Reserves Policy: Inhabitant Householders

The following is an extract from the Council minutes of 27 March 2019.

5.3 Reserves Policy. Guidance from the Charity Commission was noted. **IT WAS RESOLVED to adopt a Policy on Reserves that would:**

- **Differentiate between Capital and Revenue reserves;**
- **Hold 12 months operating expenditure as a general reserve;**
- **Transfer to the general reserve any unspent balances of expenditure on items for which invoices have not been received at the year-end;**
- **Fully provide for earmarked reserves, as identified by the Trustee;**
- **Review the Reserves at every year end.**

<u>Reserves Policy – Guidance for charity Trustees</u>

This was extracted and summarised from https://www.gov.uk/government/publications/charities-and-reserves-cc19/charities-and-reserves

Key messages for trustees

As the regulator of charities in England and Wales, the commission expects trustees to decide, publish, implement and monitor their charity's reserves policy so that they can comply with their legal duties to:

- act in the interests of their charity and its beneficiaries
- protect and safeguard the assets of their charity
- act with reasonable care and skill Take appropriate advice when you need to, for example when buying or selling land, or investing
- ensure their charity is accountable

In practice, this means that trustees should:

- develop a reserves policy that:
    - fully justifies and clearly explains keeping or not keeping reserves
    - identifies and plans for the maintenance of essential services for beneficiaries
    - reflects the risks of unplanned closure associated with the charity's business model,
    - helps to address the risks of unplanned closure on their beneficiaries
- publish the reserves policy (even if not required to by law) and ensure it is tailored to the charity's circumstances – it should not be just a standard form of wording. It should explain to funders, beneficiaries, the public and the commission exactly what reserves are kept (or not kept) for and when they are to be used
- make sure that their reserves policy is put in place and operated
- regularly monitor and review the effectiveness of the policy in the light of the changing funding and financial climate and other risks

3.1 What are reserves?

Reserves are that part of a charity's unrestricted funds that is freely available to spend on any of the charity's purposes. The starting point for calculating the amount of reserves held is therefore the amount of unrestricted funds held by a charity. However, some or all of the unrestricted funds of a charity may not be readily available for spending. This is because spending those funds may adversely impact on the charity's ability to deliver its aims. The items that should be excluded from reserves are:

- tangible fixed assets used to carry out the charity's activities, such as land and buildings
- programme-related investments those held solely to further the charity's purposes
- designated funds set aside to meet essential future spending, such as funding a project that could not be met from future income
- commitments that have not been provided for as a liability in the accounts

Restricted funds

Restricted funds fall outside the definition of reserves, but the nature and amount of such funds may impact on a charity's reserves policy. Where significant amounts are held as restricted funds the nature of the restriction should be considered, as such funds may reduce the need for reserves in particular areas of the charity's work.

3.2 Why is a reserves policy important?

A reserves policy explains to existing and potential funders, donors, beneficiaries and other stakeholders why a charity is holding a particular amount of reserves. A good reserves policy gives confidence to stakeholders that the charity's finances are being properly managed and will also provide an indicator of future funding needs and its overall resilience.

The Charities SORP requires a statement of a charity's reserves policy within its annual report. In addition, if a charity operates without a reserves policy, the regulations require this fact to be stated in the annual report.

In more detail

Deciding the level of reserves that a charity needs to hold is an important part of financial management and forward financial planning. Failure to do this may result in reserves levels which are either:

- higher than necessary and may tie up money unnecessarily. and unnecessarily limit the amount spent on charitable activities.
- too low, increasing the risk to the charity's ability to carry on its activities in future in the event of financial difficulties, and increasing the risks of unplanned and unmanaged closure and insolvency

All charities need to develop a policy on reserves which establishes a level of reserves that is right for the charity and clearly explains to its stakeholders why holding these reserves is necessary.

A reserves policy provides essential accountability to funders, donors and other stakeholders. A good reserves policy will explain how reserves are used to manage uncertainty and, if reserves are held to fund future purchases or activities, it will explain how and when the reserves will be spent. A reserves policy provides assurance that the finances of the charity are actively managed and its activities are sustainable.

