Developing a Financial Strategy for Nonprofits

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Abstract

Nonprofits operate in complex environments in which they often face two conflicting goals. The natural tendency of nonprofit management is to maximize social impact by utilizing all available resources. However, every nonprofit also requires financial stability, which demands limiting expenditures and creating reserves. This article presents guidelines for planning toward financial stability, using real-life examples from three nonprofit organizations. It introduces common measures of financial stability and demonstrates how these indicators can be projected for the relevant planning period. Based on these projections, the article outlines a methodology for determining budgetary planning needs for both the short and long term. Finally, it shows how financial stability measures can be applied to manage risks arising from the significant uncertainty surrounding income in the nonprofit sector.

Keywords: Nonprofit management; financial strategy; budget planning; risk management.

Introduction

Not-for-profit organizations (hereinafter "nonprofits") operate in two interrelated dimensions. The first concerns the organization's declared goals—such as welfare, education, culture, and advocacy. In this dimension, each nonprofit develops a unique strategy to achieve its objectives, reflected in the specific programs it operates.

The second dimension is financial. In this sphere, every nonprofit shares one overarching goal that can be described, borrowing from the Bee Gees' song, as "Staying Alive." Nonprofits seek to sustain or expand their programs while facing unpredictable and unstable income streams.

A business enterprise that experiences reduced demand typically adjusts its expenses to match lower revenues. A nonprofit, however, views this situation differently: the need for its services does not necessarily decline with its ability to raise funds. Consequently, when income falls, nonprofits attempt to maintain program levels as long as possible, cutting or closing activities only as a last resort. Because they face considerable income uncertainty, nonprofits must build adequate reserves to absorb fluctuations—reserves that act as a cushion for difficult times.

Without such reserves, nonprofits become financially vulnerable. Any interruption in income—whether a delay or temporary reduction—can disrupt operations. Unlike businesses, nonprofits cannot raise equity from owners or shareholders; their only source of reserves is internal savings, commonly referred to as accumulated surpluses. Although nonprofits are legally prohibited from distributing surpluses, they must accumulate them, at least to a reasonable level, to achieve financial stability.

Accordingly, the financial objective for nonprofits should be to create and sustain adequate reserves. Each organization, depending on its financial position, should develop a strategy to meet this goal. Yet nonprofits are often reluctant to generate surpluses. Donors frequently expect that all contributions will be fully spent and may require proof of full expenditure. As a result, nonprofits face an inherent conflict between their social mission, which emphasizes spending for impact, and their financial goal, which requires moderation to build surpluses.

The purpose of this article is to present a methodology for preparing a financial strategy for nonprofits. Real financial data from three organizations—two in the United States and one in Israel—illustrate the approach. The article proceeds in four steps: (a) presenting common measures of financial stability, calculated from financial statements or U.S. Form 990 data; (b) introducing a methodology to

bridge the time gap between past financial data and stability measures relevant for planning; (c) demonstrating how these measures guide short- and long-term budgetary planning; and (d) showing how adequate reserves can serve as a tool for risk management.

Measures of Financial Stability

The common measures of financial stability in nonprofits can be calculated from their financial statements. These statements are publicly available in many countries, often through designated online databases. In this article, we present data from two U.S.-based organizations and one Israeli organization. Although the financial data of nonprofits are publicly available in both countries, they appear in slightly different formats. In Israel, the complete financial statements are accessible, whereas in the United States, the primary publicly available document is Form 990, which is submitted to the Internal Revenue Service (IRS).

In the following examples, data from the 2016 Form 990 filings of two U.S. nonprofits are reformatted to resemble standard financial statements. Figures in **Table 1** were drawn from the balance sheet (Part X of Form 990), while those in **Table 2** were taken from the statement of activities (Parts XI and IX).

Table 1 presents the organization's balance sheet, broken down by major components.

Table 1:

Balance Sheet				
	2015	2016	Difference	Items in 990 Form
Current Assets (CA)				**Part X**
Cash equivalents	3,904,263	4,551,751	647,488	1-2
Other Current Assets	3,764,389	2,119,707	-1,644,682	3-9
Investments	4,938,261	6,864,714	1,926,453	11-15
Fixed Assets (FA)	36,302,606	34,789,827	-1,512,779	10c
Total Assets (TA)	**48,909,519**	**48,325,999**	**-583,520**	
Current Liabilities (CL)	889,932	195,316	-694,616	17-21
Long Term Debt (LTD)	598,176	618,345	20,169	22-25
Total Debt	**1,488,108**	**813,661**	**-674,447**	
Net Assets				
Unrestricted	37,327,688	33,882,575	-3,445,113	27
Temporarily restricted	4,709,130	6,245,170	1,536,040	28
Permanently restricted	5,384,593	7,384,593	2,000,000	29
Total	**47,421,411**	**47,512,338**	**90,927**	
Total Liabilities (TL)	**48,909,519**	**48,325,999**	**-583,520**	

The assets side, shown in the upper part of the table (from "Current Assets" to "Total Assets"), consists of three components:

a) **Current Assets (CA)** – including cash and equivalents (lines 1–2, Part X) and other current assets or receivables (lines 3–9, Part X). Current assets represent all liquid resources available to the organization at year-end. Receivables include

short-term commitments such as grants or donations recorded as income in 2016 but received in 2017, and service fees earned in 2016 but collected in 2017.

b) **Investments** – lines 11–15 in Part X. These may include liquid financial instruments traded on public markets or less liquid investments in private entities.

c) **Fixed Assets (FA)** – line 10c, Part X, representing the net value (cost minus depreciation) of the organization's fixed assets, such as real estate, vehicles, furniture, computers, equipment, or software.

