

**LEEDS DOMESTIC WATERUSERS ASSOCIATION  
(LDWA)**

**A NON-PROFIT ORGANIZATION**



**OPERATING RESERVES  
POLICY**

**BOARD-DESIGNATED FUNDS**

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DRAFT

## **PURPOSE**

The purpose of establishing and defining an Operating Reserves Policy for Leeds Domestic Waterusers Association (LDWA) is to provide rationale to establish, build, manage, and maintain its Operating Reserves; to ensure the long-term financial stability of LDWA and position it to respond to varying economic conditions and changes affecting LDWA's financial position and its ability to continually provide quality culinary water to its shareholders in accordance with LDWA Bylaws and Articles of Incorporation.

The LDWA Board of Directors will maintain a Board-Designated Operating Reserves to achieve the following objectives:

1. To enable LDWA to sustain operations through delays in revenues and to accept reimbursable contracts and grants without jeopardizing ongoing operations;
2. To promote shareholder confidence in the long-term sustainability of LDWA by preventing chronic cash flow crises that can diminish its reputation and force the Board to make expensive short-term, crisis-based decisions;
3. To create an internal line of credit to manage cash flow and maintain financial flexibility.

The LDWA Board of Directors recognizes that economic, demographic, political, cultural, and other circumstances can, and do, affect and change throughout the years; thus, what was previously considered an appropriate amount of Operating Reserves in past years, shall be reviewed by the LDWA Board of Directors on an annual basis.

*This document is intended for use within and by the LDWA Board of Directors and the LDWA Staff.*

## **POLICY**

The LDWA Board of Directors strives to maintain an Operating Reserves Policy in its planning process for the benefit of all shareholders and to build a perpetually strong foundation for LDWA.

Building reserves for our nonprofit organization shall remain a top priority while seeking to fortify it.

To that end, the LDWA Board of Directors continues to closely review its policies and devise plans for replenishing its operating reserves to an agreed upon and adequate level to stabilize and fortify a stronger financial position, capable to withstand any future challenge that may arise.

## **GOVERNANCE**

The collective Board of Directors is responsible for the adoption and implementation of LDWA Policies and Procedures for approving the use of operating reserves; persons authorized to establish policies and oversee the operating reserve ratio and balance; provisions for recalculating the formula of the operating reserve balance and distributing the excess operating reserve balance, or funding operating reserve deficiencies; and authorization of drawdown from the Operating Reserve fund for operating purposes in the case of a financial emergency, including procedures for eventual replenishment.

## INSIGHT

Without operating reserves, an organization can be thrown into cash flow stress and become distracted from good long-term decision-making, or forced to make expensive short-term crisis-based decisions, or worse; it may not have the resources to continue delivery of its programs.

Organizations with no operating reserves and limited or negative operating funds, by necessity focus on the short term and are less likely to engage in responsible long-term planning.

The LDWA Board of Directors recognizes the need and identifies reasons for adopting an Operating Reserves Policy to prepare for uncertainties that may arise, examples include:

**Unexpected shortfall in revenue.** This can result from overly optimistic budgeting of income projections (which is very common), vacant homes, shareholder inability to pay water bills due to property loss, foreclosures, and other factors.

**Unexpected demands on our resources and Economic Crisis.** Fire, natural disaster, drought, acts of terrorism, war, civil unrest, water pipeline breakages, or other events can result with demands on our water sources.

**Shortcomings of judgment and foresight.** A project that was believed would succeed, and did not. A good example of this is drilling for a third water source during 2009-2010, resulting with two well-site holes drilled. [This incurred a perpetual annual expense of ~\$1,000.00 for an easement with the Bureau of Land Management to access an area that will not be utilized.]

**A needed change in direction.** A long-standing program and costly expenditures is no longer in the best interests of the shareholders and company. The needs of our community change over time, requiring resources to move ahead and the need to seed capital in LDWA.

**Normal day-to-day fluctuations in income and expenses.** Reserves are needed for working capital, which include payrolls, utility expenses for water well pumps, office expenditures, etc.

**Seasonal factors.** Rainfall, or lack thereof, directly affects the amount of income LDWA receives each year; the cost to run the pumps at the water wells increase during the summer months.

**Unanticipated Opportunities.** Conversely, there exists unanticipated revenue resulting from increased water use or water meters found that were previously under-read or not read at all. In addition, while LDWA does not solicit donations, they are not outside the realm of possibility.