Developing a reserves policy is also an important part of the internal financial management of a charity. Developing a reserves policy is likely to:

- assist in strategic planning, for example considering how new projects or activities will be funded
- inform the budget process, for example is it a balanced budget or do reserves need to be drawn down or built up?
- inform the budget and risk management process by identifying any uncertainty in future income streams

The commission recommends that charities develop their reserves policy and their planning at the same time, recognising that strategic and financial planning informs the development of reserves policies and vice versa. For example, the budgets will identify peaks or troughs in cash flow and the reserves policy will need to ensure the troughs in funding can be met from reserves held.

3.3 How should a reserves policy be developed?

There is no single method or approach to setting a reserves policy. The approach adopted will vary with the size, complexity of activities, legal structure and the nature of funds received and held by a charity. However, for all charities, setting a reserves policy will involve:

- consideration of the nature of the funds received and held by the charity - are the funds unrestricted or restricted income? Is an endowment an expendable endowment or permanent endowment? Understanding the nature of the funds allows trustees to identify unrestricted funds which can be spent on any purposes of the charity
- larger charities are likely to have a formal risk management process but all charities need to think about uncertainties they may face in the future; they should therefore consider the need to hold some reserves to meet an unexpected call on funds or opportunities that may present themselves
- larger charities are likely to have strategic and operational plans - but all charities need to think about their future budgets and future projects or spending plans that cannot be met from the income of a single year
- trustees choosing to adopt a ‘zero level’ reserves policy must say in their annual return that they have adopted such a policy and should explain why; such a policy can create heightened financial risk from the possibility of unforeseen expenditure, sudden closure, trustee liability, a shortfall in income or an inability to control costs, unless the trustees have a workable alternative to holding reserves for addressing these risks

By working through these steps the trustees will be well placed to identify why reserves might need to be held and to decide the amount of reserves needed to operate effectively.

Once a reserves policy is set, it should not be regarded as a static policy. The circumstances of a charity or the environment in which it operates will change with time and trustees should review their policy at least annually as part of a charity’s planning processes. The amount held in reserves should also be monitored during the course of the year as part of a charity’s budgetary processes.

Annex 1 of this guidance sets an approach to setting a reserves policy that can be used by smaller charities which do not hold significant amounts of endowed funds, property or operate a defined benefit pension scheme or carry out activities through trading subsidiaries.

3.4 What level or range of reserves is required?

Short answer

There is no single level, or even a range of, reserves that is right for all charities. Any target set by trustees for the level of reserves to be held should reflect the particular circumstances of the individual charity. To do this, trustees need to know why the charity should hold reserves and, having identified those needs, the trustees should consider how much should be held to meet them.

In more detail

The charity’s target level of reserves can be expressed as a target figure or a target range and should be informed by:

- its forecasts for levels of income for the current and future years, taking into account the reliability of each source of income and the prospects for developing new income sources
- its forecasts for expenditure for the current and future years on the basis of planned activity
- its analysis of any future needs, opportunities, commitments or risks, where future income alone is likely to fall short of the amount of the anticipated costs

- its assessment, on the best evidence reasonably available, of the likelihood of a shortfall arising which means that reserves are necessary, and the potential consequences for the charity of not being able to make up the shortfall
- if the reserves policy is set at zero or a low level, its strategy for an orderly closure in the event of an unplanned shutdown and insolvency and particularly where there are vulnerable beneficiaries, the care of its beneficiaries

Trustees who hold (or do not hold) reserves without attempting to relate their need for reserves to factors such as these will have difficulty in satisfactorily explaining why they hold (or do not hold) the amount of reserves that they do.

3.5 What steps should trustees take to maintain and monitor reserves at the target level?

Short answer

Reserves are held to help the charity operate effectively. Trustees should keep their reserves policy and the level of reserves held under review. Trustees should also monitor the level of reserves held throughout the year. In this way trustees will be aware of the buildup of excess reserves or of reserves being unexpectedly or rapidly depleted.

