Beyond Reserves

How charities can make their reserves work harder

Third Sector Leaders ACEVO

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Foreword

Charity trustees have a fundamental duty to manage their charity's assets in the best interests of its beneficiaries. Decisions around a charity's reserves policy form a core part of that duty of care and are crucial during economically uncertain times.

This publication, which complements the Charity Commission's core guidance for trustees *Charities and Reserves* (CC19), is therefore both welcome and timely. By remaining practical and focused on the experiences of a diverse range of charities, *Beyond Reserves* will provide healthy food for thought for trustees considering their charity's reserves policy.

I especially welcome the emphasis placed in this guidance on trustees' judgement, based on the circumstances of their particular charity. As the Commission's own guidance makes clear, there is no fixed rule as to the minimum or maximum level of reserves that charities may hold – what is important is that trustees are able to justify their reserves policy as being in the best interest of their charity. Charity law makes it clear that income received by charities should be spent within a reasonable period of time and that trustees should have good reasons for holding on to funds which, in most cases, will have been donated by members of the public keen to support the cause.

Where trustees do decide that it is in their charity's best interest to hold reserves, it is important that the level is set with the charity's income and spending commitments firmly in mind, and that the policy explains in what circumstances the reserves will be used. It follows from this that it is good practice for charities to regularly review their reserves policy to ensure it is still fit for purpose.

It is also vital that trustees make it clear to the public what their approach to reserves is by explaining their reserves policy in their trustees' annual report and accounts. All charities with incomes of £25,000 or above must file these with the Commission.

The Commission would like to commend ACEVO, Charity Finance Group and the Institute of Fundraising for producing this publication for charities. By doing so, they demonstrate initiative and responsibility. As the Commission's own resources are increasingly pressed it is vital that umbrella bodies like these play a greater role in upholding high standards of governance and good practice among their members and the wider sector that they represent.

Sam Younger *Chief Executive, Charity Commission*

Why a guide on reserves?

In 2011, ACEVO, Charity Finance Group and the Institute of Fundraising came together to discuss changes in the sector and look at how we could collaborate further to support our members. One of the key issues in our discussion was reserves and how organisations manage them.

Reserves are the main resource of any organisation within our sector. However they are often not considered as a source of funding or as an asset to be managed, but rather as something which should be protected and preserved.

There are many useful guides to reserves planning, but many of them focus predominantly on the role of the finance team. In this publication we address the senior management team more widely, and consider reserves as an integral part of the strategic planning process.

By speaking to chief executives, finance directors and fundraising directors from a wide range of organisations, we have been able to build a picture of how reserves affect their roles, and how they are involved in reserves planning within their organisations. As is shown through the case studies, reserves are not just linked to finance, but also to fundraising strategy, risk assessments, and future business planning.

By collaborating together, and drawing on the expert advice of Kate Sayer, we hope that this publication will be of value to all senior managers within the sector.

Caron Bradshaw, *Chief Executive, CFG*
Sir Stephen Bubb, *Chief Executive, ACEVO*
Peter Lewis, *Chief Executive, Institute of Fundraising*

Executive summary

Introduction

This guide is for anyone who thinks their reserves could be working harder.

Many charities adopt a conservative attitude when it comes to reserves. Rather than viewing them as an asset which needs to be actively managed, reserves are often seen as a resource that should be protected and preserved. At trustee board meetings the topic of reserves will come up when discussing the year end accounts, but often that's it – charities have reported that as long as the reserves remain at 'x' months of agreed operating costs, that box is ticked and there is no further discussion or questioning whether these valuable assets are being utilised fully.

Charity and economic landscapes are changing rapidly. The global economic crisis has meant the last few years have been the worst economically. It's easy to argue the 'rainy day' scenario has been upon us – but research has shown that many charities still haven't used reserves. This begs the question – what are they here for? Could charities utilise their reserves more effectively? And how do you convince others – particularly trustees – to adopt a more dynamic approach?

This publication covers:

Why do charities hold reserves?

Every charity will need a certain level of reserves to manage cash flow and provide working capital for day-to-day operations. However, the reasons for holding reserves vary between charities, depending on factors such as income and activities. Reasons go beyond the 'rainy day' scenario – reserves can also provide cover for black swan events or fund investment in new ways of working.

However, **charities need to justify their reserves**. Holding a high level of cover for risks and unforeseen events appears sensible, but is this right if worthwhile projects are going unfunded? Charity funds are meant to be spent; therefore charities should be able to provide solid, considered justification for keeping funds back as reserves and not spending them.

Allocating resources – setting a reserves policy

Charities use many different methods and metrics for determining reserves levels. When allocating resources, the risks around future income, expenditure, needs and opportunities need consideration – as well as the likelihood of these arising and potential consequences.

It is important to take a strategic view. Reserves are unspent income and strategic decisions need to be made around when and how this is best spent. To do so, charities must balance the need to manage risks against the need to serve beneficiaries as quickly as possible. To achieve this balance, charities need to have a good understanding of the financial strategy and business model together with the risks inherent in the model.

Reserves planning should form part of overall strategic planning. When performing high level strategic review, organisations need to look at where they want to be and how they are going to get there. This means having a clear financial strategy, but also understanding how reserves will be used to enable the organisation to reach their goals.

Reserves are just one part of the complex financial management of a charity. Well run organisations manage their long-term financial requirements, liquidity and cash flow to ensure that they get the most value out of their assets for the benefit of their beneficiaries. Reserves therefore need to be considered alongside things such as fundraising strategy, risk assessments and future business planning.

Can charities work their reserves harder?

Many trustees and senior managers tend to be risk averse and cautious – supporting the retention of larger reserves. While this is prudent to a certain extent, charities should question whether it could be beneficial to be more ambitious and take a more commercial view.

Reserves can be used as **drivers for change** – to gain access to new streams of funding or increase fundraising activity, or used creatively to support the charity's strategic aims through **programme related investment**. Charities should also consider whether there might be other ways of covering risk rather than holding funds in reserves – through **pooling reserves** for example.

Communicating your level of reserves

With the trustee board

Raising the issue of reserves with the trustee board can be challenging, particularly if looking at reducing the level of reserves. Here, long-term planning and confidence in ability to forecast future incomes is key in ensuring your board is comfortable. Once an organisation is confident that they have reliable future forecasts, they can plan reserves around this.

In reports and accounts
Charities should think carefully about how they present their reserves in their report and accounts. The trustees' annual report provides a valuable opportunity to communicate the reasons for holding reserves effectively to readers. Organisations should also explain the processes that they have been through to develop their reserves policy, including identifying risks and operational requirements.

To grant makers
There are many myths about what funders want to see in charity accounts and particularly in relation to reserves. However, most grant-makers will take a rational view and assess each case on its merits, which is why communicating and explaining reserve levels – whether low or high – is so important.

Whatever decision an organisation makes about reserves, it should ensure that it is an active decision, made as part of the strategic planning, and recognising that reserves are a resource to be managed and utilised to meet the needs of beneficiaries.

What are reserves?

Reserves are the unrestricted funds held as the general funds of the charity, often described as free reserves. In the Statement of Recommended Practice (SORP) for Charities 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)

The funds of a charity are the unspent resources or income, but a charity is not free to use all funds as it chooses. All funds (and income) have to be spent on the charity's objects and area of benefit.

- **Restricted funds** are funds subject to special trusts specified by the donor. This might be because there was a public appeal, or perhaps grants or donations for a specific purpose. It may also include land, buildings or other assets donated to a charity. The trustees will be in breach of trust if they use restricted income other than for the specified purpose. Unless specified, interest or other investment income on a restricted fund will be added to the fund. Significant restricted funds have to be separately disclosed in the notes to the accounts.
- **Restricted income funds** are received for spending in the short-term on the specified purpose.
- **Permanent endowment funds** are donations that have been given to a charity to be held as capital with no power to convert the funds to income. These may be cash or other assets.
- **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.
- **Unrestricted funds** are funds available for the purposes of the charity, 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.

The term 'reserves' normally excludes endowments and restricted funds, and also any part of unrestricted funds not readily available for spending, e.g. fixed assets. The reserves policy should cover all unrestricted funds including designated funds to explain whether such funds are readily available for spending or not. Charities are obliged under the SORP to account for each type of fund separately so systems must be adequate to account for each type of fund and to track the income and its expenditure.

Why do charities hold reserves?

Introduction

This chapter explores why charities hold reserves and looks at the reasons given by different charities. It also considers the drivers for reserve levels and why some organisations will have much higher levels of reserves than others. The case studies and existing guidance for charities show that the majority hold reserves to manage the risk that income levels will dip. Other reasons for holding reserves include the need for working capital and provision against specific liabilities. Some charities also save income to invest in new activities and developing new services.

Legal background

Charities receive funds to spend on the charity's purposes – the objects for which the charity is registered. Tax relief is only given to charities on the proviso that the funds are applied to its charitable purposes. Therefore there is a presumption that charity income will be spent rather than retained.

The Charity Commission states in CC19:

> 'Charity trustees have a general legal duty to spend income within a reasonable time of receipt. Trustees may spend this income to fund charitable activities, in acquiring assets to use in the charity's work, and in meeting the day-to-day running costs of the charity. To hold income in reserve rather than spending it, trustees rely on an explicit or implicit power to hold reserves and they must use that power in the charity's best interests.'

So charities should assume that they should use the funds they receive and should have good reasons for keeping funds back and *not* spending them.

An honorary treasurer's view

David Walter is currently Honorary Treasurer of Arthritis Care and has had plenty of experience working at a senior finance level within the sector.

