

Reserves policies made simple

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consultants and auditors

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Introduction

There are a number of different approaches to developing a reserves policy. Andrew Hind has successfully summarised these in his book *Governance and Management of Charities*. Hind sets out four different approaches, but recommends the risk identification approach, which is based on an understanding of the income streams and their risk profile, the degree of commitment to expenditure and the overall risk environment in which the charity operates. The steps to developing a reserves policy on this basis are described in more detail below.

There are a number of reasons why charities may hold reserves and these will depend on the type of activity undertaken by the charity and how it operates and funds its operations. In general, reasons why charities hold reserves can be summarised as follows:

- to fund working capital
- to fund unexpected expenditure, for example when projects overrun or unplanned events occur
- to fund shortfalls in income, when income does not reach expected levels.

A helpful way for charities to view reserves is to see them as the funds they will use to cover expenditure to 'buy some time' in the event of reduced income or changes in circumstances.

step 1 Understand your funds

A charity may have some or all of the following types of funds.



- **Permanent endowment funds** are donations that have been given to a charity to be held as capital. These may be cash or other assets and should be held as investments or fixed assets. Any income earned from investments is assumed to be unrestricted and funds may be used to maintain the capital value of the assets in the fund, for example paying investment management fees.
- **Expendable endowment funds** are donations that have been given to a charity to be held as capital, where the trustees do have a discretionary power to use the funds as income.
- **Restricted funds** are donations received for purposes specified by the donor. Restrictions can be created because of the wording on public appeal literature, or through the terms of a grant award. Trustees will be in breach of trust if they use restricted income other than for the specified purpose.
- **Unrestricted funds** can be used on the charitable objects, to be spent as the trustees see fit.
- **Designated funds** are unrestricted funds that have been earmarked for a particular purpose by the trustees. The notes to the accounts should explain the purpose of designated funds.
- **General funds** are unrestricted funds which have not been earmarked and may be used generally to further the charity's objects.

Where the funding for long term assets such as buildings has come from unrestricted donations, you may wish to earmark this funding as designated funds so that the general funds do represent the free reserves of the charity which may actually be spent on the charitable objectives.

Case study **Understanding your funds**

Access for All is a relatively new charity which makes grants to disabled children and their families to fund the purchase of specialist equipment. Part of this process is assessment of each individual's needs so as well as making grants, the charity employs specialist advisors working part-time in different locations but based at home. They raise a significant amount of funding from their own efforts, running events and other fundraising activities. They generate some restricted grants and donations to fund some of their work. .

Balance sheet

| | | |
|-----------------------------------|-------------------|-----------------|
| Tangible fixed assets – property | £680,000 | Restricted fund |
| Investments | £520,000 | Endowment fund |
| Net current assets | £1,546,000 | |
| Net assets and total funds | £2,746,000 | |

The property is shown as valued by a surveyor when it was donated to the charity nearly two years ago for use as the charity's headquarters. They receive rent from the top two floors which are let to other charities. However, the property requires major maintenance work in the near future.

The investments were also received as part of a major donation when the charity was started up and consist of various UK shares which were given as an endowment.

step 1

Unspent restricted grants and donations amounted to £126,000 in net current assets. So their unrestricted funds are £1,420,000. They are considering setting up a designated fund for the property refurbishment, but otherwise the funds are to be spent on the charitable objects.

| | |
|---|------------|
| Endowment fund | £520,000 |
| Restricted fund – property | £680,000 |
| Restricted funds – unspent grants and donations | £126,000 |
| Unrestricted funds – proposed designation | £420,000 |
| Unrestricted funds – general reserves | £1,000,000 |

step 2

Review of future income streams

You start by looking at existing funding, with some assessment of the likelihood of the source of funding continuing. For example, a grant may be certain as it may be a multi-year award. For some charities, membership subscriptions will be a stable source of income, although some allowance may have to be made for non-renewals.

Other risk factors should also be taken into account in assessing the funding sources. An income stream is more at risk if it comes from only one source, such as a major grant. A large number of small donations may have a lower risk profile because the chance that all donors will cease giving is very low. There is a high risk that a few donors will cease giving, but where donations are small the financial impact is minimal. This can be taken into account when reviewing future income streams.

