Not Just for a Rainy Day?

Guidelines on developing a reserves policy and putting it into practice

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CHARITY FINANCE DIRECTORS' GROUP

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Contents

Acknowledgments

Reserves are important to charities, but the correct level of reserves has been a cause of intense debate. Welcoming the Charity Commission initiative, the Joint NCVO/CFDG Steering Committee commissioned these guidelines to help charities to work out and implement their reserves policies. They are not meant as best practice, they are a simple "how to" guide.

These guidelines would not have been possible without the knowledge and practical experience of the members of the steering committee, and the charities which allowed us access to their reserves policies. We would also like to thank Richard Corden and John Bonds of the Charity Commission, the staff of South Bank University, and Michael Archer of LOROS for allowing us access to his Guidance on a Reserves Strategy, prepared for ACENVO.

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Foreword

There is no denying that some charities have had a bad press about their reserves. It has created an impression that charities sometimes hold reserves for self-interested reasons or out of an excess of caution, rather than for reasons ultimately directed to the welfare of their users and beneficiaries. This is not true, except perhaps of an extremely small minority of charities. But it is damaging for all charities if people generally have this impression.

The Charity Commission makes clear in its publication **Charity Reserves** that charities are entitled to hold reserves as long as they justify and explain their actions. Reserves are needed for reasons of sound financial management and operational planing, and a charity's policies on reserves should be drawn up in that context. These Guidelines, jointly prepared by NCVO and CFDG, will help charities in a practical way to assess their reserves needs and to draw up a robust reserves policy. Once a charity has a justifiable policy, it can articulate it with confidence.

I do believe that most people - donors, supporters, and volunteers included - are open to persuasion that holding reserves can make good sense. Charities will influence opinion in their favour not by making excuses for holding reserves, but by explaining the reasons why it is right and necessary for them to do so.

John Bonds
Charity Commissioner

Section A:
AN INTRODUCTION TO RESERVES

1. The purpose of these guidelines

1.1 The purpose of these guidelines is to help charity trustees answer three important questions:

- Does this charity have reserves?
- Does this charity need reserves?
- What level of reserves, if any, should it have?

Although the answers to the questions are for the trustees to provide, many charities have staff and volunteers working for them who will supply information and guidance to help them. These guidelines are addressed to all of them.

They are also addressed to those who fund charities. Local authorities, corporate donors, lottery boards, individuals and those who administer family trusts. Any person, organisation or body which looks at the Annual Report and Accounts of a charity to help decide whether or not to give it some money.

1.2 Trustees have no need to be defensive about their reserves. They are expected to act prudently in conducting the affairs of the charity, just as they would in their own business or household. Provided they have thought carefully and calculated as accurately as possible, on the basis of information available, they should be able to explain to anyone who wants to know their answers to those questions.

Putting a wet finger in the air may be enough to find out which way the wind is blowing but it will not tell the strength of the wind or how long it will blow for. Something more scientific is needed. Similarly, a best guess about reserves may tell you that it would be wise to have some, but calculations are needed to decide what their value should be and how to reach or keep that value. The "feels right" principle is not enough.

1.3 There are three basic problems relating to the reserves held by charities:

- they are too large;
- they are too small;
- they cannot be clearly identified from the accounts.

These guidelines aim to give practical guidance on how to calculate an appropriate reserves level. They also aim to demonstrate how reserves can be shown in charity accounts and in the trustees' report. By following them it should be a comparatively straightforward task for the trustees, treasurer and staff of a charity, whatever its size, to work out appropriate reserve levels and plan how to reach and maintain them.

1.4 Anyone reading these guidelines should be familiar with or have access to a copy of the "Statement of Recommended Practice: Accounting by Charities" published by HMSO in October 1995. That Statement is referred to as "SORP". In these guidelines some terms are used which have a particular meaning in the context of Accounting by Charities. Those meanings are taken from SORP and are given in the glossary in appendix six of these guidelines.

1.5 In these guidelines the term "reserves" means free funds, or general purpose income. They are the resources the charity has or can make available to spend, for any or all of the charity's purposes, once it has met its commitments and covered its other planned expenditure.

"Reserves" therefore excludes income which is spent, committed or designated. Also excluded are funds which are permanent endowment, expendable endowment or restricted.

A word of **caution**, though. Choosing to designate income to avoid having it classified as reserves is not recommended. Nor will it necessarily be wise to create a designated income fund for a future purpose which could be met almost immediately from expendable capital. Attempts to disguise unapplied income could lead to more adverse comment than would high levels of free funds. Significant in the definition of reserves is the phrase "once it has met its commitments and covered its other planned expenditure". This implies that proper planning and budgeting has been done by the charity.

1.6 Trustees of many charities, especially those that were founded many years ago, have invested income steadily over the years and now rely on it to produce regular income to carry out their current activities. Although those invested income funds are, in strict legal terms, applicable as income for the purposes of the charity, they need not be taken into the calculation of the existing level of reserves available. They are not freely available as they could only be realised by disposing of fixed assets held for charity use.

Another word of caution: those who regularly invest income deliberately and regard the investment as "capitalisation" will need to reconsider. Any sum received by a charity as income remains expendable as income, no matter how long it is held prior to application. The act of investing it does not turn it into "expendable capital". To include capitalisation as part of the planned application of income would need very careful justification, and possibly a specific authority in the governing documents of the charity.

2. Why reserves are an issue

2.1 General public expectation is that every penny received by a charity will be spent directly on charitable activities soon after receipt. Individual charities have been criticised in the media for high reserves levels. Most charities rely, to varying degrees, on support from the public and it is important that they can demonstrate why reserves are necessary and for what purposes they are held.

2.2 Levels of reserves held by charities are an issue because:

A General principles of charity law require that trustees should apply charitable resources at their disposal as effectively as possible within the terms of the governing instrument. To do that they will need to have a considered and purposeful policy for applying their income and forecasts for expenditure based on planned activity.

B Charities obtain valuable concessions from the State on the basis that they spend their income and use their assets for charitable purposes.

C Funders look at levels of reserves when deciding whether to make grants or pay over funds. Too little in reserve can be as detrimental as too much.

D Improved monitoring by the Charity Commission and the increased transparency in accounts presentation required by the new accounting regulations[1] and SORP mean that charities which do not spend income may be required to explain.

E It is not enough simply to set excess income on one side and call it reserves.

2.3 Every charity needs the goodwill of the public, whether as donor, user or taxpayer, and every charity wants to keep its charitable status and tax benefits. Trustees need to be aware of the scrutiny and to address the issue of reserves for the benefit of their charity and to preserve the reputation of charities generally.

2.4 Opinions vary about what is an acceptable level of reserves and there is not a universal formula that can be applied to calculate the appropriate level. Charities operate in many different ways and comparison between them on the sole basis of financial statements is not possible. Different income sources and expenditure patterns, varying degrees of control over their activities, greater susceptibility to external influences and legislative change all contribute to their variety.

2.5 Trustees of charities must be able to explain and justify the reserves they hold. Grant makers often have an indicative level of reserves which is regarded as acceptable by them. Frequently they will ask for explanations if the reserves held deviate considerably from that level. Charities with too little in reserve may be a bad risk for further funding, those with too much may not be considered to be in need of the amount applied for.