The liabilities side, shown in the lower part of the table (from "Current Liabilities" to "Total Liabilities"), also includes three components:

d) **Current Liabilities (CL)** – lines 17–21, Part X, representing short-term debts to suppliers, employees, tax authorities, pension funds, and similar obligations.

e) **Long-Term Debt (LTD)** – lines 22–25, Part X, which include long-term loans, usually from banks but occasionally from bonds issued to the public (a practice permitted in the U.S. but not in Israel; Rosenstiel, 2016).

f) **Net Assets** – lines 27–29, Part X, divided into unrestricted, temporarily restricted, and permanently restricted categories. These components are explained in more detail below.

Table 2 presents the statement of activities, broken down by major components.

Table 2:

Statement of Activities				
	Sign	2016	Items in 990 Form	
Income	+	10,517,256	Part XI	1
Program Expenses	-	-6,938,153	Part IX	25 (B)
Overhead (G&M and Fundraising)	-	-3,913,865	Part IX	25 (C,D)
Adjustments	+/-	425,689	Part XI	5-9
Surplus/Deficit		**90,927**		
Depreciation	-	-1,737,137	Part IX	22 (A)
Adjustments to Depreciation	+/-	0		
Total Depreciation		**-1,737,137**		
Surplus/Deficit exc. Depreciation		**1,828,064**		

- Income is taken from line 1 in Part XI.
- Program and overhead expenses (management, general, and fundraising) appear in line 25 (B, C, D respectively) in Part IX.
- Adjustments between Form 990 and audited financial statements (lines 5–9 in Part XI) can be positive (additional income), negative (additional expenses), or zero.

The bottom line of Table 2 shows the surplus or deficit for 2016. Notably, the surplus of USD 91 thousand in the statement of activities ("Surplus/Deficit" in Table 2) equals the change in total net assets on the balance sheet ("Total," Difference column in Table 1). This link between the two statements is fundamental and becomes clearer in the next section.

The second part of Table 2 shows the surplus excluding depreciation (USD 1.83 million). Depreciation, from line 22(A) in Part IX, is a non-cash expense representing the reduction in the value of fixed assets over time. Only the surplus that excludes depreciation contributes to the organization's financial reserves, as demonstrated later.

A simple interpretation of the balance sheet may suggest that net assets represent the organization's reserves. Conceptually, if the organization liquidated all assets to pay all debts, the remaining funds would indeed equal its net assets. However, two key reservations apply.

First, while the book value of financial assets usually approximates market value, the same does not hold true for fixed assets. Second, net assets describe a liquidation scenario, whereas for financial stability analysis, we are interested in the remaining reserves without selling fixed assets.

To measure this, we calculate the **Operating Reserve (OR)**—the unrestricted portion of net assets not invested in fixed assets (The Nonprofit Operating Reserves Initiative Workgroup, 2008). This measure, shown in **Table 3**, captures the financial resources available after paying debts and fulfilling donor commitments.

Table 3:

Net Assets Analysis			
	2015	**2016**	**Difference**
Unrestricted N.A	37,327,688	33,882,575	
Programs (OR)	1,025,082	-907,252	-1,932,334
Fixed assets (FA)	36,302,606	34,789,827	-1,512,779
Restricted N.A (RNA)	10,093,723	13,629,763	
Temporarily restricted	4,709,130	6,245,170	1,536,040
Permanently restricted	5,384,593	7,384,593	2,000,000
Total	**47,421,411**	**47,512,338**	**90,927**

In Table 3, the restricted net assets (RNA) combine both temporarily and permanently restricted categories (USD 13.6 million in 2016). The unrestricted net assets (USD 33.9 million in 2016) are divided between amounts invested in fixed assets (FA) and the operating reserve (OR).

Some clarification is needed regarding the difference between restricted and unrestricted assets. The organizational budget of a nonprofit can be divided into separate budgets by program, each including its own income and expenses (Malki, 2014). The total net assets equal the accumulated surpluses across programs over time; hence, the annual change in total net assets equals the surplus or deficit from the statement of activities.

However, the usability of surpluses depends on the conditions tied to each income source.

- Surpluses from income linked to service levels (e.g., fees for service or government contracts with payment per client served) can be freely used and are added to unrestricted net assets, and thus to the OR (after deducting investment in fixed assets).
- Surpluses from income tied to expense reports (e.g., grants or designated donations) can be used only for the specific funded programs and therefore are added to restricted net assets (RNA) (Malki, 2025).

The OR is widely regarded as the most important measure of long-term financial stability (The Nonprofit Operating Reserves Initiative Workgroup, 2008). It represents the amount of financial (mainly liquid) assets available to the organization after paying all debts and fulfilling all donor commitments. The OR is the freely available surplus that allows a nonprofit to maintain operations during income reductions or delays.

