Charity Reserves - from basics to best practice

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Charity Reserves - from basics to best practice

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What are we going to cover?

Charity Reserves - from basics to best practice

- What do we mean by reserves and why are they important?
- How much should you hold in reserves? Using best practice to set your reserves policy.
- An example of a best-practice reserves policy.
- Using reserves as your guide for financial planning.
- What does the SORP consultation have to say on the subject?
- Time for Q&A at the end.

The basics: charity funds

Charity funds

The basics

What do we mean by…

- Unrestricted funds?
- Restricted funds?
- Designated funds?
- Endowment funds?

Unrestricted funds

What are they?

Funds that can be spent on anything in line with your charitable objects.

Restricted funds

What are they?

Funds which the donor has specified must be used for a specific purpose, known as a restriction.

Designated funds

What are they?

Funds which <u>the trustees have set aside for a specific purpose</u> (from unrestricted funds).

Endowment funds

What are they?

Restricted funds set aside to be used in the long term.

Permanent endowments generate returns but can't* be spent down. Expendable endowments can be spent down over time.

(* without permission if it's over £25,000)

The basics: what are reserves?

Reserves are freely available unrestricted funds.

So, what counts as freely available?

Count me in!

Unrestricted funds that are readily available to spend on anything covered by your charitable purpose.

Cash and invested funds all count, and you should also introduce treasury management and investment policies (not covered today).

Keep me out of it!

Things that can't easily be spent, even if the value is included in your total unrestricted reserves. For example:

- Fixed assets
- Social investments
- Designated funds - you've already set these aside for something else!

So what about restricted or endowment funds?

These are not normally included within reserves, since the restriction means they are not “freely available”.

<u>However</u>, they may have a bearing on how much a charity decides it needs to hold in reserves.

The basics: what is a reserves policy?

Holding the tension

Balancing the tension of competing obligations

<u>Spend charitable funds quickly and efficiently!</u>

The Charity Commission expects charities to spend donors’ money wisely, efficiently, and promptly. It doesn’t want trustees hoarding funds “just in case”.

<u>Make sure your charity remains financially sustainable for as long as it is needed!</u>

The Charity Commission also expects trustees to ensure the charity remains financially sustainable for as long as it is needed.

A reserves policy is the key!

Keeping it in balance

Work out how much your charity needs to hold to remain financially sustainable, and make sure anything left over is spent efficiently and effectively. This keeps the two competing obligations in healthy tension.

A clear plan for donors

Donors may be less likely to give if they think a charity’s reserves are too high. A well crafted reserves policy can help explain to donors why you hold reserves, and that you are financially sustainable. Explain it in your annual report in the clearest way you can.

Trustees must set a reserves policy that sets out how much the charity should hold in reserves.

So how much should my charity be holding in reserves?

How much should my charity hold in reserves?

It depends.

How much should my charity hold in reserves?

It depends on the nature of your charity's business operations, income streams, strategic plans, and assessment of risk.

If reserves are too high, you may be limiting your charitable impact.

If reserves are too low, you may be risking your ability to carry out charitable activities in the future.