In more detail

Having set the reserves level or range in which it is desirable to operate, trustees should monitor the reserves actually held to establish the reason for any significant difference with the target level set. If reserves during the year are below target or exceed target, the trustees should consider whether this is due to a short-term situation or a longer-term issue. Action may be needed to replenish or spend reserves.

The trustees' monitoring of reserves should not just be a year-end procedure. How the level of reserves changes during the year can be a good indicator of the underlying financial health of the charity and can be an indicator of potential problems. The level of reserves should be monitored throughout the year as part of the normal monitoring and budgetary reporting processes.

In particular, trustees should:

- identify when reserves are drawn on so that they understand the reasons and can consider the corrective action, if any, that needs to be taken
- identify when reserve levels rise significantly above target so that they understand the reasons and can consider the corrective action, if any, that needs to be taken
- where the reserves level is below target, consider whether this is due to short-term circumstance or longer term reasons which might trigger a broader review of finances and reserves
- regard the ongoing review of the reserves target, the reserves level and the reserves policy as part of managing the charity
- ensure that the reserves policy continues to be relevant as the charity develops or changes its strategy and activities
- review the statement on reserves in the trustees' annual report where there have been significant changes in the reserves policy or level of reserves held

Charities with very low or no reserves which face financial difficulty should read the commission's guidance Managing a charity's finances: planning, managing difficulties and insolvency (CC12).

4. Explaining reserves in the annual report

4.1 Explaining the charity's reserves policy in its annual report

The requirements for all charities

All charities must include in their annual report their policy on reserves, stating the level of reserves held and why they are held. Where the charity does not have a reserves policy in place, it should include a statement to that effect.

Where material funds have been designated, the reserves policy statement should quantify and explain the purposes of these designations and, where set aside for future expenditure, the likely timing of the expenditure.

4.2 The charity has no reserves or has excess reserves

Whatever the trustees' policy is, beneficiaries, funders and the commission as regulator should be able to see how it has been justified.

No or insufficient reserves

In some cases, a charity may decide to operate without any reserves. Some trustees budget to spend all the income received each year on the charity's activities. Other charities may find that the terms of some sources of funding do not allow the funds to be set aside as a reserve.

Having no reserves can create financial risk from the possibility of unforeseen expenditure, a shortfall in income or an inability to control costs. Trustees choosing to adopt a 'zero level' reserves policy should consider the financial and other risks inherent in such a policy and must explain their policy in the trustees' annual report.

Trustees should base their reserves policy on the risks that a charity and its beneficiaries might face and how to manage them. A charity's reserves policy should justify why it doesn't keep any reserves or how it is managing insufficient reserves. Whatever the trustees' policy is, beneficiaries, funders and the commission as regulator should be able to see how it has been justified.

Some charities will be able to justify holding a certain level of reserves but will be unable to build up reserves to that level, or perhaps to any level at all. Many recently established charities in particular, will be in that position. While the commission accepts that some charities will simply not have had the resources to establish a reserve, the commission still expects such charities to have a reserves policy.

Where a charity hasn't got the reserves it thinks it needs, it is exposed to greater risk and the commission expects the trustees to be addressing this actively by, for example, planning how to:

- implement their reserves policy
- raise the necessary funds
- diversify their funding base
- mitigate the risks that might arise if the charity has to close suddenly

Where a charity's reserves appear to be too high

A charity's level of reserves or unspent funds can appear to donors, beneficiaries or the commission to be too high and this is generally for two reasons:

First, because the trustees have not explained fully the reasons why they are keeping reserves. If this is the case, they should review their policy and ensure that it fully justifies why funds are being kept in reserve. If, for example, a charity is using a standard form of reserves policy wording, it is not likely that it will tell the charity's story or explain why the charity has the level of unspent income that it does.

Second, because they are having difficulty in using their funds. A charity with excess reserves or unspent funds should consider whether they could be effectively spent on the charity's purposes. If a charity has more resources than it needs to fulfil all of its purposes then the trustees must consider whether the purposes of the charity should be amended to enable the charity to operate more effectively.

