Tips on Developing a Reserves Policy

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This article is the second of a two part series on maintaining reserves for not-for-profit organizations and charities. The first part dealt with reserves and the duties of directors, while this one will provide some tips on how to develop a reserves policy. You can read the first part of the article here.

Reserves, what are they?

For the purpose of this article, reserves should be understood to mean that part of an organization's funds that are available without limitation for use in furtherance of the organization's purposes. That definition excludes tangible assets, such as land, buildings and other assets held for the organization's use. Reserves do not include amounts earmarked for necessary future spending. For registered charities, it also excludes restricted funds and endowments. Other funds that have restrictions on how they can be used, such as government contributions designated for a particular program or project, are also excluded.

Why should we have a reserves policy?

As discussed in part one of this series, directors have a legal duty to manage the organization's resources responsibly. The adoption and implementation of a reserves policy demonstrates that the directors are acting with reasonable care, diligence and skill, and in the best interest of the organization. It also illustrates the directors' commitment to implement financial controls, manage risk and protect the assets of the corporation.

Similarly, a reserves policy ensures the organization is accountable. The policy shows funders, donors, beneficiaries, members and other stakeholders why the organization is maintaining a specific amount of reserves. The first issue that should be considered when developing a reserves policy is the reasons for which the organization might need to accumulate some funds as reserves. A well-crafted reserve policy will describe how reserves will be used to manage unforeseen events and contingent liabilities. In addition, if amounts are set aside to fund future acquisitions, programs or activities, the policy should also explain how and when such moneys will be spent.

At what level should our reserves be fixed?

The other essential question is how much money should be put aside? The appropriate level of reserves will vary for each organization. When determining the right amount of reserves, the directors must first examine the organization's incoming and outgoing resources. In its recent publication on the topic, the UK Charity Commission provides useful guidance for developing a reserves policy.[1] Although the publication is intended for charities governed by UK law, Canadian charities and not-for-profit organizations should take note of the following factors that the Commission recommends be considered when establishing the amount of reserves. The Commission states that the level of reserves, which can be expressed as a target figure or a target range, should be informed by:

- the organization's forecasts for levels of income for the current and future years, taking into account the reliability of each source of income and the prospects for developing new income sources;
- the organization's forecasts for expenditure for the current and future years on the basis of planned activity;
- the organization's analysis of any future needs, opportunities, commitments or risks, where future income alone is likely to fall short of the amount of the anticipated costs;
- the organization's assessment, on the best evidence reasonably available, of the likelihood of a shortfall arising which means that reserves are necessary, and the potential consequences for the organization of not being able to make the shortfall.

Directors who establish a reserve fund without linking the organization's need for such reserves to factors such as those outlined above will struggle to provide a satisfactory explanation that justifies the amount of reserves.

Once the level of reserves has been established, the directors should continue to monitor it throughout the year as part of the board's routine financial oversight and budgetary processes. By doing so, the board will be aware of the underlying financial health of the organization and can react promptly to any signs of potential problems.

Are we complying with CRA rules?

As we mentioned in the first part of this series, the Canada Revenue Agency (CRA) has rules in respect of how not-for-profit organizations and charities may maintain reserves. The CRA's view is that the income raised by non-profit and charitable organizations should be spent on furthering its purposes. Unjustified levels of reserves, for both non-profit and charitable organizations, may put their tax-exempt status at risk. The best way to ensure compliance with CRA rules is to develop a reserves policy that is customized to your organization's specific needs and act in compliance with its terms. The justification for the accumulation of funds should be reflected in the policy, approved by the board of directors, and be directly related to good governance practices. If the organization is able to readily and promptly provide the CRA with evidence of the foregoing, the CRA is less likely to challenge the organization's rationale for maintaining its reserves.

[1] The Charity Commission, *Charity Reserves: Building Resilience (CC19)*, online: GOV.UK <https://www.gov.uk/government/publications/charities-and-reserves-cc19>