

Bulletin Article

Establishing Reserve Funds - How Much Is Enough?

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A reserve fund is an amount set aside to meet any unexpected costs that may arise, to fund future costs of upkeep, or to accumulate funds for a specific purpose. This article will explain some common types of reserve funds and outline factors to consider when determining how much should be set aside.

Types of Reserve Funds

There are many reasons to create and maintain a reserve fund. Some common types of reserve funds are those established for:

- working capital or normal cashflow needs in the operating fund;
- emergency situations (contingencies);
- new capital projects-such as building or major equipment purchases; or
- replacement of existing equipment or facility repair.

Working Capital Reserve

Even if your charity has a balanced budget, there is likely a timing difference between when you receive donation or other revenue and when expenses are incurred. Many charities also experience lower donations in the summer, so they need a source of revenue that allows them to meet payroll, rent and other expenses.

Although a bank line of credit is an option to retaining a working capital reserve, some charities find that this financing source is not cost effective or perhaps not available to them because they have no significant assets to secure the credit facility or because their operating by-laws do not permit borrowing.

Contingency Reserve

Charities are vulnerable to cyclical economies and abrupt changes in donation revenue streams. These situations can cause significant funding challenges. In a relief and development or missions-sending ministry, commitments are often made in advance. Reducing programming support unexpectedly can have long-term implications for relationships that have been established and the ministry's reputation.

In a church setting, a significant portion of the expenses are staff-related. If a drop in income is temporary, it is preferable to avoid laying off or terminating staff. This same situation could arise in a church missions fund where ongoing support is needed for missionary families or a commitment has been made for a project over a multi-year period.

In all these cases, a contingency reserve can provide a short-term solution to an immediate problem. For example, a company shuts down in a city or town where a ministry is located. A significant number of the congregation were employed by the company. Donation revenue decreases by 20% over a short period of time. A contingency fund can be used to continue church programs while a longer-term plan is made. When donation revenues return to their previous level, the contingency fund can be replenished to its previous level. Often it may take several years to restore the fund.

In another example, a relief and development agency does not receive funding from a major donor because of economic or changed circumstances. The funds had been pledged and program commitments had been made. After looking for other opportunities to reduce costs or readjust programming, there is still a funding shortfall. A contingency fund can be used to meet this need.

Capital Project Reserve Funds

Capital reserve funds are a common reserve fund both for churches and Christian agencies because it often takes several years to raise the funds needed to get a project started.

Facility Maintenance Reserve Fund

There are many excellent facilities across the country that are owned by churches and Christian agencies. As facilities age, it is important to plan for replacement of the roof, carpet, paint and heating ventilation and air conditioning

(HVAC) systems.

Unfortunately, general upkeep and repairs are not always a priority when allocating budget funds. Since some projects happen infrequently (e.g., replacement of a roof), it is easy to spend funds on other programs and urgent needs instead of building up a reserve to fund future repairs and maintenance. Planning and budgeting for repairs and maintenance is ideal and reflects good stewardship of the charity's facilities and equipment.

For some ministries, it may make sense to fundraise for these expenditures as they occur. Each ministry will need to decide on the appropriate approach, depending on their situation. For example, if your donors respond well to unexpected needs, a specific campaign may be appropriate instead of allocating a set amount from the operating budget for these types of reserves. If this is a difficult fundraising task, setting aside money each year may be the way to go.

Realistically, it may take a combination of both approaches to take care of all the needs. The following simplified facility maintenance reserve plan provides a basic illustration of how larger, infrequent expenses could be funded. This plan is shown on a five-year horizon for ease of illustration. Most maintenance plans should be a 10- or perhaps 20-year planning horizon depending on the size and complexity of the facility. In that case, allowing for inflation in the expense forecast would be wise. This type of planning document could also be used in other situations, like establishing a computer and office equipment replacement reserve.