In addition, the loss of income will have a greater impact on the charity if the source of income forms a high proportion of the overall income to the charity.

A risk profile of future income streams can be built up using the following information:

- a** Type of income/source of funding
- b** Current level in £
- c** Proportion of total income as %
- d** Do you expect the income level to go up or down? Rank as follows:
 - 1 = steady increase – by 10% or more
 - 2 = rapid increase – by 25% or more

step 2

3 = static

4 = decline

e How many different people give under this form of funding i.e. is this a single grant funder or many individuals? Rank as follows:

1 = very many

2 = several

3 = few

4 = one source or funder

f How certain is the source of income for the future? Rank as follows:

1 = committed for indefinite future

2 = for a fixed period

3 = planning well underway or by implication –
e.g. past pattern, verbal assurance

4 = not certain at all

You can multiply out the scores in the categories **c** to **f** to come to a number which will give the relative reliability of each type of income. Using the above ranking system means that a low score indicates a more reliable source of income. A high score means that there is greater risk attached to the source of income for a combination of reasons.

Using this system of ranking each source or type of funding can help the charity to produce a table to see the relative reliability of each source of funding and how secure their future income streams are. Clearly a charity with secure income streams has less need of reserves, whereas a charity with insecure future income needs higher levels of reserves.

Case study Review of future income streams

| | <i>Restricted £'000</i> | <i>Unrestricted £'000</i> | <i>Total £'000</i> |
|--------------------------------------|-----------------------------|-------------------------------|------------------------|
| Incoming resources | | | |
| Government grants | 99 | 99 | |
| Donations | 716 | 692 | 1,408 |
| <i>Activities to generate funds:</i> | | | |
| Marathons | | 1,372 | 1,372 |
| Overseas events | | 1,350 | 1,350 |
| Other events | | 228 | 228 |
| Investment income | | 110 | 110 |
| Rent | | 65 | 65 |
| Total incoming resources | 815 | 3,817 | 4,632 |

Resources expended

Cost of generating funds:

| | | | |
|-----------------------|--|-----|-----|
| Marathons | | 415 | 415 |
| Overseas events | | 480 | 480 |
| Other events | | 37 | 37 |
| Investment management | | 13 | 13 |

Additional information about donations has been extracted as follows:

| | <i>Restricted</i> | <i>Unrestricted</i> | <i>Total</i> |
|------------------------|-------------------|---------------------|---------------------|
| Individuals | 33 | 256 | 289 |
| Corporate donations | 279 | 418 | 697 |
| Trusts | 404 | 18 | 422 |
| Total donations | 716 | 692 | 1,408 |

Before we start ranking the reliability of income, there are three important aspects to take into account:

step 2

- Restricted income should be treated differently to unrestricted income. We can exclude restricted income from these calculations and exclude the related expenditure as well. This is consistent and is appropriate in this case where the proportion of restricted income is low. Alternatively, where the level of restricted income is high and funds activities that are a core activity for the charity, then it is more appropriate to keep the restricted income in the reckoning for reliability of income. The related expenditure will then need to be included as well, as a firm commitment, in order to represent the status of that income and expenditure accurately.
- Some of the income relates to events and other activities to generate funds. In reality, the income to the charity from fundraising activity is the income less the related expenditure, so for this exercise, we need to include only the net income in our assessment of reliability.
- Rental income has been excluded from the reliability table as the charity knows that they will not receive income during the refurbishment of the building.