David is clear that reserves are funds that donors have given for beneficiaries which are as yet unspent on their behalf. Therefore, an organisation always needs to be able to justify why it has not spent its funds and this justification should not simply be because they want to build reserves.

David stresses the importance of trustees being clear on the distinction between the different types of reserves. Restricted funds and properly designated funds are straightforward to identify, but general free reserves require more thought. Reserves that are not cash-backed are not really true free reserves. True 'rainy day reserves' need to be cash-backed and should be sufficient to cover the uncertainties you cannot budget for, as well as the costs of a serious event when all other options have been exhausted.

David says that as a board member he would expect any spending of reserves – or indeed any growth in them – to be tightly managed, using robust budgeting and cashflow forecasts. Ultimately any use of reserves should be determined by strategic considerations. When undertaking a strategic review, organisations need to consider where they want to be and how they are going to get there. This means having a clear financial strategy, and understanding how reserves will be used to enable the organisation to reach its goals.

David feels strongly that a lot of training and support is required in the sector to educate non-financial trustees to understand the reserves portfolio and how to make decisions about reserves. For individuals who are often quite removed from the operations and activities of an organisation, making the strategic financial decisions can be daunting and challenging. David feels that support organisations within the sector have a real part to play in addressing this.

Reasons charities give for holding reserves

The Charity Commission undertook research in 2003 and found that charities gave the following reasons for holding reserves:

- ensure continuity in the event of a large variation of income (71%)
- spend in emergencies (41%)
- pay for specific future projects (40%)
- bridge cash flow problems (37%)
- cover specific liabilities (29%)
- generate income (20%)
- other (1%)

Holding reserves as an endowment fund to generate income is not a legitimate reason to hold back funds, unless the charity has an express power to accumulate. Charity trustees are under a legal duty to spend the charity's income within a reasonable time of receiving it.

The other reasons given above for holding reserves may sound similar to each other; amounting to contingencies or a reserve to cover a specific liability. If charities hold reserves to cover a contingency and also allow for this same risk in their budget as well, they are double-counting the risk.

Views from the sector – why should charities retain reserves?

Gary Forster, Chief Executive of Transaid, talks about why his organisation holds reserves:

> 'Our organisational reserves serve two purposes – firstly they are there to mitigate risk; allowing us to navigate unexpected drops in income or sudden short-term increases in expenditure. Secondly our reserves provide a pool of resources which we can dip into when we need to cover gaps in funding, for example, if we need to proactively hire a team ahead of programme commencement.'

Andrew Hind, former Chief Executive of the Charity Commission, is of the view that charities should only retain reserves to manage continuity, i.e. the risk that charitable programmes will be jeopardised because of a fall in income.

> 'A charity should hold reserves for only one reason. That is to ensure, as far as is reasonably possible, that the charity's future expenditure objectives can be met, given certain assumptions made about future income streams. In the extreme case, if the charity has no future expenditure commitments, it needs no reserves. If it has a guaranteed income stream, equivalent to expenditure commitments, it needs no reserves. Alternatively, if the charity has a fixed future expenditure commitment, and no future income stream, its reserves would need to be equivalent to that future expenditure commitment.' (Andrew Hind, *Governance and Management of Charities*, 1995)

Keith Hickey, Group Director Resources at RNIB reinforces this point by explaining that charities should retain funds in reserves for opportunities. His view is that one of the main reasons for keeping reserves arises out of the charity's assessment of future needs. If the external environment for charities is changing, then the needs of beneficiaries change. Charities need to adapt and find alternative solutions, so need resources to invest in new ways of working and managing change.

In his book *Income to Impact*, Adrian Poffley states that reserves should be held for the following purposes:

- to protect the continuity of the charity's work
- to protect the charity's funds from loss in value e.g. market investments
- to provide the capital needed to finance expansion of the charity
- to provide the funds needed to replace assets.

Kevin Geeson is the Chief Executive of Dyslexia Action and Treasurer of both the Institute of Fundraising and Contact a Family. He was previously Chief Operating Officer at RNIB and in that role was also responsible for fundraising as well as finance and knowledge management. Over the years, Kevin has heard a number of reasons for holding reserves:

- they are a good thing
- they might be needed to pay off staff and liabilities in the event of a winding up
- reserves ensure that the organisation can continue if there is a shortfall in income and reserves enable it to take advantage of opportunities.

The second argument that you should have reserves for redundancy costs seems to be the weakest in Kevin's view. This is not a policy for an organisation that wishes to continue to deliver valuable charitable work.

In one organisation where Kevin was Treasurer, the existing policy was that three months' expenditure was held in reserves, but the trustees had a desire to increase this to six months. Kevin helped them to develop the rationale for a reserves policy framed around risks:

- what were the adverse risks and probability that they would come about, leading to a value that can be placed on the risk
- what were the opportunity risks? What does the organisation need to do to invest in its future that it might be reluctant to do if reserves are too low?

In fact, they have now worked on the strategy to diversify income streams so they now have a five-year plan that builds in sustainability. Therefore the need for reserves has reduced and six months of running costs would in fact be too high.

Royal British Legion

The Royal British Legion is the largest charity involved in the support and well-being of the armed-forces community, both serving and ex-serving. John Graham, its Deputy Director General, reflects on a recent review of risks and reserves:

> 'Over the last 12 months we have been exploring why the charity holds reserves, revising the reserves policy and developing an investment policy that ensures funds are available when required. The reserves on the balance sheet total around £75m and are essentially represented by the non-investment properties portion of our investments. They represent some nine months' forward cover of expenditure, a figure previously derived more from managerial feel than scientific calculation. This level of reserves is slightly higher than many charities, but currently it is being used to buffer the cash flow requirements of our large capital investment programme.
>
> The starting point for reviewing our reserves policy was a debate with trustees on why we actually need reserves. This debate has been held in

parallel with our development of a risk policy and we decided that the core reason for holding reserves was to provide cover against what are referred to as ‘black swans’ – those events that have a low likelihood of occurring but, if they did, would have a very significant effect on the business.

These risks are never part of an active risk management process because the cost of risk reduction balanced against impact weighted by likelihood would make it uneconomic to set up processes and procedures that would significantly reduce the risk of occurrence. For ‘black swans’, holding reserves becomes a cost effective way of protecting the charity. So we started to think about what the ‘black swans’ were for us.

We came up with a list of around ten. The most significant would be a major incident in late October or early November, such as a flu epidemic, which would prevent the Poppy Appeal from taking place. During the annual Poppy Appeal we raise over £30m in a three-week period, representing 50% of our annual voluntary income.

We modelled the impact of losing £30m of income. There is no doubt that an event of that magnitude would cause a strategic rethink that would inevitably lead to a smaller organisation. We have the usual long-term commitments of staff and leases, but we have also made grant aid commitments – not least of which is a £50m commitment over ten years to the Ministry of Defence to run the personnel recovery centres for injured service men and women. These commitments have to be protected.

The model for the Royal British Legion showed that making the decisions to set a new strategy could take up to 180 days. During this time, the organisation will need to fund a shortfall of income. Not all the £30m will have to be covered immediately because some immediate cost reduction on discretionary expenditure can start and action can be taken to realise less liquid investments. But there will be a need for some immediate liquidity to cover the drop in income, estimated to be around £10m.

There was some managerial concern that taking trustees through this exercise would cause unnecessary worry. The opposite has proved to be the case. By considering a worst case scenario and talking through how it can be addressed, trustees feel more confident that we have answers for even the worst situation. We are planning to extend the exercise into contingency planning and involve the trustees in the same way.

The impact of this exercise on the reserves of the Royal British Legion has been, firstly, to restructure the investments to meet the draw down requirements of a possible emergency and secondly, to realise there may be scope for reducing reserves towards six months’ forward expenditure. This won’t happen immediately because we need to buffer the cashflow fluctuations on our capital programme. But when that programme is finished, there is scope to reduce reserves and a case will be made at that time.’

Drivers for reserves levels

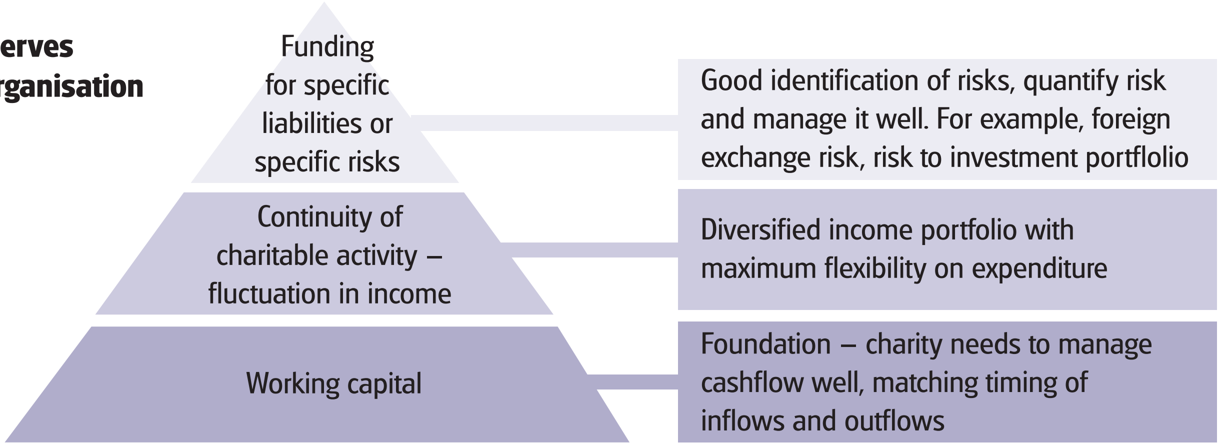
Many organisations use different methods and metrics for determining reserves levels. Gary Forster explains how Transaid sets their reserves policy.