3. What are reserves?

3.1 Freely available reserves are a pool of unapplied resources available to meet future demands on the charity's resources. They are "general purpose" money which means they can be spent on any of the purposes of the charity. Reserves will help to meet any shortfall between the anticipated income of the charity and its budgeted outgoings and its unforeseen expenditure. They will also be available to fund new activities which were not foreseen when the budget was prepared.

3.2 Charities that operate by running projects on a contract basis and have few, if any, other sources of income, will find it difficult to build a reserve of free funds. Trustees of those charities have to cost their bids carefully and make sure that charity staff and office overheads are included whenever possible. Often the need for reserves is low because staff are taken on for the duration of the project, for example, but there is still the difficulty of keeping going until the payment arrives. In some cases the only source of free income will be from a grant for core funding which can be spread as a reserve across projects.

3.3 Reserves are needed to provide a comfort factor to the charity and an assurance that functionality is protected for a while. Reserves also protect the effectiveness of income already applied. To the public and external bodies they offer an assurance that the charity is not about to go out of business and that it is able to fulfil its purpose. The reputation of the charity sector is more at risk from under reserved charities which have not thought about tomorrow than from well-managed charities with adequate reserves.

3.4 A properly judged level of reserves will balance the needs of current and future beneficiaries and allow commitments to be made with confidence that there will be funds available to carry them out. A reserves policy may demonstrate that a charity with unapplied assets is not moribund - more likely it is dynamic, planning for future growth and expansion of its activities whilst protecting existing operations. Reserves should be deliberate not accidental or left to chance.

3.5 These guidelines start from the premise that the trustees of the charity have decided there is a need for reserves. The problem is to decide when reserves would be used and therefore what purpose they are to serve, what value they should have and how that value is expressed, and in what form they are held.

4. What is a reserves policy?

4.1 A reserves policy is a statement by the trustees which answers the following questions:-

- Why does this charity require reserves of general purpose funds to ensure it can carry out its activities?
- What assumptions have been made in our budget which could leave us with too little income or too many calls on funds?
- What, from our knowledge of the finances of this charity and the way it operates, is the right level, or range, for our reserves?
- How will we build up to, or get down to, that level or range?
- How will we know if we are on target?

By answering these questions trustees will justify their reserve levels. An attempt to calculate the right level of reserves must be made if these questions are to be answered properly. For charities with a simple and stable pattern of income and outgoings the calculation should be relatively easy.

4.2 Once calculated, the basis needs to be summarised as a policy statement. There is no right or wrong way of expressing a reserves policy. A policy is a matter of good governance. The policy statement may be expressed in a concise way in a note to the Annual Accounts but should be explained more fully in the Trustees' Annual Report to comply with paragraph 28(c) of SORP.

4.3 Frequently reserves policies are expressed as a proportion of income, a proportion of expenditure or a combination of income and expenditure. The proportion may, for example, be stated as a percentage of the total annual income or of the total annual expenditure or it may be equivalent to a certain number of months' income or expenditure. Sometimes reserves policies are linked to a particular activity of the charity such as the cost of setting up new projects and the cost of closing projects down.

4.4 Those are very much shorthand expressions of a considered and often complex calculation. Trustees should be clear about which income or expenditure figure is being used to measure against when expressing or calculating their policy. For example, is the level of reserves calculated by reference to:-

- the net income after all commitments and planned expenditure have been deducted?
- the total cost of each project?
- average expenditure in each of the three preceding years?
- income from unrestricted capital funds?
- actual income or expenditure as opposed to budgeted income and expenditure for past years?
- certain strands of income and/or expenditure?

5. Does the type of charity make a difference?

5.1 Whatever the type of charity the basic principles of working out if reserves are needed and having a reserves policy remain the same. "Type of charity" is used to refer to the way the charity operates. For example, whether the charity is an endowed grant making charity, or runs projects entirely on contract funding or grant aid, or relies on fundraising and legacies for income and applies it in various ways. There are many different charitable purposes and many different ways of funding and running a charity but the principles set out in these guidelines can be applied to the funds of any of them.

For the purpose of calculating reserves the key factors which differentiate one charity from another are:

- source(s) of income;
- method(s) of application;
- the extent to which both income and expenditure are at risk;
- the age of the charity;
- the legal obligations of the charity, including commitment to contracts for work.

5.2 Every charity, whatever its annual turnover, needs to control and review its financial position on a regular basis. That is part of good governance and proper management. The complexity of the controls and the frequency of reviews may vary with the level of activity of the charity but the principle remains the same.

An *endowed charity* which relies entirely on its investments to produce income may be less complex in operation than one which fund-raises, invests some of its income and obtains contract funding.

A *charity with branches*, *trading companies* and *regular legacies* has a more complex income structure than one which is almost entirely funded from statutory sources

It may be easier to control the finances of a charity which has fewer income sources, irrespective of the level of total income. In fact, in terms of control, the total income is probably less significant than the number of sources of income. The story is different when assessing the risk to the income. (See Chapter 13 below)

5.3 How complex the charity is to run is also affected by the number of different ways a charity applies its income, and the type of application.

An *endowed charity* which applies income in grants to individuals or other charities in line with previously agreed policies is more straightforward than one which spends half as much money but employs many staff and runs many projects, whether in the UK or abroad.

A *village hall charity* which takes income from regular lettings and spends it all on maintaining the property will need careful organisation if it is to run smoothly and have enough funds when repairs are needed.

Gross income and total expenditure of charities may influence how long it takes to reach the appropriate level of reserves but it is the sources of income and the nature of the expenditure which are the main factors in deciding why reserves are needed.

5.4 The period since a charity was founded may make a difference to reserve levels too. *Young charities* founded within the last ten years may be expanding and exploring, with little if anything left over for reserves. Their pattern of income and expenditure, and possibly their reputation, will be less well established. For them, perhaps, a policy would set out an aim to achieve as part of their longer term strategic planning.

An *older charity* might have accumulated assets over many years. Calculation of its appropriate reserve levels may result in making more of those assets available for application, or even having to change the objects of the charity so that more income can be applied.

6. Where a reserves policy fits into other planning

6.1 Appendix one shows a model of where the reserves policy most often fits into the planning process. Charities, no matter what size they are, have to plan their activities and budget their resources. For some charities that is a very time consuming and technical exercise which needs constant review. For others it can be done twice a year on a single sheet of paper. In all planning there are some assumptions made and risks identified. Any significant change to the list of resources or to the priority assigned to activities will have an effect on the reserves policy.

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6.2 Small charities or charities with a single purpose may not have a strategy that prioritises activities. Some may not have any restricted income funds. The principle is the same whether the charity is large or small, single purpose or multi-purpose.

Section B:

STEPS TO WORKING OUT A RESERVES POLICY

7. Knowledge and skills

7.1 At the outset it is important to make someone within the organisation responsible for gathering together the information necessary to formulate a reserves policy. Who that person is will depend upon the structure of the organisation and what time and skills are available. Although the body of trustees (committee, executive council or whatever they are called) will have to formally agree the policy and see that it is implemented, preparation of a policy cannot be done by all of them. One person should be given the task of drafting a policy, explaining their proposals and providing facts and figures to allow it to be considered. Reserves are mainly a financial matter so in larger charities it is often the senior finance executive who puts together the first proposal. For smaller ones it may be the treasurer or the administrator.

