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# 4 steps to developing your charity’s reserves policy

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**Charities need a clear understanding of their income streams and their risk profile to develop an intelligent reserves policy…**

The Charity Commission’s July 2018 survey into public trust and confidence in charities suggested that people trust charities less than they trust the average person in the street. Two out of the five key drivers of trust identified in the report highlighted that charities need to be “transparent about where the money goes” and “demonstrate efficient use of resources”.
Charites need to take note and consider ways of rebuilding trust. One way of doing this is through the annual report which is a great opportunity to clarity and explain how charitable money is spent and equally, what funds are held as reserves and why.

A well thought out reserves policy, explained in the trustees’ annual report will help to create an effective narrative and build trust. An intelligent reserves policy is a key component of a charity’s financial strategy, as well as a very public statement on the trustees’ view on the financial position of the charity.

With increased financial pressure and public scrutiny, charities need to look both at diversifying their income and ensuring they build reserves where necessary or use them appropriately when needed.  But what does this mean in reality?

**Robust basis for reserves**
Charities need a robust basis for holding reserves as opposed to spending them on their charitable cause. Charity income is meant to be spent on the charity’s objectives to benefit the charity’s beneficiaries. It is not intended that charities should hoard reserves in order to continue in perpetuity or to allow trustees to sleep better.

There is a strong argument that high levels of reserves can lead to complacency and poor financial practices, such as allowing long credit terms to those who owe the charity money. That is not to say that charities should not hold reserves, but they should hold appropriate levels of reserves.

Charities often think they should hold three or six months’ worth of reserves without placing any context as to why this is the necessary level. By developing an intelligent reserves policy, charities consider their financial risks and build a case for reserves based on the assessed risk.

To do this, charities need a clear understanding of their income streams and their risk profile, the degree of commitment to expenditure and the overall risk environment in which the organisation operates. Here are some steps for developing an intelligent reserves policy.

**Step 1 – Understand your funds**
Larger charities will have a variety of restricted and unrestricted funds, including endowment funds, restricted income funds, designated funds and general funds. Understanding these will be key to knowing how they can be used.

**Step 2 – Review future income streams**
Charities should consider the risk factors of their existing funding and assess the likelihood of the source of funding continuing. A risk profile can then be built using a ranking system to produce a table to see the relative reliability of each source of funding and how secure their future income streams are. A charity with secure income streams has less need of reserves, whereas a charity with insecure future income needs higher levels of reserves.

**Step 3 – Review committed expenditure**
The next step 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.

Charities should build up a profile of their financial commitments. This should consider how significant that type of expenditure is to the charity's operations and the number of people affected by a decision to cut that expenditure, including beneficiaries, volunteers, as well as staff.

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.

**Step 4 – Developing a risk-based policy**
At this stage, trustees should have a lot of information on which to base their policy and help them understand why they need to hold reserves. This now needs to be converted into a range of reserve levels appropriate for the charity.

The interaction between the reliability of income and the extent to which expenditure is committed will determine the type of reserves policy needed. For a charity with uncertain income and fixed costs, the level of reserves they would need to give them cover for the risks they face would be very large. This is not a good business model.

Ultimately, the answer is not to attempt to build up high levels of reserves but to manage the risks in other ways, for example by diversifying income, changing the service model so that costs are more flexible or seeking a merger partner.

An effective charity does not need to build up large reserves – it needs to manage its strategic risks well and doing this will go a long way towards rebuilding trust.

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