> 'In setting our reserves policy, we haven't had any major challenges except the usual one when you deal with things at a high level, i.e. having a blanket statement like "our reserves policy is to maintain three months' operating costs". It is easy to get buy in from the board as a whole. Once you start to unpack what three months' operating costs means everybody starts to have differing opinions. I sincerely recommend dealing with the detail of a reserves policy at committee level, after which it can be passed to the board for approval.
>
> We have two reserve levels; the main one is £100K (approximately three months' operating costs). I am allowed to go below this down to £70K if I can present a one pager explaining why, what the money will be used for (depending on whether it's simply a cashflow blip or an investment), and the date at which it will be back above £100K. We are not currently at the stage of investing any surplus.
>
> Having been with Transaid for five years I've seen the sudden shocks that can hit – a fundraising campaign isn't as successful as predicted, or project funding gets cut short without warning. If I had a greater appetite for risk I might feel that the £70K reserve amount is being unutilised – but for me, the £70K allows me all the freedom I want to run this organisation without constantly worrying about cashflow.'

So how should charities establish the level of the unrestricted funds that should be held in reserves?

- The level of working capital you need will be driven by the type of activity, and the type of funding for your activities. However, it will also be driven by how well your funding is matched to your activity, and how well you match income streams to outflows. This is treasury management, or good cashflow forecasting.
- Continuity is a genuine risk, but it can be managed. A well-diversified income portfolio and good income forecasting will reduce the uncertainty. It is true that one cannot predict income for a whole year ahead, but you should be forecasting regularly and adjusting the amount needed in reserves as appropriate. You should not have lots of padding in reserves to avoid good management of these risks and better forecasting.
- For specific risks charities need to identify and quantify risks properly and manage them, e.g. stock market movements. Again you should not expect a static figure in reserves.

Uses for reserves within an organisation



Conclusion

Every charity will need a certain level of reserves to manage cash-flow and provide working capital for day-to-day operations. The extent to which a charity needs reserves to manage continuity will depend on how well diversified its income portfolio is and how reliable some of the sources of income are. Some charities will need specific funding for identified liabilities. For each charity, this will be different.

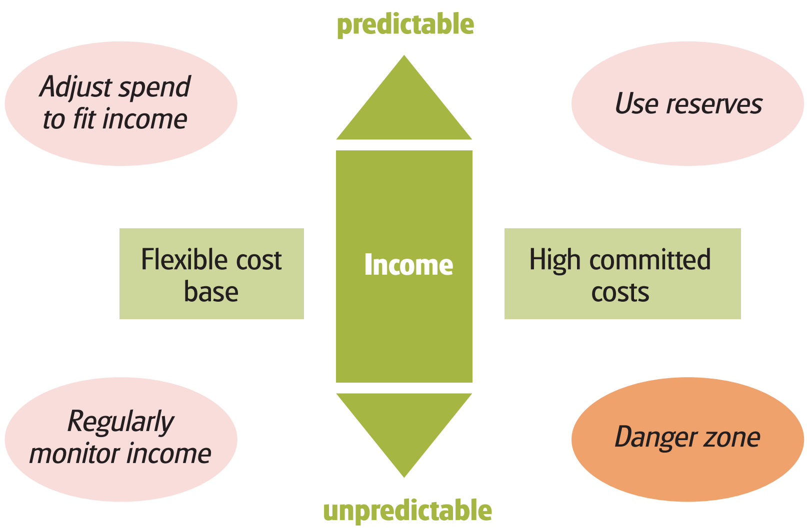
Strategic view of reserves

Introduction

In the previous chapter we stressed the importance of strategic decision making in establishing the appropriate reserves level. In this chapter we explore the detail of how to do this successfully. Reserves are unspent income and the strategic decision to be made is about when, and under what circumstances, charities spend their income. Charities must balance the management of risks against the requirement to meet the needs of the beneficiaries as quickly as possible. To achieve this balance you need to have a good understanding of your charity's financial strategy and business model together with the risks inherent in the model. You may also need to consider how reserves will help your organisation through a period of change. Charities with low reserves can look for alternatives such as borrowing, which is compatible with social enterprise models.

The need for a fresh approach

Many of those interviewed for this publication felt that there were opportunities for charities to take a fresh view of reserves. A good place to start is to consider the business model under which the charity is operating. Where is the risk in the model and why might the charity need reserves? This can be illustrated by plotting the reliability of income against the flexibility of the cost base.



In this diagram, the north-south axis describes income in terms of its reliability. Income will be predictable if it is longer-term, but will include sources such as investment income, legacies and direct mail which may fluctuate. On the other hand a charity with unreliable income is more likely to have sources such as one-year funding and fundraising that is dependent on events, where the risk of loss of funding is high.

The east-west axis describes costs in terms of whether they are fixed or variable. Costs for many charities are fixed and unavoidable unless they close the service. For example, a care home has to operate with a certain number of staff whereas a grant-making foundation can make decisions about how and when it distributes money.

The most comfortable place to be in a time of change is in the top left of the diagram, where the charity needs to understand what its forecast income will be and flex expenditure to match. In this case the charity does not need to have large reserves as it can manage its risks through day-to-day forecasting.

Charities with unreliable income and a flexible cost base (bottom left) can do the same, but their task in forecasting income is more difficult. They remain vulnerable if they suffer a significant loss of funding and may have to consider other options such as collaborative working or merger to gain more secure income. So to manage their risks, they do need some level of reserves, sufficient to buy them enough time to replace lost income or develop a response to the change.

Charities with high committed costs and predictable income (top right), such as a care home, are vulnerable to increases in costs or decreases in income. If these are likely to be relatively short-term changes, these charities should use their reserves to maintain their service levels. Clearly if the reduction in income or increase in costs is more permanent, then using reserves is only delaying a more strategic decision and is not wise.

Charities in the bottom right corner are in the danger zone. If they lose a major source of income, then the charity may be at risk. If income falls, they may be able to use reserves, but may quickly exhaust them as they struggle to reduce costs. Consequently, these charities actually need high levels of reserves. This is particularly the case if they rely on few sources for their income.

The Printing Charity

When Stephen Gilbert joined The Printing Charity (also known as the Printers' Charitable Corporation) some eight years ago, the charity had an income and expenditure of around £3m and unrestricted investment reserves of £21m. Cash was not a constraint but too much money can be just as pressing a problem as having too little. The steps to solving the problem of too much cash as opposed to too little are, in fact, very similar. The major difference is the amount of time you have to solve your problems.

The charity had ambitious plans to assist more people on low incomes, in order to deliver the charity's objects. Although the organisation was cash rich, the charity's stand-alone nursing home was losing money. The trustees were committed to the nursing home and had not appreciated the charity's wealth in relation to its income and expenditure, nor the fact that year-on-year it was helping fewer and fewer people. The first challenge was to identify this as an issue. The next step was to get the trustees to understand and agree that the reserves level was too high in relation to the organisation's need.

The next stage was to organise an away day and to produce a strategic plan. Despite its age, the charity did not have a long history of strategic planning. The process looked at the following questions:

- where are we coming from?
- where are we heading if we keep going as we are now?
- where are we now?
- where do we want to be? And by when?
- how will we get there?

From this came the strategic plan, which led to a review of objectives, services and branding.

Views from the sector – reserves as part of the overall strategic planning

Charities operate to different business models, just as businesses do. Some models are obvious, such as endowed charities making grants from the income earned from investments. Understanding the financial model of the charity allows trustees to plan ahead and incorporate their need for reserves into their planning.

Kevin Geeson observes that a consideration of reserves is absent from most conversations in the board room, among both senior managers and trustees. The topic of reserves does arise when discussing the year end accounts and the budget, but otherwise is only really discussed in a crisis situation. This is probably because reserves are not seen as an element of the finances to be proactively managed. In this view, reserves are essentially the result of other decisions, actions and transactions and therefore they are really just the unspent funds – what you have left. As such the balance of reserves is just an accident of double entry bookkeeping. Geeson has some sympathy with this outlook, because the primary focus for any charity should be on delivering the objects and benefits for its beneficiaries. However proactively managing reserve levels can be a very useful contribution towards achieving this.

Keith Hickey observes that it is key that decision making should be based on the business plan, which should reflect the business model adopted by the charity. This should mean that a consideration of risk and cashflow is an integral part of the planning process.

A good understanding of the business model, the financial flows and the risks presented by the model all help to build a picture of the charity's financial structure. This is even more important if the model is changing, for example, due to new funding methods. Starting from the strategy, the charity should build the business plan, assess it for risk and decide whether to invest or spend.

Allocating resources – to spend or to save?

Financial planning decisions on what to spend and what to save are important for a number of reasons:

- most trustees want to get help to their beneficiaries as quickly as possible
- care is needed to hold back sufficient amounts in reserves to meet contingencies and anticipated risks.