So illustrated opposite for this charity is the assessment of unrestricted income, with fundraising income shown as the net income from activities.

| | <i>£'000</i> | <i>Proportion of income %</i> | <i>Likely change</i> | <i>Number of sources</i> | <i>Certainty</i> | <i>Reliability score</i> |
|--------------------------------|--------------|-------------------------------|----------------------|--------------------------|------------------|--------------------------|
| Donations from individuals | 256 | 9.12 | 1 | 1 | 3 | 27 |
| Corporate donations | 418 | 14.89 | 1 | 2 | 2 | 60 |
| Trust donations | 18 | 0.64 | 1 | 2 | 2 | 3 |
| Marathons | 957 | 34.09 | 3 | 1 | 3 | 307 |
| Overseas events | 870 | 30.99 | 4 | 1 | 3 | 372 |
| Other events | 191 | 6.80 | 3 | 1 | 3 | 61 |
| Investment income | 97 | 3.46 | 3 | 3 | 3 | 93 |
| Net unrestricted income | 2,807 | | | | | |

The overseas events and then the marathons have the highest scores by a significant margin. This reflects the high risk nature of such fundraising methods. Unfortunately for this charity, these events also produce the highest proportion of their income. As well as informing the strategic plan for the charity, this analysis will help the charity to develop the policy on reserves. They do not have very reliable income and need to consider how they will cover committed expenditure.

step3

Review of committed expenditure

The next step in developing a reserves policy involves looking at the expenditure patterns and the extent to which the charity can curtail or change the timing of cash outflows. Ideally, a charity should be timing cash outflows to match the timing of cash inflows. Where this is not possible, reserves may be needed to fund expenditure in advance of income receipts, or expenditure delayed.

You can build up a profile of the charity's commitments using the following analysis:

- a** Type of expenditure
- b** Current level in £
- c** Proportion of total expenditure as %
- d** How significant is that type of expenditure to the charity's operations? How much does it contribute to the achievement of the charity's objects? Rank as follows:
 - 1 = unnecessary 3 = essential
 - 2 = optional 4 = core purpose
- e** Consider the number of people affected by a decision to cut the expenditure, including beneficiaries, volunteers as well as staff. Rank as follows:
 - 1 = one 3 = several
 - 2 = few 4 = very many
- f** Identify the source of funding and score as follows:
 - 1 = general funding 3 = restricted income
 - 2 = grant 4 = contract

Multiply all the scores in **c** to **f** to produce a number which may be described as the commitment score. Based on the above system of

scoring, higher scores indicate a greater degree of commitment to the expenditure line.

You can decide how to split up the expenditure, but a balance needs to be achieved between too much detail and insufficient detail. The purpose of this exercise is not to identify the types of expenditure which will be cut first, but to help to quantify the amount that may be needed in reserves to fund expenditure patterns.

Case study **Review of committed expenditure**

Charitable expenditure analysed:

| | <i>restricted £'000</i> | <i>unrestricted £'000</i> | <i>total £'000</i> |
|---------------------------------------|-----------------------------|-------------------------------|------------------------|
| Grants payable | 433 | 1,390 | 1,823 |
| Salaries including National Insurance | 245 | 811 | 1,056 |
| Office costs | 45 | 116 | 161 |
| Total charitable expenditure | 723 | 2,317 | 3,040 |

However, as mentioned in step 2, we are excluding restricted income **and** expenditure in this case.

| | <i>£'000</i> | <i>Proportion of expenditure %</i> | <i>Operational significance</i> | <i>Number of people affected</i> | <i>Source of funding</i> | <i>Commitment score</i> |
|---|--------------|--|-------------------------------------|--|------------------------------|-----------------------------|
| Grants payable | 1390 | 60 | 4 | 4 | 1 | 960 |
| Salaries including National Insurance | 811 | 35 | 4 | 4 | 1 | 560 |
| Office costs | 116 | 5 | 3 | 3 | 1 | 45 |
| Total unrestricted expenditure | 2317 | 100 | | | | |

In this case, the grants and staff costs are closely linked to the whole service provided to disabled children and their families.

step4 **Drawing up the policy**

Consideration has already been given to some aspects of risk when reviewing the future income streams. This step in developing a reserves policy needs to consider other points that may have arisen when the charity reviewed the major risks to which the charity is exposed. In terms of the reserves policy, we are most concerned here with risks that represent a contingent liability or may crystallise into a commitment.

