

How should I set my charity's reserves policy?

This question, more than any other, is the one most frequently asked of us as auditors and advisors. And forgetting all about technical matters related to the FRS's, it's also the most difficult to answer. And it's one of the most important, particularly as we sail into the murky waters of public spending cuts, delicate economic recovery and increases in the rate of VAT. So how do we start to address it?

The 'simple' approach

The SORP defines reserves and tells us what to disclose, but of course it doesn't tell us, and can't tell us what reserves level we should set. And with good reason.

One of the simplest ways to think about the most appropriate level of reserves is to think of yourself going to see your own personal bank manager. You might tell him that you were concerned about your financial position and that you needed to know how to manage your finances and what level of available cash it was appropriate to have put away (to cover for all of life's eventualities). Your bank manager, adept in the ways of financial advice, would embark upon a series of questions, which may well run as follows:

- *what level of income do you have, and how does this compare to your outgoings on a monthly/annual basis?*
- *what level of investment in non-monetary assets do you have and how easily can these be converted into cash?*
- *what level of personal risk do you carry? What is the risk that your income sources may expire or that some calamitous event might occur that would render you incapable of continuing your work?*
- *should push come to shove and you had to call a halt to your employment, what level of assets would be needed to meet all of your future obligations?*
- *is there anything that you particularly want to do or might need money for in the short, medium or long term? What are your aspirations?*

And these are pretty much all of the considerations that need to be addressed in assessing the charity's own reserves position.

In more detail

Budgets and forecasting

The first, most fundamental question is one of forecasting and financial strategy. In order to be able to set the most appropriate policy, charities have to know what their financial position is going to look like over at least the medium term (by which we mean a 3, 4 or 5 year period). Do your projected surpluses/deficits support your business plan *AND* your policy on reserves or does it look like neither will be achieved? If we believe now that major sources of funding are at risk while a significant element of your cost base is fixed, it may be futile to adopt a status quo approach to reserve levels. Overseeing sound financial management is of course a key element of trustees responsibilities and hence for that reason alone, trustees may wish to draw the link between financial outlook and reserves levels.

Charities also need to be clear about their aspirations. For example, if you have identified an opportunity to extend the charity’s activity, for example by taking advantage of the demise of a competitor, or some favourable new area of contracted activity, be aware that such opportunities also carry with them the responsibility to conduct financial planning, which ultimately has to be linked to an analysis of your reserves position. For example, taking on additional resources or getting involved in new contractual relationships for your services can have dramatic consequences on the timing and quantum of cash flows. Consider the forecasting of cash receipts in detail and consider whether cash payments are manageable on that basis.

Be careful to ensure that you consider not just the required levels of free reserves, but also the real-life everyday reality of cash flow management. Anticipate issues with cash flow and be sure that activity is managed to address these.

Liquidity and non-monetary assets

Non-monetary assets (fixed assets, long term-investments) represent something of a fairly unique problem when presenting and assessing the reserves position of any charity. This is because ‘reserves’ has a special meaning within the SORP. SORP Glossary GL51 tells us that ‘reserves’ describes that part of a charity’s income funds that is freely available. This definition therefore excludes:

- any endowment funds;
- restricted funds; and
- any part of unrestricted reserves that is not readily available for spending (ie, fixed assets).

Broadly speaking then, ‘free’ reserves =

Net assets	V
Less: endowment funds	(W)
Less: restricted funds	(X)
Less: fixed assets held for charity use	<u>(Y)</u>
‘Free’ reserves	Z

In short then, most charities need to be clear that they should exclude restricted funds and fixed assets (relatively few will have endowment funds). Care should also be taken however with designated funds. Although part of unrestricted funds, the fact that designation has taken place suggest that some element of essential spending has been identified, and hence the funds required to pay for that are not technically ‘free’.

It is the exclusion of fixed assets from our analysis that can cause difficulty for many charities, as doing so can very easily turn ‘Z’ above into a negative number. Many charities occupy property (which they may have borrowed to finance) either to deliver charitable objectives directly (care homes, hospices etc) or to accommodate their support functions and staff and those assets may be held at a substantial book value. **However**, when we calculate free reserves we **exclude** the asset but we **include** the associated borrowings. So, we take an asset of substantial value out of the equation and include a substantial liability.