In addition to the OR, another measure of financial stability is the **Working Capital (WC)**, defined as:

(1) Working Capital (WC) = Current Assets (CA) – Current Liabilities (CL)

While the OR indicates long-term stability, the WC reflects short-term stability—the amount of liquid assets remaining after meeting immediate obligations.

Table 4 presents these two measures for the example organization.

Table 4:

	2015	2016	Difference
Working Capital (WC)	6,778,720	6,476,142	-302,578
WC / Income		61.6%	
Operating Reserve (OR)	1,025,082	-907,252	-1,932,334
OR / Income		-8.6%	

At the end of 2016, the WC showed a large surplus (USD 6.5 million), indicating short-term financial stability. The WC-to-income ratio of 62% suggests that the organization could operate for approximately seven months without new income, assuming similar annual budgets.

The OR, however, showed a deficit of USD 907 thousand, indicating long-term vulnerability. The decline in the OR during 2016 is notable given that it had been positive in 2015.

The OR and WC are therefore the key determinants of a nonprofit's financial strategy. However, the figures in Table 4 represent past data—essentially "water under the bridge." Because financial statements are typically completed months after year-end, the 2016 figures were available only by mid-2017, when planning for 2018 was already underway. The delay makes historical stability measures less

useful for decision-making. Consequently, nonprofits need **projections** of these measures—particularly the OR and WC—for the end of the current year.

To create these projections, we use an alternative representation of the balance sheet known as the **simplified balance sheet** (Malki, 2016).

The Simplified Balance Sheet

The general structure of a nonprofit balance sheet is shown below (see also Tables 1 and 3).

Assets	**Liabilities**
Current assets (CA)	Current liabilities (CL)
Investment	Long-term debt (LTD)
Fixed assets (FA)	Unrestricted net assets for programs (Operating reserve - OR)
	Unrestricted net assets that were used for fixed assets (FA)
	Restricted net assets (RNA)

Because the item “Unrestricted net assets invested in fixed assets” on the liabilities side equals the “Fixed assets” entry on the assets side by definition, both can be simultaneously removed from the balance sheet.

After this adjustment, the fixed assets are deducted from both sides, allowing us to focus exclusively on financial assets and their funding sources:

Assets	**Liabilities**
Current assets (CA)	Current Liabilities (CL)
Investment	Long-term debt (LTD)
	Operating reserve (OR)
	Restricted net assets (RNA)

Using the definition of working capital (WC) from Equation (1):

WC = Current assets (CA) – Current liabilities (CL)

we can explicitly present WC by subtracting CL from both sides of the balance sheet:

Assets	Liabilities
Working capital (WC)	Long-term debt (LTD)
Investment	Operating reserve (OR)
	Restricted net assets (RNA)

Since cash balances are included in current assets (CA), we can express CA as:

(2) CA = Cash + Receivables

Next, we define **Net Working Capital (NWC)** as:

(3) NWC = Receivables – Current liabilities (CL)

NWC represents the amount remaining once the organization collects all receivables from the prior year and pays its short-term obligations. A surplus in NWC increases cash balances in the following year, while a deficit in NWC decreases them.

By substituting Equations (2) and (3) into Equation (1), we obtain:

(4) WC = Cash + NWC

Finally, inserting Equation (4) into the simplified balance sheet allows us to display cash balances explicitly:

Assets	**Liabilities**
Cash	Long-term debt (LTD)
Net working capital (NWC)	Operating reserve (OR)
Investment	Restricted net Assets (RNA)

This simplified balance sheet clearly presents the organization's financial assets—cash, NWC, and investments—and their corresponding sources of funding: debt, donor commitments (RNA), and unrestricted surpluses (OR).

Table 5 provides the simplified balance sheet for the nonprofit in our example.

Table 5:

Simplified Balance Sheet			
	2015	**2016**	**Difference**
Cash	3,904,263	4,551,751	647,488
Net Working Capital (NWC)	2,874,457	1,924,391	-950,066
Working Capital (WC)	**6,778,720**	**6,476,142**	**-302,578**
Investment	4,938,261	6,864,714	1,926,453
Financial Assets	**11,716,981**	**13,340,856**	**1,623,875**
Long Term Debt (LTD)	598,176	618,345	20,169
Commitments to Donors (RNA)	10,093,723	13,629,763	3,536,040
Internal Savings (OR)	1,025,082	-907,252	-1,932,334
Sources of Funding	**11,716,981**	**13,340,856**	**1,623,875**

At the end of 2016, the organization's financial assets totaled USD 13.3 million, an amount exceeding its total income for that year (see Table 2). The working capital represented roughly half of the financial assets, and cash balances comprised about one-third. This indicates strong short-term stability and a clear ability to absorb delays in income.

However, the main source of these financial assets was the organization's commitments to donors (RNA)—designated funds that had not been fully utilized and were restricted for specific purposes. In fact, the RNA (USD 13.6 million) exceeded total financial assets, and the organization also carried a long-term debt of USD 628 thousand. Consequently, the operating reserve (OR) was in deficit, signaling long-term financial vulnerability.