The LDWA Board of Directors has adopted this formal policy for the reserve level it believes will sustain the company through every circumstance.

## OPERATING RESERVES DEFINED

A Board-approved Operating Reserves Policy sets the goals for the reserve and terms and conditions for its use. By consciously and proactively setting the financial goal of building an operating reserve (and potentially other non-operating specific-purpose funds) LDWA's Board of Directors and staff take responsibility for our long-term financial stability.

Setting a policy to maintain and carefully manage an operating reserve helps to ensure that sufficient funds are available to manage cash flow on a day-to-day basis. Building Board-designated funds for non-operating special purposes, based on the particular needs of LDWA, positions our company to seize opportunities to enhance mission programs, to respond to spikes in demand for services, and to make planned capital purchases, among many other purposes.

Briefly, the term "Operating Reserves" refers to the portion of "Unrestricted Net Assets" that the LDWA Board of Directors maintain and/or formally designate or "reserve" for use in emergencies to sustain financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues. "Unrestricted net assets" is a required line item in the balance sheets of financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and IRS Forms 990 of nonprofit organizations.

The amount of accumulated unrestricted net assets is increased or decreased as the result of annual operating surpluses or deficits. LDWA pursues financial stability by budgeting for, and then achieving, reasonable, modest surpluses year after year until they have met their operating reserves objectives.

LDWA recognizes the Recommended definition for Operating Reserves, Board-designated Funds, as follows:

### RECOMMENDED

**Board-Designated Operating Reserves** are defined as the portion of "available unrestricted net assets" that the Board has *designated* for operating reserves. "Available unrestricted net assets" equals total unrestricted net assets less equity in fixed assets. Assets related to Board-designated operating reserves are typically invested in cash, near-cash, or other low-risk investments. Access to these funds would require Board approval since they are Board-designated.

**Board-Designated Operating Reserves** can be used as an internal line of credit during the year and only accessed according to Board-approved operating policy or Board action taken in response to the specific financial situation.

**It is strongly recommended** that when using the fund accounting systems, the use of *funded* operating reserves, shall be established where the Board-Designated operating reserves fund is established consisting of specifically identified and segregated liquid assets and investments.

The Board-Designated Fund may be presented in the asset and net asset sections of an annual audit's statement of financial position, or only in the net asset section.

**Without this level of oversight, the operating reserve may include non-current, non-liquid assets such as long-term pledges and other long-term receivables, inventory, prepaid expenses and deposits held by others that would not be readily available in the event of a cash shortage or crisis.**

**It could give the appearance that LDWA has adequate operating reserves when, in fact, liquid cash reserves would be very low or nonexistent, putting LDWA at risk of experiencing serious financial viability issues in the event of an emergency.**

## DETERMINING ADEQUATE OPERATING RESERVES

### Leeds Domestic Waterusers Association (LDWA) determination and implementation of adequate Operating Reserves Fund.

LDWA Board of Directors considered several factors in determining the minimum and ideal amounts of Operating Reserves necessary to remain viable and grow for its future. Our company's risk of volatility is based on revenue streams and spending levels.

**Revenue Risk Factors:** Common factors that affect the risk for volatility in revenue streams include, but are not limited to:

1. Stability of projected income from shareholders, LDWA's single source of income.
2. Economic health of the community.
3. Timing of funding commitments and long-term liabilities.
4. Likelihood of natural disasters such as floods, earthquakes.
5. The level of LDWA's access to disaster relief funding from outside entities, including public, private, or government sectors.
6. Certain State and Federal regulatory changes.
7. Publicity that could adversely affect current or future revenues.

**Spending Risk Factors:** Common factors that influence the ability to adjust spending levels include, but are not limited to:

1. LDWA's importance in our community during crises; LDWA's ability to provide disaster relief to the community.
2. The extent to which economic downturns or other types of events may affect demand for services, either up or down.
3. The extent of funding commitments made for longer than one year.
4. Amount of unsecured debt carried.
5. Long-term leases with penalties for cancellation.
6. Level of dependency on the stability of shareholder revenues.
7. Ability to downsize operations quickly and still provides services to the community - Board of Directors and Staff capabilities to assume multiple essential duties.

The extent to which LDWA finds itself subject to these variables, is directly related to its ability to consistently provide uninterrupted quality culinary water service, without which life cannot be sustained.