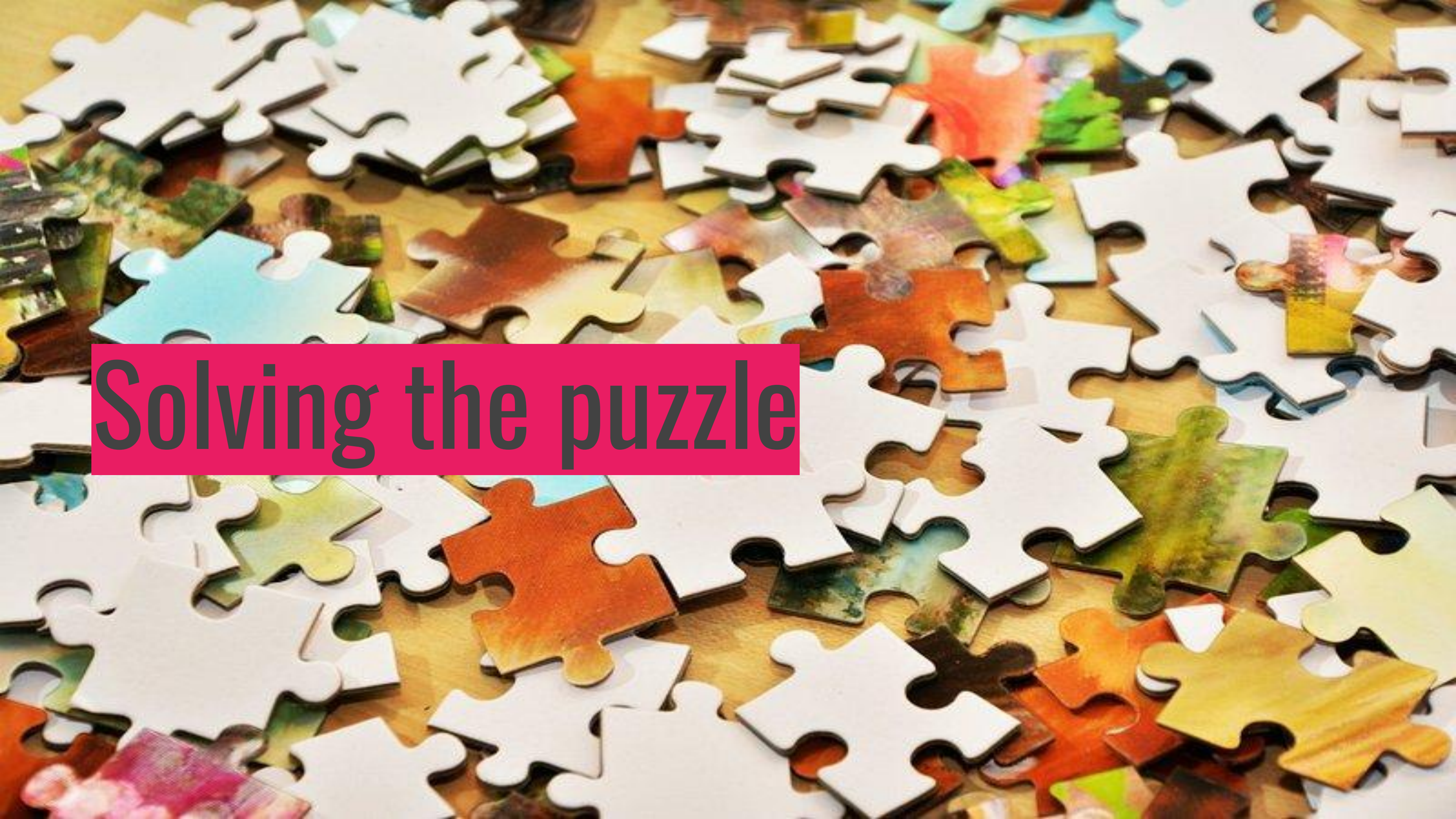
How much should my charity hold in reserves?

There is no one-size-fits-all reserves policy, and gone are the days when “between 3 and 6 months of running costs” was considered acceptable.

The approach you take will vary with the size, complexity of activities, legal structure and the nature of funds received and held by your charity.

Your policy should set a target level, or target range for freely available reserves.

Solving the puzzle



How do I work the level or range out?

Charity Commission guide CC19 is your friend!

The basic requirements are to think about:

- Income expectations for the years ahead
- Expected expenditure based on planned expenditure
- Future needs, where income alone won’t be sufficient to cover the cost
- An assessment on the likelihood of a shortfall in income, and the need for reserves to fall back on.

Best practice: setting a risk-based reserves policy (using CC19)

For smaller charities

A simple guide for smaller, less complex charities

CC19 Annex A

- An amount to cover unforeseen emergencies - apply your judgement to determine the likelihood and cost.
- A contingency fund to meet unexpected operational cost increases
- Planned spending commitments which cannot be met from expected future income.
- A contingency fund to cover “troughs” in cash flow.