Having considered the reliability of income and the extent to which expenditure is committed, as well as the major risks to which the charity is exposed, the trustees will have gathered a significant amount of information on which to base the policy for their charity. They should now understand the reasons why their particular charity needs to hold reserves, rather than the more general reasons that apply to almost every undertaking. So you may now have a better understanding of the period of time your reserves would be needed for in the event of a downturn in income. Judgement is needed to convert this understanding into a range of reserves levels that would be appropriate for the charity.

As a minimum the policy should cover:

- the reasons why the charity needs reserves
- what level or range of reserves the trustees believe the charity needs
- what steps the charity is going to take to establish this agreed level or range
- arrangements for monitoring and reviewing the policy.

In addition, you need to state the actual level of reserves at the year-end in the annual report.

Case study Drawing up the policy

Access for All is a relatively new charity, but it has the benefit of an endowment fund and donated premises, as well as established events and fundraising. So they have built up reserves of £1 million. However, the income reliability shows that they are heavily dependent on high-risk forms of fundraised income, so this could fall dramatically at some point in the future. The commitment score on expenditure is also high. There are two further factors to take into account here:

- there is a moral commitment to a child once the charity has agreed to help. It can take up to a year from the initial assessment to the delivery of a specialist piece of equipment.
- the charity will also provide on-going support to a child and will maintain equipment etc

Consequently, funding would need to continue for at least a year to meet moral commitments to children, and a smaller amount of funding would be needed to provide on-going support needs. So this is approximately one year's unrestricted expenditure. The trustees decide that this the appropriate level for the reserves policy and agree the following statement for the annual report.

'Access for All makes long-term commitments to the children and families it seeks to help. This commitment begins once an initial assessment has been completed and continues as the child grows up and needs adaptations or further new equipment. The trustees wish to ensure that they would be able to provide equipment that had been promised. Since it may take up to a year for specialised equipment to be built to the individual specification, we have commitments of at least one year. Since income can be volatile, the general reserve should represent approximately one year's worth of unrestricted expenditure. At

step 4

current levels of activity, the reserves should be approximately £2.3 million. Currently, the general reserve is £1 million. The trustees are considering ways of reducing the charity's dependence on volatile forms of income and increasing more reliable funding for its services. In addition, plans for the coming years allow for general reserves to be increased to provide 9–12 months cover for commitments. The trustees review the policy and progress towards meeting the target level of reserves annually.'

Conclusion

Trustees are under a duty to balance the needs of current and future beneficiaries of the charity. A charity needs to have sufficient reserves to allow it to cover known liabilities and contingencies, absorb setbacks and take advantage of change and opportunity. However, charities holding reserves that are greater than their needs will be subject to scrutiny and possible investigation by the Charity Commission.

The benefits of developing a reserves policy:

- It is a key element of the strategic plan – without a clear idea of the reserves you need you may not be able to meet your commitments or start new activities.
- It feeds into the budgeting and decision-making process – the policy will act as a benchmark to ensure that you use your funds to good effect. Without this the danger is that if you have high reserves you may take on projects without detailed planning and with low funds you may be forced to be reactive rather than plan constructively.
- It focuses the fundraising activities – the reserves policy will identify your level of need for funds and what they are needed for. This can be fed into the fundraising plans as it is often easier to fundraise for specific items or amounts.
- It is necessary for communication with those external to the charity – the reserves policy helps to demonstrate that the charity's money is being used to good effect. Funders, beneficiaries, members and the wider public are entitled to know this and that you have good reasons for maintaining or seeking the certain levels of reserves.

References and further information

Statement of Recommended Practice for Charities (SORP)

Issued March 2005

Available at www.charitycommission.gov.uk

RS3 Charity Reserves

Charity Commission report

Issued March 2003

RS5 Small Charities and Reserves

Charity Commission report

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CC19 Reserves

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Temporarily withdrawn and being re-written

The Governance and Management of Charities

Andrew Hind

Published 1995 by Voluntary Sector Press

A Practical Guide to Financial Management for Charities and Voluntary Organisations

Kate Sayer

Published 2007 by the Directory of Social Change

ISBN 1 903991 72 2

Not Just for a Rainy Day?

Shirley Gillingham and John Tame

Published by NCVO 1997

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