ABC MINISTRY					
Sample Facility Maintenance Reserve					
	Year 1	Year 2	Year 3	Year 4	Year 5
Funding					
Operating budget	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000	\$ 10,000
Donations		5,000			10,000
Total Revenues	10,000	15,000	10,000	10,000	20,000
Expenses					
Carpet replacement		10,000			
Painting		5,000			
Roof replacement					50,000
Office supplies					—
Sunday school supplies					—
Other					—
Total Expenses	—	15,000	—	—	50,000
Net Cash for the Year	10,000	0	10,000	10,000	(30,000)
Accumulated Fund Balance	10,000	10,000	20,000	30,000	—

How Much is Enough?

When dealing with capital reserve funds and maintenance funds, the amount needed can be determined by estimating the costs of the project being undertaken plus appropriate contingency funds for unexpected items. However, for general operating reserves or contingency reserves, the answer is not as clear-cut.

In its new Guidance on Fundraising Activities¹, the CRA recognizes that charities can, and often should, maintain reserves, but the size of the reserve fund must be justifiable. In order to justify the size of the reserve, a charity must be able to demonstrate, by reference to its current position and future prospects, why holding a particular level of reserves is right for the charity at that time. The CRA Guidance suggests that, before establishing a reserve fund, a charity take into account factors such as:

- its typical annual expenditures;
- its size;
- its long-term plans;
- its donor base;
- its projected revenue;
- its current and projected economic conditions;
- anticipated changes to the environment in which the charity operates;
- contingencies; and,
- known risks being faced.

Additional factors to consider in determining reserve levels could include: stability of funding sources, types and timing of activities, future needs, opportunities, and other risks. These factors should be reviewed regularly by charities, to take into account their changing needs.

Reserve levels or funds that are set too high could tie up money which could, and possibly should, be spent on current charitable activities. For this reason, the CRA will view fundraising that results in an unjustified level of reserves as unacceptable. One reason for the establishment of the 3.5% Disbursement Quota (DQ) was also to ensure that charities do not accumulate too much money. Charities still have the option of asking for CRA's permission to accumulate funds, if they cannot meet the 3.5% DQ.

In addition to establishing a minimum target amount, staff leadership teams and boards may also wish to consider placing a maximum cap on the amount that will be held in an operating or contingency type reserve.

Although the size of a justifiable reserve fund will depend on your organization's particular situation, some options to consider in order to establish a reasonable reserve level could include:

- a flat amount with the level determined by the size of your ministry;
- 5% of annual budget with a maximum limit for larger ministries; or
- 2 or 3 months worth of operating expenses.

After determining the necessity of the reserve and the requirements of the fund, a charity should include appropriate allocations in their annual budgeting process or donor outreach plans. Since many small charities rely on volunteer bookkeepers and treasurers, and these positions typically turn over every few years, it is important to keep good books and records so that over time, the reserves will be used for their intended purposes.

Charities should also consider creating a Reserve Fund Policy that covers:

- the purpose and rationale for each reserve fund;
- the appropriate funding level required for each type of reserve fund;
- the current level of reserves and the steps to be taken to establish or maintain the agreed upon levels;
- the mechanisms or methods to monitor and review the policy;
- the appropriate disclosure of information in fundraising appeals (charities should ensure that such appeals are not misleading or deceptive by misrepresenting their financial position and the extent/urgency of its need for funds); and,
- how the charity will engage in raising any funds to be maintained as reserves.

With respect to the last point, the CRA's position is that maintaining a reserve fund policy is one of several "best practices" that a charity should implement, to decrease the risk of engaging in fundraising that is not acceptable. According to the CRA, it is important that the policy also be reviewed periodically to take into account the changing needs of the charity. The CRA's new Guidance on Fundraising should be carefully reviewed by charities before engaging in fundraising activities. When a charity has sufficient income for its identified uses or needs, the need for new fundraising may be questioned by the CRA. Charities should therefore ensure that, before engaging in new fundraising activities, they have considered the ability of current revenues and reserves to meet existing and reasonably projected organizational needs.

Conclusion

Staff leadership teams and boards need to consider their unique situation when deciding the type and level of reserves their charity should hold, and how to fund them. The planning and budgeting of reserves should be conducted on an annual basis at a minimum, and monitored regularly throughout the year.

¹ Fundraising by Registered Charities, CRA Guidance CG-012 (April 20, 2012): <http://www.cra-arc.gc.ca/chrts-gvng/chrts/plcy/cgd/fndrsng-eng.html>

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