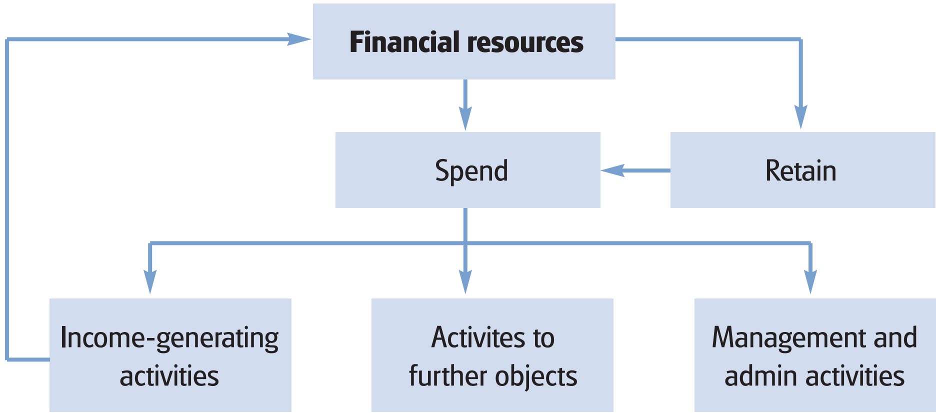
Reserves are held to help you manage financial risks, particularly for volatility of income. While you do not want to run down reserves, you may need to 'borrow' from them in the short-term. Conversely, you may have already dipped into reserves and need to replenish them, so you would not want to commit to further spending until there is greater certainty for future income.

Balancing spend or save decisions

Adrian Poffley comments on this:

> 'There is a constant need for the organisation to manage two principal, competing demands on its financial resources: spending them to meet the objectives of the organisation today versus investing or retaining them in order to be able to meet its purpose in the future. Well run not-for-profit and public sector organisations therefore operate with tight oversight of the flow of funds: on generating income, protecting the funds received until they can be used wisely, and then expending them as intended by the donor.'

Poffley illustrates this in his book *Income to Impact*:



‘The steward’s finance strategy must explain how the organisation intends to manage its finance resources optimally so that it both maximises its impact today while maintaining the organisation as a going concern so that it can have impact tomorrow. The aim is to maximise impact over time not just today.’

EveryChild

Ian Hanham is Director of Corporate Resources at EveryChild, an international development charity working to stop children growing up vulnerable and alone. Although it had done well over the past six years in steadily building up financial reserves, the financial crisis had a significant impact on EveryChild in 2008/2009.

The organisation took timely action to contain and minimise the impact of the financial crisis, but the experience affected its confidence that it could follow through on the newly-evolving strategic direction without further radical action on the existing cost base.

A strategy review in 2010/11 gave a good opportunity to take a longer-term look at reserves. The review process used the Charity Commission guidance on reserves (CC19) as a framework:
Step 1: understanding the nature of charitable funds held
Step 2: identifying functional assets
Step 3: understanding the financial impact of risk
Step 4: reviewing sources of income
Step 5: impact of future plans and commitments
Step 6: agreeing a reserves policy.

This proved to be a helpful and logical structure. It was clear that, through all of the steps, the key consideration was the financial risk profile and the organisation’s risk appetite.

The recommendation from this review was that financial risk was relatively low, even with the ambitious and to some extent untested new direction being pursued, and that the target reserves level should reflect this.

Ian says that the proposed reserves policy was ‘focused on the medium-term as we work through the early implementation plans in the strategy. Reserves should be used to provide a financial buffer such that we can absorb short-term variations to plan and/or take some degree of considered risk in new areas of operation'.

Income was assessed to be the greater risk area, largely because it is less within the direct control of management, and it is not as easy to respond quickly to adverse variances. Regular monitoring of medium-term income projections would be essential to ensure that early action could be taken in the event of income downturn.

The policy broke reserves down into three components:

- A 'liquid' reserve to cover variance to plan and to provide a buffer to allow contingency actions to be effected. This was based on the scenario sensitivity reviews conducted in the financial planning process.
- A 'security' reserve, providing an additional buffer for more radical action (e.g. restructuring) in the event of more serious or more sustained variance than anticipated.
- An 'underwriting' reserve, to allow the organisation to progress with grant-funded projects which require a funding match, before the match had been secured.

Overall, the target reserves proposed were at the lower end on the previous reserves target range, and some way lower than the reserves position at the time. EveryChild moved away from a range defined by months of expenditure, to a target expressed in absolute terms, reviewed periodically.

The conclusion was that EveryChild could afford to undertake the activities in the strategic plan by drawing down on existing reserves. The plan to draw down reserves over the strategy period was the important factor in assessing an investment and cash management strategy. As there is limited long-term investment potential, it was determined that reserves should be held in cash and short-term, low-risk investments. Historically, the organisation has held its reserves in cash – this strategy gave a much clearer rationale for such a policy than had previously been the case.

The linkage of reserves management and financial reporting is extremely useful when trying to break with the conventional cycle of rigid annual budgets and short-termist management within annual frameworks. The reserves projection has now become the single most important piece of financial information in the organisation. Regular reforecasting of the financial outlook is integral to ensuring that this projection is robust, and regular reporting of financial performance against annual budgets, while still essential, is set in a much more meaningful context tied to the organisation's overall long-term objectives.

Managing change

Business models change and so reserves policies may need to change accordingly. It is easiest to illustrate this with an example. Let's take a fictitious example of a charity providing training courses to people working in social care. Over the last twenty years they have earned income from fees charged for courses, which were subsidised by two other income streams – a membership subscription from all the organisations sending participants on the courses and a grant from a central government department. With a change in government and the need for reductions in government spending, the grant was cut. The charity now had to consider how it would meet the shortfall in funding. It had to consult with its stakeholders to establish whether an increase in subscription fees or an increase or course fees would be acceptable. In either case, it had to change to a full income-earning model rather than a subsidised model. This change had a further consequential impact on cashflow, as the grant was received quarterly in advance, whereas more of the income will now have to be invoiced and collected, often in arrears.

Many charities will be undergoing similar significant transformation as the funding model changes:

- charities moving to social enterprise models, charging fees for services rather than fundraising in advance and then spending the funds raised.
- charities working with elderly or disabled people where the funding is moving to personalised budgets. These charities will no longer be dealing with a few block contracts from local authorities, but all their beneficiaries will be their customers, choosing the elements of care that fit them as a package.
- charities changing from grant funding to contracts with payment by results will need capital input to fund the costs while they deliver services and wait for payment.

A common thread in these changed models is the changed risk profile of the new funding structure. In old models of grant funding, charities often accepted low levels of financial risk, with funders bearing the majority of the risk that interventions might not be as successful as hoped or that additional costs might be incurred. With contracts, there is often a transfer of risk to the charity as the expectation is that they will deliver outcomes, with a fixed fee for the work needed to achieve the results. This means that charities need to price contracts carefully to ensure that they have factored in the risk that costs will increase or other unforeseen events occur.

However, it may not be possible to obtain the full price and therefore the charity may have to accept a higher level of risk for contingency costs. This is the financial risk that would have to be covered by reserves or current unrestricted income.

Cashflow risk

Even if a charity can feel reasonably confident that the funding achieved is sufficient to cover the costs, it may still face a major change in the pattern of funding. It is vital that charities plan their cashflow during times of change. Contract funding is frequently paid in arrears rather than in advance. This presents a clear need for additional reserves to be held to fund the working capital needs of the organisation. Alternatively, charities would have to obtain loan funding or an overdraft.

Costs of change

For some charities, the changes they need to make will require real investment. For example, charities moving to outcome-based funding may need to keep detailed records for each beneficiary they work with. This may require investment in a case management system. Or staff may need training in a new way of working, or the charity may experience a drop in the productivity of service delivery while it goes through a transition phase.

Some charities decide to change their funding strategy, possibly due to changes in the funding environment or possibly to achieve a new strategic objective. For example, some charities decide that to manage risk they need to diversify their income, which in turn may involve recruitment, investment in a database, opening charity shops, or investment in direct marketing. This investment may be funded from reserves and it is vital that the financial plan describes the impact the new strategy will have on the level of reserves.

It may be useful to consider the cashflow aspects in terms of a 'payback period'. So you might say that you need initial cash to open a new charity shop, but that the cash investment will be recovered from income after a certain number of months, after which the shop will go into positive cashflow.

Managing with low reserves

Different strategies may be needed to manage the risks and components of reserves for less wealthy charities. On a basic level, charities need to have enough cash in reserves to manage cashflow, but this can be supplemented by borrowing. Small enterprises would commonly have bank overdrafts to help them manage cashflow, so there is no particular reason why many charities should not also have overdrafts.

The Jennifer Trust

Many charities face the challenge of managing on low reserves. The Jennifer Trust was established in 1985 to provide information, support and advice to families living with the inherited neuromuscular disease Spinal Muscular Atrophy (SMA). It also promotes essential research into the causes, treatment and eventually a cure for the disease.

The Jennifer Trust is more fortunate than most charities as it was left a legacy in 1996 which consisted of a portfolio of shares. Some of these shares have been cashed in on a couple of occasions to help with cash flow but were replaced as soon as possible. While these shares form part of the charity's reserves, the trustee board has always seen these shares as a 'rainy day fund'.

One of the charity's biggest challenges has been the ratio of restricted to unrestricted income. While its overall reserves look reasonably healthy, the majority of this sum is restricted. The organisation has never been in the position where it feels it has strong reserves. The reserves policy is three to six months.

The board proactively looks at reserves and understands the importance of setting a realistic budget in order to both grow reserves and also invest in new projects. There is a clear need for forward-looking financial information and cash flow management, as the organisation has learnt from past lessons where money was committed to a round of three year research projects before the funding had been fully secured. However, the board is clear in its remit and ensures that funds generated are spent on information, support and funding research – its core charitable activities – and understands the balance between having appropriate reserves and investing the future.

Going concern

Managing the continuity risk many charities face is obviously a legitimate reason to hold reserves. Indeed, the risk will be much higher for charities with few sources of income. Many smaller charities need to diversify their portfolio of funding to manage their risk, but this is a very difficult process to start when you have no funds to invest. However, it can also be managed through restricted funds. Some charities that have virtually only restricted funding try to ensure that they have secure forward funding for a reasonable period ahead. They measure this as a key performance indicator.

