

Drawing up a Reserves Policy

Accounting and Reporting by Charities: Statement of Recommended Practice 2005 (“SORP 2005”) requires trustees to include in their annual report a statement of the charity’s policy on reserves, including the level of reserves held at the balance sheet date and why they are held. Trustees therefore need to consider the need for reserves in their charity and develop an appropriate policy and statement, which should be reviewed annually.

What are reserves?

In this context, reserves are the unrestricted funds held as the general funds of the charity, often described as free reserves. In SORP 2005, the term reserves is defined as follows:

“In this SORP the term “reserves” (unless otherwise indicated) describes that part of a charity’s income funds that is freely available.

(SORP 2005 Appendix 1 GL51)

Designated funds should be considered when considering the charity’s reserves, although these are not part of the *general* reserves. Funds need to be properly designated for a defined purpose, which should be explained in the notes to the accounts. Charity Commission guidance in CC19 makes it clear that charities may not designate funds in order to present their reserves levels as lower than they really are.

“We expect charities to follow this recommendation and to ensure that the amount of any funds held as designated funds is appropriate to the purpose or use for which the funds have been designated. A charity will not be justified in creating, or transferring resources to a designated fund where the main purpose of doing that is to allow the charity to show a reduced level of reserves.”

(CC19 – Charities’ Reserves)

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.

Reserves policy

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.

Reasons for holding reserves

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. In this way, a charity may foresee that there is a chance that funding from a particular source will be cut. The charity will need reserves to fund the committed expenditure whilst they source alternative funding. The judgement of how long they will need to find alternative funding will help to inform the size of the reserve needed for this purpose. For example, the charity may assess that it would need six months to replace a major source of funding. The reserves level to cover this contingency would therefore need to be the equivalent of six months’ funding or expenditure.

There are a number of different approaches to developing a reserves policy. Andrew Hind has successfully summarised these, and the summary below is taken from his text on charity reserves. Hind sets out four different approaches:

- **Justifying the status quo**
In this approach to setting a reserves policy, the trustees look at the actual level of reserves (usually relatively high) and create a reserves policy to justify the actual amounts held.
- **The “Armageddon” approach**
The trustees assume the worst will happen and calculate the level of reserves needed to fund the closure of the charity’s activities, including redundancy pay and the full cost of leases and commitments which would crystallise.
- **The “actuarial liability” approach**
The charity assesses its future expenditure commitments and actuarially computes the fund needed to generate sufficient income to cover the expenditure commitments, similar to an endowment fund.
- **The risk identification approach**
This approach 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 last approach is the one recommended by Hind and now most commonly adopted by charities. The steps to developing a reserves policy on this basis are described in more detail below.

Steps in developing a reserves policy

There is no standard formula that you can apply to a charity's set of accounts in order to establish the correct level of reserves for it. The approach should involve a review along these lines:

- analysis of existing funds
- review of future income streams with an assessment of their level of reliability
- review of committed expenditure and the extent to which this is controllable
- risk assessment, to identify potential commitments and contingencies, together with the likelihood that these risks will materialise and give rise to new commitments.

Analysis of existing funds

It is important to be clear about what your starting point is i.e. your current level of reserves. Review the balance sheet for the following:

- ensure that all endowment and restricted funds have been identified
- ensure that all your designated funds can be justified and that there are no more to add
- identify any assets that cannot be readily converted into cash

Whilst technically the reserves funding long term assets such as tangible fixed assets may be unrestricted funds, in reality these are not available for use. It may be appropriate to identify the funding for fixed assets separately to reach an estimate for the free reserves of the charity.

Illustration – Analysis of existing funds

Camberwick Community Hall - balance sheet

Tangible fixed assets - property	£680,000
Investments	£20,000
Net current assets	£50,000
Net assets and total funds at 31 March 2007	£750,000

This charity has been running for a number of years. With the building of a large number of new houses in the area, there has been a sudden influx of new residents. They have received an offer of new funding of £0.75million to fund expansion.

In the early years of the hall's life maintenance costs were low. However the caretaker has noticed that repair costs are creeping up and £10,000 was spent this year. The windows will need to be replaced in the next couple of years. A member of the committee who is also a local builder thinks these are likely to cost in the region of £50,000.

The Management Committee is concerned about the condition of the hall and the growing demands of the new members. The Management Committee needs to establish a reserves policy, which will explain to the members how:

- their reserves are tied up in the property
- increasing repair costs can be met and
- to provide a balance of "free" reserves

Analysis of the existing funds reveals that three designated funds should be set up:

- Tangible Fixed Assets Fund – this will equal the net book value of the property.
- Cyclical Maintenance Fund - this will cover annual repair costs – suggested balance £10,000. This has been based on the costs incurred in 2006/07 and were thought to be the average annual costs of repairs. Costs will be charged against this fund future and transfers added to the fund to cover future costs.
- Windows Fund – this will be set up with a balance of £25,000 and will be added to in 2007/2008 so the costs of replacement windows can be covered in a couple of year's time when the work needs to be done.