For larger charities

Using best practice to set a risk-based reserves policy.

CC19 Annex B

- Sets out a step-by-step guide to working out your reserves target level or range
- It's a guide, not a prescription - you need to apply it to your charity's circumstances.

Best practice for larger charities

Step 1

Understand the nature of the funds your charity holds.

This includes thinking about how restricted funds might impact the level of free reserves you need.

Step 2

Identify any functional assets and consider why you have them.

Could they be sold in an emergency to free up funds for the charity to continue its operations?

What do you need to exclude from your calculation of available reserves?

Best practice for larger charities

Step 3

Understand the financial impact of risk.

For example, for some charities, there may be a risk of a sudden demand on services, which will have a financial cost.

For others, it could be the risk of wild variations in investment valuations.

Step 4

Assess your expected future income streams and consider how certain or predictable they are.

Roughly speaking, the less predictable your future income is, the more you need to consider holding reserves to offset falls.

Best practice for larger charities

Step 5

Consider the impact of your future plans and strategy.

Are there particular activities, for example, that you would want to protect in the event of a reduction in funding?

Putting it into practice: an example

An example

A health charity's reserves policy

This is an example. Each charity is different but by following a similar thought process you can achieve a risk-based policy.

Six steps to set a target range for reserves

- An example based on Charity Commission best practice guidance.
- Designed to continue operations and provide for unexpected closedown
- Sum of steps 1-5 is the lower target. Add step 6 to get the upper target of the range.

1. Income risk mitigation
2. A discount to reflect early termination of certain activities
3. Investment volatility mitigation
4. A provision to keep the future pipeline of new research commitments flowing
5. A discount for "functional assets" that could be disposed of
6. A small working capital requirement.

Steps 1 and 2: income risk and early termination of activity

Future income streams, Financial impact of risk

Income Risk

- Calculated by applying a risk factor to the coming year’s budget
- Analysed by income stream
- Assessment of risk is broadly based on recent history
- Full detail presented to Trustees when they approve the updated calculation.

Early termination

- If we were closing down, what would we stop?
- Mainly fundraising activity.
- Apply a discount to calculation for the estimated savings of early termination.

Step 3: investment volatility

- Calculated by looking at the range of volatility in our investment values over the preceding 3 year period.
- A maximum volatility cap is applied, to prevent over-providing.
- Applied to the latest valuation to give a value to hold in reserves.