Make someone responsible

7.2 Whoever is given the task will need:

- a sound knowledge of the way the charity works;
- access to records;
- the authority to ask questions of anybody with relevant information;
- knowledge of charity accounting requirements;
- a copy of the plans for how the charity will develop in future.

It will help to have contact with the charity's auditor and with trustees or staff of other similar charities.

7.3 It is important to decide what level of reserves is necessary, not what level of reserves can be achieved. Most charities work out a budget to show what they expect to receive and how they plan to spend it. Many of the skills needed to work out a budget are the same skills needed to work out a reserves policy.

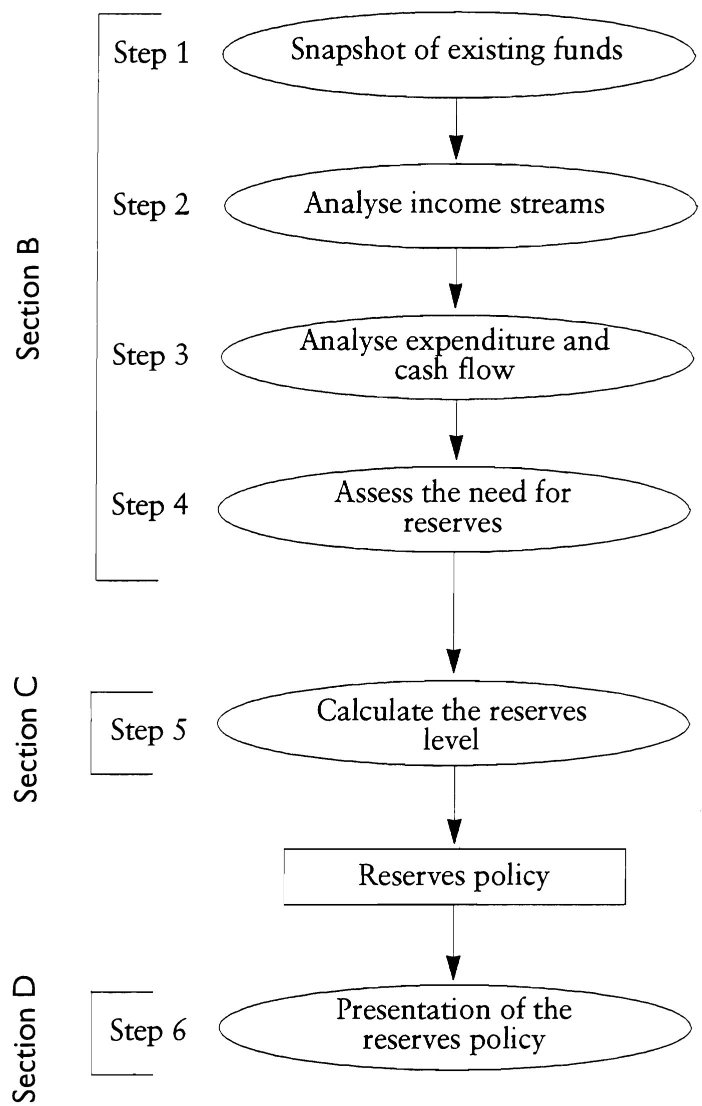
Budgeting and spreadsheet skills are useful

Basic skills include the ability to:

- estimate costs realistically;
- distinguish between essential expenditure and optional expenditure;
- distinguish between fixed costs and variable costs;
- work out expected returns on investments;
- identify connections between expenditure and income, e.g. which expenditure is linked to restricted funds;
- identify why there has been a difference between budgeted income and actual income or budgeted expenditure and actual expenditure in previous years.

It is probably easiest to use a spreadsheet package on a computer to set all the information down. Large charities may have management information systems to help. Small charities can do the job just as well with paper, pencil and calculator. The important thing, which is the same whatever the size of the charity, is to include everything.

7.4 Steps towards developing a reserves policy



8. Step one: a snapshot of existing funds

8.1 SORP helps with the analysis of existing funds as it describes and clarifies restricted and unrestricted funds and requires a distinction between capital income on the one

- Restricted funds, which may be capital or income
- Unrestricted funds, which may be general or designated

hand and endowment on the other. (The meaning of these expressions is given in the Glossary).

8.2 Once the funds have been categorised it is important to recognise what each category contains. Amongst the questions you may need to ask are:

- How have the assets been valued?
  - if they are investments are they shown at the value they have on the open market (current market value) or, if they are functionable assets for charity use, are they shown at the amount paid for them when acquired (book value less depreciation, if applicable)?

- Is the cash readily available?
  - how long would it take to realise the cash by selling the asset or giving notice of withdrawal?

- Which are operational assets essential for the activities of the charity?
  - e.g. a residential care home, a village hall.

- Are there designated funds?
  - what is the source of funds to maintain them and how much is put into the designated fund regularly?
  - what can they be used for?
  - is the designation still necessary?
  - are more designations needed?

- What are the restricted funds for?
  - is it possible to apply them within the restrictions or should we be trying to change the rules for application?
  - are the restrictions so loose and relate so much to our general purposes that we could re-classify them as general funds?

- Are there endowment funds?
  - if so they must be preserved in some form, and do not form part of the reserves.

It is important to note that capital may be permanent endowment, or it may be able to be expended. Expendable capital, or income which has been invested in the past, are often a form of reserves, although not part of the free reserves referred to in these guidelines. If the capital can be realised and spent on the purposes of the charity without damaging the way the charity operates, (e.g. it is not an indispensable source of income) charities may have to consider budgeting on the basis of using it for a major item of expenditure. In the case of a capital sum which is actually invested income the charity may have to consider how it is properly shown in their accounts. Remember that attempts to disguise unapplied income could lead to more adverse comment than would high levels of free funds which are admitted and which there are plans to spend.

8.3 This analysis will help to work out a realistic value of the reserves that could be called upon when needed to finance the charity's general activities and the value of reserves available for restricted application.

8.4 Checklist: have you identified:

- ✓ the present or realisable value of the assets held?
- ✓ the value of any truly restricted funds?
- ✓ the nature of any designated funds and whether the designation is justified and necessary?
- ✓ the value of the unrestricted funds?
- ✓ assets which represent the "tools of the trade" and cannot be realised without seriously affecting the work of the organisation?

8.5 Review: For their Annual Report the trustees need to review the activities and financial position of the charity in the context of its future plans and commitments, particularly with regard to ongoing items of expenditure, projects not yet completed and obligations not yet met. How long is it since a full review was done? Regular reviews are needed to make sure the charity is not over-committed or that money is not set aside for projects which have been terminated, for example.

9. Step two: analysing income streams

9.1 Income streams are the routes along which income reaches the charity. A stream implies an ongoing source of supply which may flow full and fast, trickle, or dry up entirely. The nature of the flow and its reliability needs to be taken into account when calculating levels of reserves. Receipts which are one-off (such as payment for use of a charity property in a film or for having temporary access across charity land or beconing the nominated charity by the London Marathon) are not part of a stream. Similarly, sums received for a specific activity which is unlikely to be repeated or substituted could be excluded from the stream.

