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 but rather widely accepted and endorsed by board members and outside observers. By definition, a reserve fund is excess, unrestricted funds generated by the association through its operating activities that 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 and designated as contributions to the association's reserve fund.

How much should an Association hold in reserves?

The amount an association should hold in its fund is widely debated and the simple answer is that every association is different and one-size does not fit all when it comes to reserve funds. Most standards are based on a formula that provides for enough excess funds to be held in reserve to cover an association's overhead expense for a period of time. On the low end, some associations have enough to cover as little as one payroll cycle while others have a year or more. Generally speaking, 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 such as a large portion of annual dues being contributed by a small number of members and what the loss of one or more of those members could mean. 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. Lastly, regardless of the targeted amount an association sets, the reserve fund amount 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 set as to 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. The first is risk in the media where you are forced to explain publically why your fund is so high. Another risk would be political in nature where the use of your funds may become difficult and changes even forced upon the uses of those funds due to outside pressures. Lastly there is 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 funds are properly monitored and reported. Associations that do not have a reserve fund policy tend to gradually spend their reserves resulting in a depleted fund that is not available when needed. Having said this, the reserve fund policy should be flexible, 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; often times a separate policy.