Defining, Calculating & Managing Your Reserve Fund

For all associations, the amount held in their reserve fund and the permitted uses of their reserve fund varies and will always be debated. However, the need for an association to have a reserve fund is not debated. It is widely accepted and endorsed by board members and outside observers. By definition, reserve funds include excess, unrestricted funds that are generated by the association through its operating activities. They are set aside, in the event of a financial emergency or an interruption of cash flow. These funds are usually built up over time, as excess operating profits are generated. They are designated as contributions to the association's reserve fund.

How much should an Association hold in reserves?

This topic has been widely debated. The answer is that every association is unique and has its own reserve fund requirements. Most standards are based on a formula that provides for enough excess funds to be held in reserve to cover an association's overhead expenses for a certain period of time. This amount can range from as little as one payroll cycle to a year or more. The average reserve fund covers three to six months of expenses and the reserve fund should never exceed three years of budgeted expenses.

Each association must look at potential risk factors. This includes whether a large portion of the annual dues are contributed by a small number of members and the implications to the association of the loss of one or more of those members. In setting your fund, you may want to research what other associations within your industry or sector hold in reserve and benchmark your organization's reserves against them. Whatever targeted amount an association sets, it should be revisited annually, as the economy and market conditions change for both the association and the industry it represents.

Can an Association have too much in its reserve fund?

While there is no legal limit on the size of an association's reserve fund, the general guideline is that the funds held should not exceed three years of budgeted overhead expenses or three times your prior year's total overhead expenses. The one exception to this is, if more than 50% of your reserves are generated from unrelated business income (UBI), which would jeopardize your tax-exempt status.

There are some downside risks to having a large reserve fund that an association should also consider. There is a risk in the media, if you are forced to publically explain why your fund is so high. There is also a political risk if the use of your funds become difficult and changes are forced upon the use of those funds due to outside pressures. There is also the potential for an excise tax, if the amount of investment income generated by your fund is too high (this is very rare).

Does an Association need a formal policy for its reserve fund?

Absolutely. The purpose of a policy is to define the desired level of reserves, clearly define when the funds are authorized for use, and ensure that funds are properly monitored and reported. Associations that do not have a reserve fund policy, tend to gradually spend their reserves. This can result in a depleted fund that is not available when needed. Nevertheless, the reserve fund policy should be flexible, to be used when needed and as intended. It should not become an untouchable bank account. A reserve fund policy should include:

- A clear purpose for building and maintaining the reserve funds
- Specific definitions as to the intended use and calculation for the reserve fund
- Assignment of authority for accessing the funds
- Responsibility for reporting the value of the funds and any use thereof
- A specific investment policy covering the investment of the funds. This is often a separate policy.