LDWA's revenues are limited to one source: shareholder income from water usage. This exponentially increases the percentage of reserves that are vital to provide a consistent and adequate culinary water source supply. While LDWA has set the basic minimum Operating Reserve ratio at the lowest point during the year, 25 percent, or 3 months of the annual expense budget, the Board will review this ratio each year during its Budget Review and consistently strive to increase the minimum Operating Reserve Ratio.

The Board recognizes that a larger Operating Reserve Fund should always include an element of public education to provide the basis supporting LDWA's Operating Reserve Fund balance.

## IMPLEMENTATION

### FINANCIAL STABILITY AND ADEQUATE OPERATING RESERVES

In accordance with Generally Accepted Accounting Principles (GAAP) and IRS Forms 990 of nonprofit organizations, the recommendation for nonprofit boards is the establishment of a *minimum Operating Reserve Ratio Policy*.

A non-profit organization's **Operating Reserve Ratio** can be calculated in terms of:

- (1) A Percentage. The operating reserves divided by the annual expense budget, or
- (2) Number of Months. The operating reserves divided by the average monthly expense budget.

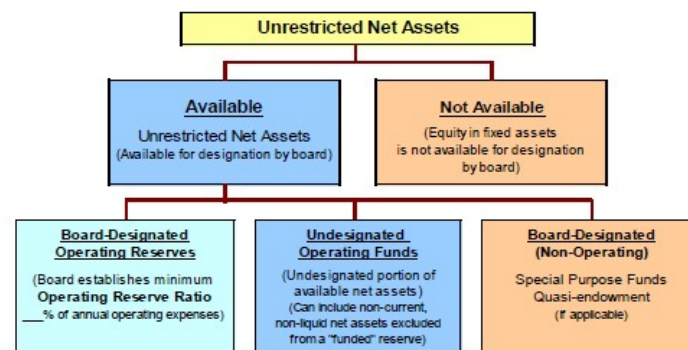
The *minimum Operating Reserve Ratio* at the lowest point during the year is 25 percent, or 3 months of the annual expense budget.

The adequacy of **Operating Reserves** beyond the minimum is variable and depends on factors such as the reliability of operating revenues and impact of economic conditions, among others.

**Available Unrestricted Net Assets defined:**

- (1) The unrestricted net assets less the equity in fixed assets – i.e., fixed assets net of related long-term debt, and
- (2) The portion of total unrestricted net assets, including operating reserves available for designation by the LDWA Board of Directors.

The classification of **unrestricted net assets** in the balance sheet, as depicted in the figure below, is critical to developing a clear and accurate snapshot of an organization's financial position.



#### UNRESTRICTED NET ASSETS

**A. AVAILABLE** – designated by the Board for Operating Expenses:

1. **Board-designated Operating Reserves** - The Board establishes a minimum Operating reserve ratio of 25% or 3 months of annual ordinary operating expenses based on 2012 projected annual revenues of \$110,775.00 in the amount of \$27,693.75.
2. **Board-Designated Non-Operating Funds** – Special Purpose Funds.
  - (i) the **Project Upgrade Shareholder Income Fund**, for repayment of the DDW/DEQ Loan #3F138;
  - (ii) the **Emergency Repair/Capital Improvement Fund & the Money Market Fund**, for non-budgeted unplanned emergencies and capital improvements;
  - (iii) the **\$72,000.00 CD @ Zions Bank**, reserved and applied as a portion of the Bonding requirements of the DDW/DEQ Loan #3F138. *(Note to CPA: The remaining required amount of this bond is held with Fidelity Bonding).*

**B. NOT AVAILABLE - Equity in fixed assets is not available for designation by the Board.**

Includes but not limited to the water delivery system infrastructure, water rights, water storage tanks, property, and other assets owned by LDWA.

## MANAGING THE OPERATING RESERVES FUND

I. With the collective consensus of the LDWA Board of Directors, the operating reserve can be funded with any available funds that are **not** temporarily or permanently restricted. Typical sources include:

1. Unrestricted contributions from individuals or corporations. Grants and 'forgiveness' loans are restricted.
2. The net surplus or "profit" from revenues collected from shareholders for their tap.
3. Surpluses from annual operations of the organization -
  - a. Planned (e.g. budgeted surplus earmarked for operating reserves).
  - b. Unplanned (e.g. surplus beyond budgeted surplus).
4. Unrestricted Investment income in the form of interest and dividends or the sales of stocks and bonds.
5. Unused and unrestricted reserves for uncollectible pledges (the losses are lower than expected).
6. Unused and unrestricted capital acquisition funding included in the annual cash-operating budget (may need board action to re-designate).

