Annex 2: An integrated approach to developing a reserves policy for a charity with more complex activities and structures

Trustees of charities with more complex activities and structures need to take into account a broader range of factors when developing their reserves policy. These charities will be undertaking a greater range of activities or be funding a scale of operations much greater than that of charities with simpler affairs. For example they may be undertaking primary purpose trading or providing goods or services under contract. They are likely to hold a number of restricted funds, employ staff and may own buildings or operate trading subsidiaries.

Setting a reserves policy is not a task undertaken in isolation. A reserves policy is a product of a charity's strategic planning, budgeting and risk management processes. These processes provide trustees with the information they need to establish exactly why they might need reserves and to help them quantify that need. The steps involved in these processes are interrelated with the outcome of one process informing another. For example, identified financial risks will inform both budgeting and the reserves policy. Setting a reserves policy can be approached in different ways. This annex presents one approach and is set out as steps in a process, but it is important to remember each of these steps is connected.

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

When taking each of these steps, trustees should reflect on the guidance and think through how it applies in the circumstances of their own charity. From this they can develop their reserves policy. Not every factor will apply to every charity. Similarly, some factors may have a greater influence than others in shaping the trustees' thinking in developing their reserves policy.

Step 1: Understanding the nature of charitable funds held

Reserves are that part of a charity's unrestricted income fund that is freely available to spend on any of the charity's purposes. To set a reserves policy, it is vital for trustees to understand any restrictions on the use of the charity's funds. In certain circumstances holding restricted funds may reduce the need to hold reserves for particular purposes.

Restricted funds can only be used for particular purposes of a charity that are narrower than the overall charitable purposes of the charity. Restricted funds include endowments and restricted income funds are excluded from the definition of reserves. However, the nature and amount of restricted funds may influence the amount of reserves held by a charity.

For example, an overseas aid charity may operate on a worldwide basis but have a restricted income fund for the area of Asia. A restricted income fund for Asia, which is not otherwise limited in its use, means that any of the activities and programmes in Asia can be funded from that restricted income fund. This flexibility can reduce or remove the need for the charity to hold unrestricted funds in reserve for its activities in Asia.

Expendable endowment is excluded from the definition of reserves. Nevertheless, expendable endowment offers trustees considerable flexibility in how they may use the funds, and this may influence the amount of reserves trustees choose to hold. Expendable endowment, when invested, can provide a relatively secure stream of income but the trustees also have the option of spending all, or part, of the endowment. This freedom may reduce the need for reserves, especially where the charity is not wholly dependent upon the investment income provided by the expendable endowment to fund its activities.

However, where charities with an expendable endowment depend on the investment income to fund core or continuing activities, then the need for reserves may be greater. Trustees are less likely to be willing to spend the expendable endowment if this will reduce the income available to fund future activities.

A permanently endowed fund cannot be spent as income and so the capital is invested to produce income for the charity. If the terms of the permanent endowment do not restrict its use then the income is unrestricted and can be spent on any of the purposes of the charity. The relative security of the investment income from an endowment fund will be a factor that may influence the need for reserves. The Charities Act also introduced amendments which give many charities greater flexibility to spend some or all of their permanent endowment in certain circumstances.

A total return approach to investment allows trustees greater flexibility in how investment returns can be allocated to income funds. The commission is able to make an order that permits the investment of permanent endowment on a total return basis. Total return is an investment management approach which considers the overall return from the investment, both capital gains (and losses) and any income. The trustees then decide how much of the total unapplied return can be allocated to income and how much is retained for future spending. In making this decision, the trustees must consider the needs of current and future beneficiaries.

The flexibility of the total return approach can enable charities with significant permanently endowed funds to a hold a lower level of reserves than similar charities without such a power. Total return gives trustees the flexibility to spend funds held as part of the unapplied total return when needed and so can reduce the need for reserves.

Step 2: Identifying functional assets

The identification of unrestricted funds is a vital initial stage in the development of a reserves policy. However, certain functional assets used operationally by a charity might be essential to the implementation of their operational strategy. The Charities SORP specifically allows funds held as tangible fixed assets for charity use to be excluded from reserves. This recognises that certain assets will be used operationally and their disposal may adversely impact on a charity’s ability to deliver its aims.

Where the trustees consider functional fixed assets to be essential to the delivery of the charity’s aims then the value of such assets can be designated and excluded from the calculation of reserves. However, it is important for trustees to ask why particular fixed assets are held. For example, could a high value administrative office be sold and rented accommodation used if funds were needed? Some trustees might regard such an asset as part of their reserves which could be realised, if necessary, to support their operational work. This situation might, for example, be contrasted with a care facility where its sale might interrupt the care of beneficiaries and obtaining alternative specialist facilities on a rental basis might prove difficult.

Similarly, where a charity makes programme related investments solely to further its charitable purposes then such investments can be excluded from reserves.

Step 3: Understanding the financial impact of risk

Identifying and managing risk is an important part of good charity governance. Certain risks, if they occur, will have a financial impact and will be considered as part of the budgetary process. Identified financial risk will also influence and inform a charity's reserves policy. Holding reserves may form part of the charity's strategy for managing the impact of an identified risk should it occur.