Although the organization's liquidity was strong, its unrestricted reserves were negative. The large volume of financial assets resulted from surpluses in restricted income and the long-term loan, not from internal savings. In essence, the organization's short-term position was stable, but its long-term position was fragile—it lacked sufficient financial assets to cover donor commitments and long-term debt obligations.

The simplified balance sheet therefore provides a concise and accurate snapshot of an organization's financial condition. Yet, when planning for the upcoming budget year (2018 in this example), management must estimate the projected financial position for the end of the current year (2017). To do this, we must first understand the connections between the simplified balance sheet and the statement of activities.

The first step in this analysis is to calculate the amount invested in fixed assets (FA). This figure does not appear directly on Form 990 but can be derived using the following equation:

(5) $FA_1 = FA_0 - \text{Depreciation} + \text{Investment in FA}$

where the subscripts 0 and 1 represent the beginning and end of the period, respectively (e.g., end of 2015 and end of 2016). The investment in FA may be

positive (net purchase of assets) or negative (net sale of assets). For our example nonprofit, this calculation appears in the upper part of **Table 6**, showing an investment of USD 224 thousand.

Table 6:

Investment in Fixed Assets				
Fixed Assets	2015 -	Depreciation	-/+ Investment	2016
	36,302,606	-1,737,137	224,358	34,789,827

Statement of Activities		**Balance Sheet**				
Surplus/Deficit exc. Depreciation	-	Investment in Fixed Assets	=	Δ O.R.	+	Δ R.N.A
1,828,064		-224,358		-1,932,334		3,536,040
		1,603,706				**1,603,706**

The lower part of Table 6 shows the relationship between net assets for programs (OR and RNA) and the statement of activities. The right side records changes in the OR and RNA, derived from the "Difference" column of Table 5. During 2016, RNA increased by USD 3.54 million, while OR decreased by USD 1.93 million—a combined increase of USD 1.6 million in total net assets for programs.

On the left side, the statement of activities shows a surplus (excluding depreciation) of USD 1.83 million (Table 2). From this surplus, the organization invested USD 224 thousand in fixed assets, leaving a final surplus of USD 1.6 million.

This relationship can be generalized as:

(6) ΔOR + ΔRNA = Income – Expenses (excluding depreciation) – Investment in FA

where Δ represents the change in OR or RNA over the period.

The final stage of the analysis explains the change in financial assets (working capital and financial investments), as shown in **Table 7**.

Table 7:

Analysis of the change in the Financial Assets				
Δ Financial Assets	=	Δ RNA +	Δ OR (Savings)	+ Δ L.T.D
1,623,875		3,536,040	-1,932,334	20,169
Δ Financial Assets =	Surplus/Deficit exc. Depreciation	-	Investment in Fixed Assets	+ LTD
1,623,875	1,828,064		-224,358	20,169

The financial assets increased by USD 1.62 million (see "Difference" column in Table 5). This increase can be interpreted in two equivalent ways:

1. As the sum of the changes in OR (–USD 1.93 million), RNA (+USD 3.54 million), and long-term debt (+USD 20 thousand); or

2. As the surplus excluding depreciation (USD 1.83 million) minus investment in FA (USD 224 thousand) plus the increase in long-term debt (USD 20 thousand).

These relationships form the building blocks for projecting the simplified balance sheet at the end of the current year (2017 in this case).

Planning for Financial Stability

The first step in financial planning is to estimate the organization's income and expenses for the current year (2017 in this example). These estimates are presented in **Table 8**.

Table 8:

Projection's assumptions		
Estimates for the year	2017	
Unrestricted donations & income	9,067,367	Including income from all other sources
Restricted Donations	0	
Operating Expenses	-6,766,031	
Investment in Fixed Assets	-781,106	
Change in Net Assets	**1,520,230**	
Change in Debt	21,679	
Change in Financial Assets	**1,541,909**	

The data in Table 8 should be drawn from the organization's updated budget. As discussed earlier, the planning timeline begins once the financial statements for the previous year (2016) are available. At that stage—typically in the second half of the current year—the organization can prepare a reasonable estimate of its annual income and expenses based on actual data for completed months and projections for the remainder of the year.

For instance, if budget planning for 2018 began in September 2017, the organization would have actual data through August and need to project the remaining four months. As the year progresses, the accuracy of projections naturally improves. In this discussion, the data in Table 8 are treated as if they were the actual results for 2017, representing perfect foresight.

The following estimates are required for Table 8:

1. **Income** – The projected income should be broken down into unrestricted and restricted categories. As discussed earlier, restricted income refers to donations and grants that must be spent fully and for specific purposes.
2. **Operating expenses** – The initial estimate should reflect total expenses, as the distribution between restricted and unrestricted funding sources may not yet be known. Once the allocation becomes clearer, it can be incorporated into the projections. These estimates should include only actual expenses and therefore exclude depreciation by definition.
3. **Investment in fixed assets (FA)** – In some nonprofits, investments in FA are included in the operating budget and separated only in the financial statements; in such cases, no additional estimate is required. However, if investments in FA are listed explicitly in the budget, a separate projection should be made.

