Annex 1: A simple approach to developing a reserves policy

The following 3 questions are designed to help guide trustees of smaller charities through the issues that need to be considered when developing their reserves policy. Trustees managing charities with more complex activities or structures may find that this approach does not go into enough detail and should look at the guidance given in Annex 2 instead.

Question 1. Why might you need reserves for the charity to be effective?

The basis of a good reserves policy is thinking through exactly why you might need to hold back some funds as reserves. In a small charity, with a simple structure and uncomplicated activities, the reasons might include:

a) The risk of unforeseen emergency or other unexpected need for funds, eg an unexpected large repair bill or finding 'seed-funding' for an urgent project.

b) Covering unforeseen day-to-day operational costs, eg employing temporary staff to cover a long-term sick absence.

c) A source of income, eg a grant, not being renewed. Funds might be needed to give the trustees time to take action if income falls below expectations.

d) Planned commitments, or designations, that cannot be met by future income alone, eg plans for a major asset purchase or to a significant project that requires the charity to provide 'matched funding'.

e) The need to fund short-term deficits in a cash budget, eg money may need to be spent before a funding grant is received.

If, after considering the above, you think that reserves are needed please go to question 2. If you conclude that your charity does not need to hold any reserves, then you must explain that in your annual report.

Question 2. How much do you need in reserve?

The reserves level may be a target amount or a target range. For example, for each reason set out in question 1:

a) An amount might be needed to meet an unforeseen emergency or other unexpected need - consider risks and how much might be needed for such contingencies; this will involve judgment of events that may occur and their likelihood.

b) Look at your expenditure budget - do you need a small contingency fund to meet unforeseen operational costs?

c) Uncertainty over future income might mean having reserves equivalent to a number of weeks of income equivalent to a range of £x to £y, to allow time to develop new sources of income or to cut-back on related expenditure.

d) A planned spending commitment which cannot be met from future income would imply a need for a specific sum to be set aside - often this amount will be included within designations in accounts.

e) An amount might be needed to cover 'troughs' in the cash budget - review budgets to ascertain how much might be needed.

In summary, the financial risks you identify should influence the amount of reserves you target to hold and be explained in your reserves policy.

Question 3. Have you got any funds in reserve at the end of the year?

The final step is to compare what you might need in reserve with what you actually hold. You should:

- calculate the amount of any reserves according to the definition of reserves given in section 3.1 of the guidance
- state the amount of reserves held and compare with the target amount or target range set for reserves
- explain any shortfall or excess in reserves against target set
- explain any action being taken or planned to bring reserves into line with your target

Where the difference is small, no action may be needed.

Information about the reserves policy and the level of reserves held must be included in the trustees' annual report.