5. Other questions about reserves

5.1 Can a charity invest its reserves?

Short answer

Yes, reserves can be invested. However, by their nature, reserves tend to be resources that may be needed in the short to medium term. Trustees therefore should ensure that reserves are invested in a way can be readily realised as cash, when needed.

5.2 What is the legal basis for holding and reporting reserves?

Short answer (legal requirement)

Some charities have a power to hold reserves in their governing document – all others can rely on powers implicit in the law. Trustees can use these powers where they are satisfied that to do so is in the best interests of the charity: their charity's reserves policy should reflect their reasoning. When making this decision, trustees of unincorporated charities should weigh it against the general trust law principle that funds received as income should be spent within a reasonable period of receipt of the funds.

5.3 Can trustees accumulate income funds?

A power to accumulate income by adding income to the capital of an endowment fund should not be confused with holding income as reserves. A small number of charities have a power in their governing document to add income of the charity to capital of an endowment fund. Income cannot be accumulated in this way unless the trustees have an express power that allows them to do so.

If funds are accumulated without a power to convert them to endowment, then they continue to be income funds. Such accumulated income funds are unrestricted and count as reserves; they must be reported as such in the annual report.

5.4 What are the tax issues involved in holding reserves?

The justifiable retention of reserves should not have any adverse tax implications.

Much of the income received by charities is exempt from Income Tax and Corporation Tax provided that the money is used for charitable purposes only. More information is available from HM Revenue & Customs.

5.5 Fundraising, applying for grants or contracts if a charity has reserves

Short answer

It is important when fundraising that trustees maintain the confidence of the public in their charity by being open and transparent about their charity's need for funds. If the charity has excess reserves, the trustees should ensure that they do not misrepresent the urgency or need for funds.

When a charity is applying for a grant or is bidding for a contract, it is important that the funder understands the charity's reserves policy and that the policy explains and justifies the reserves held.

Annex 1: A simple approach to developing a reserves policy

The following 3 questions are designed to help guide trustees of smaller charities through the issues that need to be considered when developing their reserves policy. Trustees managing charities with more complex activities or structures may find that this approach does not go into enough detail and should look at the guidance given in Annex 2 instead.

Question 1. Why might you need reserves for the charity to be effective?

The basis of a good reserves policy is thinking through exactly why you might need to hold back some funds as reserves. In a small charity, with a simple structure and uncomplicated activities, the reasons might include:

a) The risk of unforeseen emergency or other unexpected need for funds, e.g. an unexpected large repair bill or finding 'seed-funding' for an urgent project.

b) Covering unforeseen day-to-day operational costs, e.g. employing temporary staff to cover a long-term sick absence.

c) A source of income, e.g. a grant, not being renewed. Funds might be needed to give the trustees time to take action if income falls below expectations.

d) Planned commitments, or designations, that cannot be met by future income alone, e.g. plans for a major asset purchase or to a significant project that requires the charity to provide ‘matched funding’.

e) The need to fund short-term deficits in a cash budget, e.g. money may need to be spent before a funding grant is received.

If, after considering the above, you think that reserves are needed please go to question 2. If you conclude that your charity does not need to hold any reserves, then you must explain that in your annual report.

Question 2. How much do you need in reserve?

The reserves level may be a target amount or a target range. For example, for each reason set out in question 1:

a) An amount might be needed to meet an unforeseen emergency or other unexpected need - consider risks and how much might be needed for such contingencies; this will involve judgment of events that may occur and their likelihood.

b) Look at your expenditure budget - do you need a small contingency fund to meet unforeseen operational costs?

c) Uncertainty over future income might mean having reserves equivalent to a number of weeks of income equivalent to a range of £x to £y, to allow time to develop new sources of income or to cut-back on related expenditure.

d) A planned spending commitment which cannot be met from future income would imply a need for a specific sum to be set aside - often this amount will be included within designations in accounts.

e) An amount might be needed to cover ‘troughs’ in the cash budget - review budgets to ascertain how much might be needed.

In summary, the financial risks you identify should influence the amount of reserves you target to hold and be explained in your reserves policy.

Question 3. Have you got any funds in reserve at the end of the year?