9.2 The purpose of analysing income streams is to assess their reliability and to recognise how significant they are in the context of the entire income of the charity.

To assess reliability ask the following questions in respect of each income source:

- Is it increasing year on year? Rapid increase may mean equally rapid decline. A steady increase is generally preferable.
- Does it come from one source? Usually the greater the number of sources the more reliable the income. Investments may be an exception: a single holding of British Government stock, for example, would be a reliable source of income from a single source. A charity regularly receiving many smaller legacies will have a more reliable income source than one which receives an occasional large legacy.
- Is it committed? Do we know we will receive it in the future? How much affinity does the donor have with the charity?

Clearly, the questions to ask will vary according to the charity. The reliability factor will also be relevant in examining the importance of the income stream to the overall income of the charity.

9.3 One way of completing this analysis is to make a chart and assign your ratings to the responses as in the example that follows over:

Income stream analysis chart

AB Charity	% of total	Change each year?	How many sources?	Committed?	Reliability score
INCOME FROM:		1. decline 2. static 3. rapid increase 4. steady increase	1. one 2. few 3. several 4. very many	1. not at all 2. by implication 3. for a fixed period 4. yes	Higher score = greater reliability
Membership fees	25	4	4	4	12
Donations	5	4	4	2	10
Flagday	15	1	4	1	6
Appeals	10	4	4	1	9
Covenants	2	2	3	3	8
Legacies	3	4	3	2	9
Investments	30	4	4	4	12
Statutory	10	2	1	3	6

Although this is not a scientific method it does provide a guide to help with risk analysis. Information about using the chart is given below.

9.4 To customise the chart for your charity insert the appropriate income sources. In the example "Statutory" has been used to indicate grant funding from central government agencies and contract funding from local authorities. Some charities may need to split out those components and take out "investments", or make other changes which represent their own income sources. Others may not split income from donations, appeals and flagdays, for example, or may distinguish between smaller donations and donations by Gift Aid.

The Reliability score in the end column is the total of the points given in the three preceding columns. An income source which is increasing steadily gives more points than one which is increasing rapidly. In some circumstances, particularly for a new charity, a rapidly increasing income source may be preferable to a steadily increasing source. However, it is also possible that a rapid increase could be followed by an equally rapid decline. Diverse sources are generally preferable to a single source. Income which is committed by implication means that the supply from that source has been steady over several years but is not actually promised.

Using your knowledge of your charity you can insert the ratings in each column. If the Reliability score shows that you rate an income source as reliable it may mean that the more optimistic assessment of expected income can be used in calculating total income forecasts. In the example given the flagday provides 15% of the annual income but only has a reliability score of 6. In that case assessment of future income would be based on a pessimistic view. (Of course, the chart may also suggest that the charity may need to examine its fundraising and look at how much it costs and whether the costs are justified by the end product).

10. Step three: Analysing expenditure and cash flow

10.1 The way a charity spends its money is important in working out whether it needs reserves. A useful way to analyse expenditure is to make a list of all the ways money is spent then check each one to see how soon, and with what consequences, payments could stop. For example, a charity which makes one-off grants could readily reduce the value or the number of grants if income falls whereas one that employs many staff and runs a residential home would find it more difficult to cut back.

Some questions to address are:

- How much expenditure is fixed and how much is variable?
- What is the operational structure of the charity?
- What policies apply when prioritising expenditure?
- How quickly can the expenditure pattern be changed?
- What activities could be cut back with minimum damage to anyone?
- What contractual commitments exist?

10.2 Part of expenditure planning is to look at cash flows. When does the money come in? A calendar showing receipts from each income stream, mapped against the calendar for committed and fixed expenditure will show up vulnerable periods. Reserves may be needed to bridge the gap. A similar exercise to the one for income streams (see 9.3) can be set up for expenditure. Instead of a reliability score it would have a commitment score. The column headed "How many sources?" might be changed to "How many people affected?" or another suitable measure depending on the activities of the charity. An example may be as follows:

Expenditure analysis chart

AB CHARITY	**% of total**	**Central to operations?**	**How many people affected?**	**Main source of funds?**	**Commitment score**
EXPENDITURE ON:		1. unnecessary 2. optional 3. essential 4. core purpose	1. one 2. few 3. several 4. very many	1. general income 2. grant 3. restricted income 4. contract	Higher score = greater commitment
Welfare grants	5	3	3	3	9
Day Centre	20	2	4	4	10
Care of residents	40	4	4	3	11
Salaries & wages	10	3	4	1	8
Building costs	3	4	4	1	9
Fundraising	3	3	2	1	6
Minibuses	2	2	4	2	8
Membership services	5	3	4	1	8
Administration	12	3	4	1	8

In this example, modelled on a care providing charity, the highest level of commitment is to the care of residents, which is met mainly from restricted funds. Commitment to the Day Centre is high, although it is an optional activity, as there is a legal commitment to provide it under the contract which funds it. Wages and salaries of care staff are included in the cost of providing the services but there are still staff needed to run the charity who are paid from general funds. A chart like this may be helpful in showing which items of expenditure can be deferred or how they can be matched to the income streams and cash flows.

10.3 Checklist:

When matching cash flows to expenditure look at:

- ✓ which expenditure is met from general funds
- ✓ which expenditure is met from restricted funds
- ✓ how crucial the expenditure is to the core purpose of the charity and its continued existence.

11. Step four: assessing the need for reserves

11.1 After analysing income and expenditure and looking at the cash flow the next stage is to consider whether there are areas in the operation of the charity that look vulnerable. Go back to the budget and long term plans for the charity. Look at them beside the analysis you have prepared.

A It may be that some of the income looks unreliable or that there is an over commitment to some of the expenditure.

> Questions to ask at this stage include:
>
> - General position: are we being reckless or over cautious?
> - Creditors/debtors: do we give too much credit or anticipate income more than is wise?
> - Projects: who will benefit and who will suffer if funds are unavailable?
> - Property and equipment: what condition is it in? Is it well maintained?
> - Commitments: have we overreached ourselves? Do we need to provide for financial commitments in advance or will future income meet them when they fall due?
> - Beneficiaries: will some benefit at the expense of others?

B Conversely, the analysis may show up areas where there is too much money available.

> Additional questions here might include:
>
> - New activities: can we take on new tasks or expand the projects?
> - Equipment: could we be more effective if we had new equipment? Is it a false economy to keep the old?
> - Purposes: are the objects of the charity wide enough to let us spend all the income or should we take legal advice on how to extend them?

11.2 By asking these questions you have reviewed what reserves are for. Does the charity actually need them? It may be that as little as one month's expenditure is enough for charities run entirely by volunteers, with no premises and no promises!

11.3 A realistic approach to preparing the budget, assessing future income and expenditure, and assessing the opportunities for the charity to carry out its objects will identify where reserves are needed.

The next step is to quantify them, this is dealt with in section C: Methods of calculating reserves.