II. The LDWA Treasurer or his/her appointee, with only written consensus of the Board of Directors, may access the fund. The maximum amount, time, and date for repayment of the accessed funds shall be established with written consent only by the Board of Directors. The Board of Directors will provide written description of the relationship between the reserve and a commercial line of credit (if applicable) i.e., which should be used first, etc. The choice of hierarchy of use depends on the particular circumstances.

III. The LDWA Treasurer, with written consensus of all Board members, may access up to \$XX,000 for purposes as outlined above, as long as sufficient accounts or grants receivable are available to repay such usage within three months time. The Executive Director will notify the Treasurer in writing, and usage will be acknowledged in writing by the Treasurer. E-mail or fax shall be acceptable forms of notification and acknowledgement.

IV. Any funds borrowed from the Operating Reserve Fund for greater than \$XX,000 and/or for longer than 90 days will be paid back through a prescribed repayment schedule/method. Approval of any such usage and the proposed repayment schedule shall be requested in writing, by the LDWA Board President or Treasurer, and provided to the Board of Directors for written approval. If approved by the Board of Directors, such disbursement shall be reported at the next Board meeting.

V. At any time that a borrowing from the Operating Reserve is outstanding, the status of the borrowing and payments made against the proposed repayment schedule will be reviewed at the regularly scheduled Board meetings.

VI. Use of the Operating Reserve Fund will be subsequent to fully depleting any existing commercial lines of credit, or the Operating Reserve Fund will be fully depleted before use of the commercial line of credit.

VII. Under the direction of the LDWA Treasurer and with written consensus of the Board of Directors, the Board shall appoint the Corporate Secretary to establish a separate bank account for the Board-Designated Operating Reserve Fund.

VIII. Policies and procedures for handling deposits, reconciling statements, safeguarding access, etc. will be the same as established by the LDWA Board President for LDWA's bank accounts. If feasible, the funds will be invested according to the guidelines set forth in the Operating Reserve Investment Policy included herein.

The Operating Reserve Fund will be listed separately in the net assets section of LDWA's statement of financial position as "Board-Designated Operating Reserve" and longer-term borrowings from the reserve will be shown as a liability: "Due to Operating Reserve" included in internal financial reports.

## USES of BOARD-DESIGNATED OPERATING RESERVES

Operating reserves **can** be used for meeting commitments, obligations, or other contingencies for day-to-day operations. They would **not**, however, be used for non-operating expenses such as funding the purchase of a new building, barring the loss of an existing facility with insufficient insurance proceeds, or establishing an endowment.

### Examples of some Operating Reserve uses:

1. To offset the negative impact of any of the following scenarios that may arise:
  - a. Sudden shutdown or decrease in anticipated revenue;
  - b. To maintain current program operations when government payments are delayed;
  - c. Community disaster – to respond to special community needs resulting from an unanticipated disaster, such as fire or earthquake.
2. To provide a funding source for extraordinary or unplanned capital purchases as approved by the LDWA Board. Example of appropriate use of Operating Reserves Fund would be replacement of structure(s) or assets due to uninsured damage. Replacement of a fully depreciated asset should be paid from asset replacement reserves.
3. To make up the budget gap between anticipated and actual contributions when revenue losses are higher than expected.

## REVIEW

At a minimum, the Operating Reserve balance will be reviewed as part of the LDWA Board's annual budgeting process. It is recommended that the LDWA Treasurer will monitor the balance on an ongoing basis and report to the Board any significant variations from the target balance as part of its regular monthly financial reporting to the Board. It may be reviewed by the Board (or designated committee) more often if events with major financial or operational implications are planned or expected. Variables to consider when re-evaluating the policy include significant changes in operations, anticipated changes in community or other needs, significant changes in funding base, changes in the regulatory environment and the stability of the local economy. Any changes to the policy must be approved by a consensus of the LDWA Board of Directors.

## SURPLUSES AND SHORTFALLS

The intent of sustaining operating reserves is to assure the mission of LDWA continues to advance. It is a long-term approach, allowing those charged with carrying out the mission in the future have access to the needed level of financial resources. Target variances (actual operating reserves versus targeted reserve levels) will be reviewed by the LDWA Board of Directors on an annual basis.

If the operating reserves exceed the targeted reserve level for three consecutive years, the excess [or x% of the excess] should be made available for current use.