The commission's guidance **Charities and risk management (CC26)** identifies the key risks which most charities should consider. Whilst risk is broader than just financial risk, in working through the guidance on risk management, trustees should consider the financial impact on the charity of the identified occurring and ask whether reserves are needed to help manage the financial impact.

Charities should be responsive to beneficiary needs and for some charities this can arise urgently and unexpectedly. Again, charities should consider the need to hold reserves in response to such events or whether it can rely on an appeal to the public where urgent need arises.

Step 4: Reviewing sources of income

The stability of future income is a key factor in the financial health of a charity. The assessment of the stability and certainty of future income sources will form an important part of a charity's assessment of risk and will feed into both budget setting and reserves policy. Some of the issues trustees should consider include, whether:

- the charity's income is from a single or multiple sources
- the charity is particularly vulnerable should there be a sudden or unforeseen decline in a particular source of income
- the charity relies on a single contract or grant for a significant part of its funding which is subject to tender or review in the near future
- any major donor has indicated a change in their planned giving
- appeals or fundraising activities provide a stable funding source
- certain sources of income are particularly vulnerable to the general economic situation

In reviewing the stability of income, trustees should consider:

- how much notice of a change in income would the charity get
- the key dates at which major contracts or grants are due for review or renewal
- the impact of any other organisations seeking funding from the same sources
- the strength of the charity's relationships and communications with its donors and financial supporters about explaining its financial needs

If a charity has stable or predictable income this may reduce the need for reserves. Alternatively, if a charity's income is volatile or insecure, or is vulnerable to factors outside of its own control, this may justify holding more reserves. Trustees should also consider if the charity's reserves are sufficient to protect it from the risk of insolvency or serious disruption to its charitable work.

Step 5: Impact of future plans and commitments

When setting the operational plan for the year, trustees will have considered how that plan will further the charity's aims for public benefit. The operational plan brings together the activities that the charity will undertake with the resources at its disposal.

Usually the operational plan is then expressed in financial terms as a budget with the expected income identified by source and the expected costs identified by planned activity. In setting a budget, consideration will need to be given to any restriction on the use of particular funds and uncertainty associated with predicting future income. The cash budget will help identify peaks and troughs in the charity's cash flow and will give a warning of when reserves might need to be called on.

Commitments and designations

Commitments made in previous and current financial years will also impact on cash budgets. For example, where commitments have been made to pay grants over a number of years then reserves may need to be built up to meet these costs if future income streams are uncertain.

As part of a charity's strategic planning, the trustees will also look beyond the annual operational plan and annual budget. This will be particularly important in identifying projects or capital spending plans that cannot be met from anticipated future income alone. Where planned expenditure cannot be met from a single year's income alone then this may point to the need to build up reserves to meet future expenditure. If reserves are to be built up in this way, then budgets will need to reflect these plans.

Often the funds set aside to meet future commitments and plans will be held as designated funds. By identifying a need and setting funds aside in a designated fund, trustees can build up the funds needed over a period of time and help manage the financial risk of a project. In this way they spread the burden over several years. When calculating the amount of reserves stated in an annual report, trustees may exclude the amount properly designated from the reserves total. The amount and nature of the designations should be explained in the annual report as should the likely time of their expenditure.

Designations relate to future plans that exist at a point in time. The annual report explains the year end position of a charity and therefore no new designations can be set up retrospectively after the year end to disguise the true level of unrestricted funds held in reserve. Designations which are never used, or the nature of which are frequently changed without funds being spent, risk bringing the charity into disrepute with donors and financial supporters. If a complaint is made to the commission about a charity's reserves, the inappropriate use of designated funds may attract regulatory attention.

Defined benefit pension schemes

Where charities have employees who are entitled to defined benefit pensions (final salary pensions), there are particular issues that arise in relation to the obligations of the charity to the pension scheme which may affect the charity's reserves.

Where a charity operates, or is a member of, a defined benefit pension scheme, trustees should read the guidance **Charity reserves and defined benefit pension schemes**. The defined benefit pension scheme may be a multi-employer scheme or the charity's own scheme. Depending upon the balance of assets and liabilities within the scheme, the charity may have a pension asset or liability.

Where the pension asset or liability is material, the reserves policy statement should separately consider the impact on the charity's financial position and reserves. The cash flow implications of making good any pension liability will influence the reserves policy and the reporting of the reserves.

Where there is a pension asset, this is normally designated and not counted as part of the charity's reserves because it is not available to the charity's trustees to spend. Where there is a pension liability this may require some or all of the available unrestricted funds that are otherwise uncommitted to be designated to meet all or part of that liability. The decision on whether to designate funds to meet a pension liability will depend upon the charity's ability to finance that liability out of its current and future income.

Trustees should explain to the charity's stakeholders the impact on its reserves policy of a defined benefit pension scheme. Trustees should pay particular attention to explaining clearly and simply how the pensions accounting disclosures should be interpreted in the context of the charity's finances.

Step 6: Agreeing a reserves policy

After considering the issues described in steps 1 to 5 the trustees can make an informed decision about holding reserves and the amount to be held. Where the trustees agree that reserves are needed these should be explained in the reserves policy along with a justification of the planned level of reserves and a statement of the reserves currently held. Trustees should also provide an explanation if the reserves held differ significantly from the target they have set for reserves.