Reserves policies when reserves are low

Charities with lower levels of reserves and fewer opportunities to hold back unrestricted income to build reserves may wish to consider alternative approaches. These are not prescriptive – charities with lower levels of reserves are far more inventive and may be able to come up with their own solutions.

1 The working capital element of reserves will be needed in any charity, but it may be kept to a minimum by managing cashflow well – matching the timing of incoming and outgoing resources as best you can. Small businesses would typically consider an overdraft as another means of managing short-term cashflow needs. This option could be available to charities, particularly if they have secure income streams.

2 Reserves to manage continuity risk are a genuine reason to hold back unspent income as we have seen above. Charities need to identify the risks more precisely and attempt to plan for them in more ways than retaining reserves. Charities that are able to diversify their income or respond to change more quickly will be able to manage on lower levels of reserves. If a charity has high levels of fixed costs, then it is likely that it will be slow to respond to change. This will depend on the nature of its activity.

1 Working capital	Manage cashflow
2 Continuity risk	Diversify income, responsive
3 Specifc risks	Build into price
4 New projects	Borrow or fund
5 Fixed assets	Borrow or fund

3 Charities with high levels of restricted funds may not have unrestricted income to put aside to cover specific risks. They should really be considering all the specific risks connected with their work and the delivery of services when they are preparing bids. In other words, the funding they receive for the work should be adequate to cover these risks.

4 & 5 Without reserves, charities have to borrow or obtain specific funding to develop new projects and purchase new fixed assets. In fact, they may be able to obtain the level of funds they need through a mix of grants and loans. This is common practice in programme-related investment. Larger charities could consider whether they could support smaller charities operating at a local level or providing specialist services in this way.

Conclusion

Charities need to understand their business model, the implications for managing financial risk and the impact on reserves. It is important to be aware of changes to the business model and the consequences for reserves. Charities with low reserves need to consider other options such as borrowing and managing cashflow.

Can charities work their reserves harder?

Introduction

Charities are generally quite conservative and like to have a high level of cover for risks and unforeseen events. This means that large amounts of funds are held on balance sheets yet worthwhile projects remain unfunded. A number of finance directors and fundraising directors agree that charities could be more ambitious and take a more commercial view. From a fundraiser's perspective, charities should compare the return they could earn from investment in new donor recruitment to the return earned from investing the funds in gilts. For a number of charities with case studies in this publication, their review of reserves led them to reducing the level of reserves held by a considerable amount. This lesson is particularly relevant for charities which have been covering risks through the charity's strategy (such as diversifying income) as well as holding back funds in reserves – effectively providing double cover for the same risk.

Drivers for change

Keith Hickey observes that 20 years ago, the charity model was donation-led. A charity would bring the funds in and then use them to deliver benefits and programmes to beneficiaries. Contracts and new forms of financing charitable activity are bringing different skills to the fore. Charities will need to consider reserves in the light of long-term viability, cashflow and liquidity. The emphasis in this scenario is on cashflow, not reserves. This is more in keeping with a social enterprise model.

He adds that recessionary times may galvanise more charities to think about new ways to generate funds to keep up levels of charitable activity for beneficiaries. For example, it would be possible to securitise a legacy income stream. In this scenario, the charity would be able to retain some level of reserves for a rainy day, but gain access to new streams of funding earlier in order to maintain services when beneficiaries most need them.

Ken Moon, Director of Finance, Planning and Operations at Sightsavers, also notes that the focus on trustee liability leads to short-term thinking, emphasising the need to hold a certain proportion of income in reserve. If charities were to take a much longer-term view to funding their work, say ten years, this would probably lead to better planning and greater efficiency and effectiveness. The social bonds now being considered are the early beginnings of such a model. Ken can see that in the future there may be more consortia for this form of funding and it could be used to leverage government funding.

This approach to funding would be much more effective in allowing to charities to scale up to the problems they are trying to resolve. Take an example in the health field. It may be possible to eliminate trachoma from the world if funding between £1–2 billion were devoted to eradication programmes. It would be possible to get funding of that scale if a mixed economy were deployed. This could involve governments, world health bodies, charities and the private sector. As well as funding, in-kind support may be valued, such as private sector companies because their know-how can be used to support delivery of major projects.

Views from the sector – charities are often risk averse

Even if a charity has undertaken a review of its reserves level, the amount needed in total may still amount to a considerable resource. It is highly unlikely that all this would be needed at one time, and yet trustees may be uncomfortable about reducing the level of reserves. Indeed, Keith Hickey points out that it is not only charity trustees who may be risk averse; many senior managers in charities are comfortable with relatively high level of reserves.

Ken Moon, observes that the governance of charities emphasises the responsibility and liability of trustees. Trustees are therefore cautious because they are constantly reminded of their liabilities, supporting the retention of large reserves.

Kevin Geeson, contrasts the typical charity view with that of a business, where a management team would be expected to work their assets hard. A business has a clear focus on the balance sheet and does not allow cash to sit around doing nothing. He also observes that it is harder for non-executives to have the same risk appetite as the full-time managers.

British Red Cross

Rohan Hewavisenti is Director of Finance at British Red Cross and Mark Astarita is the Director of Fundraising. With support from some external advisors the Red Cross has recently been through an exercise to assess whether it can work its reserves harder. At the beginning of the review, Red Cross had free reserves in the region of £35m, but has now agreed that £15m would be an appropriate level.

Rohan has worked in a number of different charities and has noticed the generally conservative attitudes towards reserves. This seems to be based on an underlying fear that the money is going to run out. However, commercial organisations do not tend to operate in this way, but rather borrow against future income streams and have lower amounts of cash tied up as capital. Rohan also pointed out the importance of the opportunity cost of reserves. However sophisticated your financial management, you still need to understand the cost of the capital being held in reserves. You need to remember that £1 today is worth more than £1 in five years' time, therefore, the impact that you could make with £1 today could largely outweigh the impact in the future. There may be more efficient uses of reserves and organisations need to understand their internal cost of capital, as this should inform the level and form for holding reserves.

Organisations need to be careful when holding funds for a 'rainy day'. The past four years have seen the worst recession since the Great Depression, and while overall charity reserves are reported to have reduced, a large number of organisations have not needed to use their reserves significantly. This begs the question of why they retain them. Realistically, everything doesn't stop at once, unless you are a single project organisation, so having reserves equal to closing down costs isn't always appropriate.

One important factor in looking at the level of reserves is understanding their make-up.. Restricted funds should not be included as reserves, and should also not be held in investments or anything volatile, as these funds are required to be spent on specific activity so need to be managed with minimum risk. Rohan and Mark both agreed that true free reserves should be cash-backed and that organisations need to be careful when holding assets in investments.

Because investments are shown at market value in charity annual accounts, this has a misleading effect on the level of reserves. This can skew operational decisions made by organisations. The volatility in investments should not form part of the overall reserves review.

Mark talked about how important the link is between fundraising and finance, and also the key role that fundraising plays in reserves planning. For organisations, particularly large charities, where fundraising income is relatively easy to forecast, there is a lesser need for large reserves. Rohan added that banks are also more open to lending against future income streams and for those organisations which have predictable fundraising income, this does make funding easier to support.

When asked what organisations should be investing in challenging times, both Mark and Rohan felt it was a no-brainer that fundraising is a really key area for organisations. However, it also feels like a challenge convincing boards and others to invest in fundraising. When you compare returns to those in conventional methods of investment, you would find it hard to argue not to invest in fundraising. However, the return from fundraising, particularly certain types like legacies, may not been seen for a number of years, which does add to the risk of fundraising.

Mark added that is really important to remember that spending reserves is a one-off spend and as an organisation, you need to make sure that this is investing in the future, so the spend needs to be made well.

Programme related investment

There may be legitimate reasons why charities need to retain funds, but they could also think more creatively about how they use them in the shorter-term. Rather than spending funds, charities can lend them in schemes that are broadly called programme-related investment.*

* Further information on the practical implications of this is provided in *The Magic Roundabout*, 2003

In this kind of scheme, charities lend to other charities with similar objects, or even to non-charities carrying out activities that fit with their charitable objects. The term covers not only lending, but also equity investment, providing guarantees for another organisation's borrowing, or underwriting its financial position in some way. Charities with less experience in these areas of activity are also choosing to undertake programme-related investment through Community Development Finance initiatives, placing funds at their disposal to lend or grant to others. Investing in specialist charity vehicles and social bonds might also fulfil these criteria. These are all clear ways that larger charities and endowed charities can support service delivery that meets their strategic aims.

Pooled reserves

Charities with low reserves face the greatest problems when faced with risks to the continuity of programmed activity. With the best will in the world, there will still be some residual risk even if a charity has diversified income and manages known risks well. So could charities pool their reserves? This would mean that each charity would only have to have much smaller levels of reserves, but would have access to borrowing from other charities if it needed. For larger charities, this might be a form of programme related investment – when necessary they would lend to a charity that has sufficient similarity of objects. This could be set up in a similar way to the original mutual societies or friendly societies – a form of mutual saving or insurance. Clearly a scheme for pooled reserves would have to have members and rules, but it should be possible to develop such a scheme. It probably only takes a few charities to get together and test this out with the Charity Commission in order to develop a first scheme.