Section C

METHODS OF CALCULATING RESERVES

12. Introduction

12.1 We have already looked at where a reserves policy fits into the financial management of charities. The process is a rolling one so at any time there should be in place a budget of income and expenditure for the current year and a projection for future years. There may also be records of actual income and expenditure in prior years possibly against budgeted income and expenditure. These will be supported by and contribute to the analyses of income and expenditure described above.

12.2 There are a variety of approaches used by charities in setting the level of reserves, some more scientific than others. These include:

- Justifying the status quo
- Covering all liabilities
- Actuarial assessment
- Regression analysis
- Risk identification
- Scenario planning

The choice of approach is one for the charity to decide upon but for the majority of charities the risk identification is probably the most useful in strategic planning terms. It helps to tie together all the components of the planning process. These guidelines look at the last two methods listed in more detail as they are likely to produce the best results.

12.3 *Justifying the status quo* means going through the accounts and balance sheet and working out what the reserves are now, then devising a form of words which describes them. Once that has been done it may show up that there is more work to be done because they seem too high, or possibly too low.

12.4 *Covering all liabilities* means that an assumption is made that all income sources will dry up simultaneously. For a single source charity it may be appropriate, but trustees would be better advised to plan diversification of their income if possible, and, for example, try to generate income to match expenditure in any project work. To make an assessment on this basis all liabilities such as cost of terminating leases, staff severance, contract completion and so on are calculated then the value of the assets deducted. The resultant figure is what is needed as a reserve. This calculation can be useful, especially if it indicates that a change in the way the charity operates might be wise, but there are few circumstances where it could be justified - what are they?

12.5 The *actuarial assessment approach* is mainly used by charities which have a long term commitment to their beneficiaries. This approach might be taken by a research charity which has commitments to research projects of indeterminate length, or by benevolent funds which have commitments to pay pensions or provide accommodation. It is possible to forecast fairly accurately the expenditure needed to meet known commitments over a long period.

Forecasting of income levels however, even if mainly derived from investments, is not so reliable. A reserve which would meet or go a long way towards meeting the gap between the highest forecast demand and the lowest forecast income in any given year might need to be built up.

12.6 *Regression analysis* is a very sophisticated approach and it would be wise to use an accountant if you think this may be the best way to proceed. Regression analysis can be a useful tool in assessing whether, based upon past experience, an organisation can expand and contract its operations in response to demand for its services without having a material effect upon its reserves. This technique is commonly used in marketing but can be applicable to charities. For example, if there has been an influx of funds following a high profile event can the funds be quickly translated into services?

Similarly, an educational charity could forecast the demand for a particular course or publication and measure the level of reserves needed to smooth cashflow between outlay on provision and receipt on sales. An analysis of the relationship between expenditure, income and demand on previous occasions may indicate the level of reserves needed to bridge that gap.

To our knowledge, few charities have utilised this technique, as it requires many records of prior years' income and expenditure. Please see appendix 5 for further details.

13. Calculating reserves by risk identification

13.1 The risk identification approach requires an analysis of income and expenditure as suggested in chapters nine and ten. Examining the risks involved means asking the question "how likely is...?". Reserves are for future use, so it is necessary to look to the future, applying information gained from the analysis.

Questions to ask against each identified income source and/or method of application might include:

- What is the maximum shortfall against budget in any of the last five years? Was there a good reason for it? Has anything been done to avoid a repeat?
- What is the maximum overspend against budget in any of the last five years? Was there a good reason for it? Has anything been done to avoid a repeat?
- What has been the variation in value of investments against the forecast provided by the professionals for each of the last five years? What was the maximum adverse variation?
- Are there any known or possible external changes which might occur, such as a tax rate change, which might have the effect of depressing or increasing income, or expenditure, or the value of the charity's assets?
- Are changes anticipated in the way the charity does its work which may have financial repercussions?
- What is the relationship between future commitments and future income forecasts? How flexible are the spending plans?

13.2 Additional risks such as the risk involved in entering contracts for purchase of IT equipment, taking leases of property or buying new property should also be considered.

13.3 Once risks have been identified they can be quantified and the basis of a reserves policy devised. This is where the future budgets and the strategic plan are helpful.

13.4 One method of assessing the charity's risk might then be to :

i) consider the maximum variance from budget or previous year of each strand of income in each of the last five years;

ii) select the worst example of each income strand and total them all up.

This will give you a value which might approximate to the result of everything going wrong at once.

To be a little more sophisticated, the values could be adjusted for inflation and they might be translated into percentage terms which could then be applied to next year's budget.
A similar review of expenditure might be applied to all or some of the expenditure heads, bearing in mind that some heads are easier to rein back than others.

Of course, if comparisons are being made to budget it may be necessary to make allowances for any lack of expertise in setting the budget!

13.5 The figure obtained can be compared with the reserves identified in chapter 11. However, each charity has different strategies and it is worth talking to people in similar charities to see what they do. Some figures showing reserve levels of the largest charities are in Appendix 2.

14. Calculating reserves by scenario planning

14.1 This is the process of asking "what if....?" By examining each part of the charity's activities and using some imagination it is possible to test what could happen if certain situations arise. The answer may impact on the income, planned expenditure or any aspect of the charity's operations. It is a tool used particularly in strategic planing and budgeting.

14.2 Questions should be asked in all areas of the work of the charity

For example, against each income source, what if:

- the stockmarket dives by 15%?
- the charity's principal benefactor dies?
- the fund-raising appeal misses the target by 20%
- we are notified of a huge legacy?
- our corporate sponsors double their support?
- the local authority does not renew the grant following the council election?
- there is a drop of 2 pence in the standard rate of income tax?
- VAT zero rating is abolished?
- the minimum payment by Gift Aid is reduced to £50?

. . . and against each expenditure, what if:

- the project overruns by six months?
- the kitchen used for carrying out the activities burns down?
- the situation in place y escalates into war?
- the accountant waives his fee this year?
- the adjoining owner shares costs on roof repairs?
- the computer chips are stolen?

14.3 Put a value against each question and decide what, if anything, the charity can do about it. That examines the effectiveness of the budget and helps indicate where reserves are needed. It also helps to show up where more funds may be coming from so that reserves requirement is reduced.

15. Alternatives to reserves

Apart from careful planning, (including, for many charities, planned fund-raising), and attention to cash flow, cost cutting, value for money, consider other ways in which contingencies could be met. Alternatives include:

- insurance cover to provide replacement premises if those used for any activity are damaged by fire;
- borrowing on the security of real estate to meet a temporary shortfall between appeal income and the cost of acquiring new property;
- a sale and leaseback of certain assets, or a refinancing arrangement;
- reciprocal arrangements with another charity to share services or facilities in emergency, e.g. meals on wheels if a power failure hits the kitchen of a residential home and the loan of a minibus should the delivery vehicle be off the road;
- a bank overdraft facility to smooth cashflow.

A full review of the finances of the charity and how they are arranged could improve the financial health of the charity, with a bit of time and effort and a lot of common sense.