The final step is to compare what you might need in reserve with what you actually hold. You should:

- calculate the amount of any reserves according to the definition of reserves given in section 3.1 of the guidance
- state the amount of reserves held and compare with the target amount or target range set for reserves
- explain any shortfall or excess in reserves against target set
- explain any action being taken or planned to bring reserves into line with your target

Where the difference is small, no action may be needed.

Information about the reserves policy and the level of reserves held must be included in the trustees’ annual report.

6. Technical terms used in this guidance

The following terms are used throughout this guidance and should be interpreted as having the specific meanings given.

Annual report: the trustees’ annual report prepared under the Charities Act.

Charities SORP (FRS102): this provides guidance for charities on how to apply the Financial Reporting Standard applicable. The SORP does not apply to charities preparing receipts and payments accounts.

Designated funds: part of the unrestricted funds which trustees have earmarked for a particular project or use, without restricting or committing the funds legally. The designation may be cancelled by the trustees if they later decide that the charity should not proceed or continue with the use or project for which the funds were designated.

Endowment funds: funds which the trustees are legally required to invest or to keep and use for the charity's purposes. Endowment may be expendable or permanent.

Expendable endowment: an endowment fund where the trustees have the power to convert the property (i.e. land, buildings, investments or cash) into 'income'. It is distinguishable from 'income' by the absence of a positive duty on the part of the trustees to apply it for the purposes of the charity, unless and until this power to convert into 'income' is actually exercised.

Governing document: any document which sets out the charity's purposes; in IH's case, the 1925 Conveyance.

Income and income funds: all incoming resources that become available to a charity and that the trustees are legally required to spend in furtherance of its charitable purposes within a reasonable time of receipt. Income funds may be unrestricted or restricted to a particular purpose of the charity.

Material or materiality: a material fund is one which the trustees or their auditor or independent examiner judge to be of such importance that its omission or misstatement would affect the reader's understanding of the accounts. Materiality depends on the size, amount or importance of the fund in relation to the total unrestricted and restricted funds managed by the trustees.

Permanent endowment: property of the charity (including land, buildings, cash or investments) that the trustees may not spend as if it were income. It must be held permanently, sometimes to be used furthering the charity's purposes, sometimes to produce an income for the charity. The trustees cannot normally spend permanent endowment without the commission's authority. The terms of the endowment may permit assets within the fund to be sold and reinvested, or may provide that some or all of the assets are retained indefinitely (for example, in the form of a particular building).

Programme related or social investment: not 'investment' in the conventional sense of a financial investment. Conventional investments involve the acquisition of an asset with the sole aim of financial return which will be applied to the charity's objects. Programme related or social investments, by contrast, are made directly in pursuit of the organisation's charitable purposes. Although they can generate some financial return, the primary motivation for making them is not financial but the actual furtherance of the charity's objects.

Restricted funds: funds subject to specific trusts, which may be declared by the donor(s) or with their authority (e.g. in a public appeal) or created through legal process, but still within the wider objects of the charity. Restricted funds may be restricted income funds, which are spent at the discretion of the trustees in furtherance of some particular aspect(s) of the objects of the charity, or they may be endowment funds, where the assets are required to be invested, or retained for actual use, rather than spent.

Risk: used in this guidance to describe the uncertainty surrounding events and their outcomes that may have a significant financial impact. Risk may affect any area of a charity's operations.

Subsidiary trading company: any non-charitable trading company wholly owned, or the majority of which is owned, by a charity to carry out trading activities on behalf of the charity.

Trustee: a charity trustee. Charity trustees are the people who are responsible for the general control and management of the administration of the charity. In the charity's governing document they may be collectively called trustees, the trustee board, managing trustees, the management committee, governors or directors, or they may be referred to by some other title.

Unrestricted funds (including designated funds): income or income funds which can be spent at the discretion of the trustees in furtherance of any of the charity's objects. If part of an unrestricted income fund is earmarked for a particular project it may be designated as a separate fund, but the designation has an administrative purpose only, and does not legally restrict the trustees' discretion to spend the fund.