View from a fundraiser – Giles Pegram CBE, consultant and retired Director of Fundraising at NSPCC

Obviously voluntary income for a charity can be volatile, but the purpose of reserves is to provide cover for the risk that the income generated will fall short of expectations. Therefore charities should be prepared to use their reserves for a period of time to cover a fundraising shortfall. This time can be used to make new plans and find other ways of replacing that income and the reserves.

It is important to understand the return that an investment in fundraising activity can generate. There is good evidence to support the case for investment in fundraising. If you invest £1m in a regular giving campaign, then over ten years you would get back up to £3m as a return on your investment, whereas if you invested £1m in bonds, then your return over the same period would only be £300,000. And in fact the payback period for the fundraising investment would only be 2–3 years. In addition, you would be able to flex your investment in fundraising, increasing it when the returns seem good and decreasing the level of spend when the returns seem less favourable. So you have control over the fundraising expenditure and the risk is not as high as it is often perceived. However, the point is that the charity enjoys a significantly better return for a slightly higher risk. The graph below illustrates more starkly the difference, with the red line representing a strategy to invest in fundraising in order to recruit new donors.

£1 million reserves

Pegram also warns that income data has to be used carefully. Legacy income, for example, is inherently volatile: the correct assumption would be to consider the best fit for the trend of legacy income over a long period, say

15 years. However, Pegram has seen examples where the charity uses only the last four years' data and comes to the conclusion that legacy income should be budgeted at a level that is £1m lower than this best fit level. As a consequence, the charity is making decisions to close services as they are considered unaffordable.

A flaw in the preparation of reserves levels based on a number of months of operating costs is that inappropriate costs are included in the calculation. For example, come charities include the cost of acquiring donors in operating costs, whereas in reality this is a cost that would be stopped in the event of a poor financial outlook.

Reserves should be at an appropriate level to reflect the income risk to the charity. For example, regular giving by individuals is a reliable and predictable source of income for charities. Consequently, reserves levels can be lower to reflect the low risk profile. However, some charities have arbitrary levels of reserves and thereby deprive beneficiaries of services.

Conclusion

Charities should consider whether there might be other ways of covering risk rather than holding funds in reserves. Sharing risk and diversifying income portfolios are examples of the alternative strategies that charities adopt. A more commercial undertaking would hold less cash on the balance sheet and make sure that it was working for the charity.

Managing low reserves: a case study from Scope

Geetha Rabindrakumar is Director of Finance at disability charity Scope. Together with Scope's Chief Executive, Richard Hawkes, and Director of Fundraising, Alan Gosschalk, she describes how Scope managed the challenge of moving from having no reserves at all several years ago.

Scope supports disabled people and their families through direct information, care and support services and by campaigning and raising awareness of issues affecting disabled people's lives. Several years ago Scope found itself in a difficult financial position without any free reserves, a situation it rapidly needed to turn around.

The charity prioritised the development of a new reserves policy, one that was fully integrated with its financial planning cycle, and which gave it the flexibility to take advantage of opportunities as well as react to other external changes.

The development of this new approach to managing reserves not only enabled Scope to rebuild its finances at an appropriate pace, but as Richard Hawkes, Chief Executive of the charity explains, 'The increase in reserves levels over recent years has increased our confidence to be able to grow, take risks, and therefore innovate'.

This journey towards financial recovery means the charity is not only in a position now to look ahead to the long-term sustainability of its finances but it is also leading the charity sector with its development of innovative approaches to income generation and financing.

A brief history of the charity's reserves

After reporting operating deficits for several years, in 2006 Scope launched an internal project to review and address weaknesses in the organisation's financial infrastructure and sustainability. While the change project delivered improvements in operating results, the results were not sufficient to offset the impact of cash commitments the charity was tied into, including capital expenditure and pension contributions. Scope was particularly affected by the devaluation of existing investments and legacies as a result of the economic downturn.

This meant despite operating results improving, in 2008/9, the charity reported nil free reserves. Even though the charity held fixed assets, such as the properties it uses to provide residential care and its schools, a lack of free reserves drove the charity to scale back costs, challenged the security of the charity's operations and impeded its ability to fulfil its strategic aims.

The challenges of historical reserves policy

Until 2009/10, the objectives of Scope's reserves policy were to ensure the organisation held reserves to:

- manage risks to which the charity was exposed
- finance capital expenditure and future plans

The minimum level of reserves the charity was required to hold was between 8–13 weeks' expenditure, £15m to £25m. Yet as Alan Gosschalk, Director of Fundraising, stresses 'It's essential that we can demonstrate to prospective donors that our reserves aren't excessive. While we need to be sustainable, we also need to ensure we're spending the money we raise on bringing about changes that benefit disabled people and their families.'

While the reserves policy met requirements of the Charity Commission SORP for the annual report and accounts purposes, there were several drawbacks:

- the policy wasn't integrated with financial planning
- the target requirement wasn't based on a developed rationale linked to a risk assessment
- the target requirement wasn't related to the reality of Scope's financial position or circumstances
- there was no realistic plan that identified how the organisation would reach the stated target.

Developing a modern reserves policy for Scope

One of Scope's current strategic aims, highlighted in the organisational strategy is to 'achieve and build on a position of financial strength'.

'In order to achieve this strategic aim, we prioritised the development of a new reserves policy which would increase our future resilience and therefore our ability to weather future economic downturns', says the charity's Director of Finance, Geetha Rabindrakumar. By identifying specific short and long-term financial risks the organisation is likely to face and evaluating these to determine their impact and the likelihood of them occurring, the charity was able to define what level of reserves it needed to hold to manage:

- short-term cash flow requirements,
- the impact of risks arising from its annual its operating plans and budgets and
- the impact of other medium-term risks.

Alongside this risk-based strategy, a target amount of reserves was set to enable the charity to capitalise on and take advantage of unplanned development opportunities. Under the new policy, the target free reserves level is around £8m, but the nature of the policy framework means this target is updated at least annually to take account of changes to the external environment and the performance of current operations.

Scope's financial plans indicated that it would take approximately three years to reach its target reserves level through improved operating results. The charity also recognised that while it was rebuilding the reserves, it wouldn't be appropriate to utilise them to fund new organisational developments. It therefore also agreed that it needed to fund new developments through additional fundraised income or loan finance during this time.

Securing organisational support

The development of Scope's reserves policy was overseen by a Finance & Sustainability Committee, (made up of some trustees and as well as independent members) prior to approval by the board of trustees.

The Committee endorsed the policy's focus on the charity's specific circumstances, and its capacity to respond to the external context and risks. It also approved the principle of not holding excessive funds in reserves, so that charitable funds were used on a timely basis in order to achieve the organisation's purpose.

However, the Committee also raised concerns about whether the approach would enable the charity to reach its reserves target quickly enough, and questioned whether more drastic measures to secure the target level of reserves in a shorter timescale should have been taken. Despite their reservations and the fact that the target level of reserves defined by the new policy was lower than what other organisations of a similar size and involved in similar activities adopted, the committee was broadly supportive.

'We needed the Committee to champion the policy with trustees', said Rabindrakumar. 'By demonstrating that the new policy would strike a balance, allowing the organisation to invest in areas to further our mission and improve long-term sustainability, at the same time as rebuilding the reserves in the medium-term, we were able to secure their support'.

The role of planning and developments within the reserves policy

Since its approval, Scope's reserves policy has underpinned the charity's financial planning process. A three-year rolling budget is produced, which is updated annually. A key objective of the planning process requires the free reserves to be reviewed and updated regularly to ensure that the overall budget supports objective of reaching an appropriate level of reserves in an acceptable timeframe.

The charity continues to hold reserves primarily to offset the impact of changes in its financial position, including meeting unexpected costs.

The impact on investment opportunities

The introduction of the reserves policy and a risk-based approach to financial planning has driven a review of the organisations investment policy. It aims to ensure the right types of assets are held in order to represent the actual level of risk and the operational time they are intended to cover.

'The fact that we need short to medium-term free reserves to cover our financial risks means the balance of our investment policy has shifted from primarily equities to holding cash', explains Rabindrakumar.

The charity's lack of sufficient levels of reserves has also meant it hasn't been able to invest in new service developments from its own funds. Yet this has driven it to look for other ways of financing activities.

Scope is currently leading the sector with its progression into the social investment market, for example securing loans and grants which it uses to create new services and developing new financial products.

A look ahead

Over the last two years Scope has delivered strong operating surpluses as a result of management restructures, cost controls and property sales as the charity replaces traditional services for disabled people with more modern offerings. This has meant it has rebuilt its free reserves more quickly than originally expected and reported £9m of free reserves at the end of 2010/11.

The charity continues to reassess its free reserves requirements by re-evaluating the financial risks it faces. 'We're now working towards a target level of around £10m free reserves as a result of the increased financial risks we face with our operational services and with public sector funding pressures', reveals Rabindrakumar.

While Scope is in a much stronger financial position than several years ago, cuts to public sector funding and changes to local authority commissioning mean there is an increased urgency to speed up the transformation. Thus the need to significantly raise its income remains critical.

The charity's current three year plan includes investments to expand its charity shop operations and to recruit more individual donors who support Scope financially. These investments are set to deliver increased surpluses over two to three years, but means the charity's free reserves are projected to reduce over the next two financial years.

Once again the decision was taken to the charity's board of trustees. They approved the approach on the basis that a temporary planned decline from the existing reserves position to invest in income generation will generate operating surpluses in the long-term.

Rabindrakumar has been pivotal in steering the organisation to explore new financing mechanisms that allow the charity to maintain liquidity while its reserves are reduced.

As a result, Scope plans to offset the cash impact of its planned investments by raising finance through alternative routes, including traditional bank finance.