Section D:

THE IMPORTANCE OF PRESENTATION

16. Presenting reserves

16.1 Charity trustees have a responsibility not only to use funds given and entrusted to them wisely but to be seen to be using them wisely. This especially includes presentations in their Annual Accounts. The fact that they may be independently examined or audited on behalf of beneficiaries, supporters and others with an interest, or stake, in the charity . The Annual Accounts and Report may be the only official yearly communication with people who have an interest in the affairs of the charity (the "stakeholders") adds weight to the importance of them being readily understood.

Accounts are technical documents and many stakeholders will not be trained in how to read them. Charities should therefore present their message as clearly and understandably as possible. "Reserves" can easily be misunderstood; why is a donor being asked for yet more money when the organisation appears to have a large sum in Reserves?

16.2 There is a danger that everything under the heading of "Funds" on the balance sheet will be seen by the reader as reserves. There is a growing practice for charities to include among their funds one fund which identifies their investment in Tangible Fixed Assets. The work of some charities requires little in the way of Tangible Fixed Assets, or they are able to lease what is required easily and economically. Others have a high proportion of their funds tied up in fixed assets, whether this is buildings or equipment. For example, residential or day care accommodation, equipment for those with physical disabilities, recording and playback equipment for talking books are all essential fixed assets without which the organisation could not function effectively.

16.3 By identifying and explaining clearly the component parts of the funds of the organisation the reader can be guided to what remains - the reserves. The Notes to the Account and the Trustees Annual Report may be used to describe or explain terms such as "Endowment", the function of a "Designated Fund" and the reasons for and purpose of "Restricted Funds". The reserves may comprise a base reserve and any surplus. The basis on which the base reserve is calculated and plans for application of any surplus should be explained in the Notes to the Accounts, with explanations and justifications amplified in the Annual Report. As should any part of the reserves which are ear marked for particular purposes.

16.4 It makes no difference if a charity is large or small, or if it produces Receipts and Payments Accounts, not Accruals Accounts. Every charity has supporters, beneficiaries, potential donors or grant makers, regulators and others who will read the accounts and expect to see what the funds available to the charity really are. An under-resourced charity existing hand-to-mouth should explain its reserves policy in terms which set targets for achieving the desired level. An over-resourced charity which has not been applying income fully should explain why the accumulations have built up and how it proposes to apply them in the foreseeable future.

16.5 Accounts should be clear as to which funds are free and which funds are committed. Funds that are, for example, prepayments, or matching funds to support a grant yet to be received, or are due to a creditor, should all be easily identifiable and fully explained.

The examples in Appendix two show how the presentation of the balance sheet can help to make the reserves policy more easily understood.

17. Conclusion

17.1 There is no universal formula for agreeing the appropriate level of reserves. The examples and ideas contained in these guidelines should help each charity to reach a justifiable target for reserves levels. Most charities consulted in the preparation of the guidelines favoured linking the reserves levels to expenditure levels. That is most likely the case when there is a high level of commitment, whether legal or moral, to apply funds for specific purposes. Others took into account the whole budget process. If income for budget purposes is assessed at the median of probability then reserves are needed to protect the gap between the worst forecast and the median. Some identify only crucial activities which are the very core of their existence and seek to protect them, spending in the next year any unapplied reserves.

17.2 Whatever the approach, it must show up clearly in the trustees report, be discussed with and explained to the auditor and show up clearly in the accounts. The examples in the Appendix illustrate how reserves might be shown in accounts.

17.3 A clear reserves policy, which is measurable and regularly reviewed, is an asset to the charity. Each charity must be considered in the context of its own income streams and expenditure commitments. The size of reserves must be appropriate for the purposes for which the reserves are maintained.

17.4 Trustees have no need to be defensive about their reserves policy provided that they have thought carefully and calculated as accurately as possible.

About the authors

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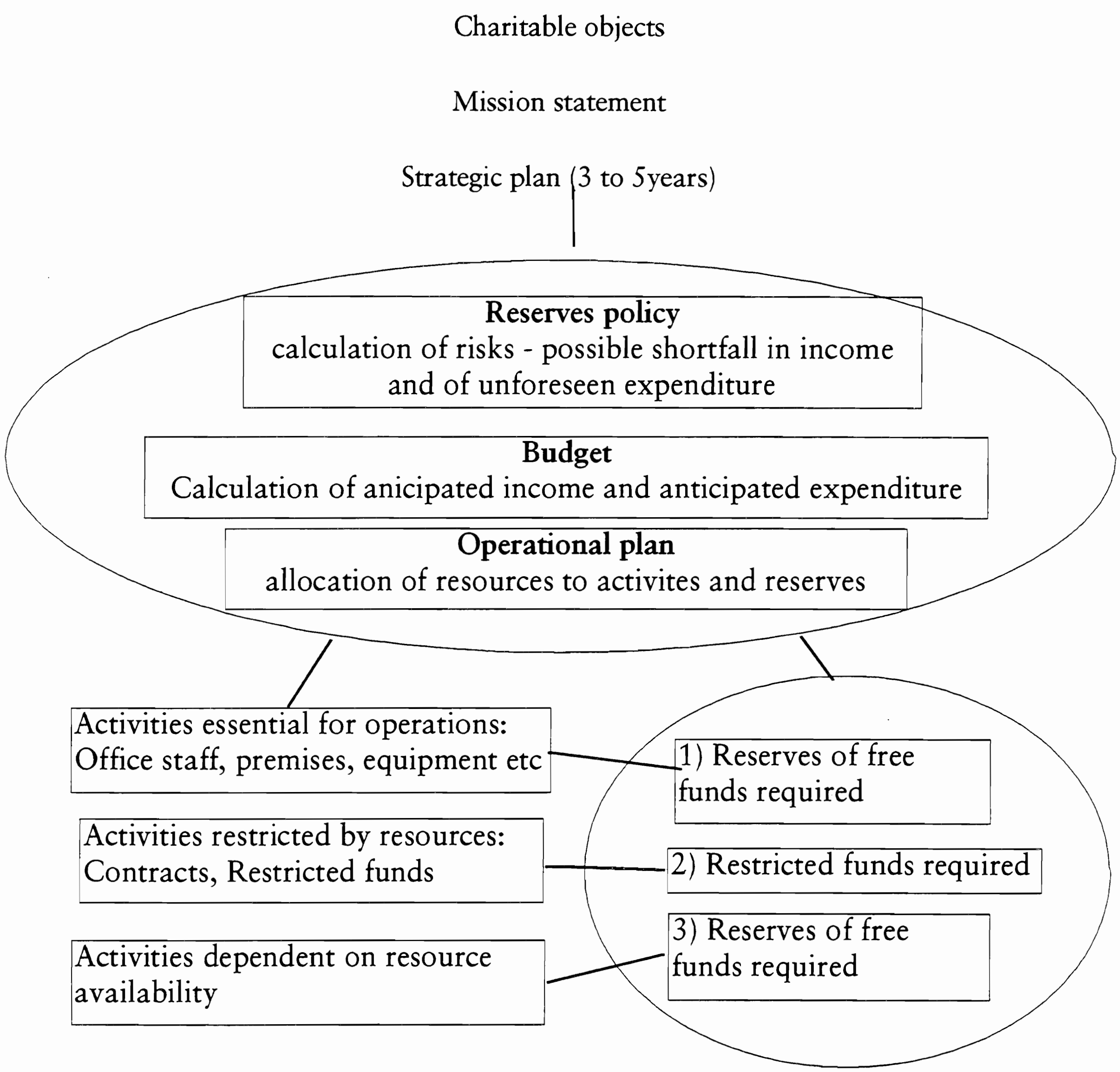
John Tame is a chartered accountant who became Chief Accountant of Macmillan Cancer Relief in 1985 after a career in England and abroad in various capacities, including Finance Director and Company Secretary of subsidiaries of Unilever and Tootal. He has long been active within charity in a voluntary capacity as administrator, adviser and committee member. Macmillan Cancer Relief won the 1992 and 1995 awards for the best Annual Accounts in the large charity section of the competition organised by the Institute of Chartered Accountants, CAF and Charity Forum.