As shown in Equation (6) and Table 6, these estimates are sufficient to calculate the projected change in financial net assets (the combined change in OR and RNA) at the end of the period. In this example, the sum of OR and RNA was expected to increase by USD 1.52 million.

To estimate the change in financial assets, we must also project the net change in long-term debt (LTD). Because repayment schedules are predetermined, any expected reduction in LTD is known with certainty; only anticipated new borrowing requires estimation. In this case, an increase of USD 21 thousand was projected, resulting in an expected rise in financial assets of USD 1.54 million.

Based on the estimates in Table 8, it is possible to prepare an initial projection of the simplified balance sheet for the end of 2017, as shown in **Table 9**.

Table 9:

Projected Simplified Balance Sheet for the end of 2017			
	2016	**2017**	**Difference**
Working Capital	6,476,142		
Investment	6,864,714		(*)
Financial Assets	**13,340,856**	**14,882,765**	**1,541,909**
Long Term Debt (LTD)	618,345	640,024	21,679
Commitments to Donors (RNA)	13,629,763		
Internal Savings (OR)	-907,252		
Net Assets	12,722,511	14,242,741	1,520,230
Sources of Funding	**13,340,856**	**14,882,765**	**1,541,909**
(*) Excluding gains or losses from the investment			

The financial assets were expected to increase to USD 14.9 million. Given that both financial assets and working capital were already substantial at the end of 2016, the organization's short-term financial position was stable. Consequently, an increase of USD 1.54 million in financial assets would likely strengthen this position further.

Although it is impossible to predict the precise allocation of financial assets between working capital and investments at year-end—or to anticipate gains and losses from investments—it is reasonable to expect that the volume of liquid assets (working capital plus liquid investments) would remain significant, and most likely exceed the previous year's level.

Predicting the long-term financial position, however, is more complex. As demonstrated in Tables 6 and 7, an increase in total financial net assets does not necessarily imply a corresponding increase in the operating reserve (OR). At this stage of planning, the distribution of expenses between restricted and unrestricted sources remains uncertain. This allocation can be estimated more accurately toward the end of the year, once the organization has a clearer understanding of actual expenditures.

Nevertheless, it is possible to examine two scenarios representing the full range of outcomes for the OR: a best-case and a worst-case scenario. These are illustrated in **Table 10**, following Equation (6).

In the best-case scenario (**Table 10-A**), all expenses—including investments in fixed assets—are attributed to restricted sources (RNA).

Table 10-A:

The expenses are from restricted income and the RNA, until the full use of the RNA						
Scenario 1: the best case scenario						
	2016	**2017**				
	Balance	Income	Expenses	Inv. in FA	Balance	Difference
OR	-907,252	9,067,367	0	0	8,160,115	9,067,367
RNA	13,629,763	0	-6,766,031	-781,106	6,082,626	-7,547,137
Total	**12,722,511**	**9,067,367**	**-6,766,031**	**-781,106**	**14,242,741**	**1,520,230**
OR/Income	90%					

The RNA balance is therefore expected to decrease to USD 6.1 million, while the unrestricted income generates a full surplus. Consequently, the OR increases to USD 8.16 million (approximately 90% of total income). In this specific example, the RNA exceeded the combined total of expenses and fixed-asset investments.

It is important to note that this example represents a special case. In general, expenses attributed to restricted sources cannot exceed the remaining RNA balance, since RNA cannot be negative. Once the RNA balance reaches zero, remaining expenses must be covered by unrestricted funds.

An example of this general case, drawn from a different nonprofit, is presented in **Table 10-A-1**.

Table 10-A-1:

The expenses are from restricted income and the RNA, until the full use of the RNA						
Scenario 1: the best case scenario						
	2015	**2016**				
	Balance	Income	Expenses	Inv. in FA	Balance	Difference
OR	1,883,633	6,097,993	-213,621	-8,208	7,759,797	5,876,164
RNA	3,672,311	2,576,811	-6,249,122	0	0	-3,672,311
Total	**5,555,944**	**8,674,804**	**-6,462,743**	**-8,208**	**7,759,797**	2,203,853
OR/Income					89%	

This organization had an expected income of USD 8.7 million, divided between restricted sources (USD 2.6 million) and unrestricted sources (USD 6.1 million).

Of its total expenses (USD 6.46 million), USD 6.25 million was attributable to restricted sources (RNA and restricted income). The remaining USD 214 thousand in expenses and USD 8 thousand in FA investments were covered by unrestricted income. The resulting free surplus of USD 5.9 million increased the OR to USD 7.76 million.

In the worst-case scenario for the first organization (**Table 10-B**), all expenses—including FA investments—are attributed to unrestricted income, leaving the RNA unchanged. The total increase in net assets (USD 1.52 million) is thus attributed entirely to the OR, raising it to USD 613 thousand (7% of income).

Table 10-B:

All the expenses are from unrestricted income						
Scenario 2: the worst case scenario						
	2016	**2017**				
	Balance	Income	Expenses	Inv. in FA	Balance	Difference
OR	-907,252	9,067,367	-6,766,031	-781,106	612,978	1,520,230
RNA	13,629,763	0			13,629,763	0
Total	**12,722,511**	**9,067,367**	**-6,766,031**	**-781,106**	**14,242,741**	**1,520,230**
OR/Income	7%					

A variation occurs when income is divided between restricted and unrestricted sources, as in the second organization presented in Table 10-A-1. In its worst-case scenario (**Table 10-B-1**), RNA increases by the full amount of restricted income to

USD 6.25 million, while the OR decreases by USD 373 thousand, maintaining a surplus of USD 1.51 million.

