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### **Guidance on Financial Reserves Policies**

The consideration of financial reserves and an effective policy to cover the issue is a matter that is often overlooked by organisations operating in the not-for-profit sector. However, consideration of financial reserves is an important part of the planning and financial management activities of an organisation, and should ideally be formalised in a written policy.

#### **What are financial reserves and why are they important?**

We use the term “financial reserves” here to refer to the funds retained by an organisation to help meet future needs. Holding a certain amount of funds in reserve can help an organisation to operate effectively in times of economic difficulty, as well as help cover unforeseen or unplanned future costs that may arise, and facilitate planning for major works in the future. Retaining an appropriate level of reserves is an important step for all not-for-profit organisations to help balance the current and future needs of its beneficiaries.

#### **Why is a reserves policy important?**

The very nature of a not-for-profit organisation stipulates that all funds received should be distributed or expended in the course of operations, so that there are no excess funds to be retained. This is also what is generally expected by donors and the public, and makes it difficult for an entity to retain an appropriate level of reserves without a policy in place to support it. An appropriate reserves policy that is made available to the public will help to educate donors about the need for reserves to be held, and about what these funds will be used for in the future. It will also improve the transparency with which an organisation is reporting to its members and the public.

#### **Development of an effective financial reserves policy**

There is no set formula for the development of an effective financial reserves policy, and such a policy will be different for each organisation. Factors to be considered in the development process include:

- the need for reserves in the first place – what purpose will the funds be used for?
- the level of reserves needed;
- situations in which reserves are expected to be drawn upon;
- how to build up and maintain the required level of reserves; and
- how to manage the funds being held.

One of the first steps an organisation should undertake in the development of an effective financial reserves policy is a comprehensive risk assessment. Identifying the risks that an

organisation faces will assist the governing body to determine both the need for reserves, and the appropriate amount of reserves that should be held. Other factors to consider in determining this amount might include the organisation's areas of activity, sources of funds, expected levels of future income and expenses, future plans and needs, and economic conditions.

### **Recommendations for an effective financial reserves policy**

An effective financial reserves policy should:

1. be appropriate to the needs of the organisation, taking into account its objectives, its nature and size, and the risks it faces;
2. explain the reasons why the organisation needs to maintain reserves;
3. clearly stipulate the level or range of reserves needed to operate effectively, or how this amount is to be determined;
4. explain how the organisation intends to establish and maintain the required level of reserves; and
5. be reviewed periodically to adjust for any changes in the organisation's operating environment, the risks it faces, or its activities.

It is important to note that the complexity and level of detail contained in a financial reserves policy should be in proportion to the size and complexity of the organisation and its activities. A relatively small organisation involved in straightforward activities and operating in a stable environment should only require a relatively simple financial reserves policy to address its needs. The larger and more complex the organisation, and the more risks it faces, the more detailed this policy will need to be.

Common types of reserves maintained by non-for-profit organisations include restricted and unrestricted reserves, designated reserves, and endowment reserves. The reserves policy should mention each type held by the organisation, including a description of the reserve, and the purpose it may be used for.

### **Resources**

The following resources may be useful to Code of Conduct signatories in the development of a financial reserves policy:

1. [www.charity-commission.gov.uk](http://www.charity-commission.gov.uk) - this site has comprehensive resources on the need for financial reserves available for viewing, as well as examples of reserve policies;
2. [www.childfund.org.au](http://www.childfund.org.au) - ChildFund Australia have their reserves policy publicly available on their website.