It is less disruptive for organizations to set aside funds for operating reserves from surpluses in years when revenues exceed expenses than to find new sources of funding when the organization is in desperate need. Thus, in the event operating reserves fall below the policy-stated target, planned measures should be taken to restore the balance to a more acceptable level before new needs arise.

A policy should be adopted by the board to deal with ongoing shortfalls in the level of operating reserves. It is important that the policy take into account what is right for your organization in the environment in which it operates, and that this be a discussion between your executive and the board. Thus, these are examples only – the wording and policy choices for your organization should be customized based on the circumstances directly pertaining to your situation. This may contain language such as:

### Policy for Operating Reserves Shortfall #1:

If the Operating Reserves Fund is and has been less than 75% of the targeted reserve level for two consecutive years, the LDWA Board of Directors, in the absence of any extraordinary circumstances, should adopt an operational budget that includes a projected surplus sufficient to rebuild operating reserves over the following two years back to its targeted reserve level.

### Policy for Operating Reserves Shortfall #2:

If the Operating Reserves Fund is less than 50% of the targeted reserve level for two consecutive years, the Board of Directors should adopt an operational budget with a projected surplus to rebuild operating reserves back to the targeted level over the following two to four years.

### Policy for Operating Reserves Shortfall #3:

In the event the Operating Reserves Fund are less than the targeted reserve levels, this deficit must be eliminated in a minimum of three years, with one third of the deficit balance being required to be funded in the current operating budget, until the reserve is restored to the target balance.



## **INVESTMENT CONSIDERATIONS**

### **Developing an Investment Strategy for the Operating Reserves Fund**

Board-designated operating reserves are defined as the portion of “available unrestricted net assets” that the LDWA Board has designated for operating reserves. “Available unrestricted net assets” equals total unrestricted net assets less equity in fixed assets.

Assets related to board-designated operating reserves are typically invested in cash, near-cash or other low-risk investments. Access to these funds requires a written consensus of the LDWA Board of Directors approval.

In the future, the LDWA Board of Directors, at their discretion, may adopt a written formal process to appropriate the development of an investment policy dealing with the cash management for LDWA, keeping in mind the cash market is presently recognized as multi-faceted, complex and subject to risk.

## **LEGAL, TAX, AND ACCOUNTING IMPLICATIONS**

An operating reserve does not automatically fall under the Financial Accounting Standards Board Staff position (FSP) 117-1.

FSP 117-1 deals with “endowments,” as defined in the document:

An established fund of cash, securities, or other assets to provide income for the maintenance of a not-for-profit organization. The use of the assets of the fund may be permanently restricted, temporarily restricted, or unrestricted. Endowment funds generally are established by donor-restricted gifts and bequests to provide a permanent endowment for a permanent source of income, or a term endowment for income for a specified period. An organization’s governing Board may earmark a portion of its unrestricted net assets as a Board-designated endowment (sometimes called, “funds functioning as endowment,” or “quasi-endowment funds”) to be invested to provide income for a long, but unspecified, period. A board-designated endowment, which results from an internal designation, is not donor-restricted and is classified as unrestricted net assets.

This FSP uses the term endowment to mean all of an organization’s endowment funds collectively, which encompasses both donor-restricted endowment funds and those established by Board designation (herein called Board-designated endowment funds). The latter are sometimes called “funds functioning as endowment,” or “quasi-endowment funds”. Thus, whether or not some portions of an organization’s assets are covered by the FSP depends on the organization’s intention regarding the assets. Since operating reserves are normally not donor-restricted, the question becomes one of the intentions regarding any board-designated amounts. If the board has formally designated such reserves as endowment (or specifically for the long-term production of investment income, regardless of whether the word “endowment” is used), then they are covered by 117-1. If the purpose is expressly or implicitly for some other purpose – even though some income may incidentally be earned from temporary investment of the funds – then they would not be covered by 117-1.

### **A GRANT RECEIVED FOR RESERVES - UNRESTRICTED CONSIDERATIONS**

The particular guidelines for such grants may or may not be clear regarding whether the grant is to be considered restricted. Since a board designation can only be applied to unrestricted funds, it could be assumed that the grant will be unrestricted. It is best to work with your accountant and grant program officer to craft clear wording for the grant relative to the granting organization’s intent for the funds to be unrestricted. The presence of an actual restriction in the grant documentation may have an impact on whether or not it can fall under the terms of your reserve policy.