather than use a generic reserves policy wording. For that reason, an organisation-specific policy on reserves is advisable. It may also be wise to publish this policy on the organisation’s website in order to allow stakeholders to access it.

Note: Developing a reserves policy is not intended to add to existing requirements. In fact, when done correctly, it may even supplant existing (non-legislative) reporting and, importantly, support board decision making.

So how can you best develop a reserves policy?

1) Start with your 'why'?

A reserves policy should be specific to your individual organisation, but the essential aim of any reserves policy is the same. That is, to communicate to your stakeholders why your entity has chosen its current level of reserves, its reserve requirements and how these two fit with your overall purpose.

It makes sense, then, to start with your purpose or mission. What is your organisation trying to achieve? What does 'success' look like for your entity?

At a nuts-and-bolts level, this communication can take just about any form so choose one that encapsulates your business best. Use images, case studies and/or endorsements from those who have benefitted from your entity. This is your chance to tell your stakeholders how you're fulfilling your 'why'.

2) Think about your audience

The next step in explaining your reserves is to think about who it is that you are explaining your reasoning to. Spend some time working out who your key stakeholders are, and what it is they want to know. This may require the input of several parts of the organisation. Seek the view of the board and management, talk to experts in Marketing and Finance. Also, consider asking your stakeholders directly. There is nothing that makes a funder feel more appreciated than tailoring your communication to their needs. And include the reader who has little or no training in interpreting financial statements. A good approach is to ask a person who knows little about the organisation to read the financial report. It will often be surprising what unexpected interpretations flow from that review.

3) Be objective and comprehensive

When reporting on your reserves, offer a comprehensive picture to your stakeholders. Explain to funders why it is you are building up any reserves, or what previously accumulated reserves are earmarked for. Describe how reserves levels are determined and monitored. Explain any processes.

It is important to be thorough in what you disclose to stakeholders. Do not cherry-pick information because you are afraid to report bad news. Stakeholders should not expect your results to be perpetually positive, and they would rather know about any negative results than have you sweep them under the carpet. When you report negative results, always report your intentions regarding rectifying this outcome in the future. It goes without saying that results should be fairly presented and free from material error.

Also, be selective

At the same time, only report what is relevant to your stakeholders. Be concise in your reporting on reserves. Be led by your organisation's strategy and overall aims, and consider the needs of your stakeholders when deciding exactly what to report.

Don't set and forget

Just because your reserves policy (and resulting communication) worked last financial year, it does not mean you can repeat it this time around. Periodically review the level of reserves you hold in light of changing risk factors and the broader economy. Declining economic conditions and dampening consumer outlook may indicate a good time to try and hold more in reserve, while a robust NFP sector and consumer optimism may increase your organisation's appetite for risk. Be flexible in both your approach to reserves, and the way you report them. Remember, your purpose may mean that your resource requirements run counter-cyclically. For instance, St Vincent de Paul will always need resources when the economy has had a down turn and donations are much harder to come by.

A reserves policy

According to the ACNC a policy for managing reserves should include:

- why it is important for the entity to have reserves
- an appropriate level of reserves for the entity (updated from time to time)
- a clear explanation for how the entity determines its appropriate level of reserves (such as a formula, or a range of formulas)
- a strategy for building an appropriate level of reserves
- a process for reviewing the level of reserves
- the authority within the charity for determining and using reserves
- reporting and monitoring requirements
- how reserves will be identified in accounts and budgets
- criteria by which spending reserves are considered
- a communication strategy for explaining the entity's reserves to the public.

Check what level of reserves comparable organisations are holding via the [ACNC Charity Register](#).

Source: *Charity Reserves: Financial Stability and Sustainability*, ACNC.⁷

⁷ *Charity Reserves: Financial Stability and Sustainability*, published by ACNC, 2016.

Case study: NZ service performance reporting

In 2015, in one of the biggest ever shake-ups of the charities sector, the New Zealand Accounting Standards Board introduced new Public Benefit Entity (PBE) standards featuring [mandatory service performance reporting](#).

New Zealand's 27,000+ registered charities along with other PBEs who are required to prepare GPFR must now combine traditional financial reporting with much more qualitative service performance reporting – and the results have been impressive.

A few years into the regime and many organisations are displaying more holistic and sustainable approaches to reporting, driven by strategy rather than spreadsheets. Meanwhile funders and other stakeholders, who formerly only received around 60% of the information they required from PBEs' financial statements, are now, in many cases, finding almost *all* information they need is captured and communicated by service performance reporting. (To the extent that some funders are only accepting funding applications from those PBEs that follow the XRB reporting standards).

As a result, many NFPs that are not required to report under the XRB reporting standards are already voluntarily choosing to do so. They are seeing value in this more holistic organisational reporting to their stakeholders.

Both camps are reporting that the funder/NFP dialogue has improved dramatically as a direct result of the service performance reporting requirements.

So what does the new reporting look like?

Service performance reporting is based around two elements:

- 1 Outcomes (What is the entity seeking to achieve? What is its impact on society?)
- 2 Outputs (What goods or services has the entity delivered during the year?)

Or to put it another way, the reporting requires entities to consider: What did your entity set out to do versus what have you actually achieved? In answering, entities may supply financial or operational metrics, or they may take a more descriptive approach. Many provide a combination of approaches.

Regardless of format, the value of the new regime is that it requires people to radically rethink the way they approach NFPs. Organisations are beginning to be assessed on much more than their financial results, while NFPs are focussed on their organisation's impact and the effectiveness of their service delivery.

Sources of information/references

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