Appendix one: Planning model

A simple model of charity planning showing where the reserves policy fits in



1) is to meet the cost of maintaining essential operations, including core support costs of other activities, either until more resources are received or, in the extreme, to wind up the entire operation.
2) refers to funds which are limited as to their application. Those activities will probably cease when the restricted resources are no longer available. May need to draw on reserves, eg to cover contractual obligations.
3) is a way to reach or maintain the agreed level of reserves. It may also include an emergency fund available to "pump prime" urgent activities pending fundraising (eg relief of victims of an earthquake).

The three stages shown in the central circle are repeated until an acceptable balance is reached as the stages depend on each other. The whole process should be reviewed regularly.

Appendix two: Presentation of reserves

Not all charities have had formal policies on reserves in the past. Recently however, many charities have given considerable thought to this aspect of financial management, and a significant number have joined those who have long recognised the need to formulate and regularly review their policy. Yet there are still few who give much detail, of what are sometimes quite complex reasonings, about the basis of their policy in their published Accounts.

SORP affects not only the content of an organisation's Accounts but also the way in which some of that content - including reserves - is presented. This, together with Charity Reserves, published by the Charity Commission will mean that many Accounts which will be published over the coming months will contain more information, and in a variety of styles and places within the Accounts, than has hitherto been the custom.

There is as yet no standard form and sequence for presenting reserves on the face of charity Balance Sheets. Even the SORP reverses the order of restricted and unrestricted funds between Examples two and three. Terminology is also variable, the words "fund" and "reserve" often being interchangeable. Sometimes endowments and restricted reserves have been deducted from the "top half" of the Balance Sheet to more clearly identify the general or free reserves.

It is also arguable that a different name altogether should be given to a Tangible Fixed Assets Reserve, as, apart from being rather a mouthful, it represents money already spent whereas other reserves represent money set aside. Certainly reserves should always be explained, but a different name might help the lay reader or supporter to more easily and quickly understand the message.

Doubtless common forms and terminology will quickly emerge to enable supporters and others to more easily understand the Accounts that they read.

The following extracts have been taken from Charities' Accounts published when only draft versions of the Commission's Reserves Guidelines were available. Most of these organisations have indicated that there may be significant changes regarding this subject in their forthcoming Accounts.

A. The Royal Star and Garter Home for Disabled Sailers, Soldiers and Airmen

The Royal Star and Garter Home provides hospitals and accommodation for disabled members and former members of the Forces, and financial and other help.

The charity's 1995 Accounts, which were prepared under the 1988 SORP, valued investments at cost and did not provide a Capital Assets Fund.

Balance Sheet at 31 December 1995.

		as published	*revaluing investments*	*with a Capital Assets Fund*
		£ooo	£ooo	£ooo
Tangible Fixed Assets		2601	2601	2601
Investments and Deposits:	Cost	9267		
	Market		12215	12215
Subsidiary Companies		273	273	273
Net Current Assets		879	879	879
		13020	15968	15968
General Fund		11020	13968	11367
Capital Assets Fund *(designated)*				2601
Anniversary Fund *(restricted)*		2000	2000	2000
		13020	15968	15968

Reference is made in the Governors' Report to the Funds held by the charity:

"The funds held by the Charity at 31 December 1995 are equivalent to approximately 1.75 times the operating costs of the year then ended (i.e. 21 months' cover). *The present levels of fee and voluntary income, if maintained, are adequate to support operations."*

Note that, had the Home revalued its Investments (and not created a Capital Assets Fund), its cover would have risen to 27 months. However, by also creating a Capital Assets Fund, coincidentally the General Fund comes back to almost exactly the value considered by the Governors to be adequate.

B. The Tear Fund

The Tear Fund is a christian charity which aims to bring good news to the poor. About half of its income is restricted.

Balance Sheet at 31 March 1996.

		£000
Tangible Fixed Assets		4695
Investments		1
Net Current Assets		4652
Creditors more than one year		(69)
		____
		9279
		====

FUNDS			
Designated Fixed Assets Fund		4695	Informal Reserves Policy
Funds available for programmes:			(not quoted in published Accounts)
Restricted Funds	2697		*Cash balances of a minimum of*
General Funds	1887		*£2 million, representing approx.*
	___	4584	*one month's expenditure based*
		____	*on the following year's budget.*
		9279	
		====	

Accounting Policies and Note 20 explain that the Fixed Assets Fund has been designated by the Board and comprises Funds invested in the net value of land and buildings, fixtures, fittings and equipment, and motor vehicles, and are not therefore available for other purposes.

The informal reserves policy, devised before the Charity Commission's 1997 Guidelines which focused upon unrestricted reserves, *embraces the total work of the charity whether funded from restricted or unrestricted income.*

If, as may be likely, a substantial part of the income continues to be restricted, any future reserves policy may have to address both restricted and unrestricted income, in combination.

C. The Nene Valley Railway

At first sight, the Railway, with almost £1million of unrestricted reserves may appear to be very comfortably placed. But when it becomes apparent that £873,000 is tied up in Tangible Fixed Assets, and there is a negative balance on the Revaluation Reserve, the picture changes dramatically!

Balance Sheet at 31 January 1996.

	as published £000	*with a Capital Assets Fund* £000
Tangible Fixed Assets	874	
Investments *(at market value)*	148	
Net Current Assets	57	
Creditors more than one year	(3)	
	1076	
Financed by:		
Restricted Funds *(expendable endowment)*	226	226
Revaluation Reserve	(95)	(95)
Capital Assets Fund		874
Unrestricted Funds	945	71
	1076	1076

D. The Royal National Institute for the Blind

RNIB promotes education, training, employment and welfare of blind and partially-sighted people. About half of its income is in grants and fees.

Balance Sheet at 31 March 1996.

	as published	*including all Tangible Fixed Assets in the Designated Fund*
	£000	£000
Tangible Fixed Assets	41279	
Investments	30002	
Net Current Assets	2839	
Creditors more than one year etc.	(4462)	
	69658	
Represented by:		
Designated Funds:		
Property in use by RNIB	33164	41279
Earmarked Funds	1155	1155
Development Fund	7662	7662
	41981	50096
General Reserves	24692	16577
Endowment Funds	2985	2985
	69658	69658

The Accounting Policies explain that property in use by RNIB "represents the value of RNIB's interests in land and buildings [..] and [..] is shown as a separate fund as the properties represented are essential for the provision of RNIB's services to blind and partially sighted people." It is interesting to note that this fund does not include Talking Book Machines and other fixed assets: if it did, General Reserves would be reduced by about a third (see column on right).