An illustration would be useful here – imagine a charity that completes a property transaction on the very last day of its financial year end. Prior to completion, it had no fixed assets, cash of £500,000, debtors of £50,000 and creditors due in less than 1 year of £100,000 – restricted funds accounted for £50,000 and unrestricted funds £400,000. The cost of the property is £400,000, which has been entirely financed by a mortgage. Take a look at what happens to the balance sheet pre and post transaction and the impact upon ‘free’ reserves:

Pre completion		(£)	Post completion		(£)
Balance sheet	Fixed assets	-	Balance sheet	Fixed assets	400,000
	Cash	500,000		Cash	500,000
	Debtors	50,000		Debtors	50,000
	Total assets	550,000		Total assets	950,000
	Creditors <1yr	(100,000)		Creditors <1yr	(100,000)
	Total assets less current liab.	450,000		Total assets less current liab.	850,000
	Loans >1yr	-		Loans >1yr	(400,000)
	Net assets	450,000		Net assets	450,000
Comprising	Restricted funds	50,000		Restricted funds	50,000
	Unrestricted funds	400,000		Unrestricted funds	400,000
		450,000			450,000
Free reserves	Net assets	450,000	Free reserves	Net assets	450,000
	Less restricted reserves	(50,000)		Less restricted reserves	(50,000)
	Less unrestricted fixed assets	-		Less unrestricted fixed assets	400,000
	Free reserves	400,000		Free reserves	-

Using the SORP definition, the investment in fixed assets has completely wiped out our charity’s free reserves, as we exclude the asset, but not the related finance. This has been done even though the working capital position of the charity is completely unchanged and even though the charity might remain entirely viable assuming that its financial position is sufficiently stable that it can continue to service the capital, interest and other creditors. Note also that neither would the impact upon the free reserves position improve if the charity part-financed the acquisition with its own cash. The problem is not how fixed assets are financed, but rather it’s the fact that the calculation of free reserves ignores the relevance of financing fixed assets.

One can quite easily imagine how the uninformed reader of the charity’s reserves policy disclosures might draw a negative conclusion with regard to its financial risk, notwithstanding the fact that it may in the longer term be in a much stronger position with regard to lower establishment and property related costs.

So what do we do? The answer is to be explicit when describing the charity’s reserves position. The charity is required to quantify the free reserves position when applying the SORPs definition of free reserves, but in a situation like that described above, it might also comment that the zero (or low) ‘free reserves’ position “is attributable to the fact that the SORP’s definition of reserves excludes the fixed assets which have been financed by long term liabilities which are included within the definition.”

The charity might also go on to state that “for the purposes of short and medium term financial management, the trustees are concerned more with the management of working capital, and the healthy working capital position is entirely in line with their policy of holding free resources sufficient to fund X months of ongoing unrestricted expenditure to cover the eventuality of a material decline in incoming resources.”

Risk and contingency

The trustees, who are often also directors of the Charity for company law purposes, also need to satisfy themselves that the charity will remain able to fulfil its obligations as they fall due. In the event that the charity

should need to consider insolvency (which a great many charities do as a consequence of their reliance upon variable and vulnerable income sources) then they will need to carefully consider the costs that may arise.

The costs associated with insolvency are not restricted to redundancy and liquidators fees. All charities would benefit from running through their SOFA & Balance Sheet and considering whether there are any hidden items that may need to be considered. For example, there might be contractual relationships (income and expenditure) which may incur penalties for non-performance, leases upon which there are early exit charges, leased assets upon which there may be dilapidations clauses and so on. Any assessment of the costs associated with liquidation needs to be vigorous if it is to be relied upon.

Of course, effective risk management is key to this entire process and trustees need to be clear that they have put in place appropriate mechanisms for identifying risks, assessing and scoring them and for ensuring that they are satisfied with the response being made. It is critical that contingency plans are identified in response to potential risks - for example the risk of loss of one income source can be mitigated by the identification of revenue generating activities from other sources.

Looking at risk can be very daunting from a trustees point of view. The potential risks identified can be vast, even for smaller charities with a fairly limited sphere of activity. It must be remembered that all risks carry a probability, and the probability that one or more risks materialises at the same time is more unlikely than each risk in isolation. Be wary of any tendency to consider the impact all risks taken together materialising together. A practical, measured approach is all that can be reasonably expected.

Find the right words

Finding the right wording to explain the reserves position can present a very valuable opportunity to make a key communication about the work that the charity does, the care exercised in putting charitable funds to work, the risks posed to incoming resources and the extent to which it is deserving of the continued support of those funding it.

The SORP doesn't require you to state how many months (or years) worth of free reserves you might hold. Rather, it requires you, if indeed you have a policy, to elaborate upon why you hold the level of reserves that you do. Quantifying this in terms of months may just be a convenient and understandable way of doing this, but unless it has some more credible foundation, based upon the combination of factors detailed above, it might not be appropriate.

And finally, remember that the reserves level will always be a moving target and so the policy may need to move with it. An effective reserves policy is one that is constantly under review having regard to the changing financial, regulatory and competitive environment in which the charity is placed.

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