In 2010 the charity developed and launched the UK's first leveraged fundraising product which asked high net worth individuals for a combination of donations and soft loans. In 2011 it was one of the first UK charities to enter capital markets with the launch of a listed bond programme. It continues to explore other forms of social investment from both individuals and organisations.

Presenting reserves in your report and accounts

Introduction

This chapter explains the requirements for disclosure on reserves in the annual report and accounts. It also suggests ways to present reserves so that readers can understand the overall financial position of the charity. In particular, this section looks at ways of presenting reserves that are funding fixed assets and the effect of pension fund deficits on reserves policies.

SORP requirements

The charity SORP (Statement of Recommended Practice) requires an explanation of the reserves policy in the trustees' annual report. This needs to set out:

- the reasons for holding reserves
- the target level of reserves
- the actual level of reserves at the balance sheet date.

The policy should cover all unrestricted funds including designated funds, providing an explanation for the reasons for designating funds. In practice it can be helpful to set out all the funds of the charity including restricted funds and ensure that the model used by the charity is understood.

It is also wise to explain any differences between the target level and the actual level of reserves, setting out the charity's plans to achieve the target level. It may also be more appropriate to state the target level of reserves as a range, as in practice, the level of reserves will fluctuate during the year.

Charities should also follow Charity Commission guidance CC19 in presenting the reserves policy in the trustees' annual report.

The aim for this section in the trustees' annual report is to communicate the reasons for holding reserves effectively to readers. It needs to link to the actual amounts in the funds section of the balance sheet.

Balance sheet presentation

The balance sheet needs to show the full amount of the funds held by the charity, with notes to the accounts to explain the movements on those funds. The funds on the balance sheet should be divided into endowment, restricted and unrestricted funds. Designated funds should be a sub-division of unrestricted funds. The element of unrestricted funds not designated is usually called the 'general reserves' of the charity. Notes to the accounts will provide further analysis and explanation of all funds.

Typically the amount of a charity's general reserves will represent the amount available for spending. However, this will not always be the case where unrestricted funds have been used to buy fixed assets such as property and equipment for delivering services. To make the financial position of the charity clearer, many charities designate the funds used in this way. The net book value of the tangible fixed assets will be balanced by a designated fund (or a combination of designated funds and restricted funds).

Many charities will find it useful to demonstrate clearly the level of free reserves. NCVO describe this as 'readily realisable reserves' and show how this is calculated in their trustees' annual report.

Extract from NCVO Report of the Trustee Board for the year ended 31 March 2011

Reserves policy

The Trustees have set a reserves policy which requires that reserves be maintained at a level which ensures that NCVO's core activity could continue during a period of unforeseen difficulty and that a proportion of reserves be maintained in a readily realisable form. The trustees consider readily realisable reserves to be the amount of reserves that are easily converted into cash should the need arise. The calculation of the required level of reserves is an integral part of NCVO's planning, budgeting and forecasting cycle. It takes into account the risks associated with each stream of income and expenditure varying from budget; the planned activity level; and NCVO's future commitments.

The Trustees assess the reserves policy on an annual basis. They discuss levels of readily realisable reserves, NCVO's main commitments and the market valuation of investments. The main risks to both income and expenditure are highlighted and a calculation made of the possible financial consequences of adverse movements.

The Trustees use this information to ensure an adequate level of readily realisable reserves is maintained. In March 2011 the reserves policy was reviewed, and based on the risk analysis, a readily realisable reserves figure of a minimum of £1.7m was agreed necessary.

At 31 March 2011, NCVO's readily realisable reserves were as follows:

	31 March 2011	31 March 2010
	£'000	£'000
Investments	1,740	1,715
Other Working Capital	(658)	(695)
Bank Accounts	1,369	1,464
Readily Realisable Reserves	**2,451**	**2,484**

Risk-based reserves

Disclosure of reserves in the accounts is not just about presenting numbers and justifying financial measurement of reserves. Organisations should also explain the processes that they have been through to develop their reserves policy, including identifying risks and operational requirements.

Sightsavers has a fairly robust business model with reasonably diverse sources of income. The trustees also want to ensure that the donations they receive reach beneficiaries as quickly as possible. Nonetheless, they recognise the need for financial prudence to ensure that they can provide guarantees to programme partners and continuity of funding to programmes

SIghtsavers uses its risk assessment to inform its reserves policy and focuses on key financial risks for this purpose. The extract below explains how they have quantified risk and then covered these risks in their reserves policy.

Extract from Sightsavers' reserves policy

Key risks with the potential to impact reserves have been identified, with a focus on the short-term potential drawdown of reserves requiring time to undertake additional mitigation activities and adjust to the changed financial circumstances.

Financial loss due to currency volatility:

Sightsavers is exposed to exchange rate risk. Most income is denominated in sterling and the Euro, while most overseas charitable expenditure takes place in Africa and South Asia. When sterling depreciates in value, particularly against the US dollar, the ability to maintain funding of overseas expenditure is impacted. Foreign exchange hedging was introduced in 2009 to partially mitigate short-term movement in exchange rates.

A 10% depreciation (un-hedged) impacts funding by around £1 million per annum. A drop in sterling's value to a level significantly below $1.50 would damage the ability to support charitable activity if it persisted for a period beyond six months. However, there would be time to explore cost mitigation options in response.

The financial impact of currency volatility risk on reserves is estimated at £1–2 million.

Inability to raise income

Inability to raise income could have many root causes including recession in fundraising markets, failure to demonstrate impact, or a reputation event such as a significant programmatic failure.

Cash income levels are forecast in excess of £32 million. Income sources are not concentrated to any single donor and a significant portion of voluntary income from individuals is committed through monthly direct debit or standing order (around two-thirds).

A decline in income of 12.5%, around £4.0 million, is estimated as a prudent view of the financial impact of this risk on reserves.

Financial loss due to fraud

Given the spread of countries in which Sightsavers operates financial loss due to fraud is a risk. There is on-going effort to refine and improve the control framework, but investment levels in controls are balanced against operational risk. With the spread of activity internationally and programmatically it is unlikely that any single instance of fraud would be material.

The financial impact of fraud risk on reserves is estimated at £ 100,000–£300,000.

Credit events leading to financial loss

Large supplier credit exposure is mitigated through use of letters of credit. The material credit risk to Sightsavers would be a failure of one of our lead banks, HSBC, SCB, AIB or HBOS. This is unlikely to mean a complete loss of deposit funds, but there would be significant impact on short-term liquidity, as well as overall economic and market confidence consequences that would follow.

There are specific risks associated with the Irish economy, its banking sector and continued participation in the Euro. This situation remains under review.

The financial impact of this risk on reserves, based on holding 10–15% of our cash holdings against a credit event risk is estimated at £500,000–£800,000.

Other

There are other risks Sightsavers faces that could have a financial impact, such as inappropriate controls leading to mismanagement of resources, accuracy of forecasting information or a business discontinuity event at Grosvenor Hall. However, the short-term financial impact of these is less tangible.

Overall, given the risks Sightsavers faces, and unlikelihood that all risks impact at the same time, a prudent case estimated financial impact of risk events on reserves could be in range of £5–6 million. Although this may appear conservative the assessment should give some headroom for potential impact of the 'unknown unknowns'.

Dealing with pension assets and liabilities

When Financial Reporting Standard 17 (‘FRS 17’) was introduced into UK accounting, this required all entities operating a defined benefit pension scheme to bring the assets and liabilities of the pension scheme onto the entity’s balance sheet. With investment values falling, many charities have schemes that are valued under FRS as in deficit. So in 2005, the question ‘do charities need to adjust their reserves policies for pension deficits?’ arose.

Guidance issued by the Charity Commission in May 2005 clarified that the FRS 17 liability was long-term and should not impact on a charity’s immediate ability to meet commitments.

> ‘FRS17 does not, of itself, affect the cash flows of a charity. The contributions made by an employer charity into a defined benefit pension scheme are usually arrived at in accordance with the terms of the pension scheme, in light of advice from its actuary based on the results of an actuarial valuation of the pension scheme and through statutory requirements.’
>
> ‘… Where, under FRS17, a charity discloses a significant pension fund deficit, this does not mean that an immediate liability for this amount crystallises. Similarly, where a pension surplus is disclosed this does not create an immediately realisable asset that can be released straight away and expended on the purposes of the charity. In particular, the disclosure of a pension liability does not mean that the equivalent amount is already committed and is no longer available to the trustees to further the charity's objectives.’
>
> ‘A good starting point is for a charity to exclude the FRS17 calculated asset or liability when calculating free reserves but then to give careful consideration to the cash flow implications that may arise from the accounting disclosure in terms of increased or reduced contributions. Where a charity is confident that it can meet contributions from projected future income without significant impact on its planned levels of charitable activity then it is unlikely that trustees will need to designate any of their existing funds to meet future pension commitments.’

Therefore, it is appropriate for a charity to explain its pension fund position in the annual report. If the charity is continuing as a going concern and can meet the more immediate obligations of contributions, then it is not necessary to cover any pension fund deficit under FRS 17 with the general reserves.

Extract from NCVO Report of the Trustee Board for the year ended 31 March 2011

The pension reserve of £2.5m (£3.0m in 2009/10) is the long-term liability relating to the defined benefit scheme. This does not have an immediate cashflow obligation for NCVO as any liabilities will crystallise as employees take up pension benefits in future years. The scheme moved to a reduced deficit position following the FRS 17 valuation in March 2011.