Financial impact of risk

Step 4: Research activity

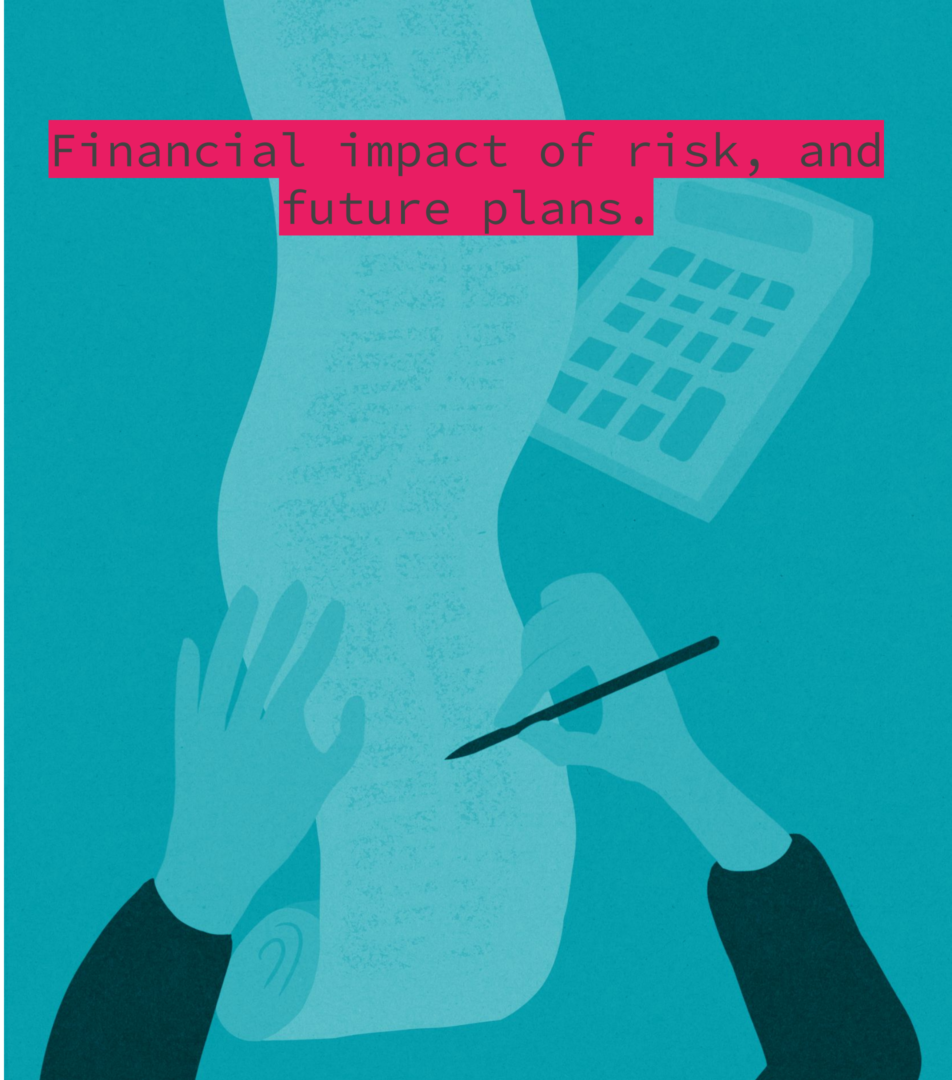
- Nothing to do with historic commitments (recognised in full at the time they're made).
- This is about stabilising the flow of research output.
- A provision to ensure we can continue to fund research during periods of financial volatility.

Step 5: functional assets

- Do you have assets you could sell, even if for a marked-down price?
- Estimate the emergency-sale value, and apply that as a discount to your reserves requirement.
- In this example, an office was assumed to be saleable in an emergency for 50% of its market value.

Step 6: working capital

- Steps 1-5 give us our lower target.
- To work out our upper limit we add a working capital allowance, calculated based on the budget for the year-ahead as follows:
  - Total planned expenditure less grants
  - Adjust for early termination activity as in step 2
  - $1/12^{th}$ of the result.



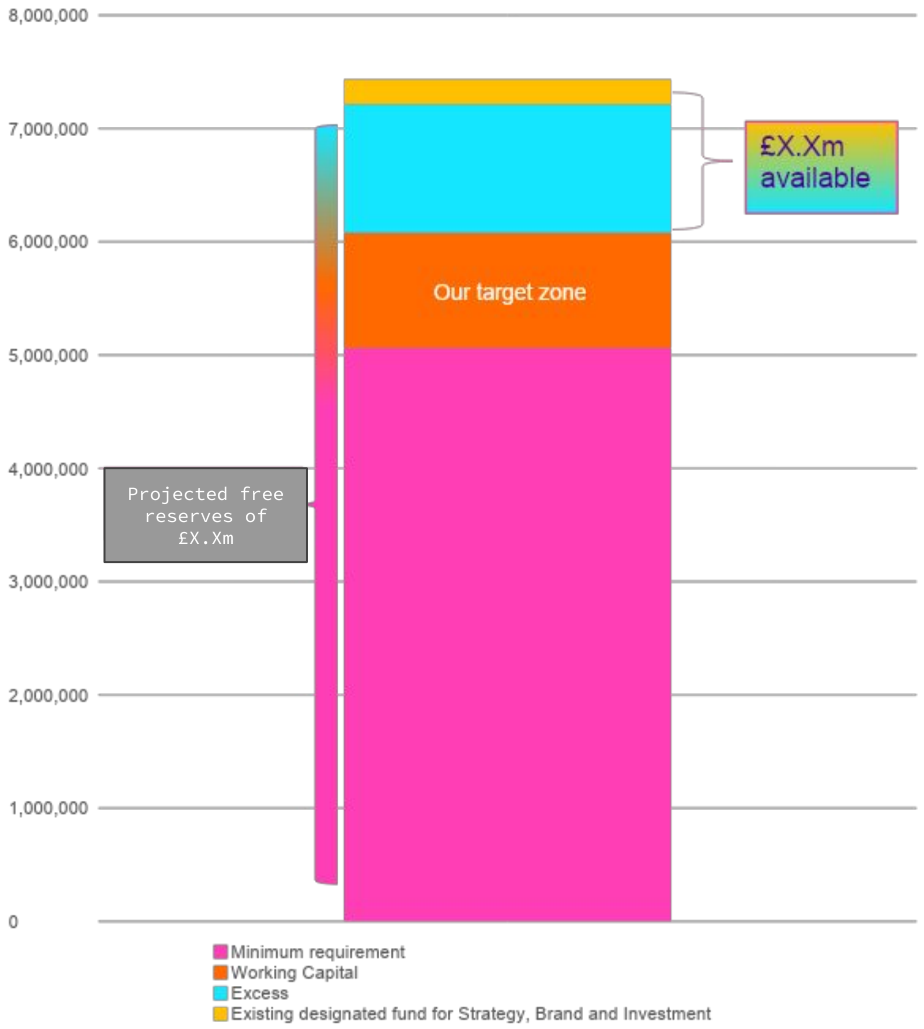
How does it come together?