Table 10-B-1:

All the expenses are from unrestricted income and the OR						
Scenario 2: the worst case scenario						
	2015	**2016**				
	Balance	Income	Expenses	Inv. in FA	Balance	Difference
OR	1,883,633	6,097,993	-6,462,743	-8,208	1,510,675	-372,958
RNA	3,672,311	2,576,811			6,249,122	2,576,811
Total	**5,555,944**	**8,674,804**	**-6,462,743**	**-8,208**	**7,759,797**	2,203,853
OR/Income					17%	

The best- and worst-case scenarios define the range of possible outcomes for the OR. The actual result will fall within this range. Scenario analysis is therefore a valuable tool for guiding financial strategy.

For example, the first organization's OR—initially in deficit—was expected to increase to a surplus in both scenarios (Tables 10-A and 10-B). Similarly, the second organization's OR—already in surplus—was expected to grow further (Tables 10-A-1 and 10-B-1). In both cases, the projected positive OR under all scenarios had important implications for financial strategy.

Before turning to those strategic implications, it is useful to present the final stage of financial projections, which becomes possible once a reliable breakdown of

expenses between restricted and unrestricted sources is available. This allocation, for the first organization, is shown in **Table 11**.

Table 11:

Actual Breakdown of Income and Expenses						
	2016	**2017**				
	Balance	Income	Expenses	Inv. in FA	Balance	Difference
OR	-907,252	9,067,367	-3,438,885	-781,106	3,940,124	4,847,376
RNA	13,629,763	0	-3,327,146		10,302,617	-3,327,146
Total	**12,722,511**	**9,067,367**	**-6,766,031**	**-781,106**	**14,242,741**	**1,520,230**
OR/Income					43%	

Here, total expenses were divided nearly evenly: USD 3.3 million attributed to RNA and USD 3.4 million (plus FA investments) attributed to unrestricted income. Consequently, RNA decreased to USD 10.3 million, and the OR increased to USD 3.9 million (43% of income).

The discussion thus far demonstrates how to project stability measures—OR and financial assets—through the end of the current year. The next section presents three possible financial position scenarios and the corresponding strategies appropriate for each.

(i) A Deficit in Financial Assets and in the Operating Reserves (OR)

This situation should raise a red flag for the organization's management. A deficit in financial assets is, by definition, also a deficit in working capital (WC), since the investment cannot be negative. Likewise, a deficit in financial assets implies a deficit in the OR. In practical terms, this means that short-term obligations (current liabilities, CL) exceed the sum of current assets (CA) and investments. Therefore, an organization in this situation does not have sufficient financial resources to cover even its short-term obligations.

The organization is extremely vulnerable, and even short delays in income can cause financial distress. The required financial strategy in this case is to plan a budget with a surplus large enough to close the deficit in financial assets. This strategy should be given first priority, as the organization's ability to continue operations is at risk.

If it is impossible to close the deficit within one year, the organization may seek a multi-year loan to mitigate short-term financial pressure and buy time. However, such a loan will not address the underlying deficit in the OR, which must be resolved in the long term. It is advisable in this situation to prepare staff for a period of tight budgets in order to create the necessary surplus that will ensure financial stability.

It should be emphasized that planning a budget with a surplus may require limiting the scope of programs or even closing subsidized programs with negative contributions (Malki, 2014).

(ii) A Surplus in Financial Assets but a Deficit in the Operating Reserves (OR)

This was the situation of the first organization in our example at the end of 2016. A surplus in financial assets alongside a deficit in OR is possible only if the organization has restricted net assets (RNA) and/or long-term debt (LTD) that offset the OR deficit.

In this case, the financial risk depends on the timeline of commitments to donors (RNA) and the payment schedule of the LTD. The shorter these timelines, the sooner the deficit in the OR will translate into a deficit in financial assets. Therefore, the organization must prepare a plan to close the OR deficit. Although this plan may be less urgent than in the previous scenario, it remains necessary.

Creating a budgetary surplus may not be sufficient. A surplus in the RNA can reduce the risk of a deficit in financial assets by extending the RNA timeline. However, to solve the fundamental issue, the organization must generate a surplus in its OR. The first step toward this goal is to allocate as many expenses as possible to RNA and restricted income sources (see Tables 10-A and 10-A-1 above). This

requires only proper financial reporting and, in some cases, may be enough to resolve the issue. In other cases, the organization will need to plan its budget so that expenses from unrestricted sources are lower than income. Typically, this does not require closing programs entirely but rather limiting the scope of certain activities.

(iii) A Surplus in Financial Assets and in the Operating Reserves (OR)

This was the predicted situation for the end of 2017 for both organizations in our example, in both best- and worst-case scenarios (Tables 10-A, 10-A-1, 10-B, and 10-B-1). This was also the final scenario for the first organization (Table 11). In such a situation, there is no immediate financial risk to the nonprofit. However, the remaining question is whether the level of OR is large enough to be considered safe.