Conclusion

Charities should think carefully about how they present their reserves in their report and accounts. The reserves policy paragraph in the trustees' annual report provides an opportunity to explain clearly and succinctly to readers what the rationale for the reserves policy is. Designated funds can be used to earmark unrestricted funds that are not available for spending because they are tied up in long-term assets. Providing a charity is a going concern, any pension fund deficit which has to be brought into the accounts under FRS 17 can be considered separately to the general reserves.

What do grant-makers want?

Introduction

There are many myths about what funders want to see in charity accounts, particularly in relation to reserves. However, most grant-makers will take a rational view and assess each case on its merits. This means that charities do need to explain their position well, regardless of whether they have high or low reserves.

Different approaches

There are many varying opinions about the levels of reserves that funders expect to see when considering funding applications. Different foundations approach the whole process of grant-making in different ways, as described by Julia Unwin in *The Grant-Making Tango: Issues for Funders*. Thus different funders will have different approaches to handling the issue of reserves held by applicant charities.

Some funders will consider applications from organisations with low reserves. It may be more difficult however to enter into competitive tendering for commissioned services with low reserves, and in these circumstances small organisations may be better off bidding as part of a consortium as there are likely to be requirements for a certain asset base. However, some funders have a preference for organisations that can demonstrate their need for funding.

The John Ellerman Foundation

Patricia Yearley has been Finance Manager at The John Ellerman Foundation for many years and helps trustees in their assessment of applications by preparing a financial report on each applicant. Patricia explains:

> 'Reserves are not the most important consideration when we are assessing an application, but they are certainly one aspect of our review. Reserves are critical in deciding whether a charity needs a grant from the Foundation. Reserves which are "too high" may mean that they have sufficient funds of their own and are not applying what they have already accumulated in a way which benefits the charity. Conversely, reserves which are "too low" raise questions about the financial stability of the charity. However, there is no simple formula which can be applied to determine whether the level of reserves is too high, too low or about right.'

The John Ellerman Foundation does not have a rigid policy to assess charity reserves. Each application is considered on its merits, taking into account the specific circumstances of the charity. This requires interpretation and judgement. Having reviewed hundreds of charity accounts, Patricia has developed a flexible template to aid this process. This covers the following:

- five-year financial history to show the development of the charity over time, since one year's data can be difficult to interpret.
- sources of income to show how well diversified the income streams are and highlight any risk of reliance on one major funder.
- main categories of expenditure on fundraising, direct charitable work and governance.
- assessing the clarity and appropriateness of the reserves policy, how close the actual level of reserves is to the policy and actions taken or planned to address any discrepancy. The actual free reserves are analysed in terms of the assets held.
- other points of interest such as large outstanding loan commitments, significant assets or unusual transactions.

The key point about explanations of reserves in accounts is that the reserves policy should clearly explain the rationale behind the policy and the level of reserves held. Patricia comments:

> 'What is frustrating is the poor linking and communication in some annual reports. The policy level may be explained and the current level noted, but then the report sometimes fails to address any discrepancy or explain what the trustees plan to do about it.
>
> We are looking for a coherent picture that shows us that the trustees and managers of the applicant charity understand their own need for reserves. If they recognise that they have low levels of reserves and they are undertaking valuable work, that would not put us off funding them. We are happy to take a financial risk in order to achieve social returns. Equally, we also support charities which have strong balance sheets with solid reserves providing we are satisfied that it is prudent.'

Patricia concluded:

> 'This is a complex area. No two charities are the same. So it follows that no two reserves positions or policies are likely to be the same. Judgement is required and further investigation necessary to determine whether they are appropriate, so we will ask questions if we are interested in the proposal. The most important thing for us is that charities have a good understanding of their financial position, including their reserves, and a clear plan.'

Funding strong organisations

Dawn Austwick, Chief Executive of the Esmée Fairbairn Foundation, commented on the practices of grant-makers when she addressed an investment seminar organised by JP Morgan in November 2010 (reported in Charity Finance 23 November 2010). She was making the point that grant-makers can be reluctant to give grants to charities with strong reserves.

Austwick explained that the tendency of funders not to give grants to organisations with high reserves and strong assets, 'subconsciously discourages those organisations from building robust balance sheets. It's symptomatic across the sector,' she said. 'We have got ourselves into a bit of a pickle and we need to unravel it because it is inadvertently making things worse for the sector as a whole. We need to think about building up our organisations because they need to be sustainable.'

Conclusion

Grant funders do say that what they require is a good explanation of the financial position and above all what they want is clarity and straightforward statements of the position. It would be wise to explain the background and the charity's plans to address the issue. The most important thing is to demonstrate that the charity can fund its plans in the future.

Conclusion

Most charities would say that they hold reserves to manage the uncertainty of income streams. However, the reviews undertaken by various charities reveal that a more strategic approach to managing reserves levels can help charities to reduce the funds they hold back 'for a rainy day'.

The interviews and case studies show that there are several other reasons why charities may need to hold reserves, such as responding to change and investing in new services for beneficiaries. There may also be specific risks and liabilities, such as foreign exchange risk.

Most charity managers recognise that they are holding back reserves to manage risks. As part of the organisational strategy, they might have other ways of managing those risks, such as diversifying income or adopting a different business model. Consequently, the levels of reserves previously held were often shown to be higher than necessary when the other strategic ways of managing those risks had been taken into account.

Finally, charities need to present their case for holding reserves well to external stakeholders. Donors and funders need to feel confident that their funds are being held back for good reason and not simply to make trustees and managers feel more comfortable in their beds at night.

Appendix
Developing a reserves policy

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 most common approach can be summarised in the following steps:
- Understand your funds and balance sheet
- Review your income streams for reliability, sustainability and diversity
- Review expenditure patterns and the degree to which the charity is committed to expenditure
- Overall assessment of the risk profile of the charity and the level of reserves needed to manage financial risk and exposure to changes in income to cover committed expenditure.

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.

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 set-backs 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.

Designated funds

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 and Reserves)

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, issued June 2003

CC19 Charities and Reserves Guidance published by the Charity Commission, June 2010

Charity Reserves and Defined Benefit Pension Schemes
Charity Commission guidance, issued May 2005

The Governance and Management of Charities
by Andrew Hind. Published 1995 by Voluntary Sector Press

A Practical Guide to Financial Management for Charities and Voluntary Organisations
by Kate Sayer. Published 2007 by the Directory of Social Change
ISBN 1 903991 72 2

Not Just for a Rainy Day?
by Shirley Gillingham and John Tame. Published by NCVO, 1997

The Grant-Making Tango: Issues for Funders
by Julia Unwin. Published by The Baring Foundation and others

Income to Impact: The Financial Stewardship of Not-for-Profit and Public Sector Organisations
by Adrian Poffley. Published by the Directory of Social Change, 2010

The Trustee's Dilemma: to spend or to save?
Published by the Coalition for Efficiency, February 2011

Magic Roundabout – how charities can make their money go further
by Geraldine Peacock, Keith Hickey, Paul Voller, Kate Sayer and Nick Wilkie. Published by Bircham Dyson and Bell and Sayer Vincent. Available to download from www.sayervincent.co.uk

CC RS13 Tell It Like It Is: The extent of charity reserves and reserves policies
Published by the Charity Commission, November 2006

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Authors

Kate Sayer, *Partner, Sayer Vincent*

Louise Smith, *Finance Director, ACEVO*

Steering group

Keith Hickey, *Group Director Resources, RNIB*

Bruce Leeke, *Head of Operations, Institute of Fundraising*

Mark Lever, *Chief Executive, National Autistic Society*

Alastair McCapra, *Chief Executive, Landscape Institute*

Colin Norman, *Finance Director, EPP CIC*

Giles Pegram CBE, *Consultant*

Rekha Wadhwani, *Chief Executive, Helplines Association*

Article and case study authors

Stephen Gilbert, *Chief Executive,The Printing Charity*

John Graham, *Deputy Director General, Royal British Legion*

Ian Hanham, *Director of Corporate Resources, EveryChild*

Geetha Rabindrakumar, *Director of Finance;* Richard Hawkes, *Chief Executive* and Alan Gosschalk, *Director of Fundraising, Scope*

Case study contributors

Heather Brown, *General Manager, The Jennifer Trust*

Gary Forster, *Chief Executive, Transaid*

Kevin Geeson, *Chief Executive, Dyslexia Action*

Rohan Hewavisenti, *Director of Finance and Business Development* and Mark Astarita, *Director of Fundraising, British Red Cross*

Keith Hickey, *Group Director Resources, RNIB*

Ken Moon, *Director of Finance, Planning and Operations, Sightsavers*

Giles Pegram CBE, *Consultant*

David Walter, *Honorary Treasurer, Arthritis Care*

Patricia Yearley, *Finance Manager, The John Ellerman Foundation*

Beyond Reserves

How charities can make their reserves work harder

Charity Finance Group, ACEVO and the Institute of Fundraising have teamed up to produce a publication on the strategic management of charity reserves.

In the current economic climate, an increasing number of charities are looking for guidance on best practice in relation to reserves. Should they use them to fund deficits or only to invest in new ways of working or to restructure in response to changes in the operating and funding environment? Or should they retain them and cut services?

This publication goes beyond a simple 'how to' guide, and explores when and how you might want to utilise reserves as part of your wider financial strategy. It also looks at issues you might encounter, such as funders questioning your level of reserves or reluctance to spend from your trustee board. Persuading the board to use reserves is a challenge for many charities – it is important that you make a clear and compelling case to communicate to trustees and the rest of the charity.

The publication is a collaborative project in recognition that reserves aren't solely an issue for the finance team – CEOs, trustees, finance and fundraisers are all stakeholders and it is essential that the whole organisation is engaged.

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sayer vincent auditors and advisors