The result is a detailed calculation, which is then summarised like this...

	Step	Impact +/-	Total core Reserves Requirement £
Income risk	1		
Total requirement to cover income risk		+	3,198,240
Expenditure factors	2		
Discount for activity terminated early in an unexpected closure		-	(614,086)
Investment volatility risk	3	+	1,847,663
Provision for future research activity	4		
Net funding required for planned research activity		+	2,000,000
Functional Assets	5		
Discount for available functional assets (Property)		-	(1,100,000)
Total reserves requirement - lower limit		=	5,331,816
Working capital requirement. 1 month	6	+	953,945
Total reserves requirement - upper limit		=	6,285,761

How does it come together?

… and presented like this to show trustees where our position relative to the target.



So you’ve set a reserves policy. Now what?

Next steps once you've set your policy

Designating "excess" funds

If your available free reserves are far in excess of your target level or range, then you may wish to spend some of this "excess" on furthering your charitable mission. For example, launching additional investment in certain key strategic activities for a fixed period.

Using reserves management to set your plans and budgets

If you have a target level or range, your budgets and plans can be set to maintain this in the short to medium term.

Rather than always aiming for a break-even budget, set a target surplus or deficit to bring reserves into line, if they're not.

Designating funds

When and why to do it

If you designate your "excess" funds, this separates them from your freely available reserves, so the remaining level is closer to your target.

This also signals to donors that you have a clear intention to spend those funds.

Designating funds

How to do it

Designated funds must be for a specific purpose. For example, a plan to boost charitable activity in the short to medium term, or investment in income generation to grow your charity.

Trustees collectively approve the plan to designate the funds.

You can undesignate or redesignate them if something changes.

Reserves led financial planning

A different way of thinking.

Once you have a clear target level or range for your reserves, you can set your budgets (and the plans behind them) to maintain it.

For example, if you have less than your stated target, you plan for surpluses, and if you have too much, you plan for deficits.

Reserves led financial planning

A different way of thinking.

Moving away from a “break even” mindset can be challenging and running large deficits in particular can be concerning for staff and key stakeholders. Designating funds is a good way of dealing with this.

What about the new SORP?

Clearer definitions

Removing ambiguity

Clearer definitions of what to include in your assessment of reserves, and what to exclude.

Clearer explanation of the impact of restricted and endowment funds.

Clearer disclosures

Making it easier for the reader to understand.

A requirement to reconcile the reserves in the Trustees Annual Report to the figures in the accounts.

Optional presentation on the balance sheet to show the required reserves as a separate line.

Thank you

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