To address this issue, a benchmark for the minimum OR required for financial stability was recommended by the Nonprofit Operating Reserves Initiative Workgroup (2008). This benchmark is 25% of the organization's income—equivalent to three months of operations without any income. Nonprofits with OR below this benchmark should plan for a surplus in their OR using the methods described above. Since there is no immediate risk, these steps can be implemented gradually through a multiyear plan to increase the OR surplus.

Nonprofits with OR exceeding the benchmark have achieved their financial stability goal but must continue taking measures to maintain that level.

Based on the discussion above, we can now return to the organization from our first example to demonstrate how its financial planning for the 2018 budget should have proceeded. The organization began planning in the second half of 2017, knowing that at the end of 2016 it had a significant surplus in financial assets but a deficit in OR.

Steps appear to have been taken in the 2017 budget, as shown in the projections for best- and worst-case scenarios (Tables 10-A and 10-B). In the best-case scenario, the OR was expected to reach 90% of income, while in the worst case, a small OR surplus of 7% was anticipated. In both cases, there was no immediate financial risk.

If the worst-case scenario had materialized, the organization should have developed a plan to gradually increase its OR. However, given the lack of urgency, it likely waited until more accurate expense estimates were available to refine its OR projection (Table 11). This projection indicated that OR was expected to increase to 43% of income, achieving the goal of financial stability by the end of 2017.

As discussed earlier, maintaining a sufficient level of OR allows nonprofits to sustain their programs during disruptions in income. However, many nonprofits must draw on their OR each year to manage inherent uncertainty in income projections (Malki, 2016). An example of such use is presented in the following section.

Financial Stability and Risk Management

The next example illustrates budgetary planning for a small Israeli nonprofit preparing its 2022 budget. At the final stage of planning (late 2021), the organization already had a reasonable breakdown of expenses between restricted and unrestricted sources. The relevant data and projections are presented in **Table 12**.

Table 12:

Forecast for the OR in 2021	OR	RNA	**Total**
OR in 1/1/2021	1,267,007	625,303	1,892,310
Expected Income 2021	2,426,380	102,000	2,528,380
Expected Expenses 2021 (*)	-1,785,404	-727,303	-2,512,707
Surplus / Deficit 2021	640,976	-625,303	15,673
Forecast for the OR 1/1/2022	**1,907,983**	**0**	**1,907,983**
(*) Including Fixed Assets			

According to the organization's financial statements, the operating reserve (OR) at the end of 2020 was NIS 1.27 million, and the restricted net assets (RNA) totaled NIS 625 thousand. The expected income and expenses for 2021 were NIS 2.53 million and NIS 2.51 million, respectively. The breakdown of expenses indicated that NIS 727 thousand could be attributed to restricted sources, thereby fully utilizing the RNA. As a result, the surplus from unrestricted sources was projected at NIS 641 thousand, increasing the OR to NIS 1.91 million (approximately 76% of income).

The organization's CEO presented a proposed 2022 budget of NIS 2.75 million to the board of directors. This budget included expanded program activities and salary increases for several employees. The board was asked to determine whether this higher budget could be approved.

To make an informed decision, the board requested a forecast of expected 2022 income. This scenario reflects a challenge faced by many nonprofits: significant uncertainty surrounding income projections. Nonprofits typically depend on donations and grants, which can be unpredictable. To address this uncertainty, it is common practice to categorize income into three groups:

1. Guaranteed income
2. High-probability income

3. Unclear or uncertain income

The income breakdown for this organization is shown in **Table 13**.

Table 13:

Risk Analysis for the 2022 budget	Income Forecast		
Expected Income for 2022	**Guaranteed**	**High Probability**	**Unclear**
Income Projections	791,910	964,191	350,000
Accumulated Income	791,910	1,756,101	2,106,101
Expected Expenses 2022	-2,746,290	-2,746,290	-2,746,290
Expected Surplus / Deficit 2022	-1,954,380	-990,189	-640,189
Expected OR 1/1/2023	**-46,397**	**917,794**	**1,267,794**

Risk	Very Low	Low	High
Feasibility	Not Feasible	Feasible	Feasible

All expected income for 2022 was unrestricted and divided as follows:

- NIS 792 thousand guaranteed income,
- NIS 964 thousand high-probability income, and
- NIS 350 thousand unclear income.

Based on these categories, the organization faced three possible income scenarios:

1. Only guaranteed income is received (NIS 792K).
2. Guaranteed income plus high-probability income is received (NIS 1.76M).
3. All projected income, including unclear sources, is received (NIS 2.1M).

The implications of approving the proposed NIS 2.75M budget were analyzed for each scenario. In all cases, the organization would incur a deficit by year-end. Without a surplus in its OR, such a budget could not be approved. However, given the expected OR of NIS 1.91M at the end of 2021, the organization could sustain a budget deficit provided it did not create a deficit in the OR.

For each income scenario, the expected OR at the end of 2022 was calculated. Each scenario was then classified along two dimensions:

- **Feasibility:** Scenarios resulting in a negative OR at year-end were deemed infeasible.
- **Risk level:** Determined by the degree of uncertainty in income projections.