The charity is left with £35,000 of free reserves i.e. unrestricted, undesignated funds.

Tangible fixed assets - property	£680,000
Investments	£20,000
Net current assets	£50,000
Net assets	£750,000
General reserves	£35,000
Designated funds:	
Tangible Fixed Asset Fund	£680,000
Cyclical Maintenance Fund	£10,000
Windows Fund	£25,000
Total funds	£750,000

Showing £35,000 as the general reserves gives a more accurate picture of the charity's financial position. Investments and current assets amount to £70,000, of which half will be needed for repairs to the building.

Review of future income streams

This review may also need to start with the current position. 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 donating is very low. There is a high risk that a few donors will cease donating, 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 using the following information:

- Type of income/source of funding
- Current level in £
- Proportion of total income as %
- 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
 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.

Illustration – Review of future income streams

Access for All is a relatively new charity. Its recent accounts showed the following information:

	Restricted £'000	Unrestricted £'000	Total £'000
Incoming resources			
Government grants	74	-	74
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 and interest	25	20	45
Total incoming resources	815	3,662	4,477
Resources expended			
<i>Cost of generating funds:</i>			
Marathons	-	415	415
Overseas events	-	480	480
Other events	-	37	37

Additional information about donations has been extracted as follows:

	Restricted	Unrestricted	Total
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 two important aspects to take into account:

- 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.

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

	£'000	Proportion of income %	Likely change	Number of sources	Certainty	Reliability score
Donations from individuals	256	9.38	1	1	3	28
Corporate donations	418	15.31	1	2	2	61
Trust donations	18	0.66	1	2	2	3
Marathons	957	35.05	3	1	3	315
Overseas events	870	31.87	4	1	3	382
Other events	191	7.00	3	1	3	63
Investment income	20	0.73	3	3	3	20
Total income net of direct costs	2,730					

The overseas events and then the marathons have the highest score, 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.

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
 - 2 = optional
 - 3 = essential
 - 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
 - 2 = few
 - 3 = several
 - 4 = very many
- f) Identify the source of funding and score as follows:
 - 1 = general funding
 - 2 = grant
 - 3 = restricted income
 - 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.

Illustration – Review of committed expenditure

Support for Disabled Children makes grants to children and their families to fund the purchase of specialist equipment, and provides information and support to families. They raise a significant amount of funding from their own efforts, running lotteries and other fundraising activities. They generate restricted donations to fund much of the grants payable. An analysis of the accounts for the last financial year produces the following summary relating to expenditure:

Salaries including National Insurance	£392,708
Grants payable	£238,580
Direct costs of fundraising	£248,275
Office and general running costs	£171,296
Total expenditure	£1,050,859

	£'000	Proportion of expenditure %	Operational significance	Number of people affected	Source of funding	Commitment score
Salaries including National Insurance	393	37.37	2	4	1	298.96
Grants payable	239	22.70	4	4	3	1089.76
Direct costs of fundraising	248	23.63	1	2	1	47.25
Office and general running costs	171	16.30	3	3	1	146.71
Total	1,051	100.00				

Because grants are a core activity and they receive restricted funding for this activity, this will be the most difficult expenditure to curtail. Obviously salaries are always a major commitment, although within the salaries total, there may be some temporary and project staff, which may be more controllable than staff engaged on core activities. This area may need further analysis.

Risk assessment

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.

Drawing the policy up

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. They can then consider the range of reserves levels that would be appropriate for the charity.

What should the policy contain?

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.

Reference material

RS3 Charity Reserves

Charity Commission report

Issued March 2003

Available at www.charitycommission.gov.uk

CC19 Reserves

Guidance published by the Charity Commission on their website

OG43 Charity Reserves

Operational guidance published by the Charity Commission on their website

The Governance and Management of Charities

By Andrew Hind

Published 1995 by Voluntary Sector Press

Financial Stewardship of Charities

By Adrian Poffley

Published 2002 by the Directory of Social Change

Available at www.dsc.org.uk

A Practical Guide to Charity Accounting

By Kate Sayer and others at Sayer Vincent

Published 2003 by the Directory of Social Change

Not Just for a Rainy Day?

By Shirley Gillingham and John Tame

Published by NCVO

The Magic Roundabout – an introductory guide to programme related investment

By Keith Hickey, Geraldine Peacock, Kate Sayer, Paul Voller, Nick Wilkie

Published 2003 by Bircham Dyson Bell and Sayer Vincent