The **f**irst scenario (guaranteed income only) was very low risk but not feasible, as it would result in a negative OR.
The second scenario (guaranteed + high-probability income) involved low risk and remained feasible, with a positive OR.
The third scenario (including unclear income) was feasible but high risk, since those income sources might not materialize.

Based on these parameters, the board established a simple decision rule:

"Consider only feasible scenarios and approve the highest-risk scenario within the organization's accepted risk tolerance."

Applying this rule, the board determined it was willing to accept low risk—that is, to rely on guaranteed and high-probability income but not on unclear sources. Since the second scenario met these criteria, the requested budget was approved.

This decision implied a commitment to continuous income monitoring throughout 2022 to ensure projections were realized (Malki, 2016; Malki, 2025). Once the 2021 financial statements became available, the organization also reviewed its actual OR to compare it with projections. The actual data are presented in **Table 14**.

Table 14:

Actual OR in 2021	OR	RNA	**Total**
OR in 1/1/2021	1,267,007	625,303	1,892,310
Income 2021	2,426,298	102,000	2,528,298
Operating Expenses 2021	-1,822,738	-727,303	-2,550,041
Fixed Assets 2021	-7,898		-7,898
Total Expenses 2021	-1,830,636	-727,303	-2,557,939
Surplus / Deficit 2021	595,662	-625,303	-29,641
OR in 1/1/2022	**1,862,669**	**0**	**1,862,669**

A comparison of Table 14 with Table 12 shows that income projections were highly accurate. There was only a slight underestimation of expenses, resulting in a slightly smaller actual OR—NIS 1.86M instead of the projected NIS 1.91M.

Despite this minor deviation, the projections provided a reliable basis for effective risk management. Even if the board had known the precise OR in advance, its decision would have remained unchanged. This demonstrates that projections based on financial stability measures can serve as an adequate foundation for informed, risk-aware budget decisions in nonprofits.

Summary and Conclusions

A central challenge for nonprofit management is the need to achieve two inherently conflicting goals. On one hand, nonprofit leaders are naturally inclined to maximize their organizations' social objectives by fully utilizing all available resources. On the other hand, achieving financial stability requires limiting expenditures and building reserves—actions that may appear to restrict programmatic impact in the short term.

In many cases, such actions are not optional but urgent, as neglecting financial planning can lead to severe fiscal distress. Consequently, nonprofits must develop and manage a comprehensive financial strategy to ensure long-term sustainability.

The first step in this strategy is to establish clear, quantifiable measures of financial stability. Two commonly used indicators were described in the preceding discussion:

1. **Working Capital (WC)** — a measure of short-term stability, and
2. **Operating Reserve (OR)** — a measure of long-term stability.

These measures can be derived from the organization's financial statements or, in the United States, from IRS Form 990. Given the inevitable delay in preparing

these statements, organizations must also project the expected values of these indicators for the end of the current fiscal year.

The article introduced the simplified balance sheet as a tool for generating such projections. The projected OR serves as the primary long-term stability measure, while the financial assets (the sum of WC and financial investments) provide insight into short-term resilience. A deficit in financial assets, by definition, also indicates a deficit in WC.

The second step is to determine the appropriate financial strategy based on the projected stability measures. In general, four strategic situations can be identified:

1. Deficit in financial assets (and therefore in WC and OR):
    - This situation signals immediate financial vulnerability.
    - The organization must urgently reduce expenses to produce a budgetary surplus.
    - If closing the deficit within one year is not feasible, management may consider a long-term loan to alleviate short-term pressure while pursuing a longer-term recovery plan.
2. Surplus in financial assets but deficit in OR:
    - The organization has liquidity but lacks unrestricted reserves.

- The priority should be to increase the OR, first by attributing as many expenses as possible to restricted income sources (RNA).
- If this step is insufficient, expenses should be reduced gradually, depending on the timeline of donor commitments.

3. OR surplus below the benchmark (25% of annual income):
    - The organization is financially stable but below the recommended safety threshold.
    - Management should consider moderate spending adjustments or limited program reductions to build surpluses and bring the OR up to the recommended benchmark (equivalent to three months of operation without income).
4. OR surplus above the benchmark (≥25% of annual income):
    - The organization has achieved its goal of financial stability.
    - The OR can now be used as a risk management tool to address uncertainty in future income projections.
    - The organization should continue to monitor and sustain the OR, taking corrective action if it falls below the benchmark.

Finally, the discussion must acknowledge the influence of organizational culture on financial strategy. Achieving financial stability often requires difficult decisions—including expense reductions, program cuts, salary freezes, or even

layoffs. Such measures are inherently painful, and nonprofit boards and executives often postpone them until a crisis occurs.

However, experience shows that delayed action frequently leads to failure. Recovery efforts initiated too late may prove ineffective, forcing organizations to cease operations. As in other management contexts, the principle holds true: prevention is less costly than correction.

This principle is especially relevant to nonprofit financial management. Developing a deliberate, data-driven financial strategy—supported by clear stability measures, projections, and disciplined planning—enables nonprofits to sustain their missions, safeguard operations, and remain resilient in the face of uncertainty.

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