The Treasurer's Report states that the "reserves policy is broadly in line with the proposals set out in the Charity Commission's latest Exposure Draft on Charities and the Retention of Income Reserves." It goes on to say "We felt it important to identify more clearly those elements of reserves which are designated for particular projects from those which a charity of RNIB's size and complexity *(with over 60 services)* must retain to function effectively."

The Treasurer's Statement goes on to explain that the Development Fund is expected to be increased to provide for RNIB's "Strategy 2000", the concept of which is explained elsewhere.

E. ACTIONAID

ACTIONAID seeks to enable the poorest people in the world to address the root causes of their poverty and improve their living standards. Two of the principle ways it does this are long term development programmes and emergency assistance, both of which attract substantial restricted funds. Emergency funds are expended as soon as practicable, and are by nature outside any reserves policy.

Balance Sheet at 31 December 1995.

		£ooo
Tangible Fixed Assets		1113
Net Current Assets		12565
		13678
		=====
FUNDS		
Designated Capital Fund		1113
Funds available for programmes:		
Restricted Development Fund	7548	
Restricted Emergency Fund	1962	
	9510	
General (Unrestricted) Fund	3055	
		12565
		13678
		=====

Reserves Policy in respect of Development Work:*
"at least a quarter of next year's planned expenditure for each project."

*Strictly speaking, as the policy relates to Restricted Funds it is outside the scope of the Charity Commission guidelines. However, 75% of ACTIONAID's income is, by nature of the style of its fundraising, restricted. It is therefore very responsible of the charity to explain to its supporters - and beneficiaries - how it plans its work, as to address only the unrestricted 25% might lead to criticism.

Note 13 explains that the trustees have designated from Unrestricted Funds a Capital Fund which represents the net book value of Fixed Assets and is, therefore, not available for distribution.

F. The Save the Children Fund

The Fund works to achieve lasting benefits for children in different parts of the world. In 1995/96, 60% of its income was restricted.

Balance Sheet at 31 March 1996.

		£m
Fixed Assets		
Tangible assets		8
Investments		16
		—
		24
Net Current Assets		23
Pension Scheme Contributions		(4)
		—
Net Assets		43
		==
Accumulated Funds		
Unrestricted Funds:		
General Funds:		
Unrealised Investment Gains	3	
Other	6	
	—	9
Designated Funds:		
Tangible Fixed Assets Reserve	8	
Base Reserve	10	
Emergency Response Reserve	1	
	—	19
Restricted and Other Funds	15	15
		—
		43
		==

The Charity plans on a rolling four year anticipation of activity and income. From short-term funding it is committed to providing both emergency programmes and long-term development work. It is assumed that fluctuations will occur in both income and requirements for funding which cannot be taken into account in the planning process. A Base Reserve has therefore been created, described in the Report of the Council as being equivalent to approximately three months' expenditure on recurring work. It is held to protect SCF's work in the event of sudden and significant change such as a sharp downturn in income. The Tangible Fixed Assets Reserve equates to the investment in properties and equipment used in SCF's operation. The Emergency Response Reserve reflects the nature of the work of the charity by enabling responses in advance of special appeals. The Reserve is held in two parts, £250,000 having been given specially for this purpose and therefore being included within Restricted and Other Funds, and £750,000 being designated.

G. The Guide Dogs for the Blind Association

The objects of the Association include the provision of guide dogs - of which there are presently over 4500 - their training and upkeep, and other services to blind people.
The Association offers a lifelong commitment to any sight-impaired person who could benefit from a guide dog. An owner may need up to ten dogs in his/her lifetime. The Association's strong financial position ensures this continuing commitment.

Balance Sheet at 31 December 1995.

	£m	£m
Tangible Fixed Assets		39
Investments (at market value)		146
Net Current Assets		9
		194
Representing		
General Fund		
Balance from previous year	168	
Transfer from Income and Expenditure Account	(9)	
Transfer from Unrealised Investment Gains	7	
		166
Unrealised Investment Gains		
Balance from previous year	16	
Transfer from Statement of Investment Gains	19	
Transfer of realised gains to General Fund	(7)	
		28
		194

The Financial Policy of the Report of the Council identifies four "specific reserves" (designations) within the General Funds:

		£m
1	Fixed Assets Reserve - representing property and equipment	39
2	Guide dog replacement - an actuarial valuation of replacing current dogs over the next ten years	79
3	Opthalmic, canine and other research, commitments already made	5
4	Expansion Programme - projected capital and revenue costs in excess of current levels to AD2000	42
	Balance - the level of unrestricted funds necessary for the overall strategy in an environment susceptible to declines in income flows	29

During 1995, £ 9.5m was released from Reserves towards current programmes.

Note. An alternative presentation of this information would be to retain the narration in the Report, to show the above breakdown in the Balance Sheet, identifying the designations, and to show the Movements in the Funds in the Notes.

H. Barnardos

Barnardos works throughout the UK with children, young people and their families by offering support, guidance and care. The Report of the Council explains that a Reserves Policy has been developed to strike a balance between funding immediate services and the consequent open-ended commitments.

Balance Sheet at 31 March 1996

		£m
Tangible Fixed Assets		75.6
Investments		96.7
Net Current Assets		13.4
		185.7
FUND BALANCES		
Restricted and Endowment Funds:		
Restricted Income Funds	0.3	
Restricted Capital Funds	8.6	
Endowment Funds	11.7	
		20.6
Designated Funds:		
Base Reserve	22.3	
Properties Reserve	70.0	
		92.3
Unrestricted Funds		72.8
		185.7

The Base Reserve is described in the Report of the Council as being over and above that held in Fixed Assets Equivalent, and equivalent to nine months' anticipated net voluntary income* in the year ahead. The Report goes on to warn, however, that although this policy has enabled the organisation to draw on surplus reserves over the past three years to fund work which could not otherwise have taken place, reserves are not sufficient to fund all the predicted growth in demand, for which fund raising and local authority income will both need to increase.

* *ie the elements in the Income and Expenditure Account considered most at risk.*

The Charity advises that the deregulated reserve for property will be developed to include all tangible fixed assets in its 1997 accounts.

Unrealised gains on revaluations are identified in the Notes rather than on the face of the Balance Sheet.

I. Rathbone Community Industry

Rathbone provides training for young people and unemployed adults, with 90% of training for those with special educational of training needs, mainly under contracts with TECs (and LECs in Scotland) to NVQ level. This funding requires measurable outputs, thus militating against risk taking and making it hard to accumulate reserves.

Balance Sheet at 24 March 1996

	£ooo
Tangible Fixed Assets	983
Net Current Assets	3218
Provisions and Creditors over one year	(2465)
	1736
RESERVES	
Unrestricted Funds	
Designated Reserve	1600
Accumulated Surplus	136
	1736

Income and Expenditure for the year both amounted to £25.8 million, and there was a surplus of £2 thousand (last year there was a loss of £400 thousand). Amounts due from TECS/LECS at year end amounted to £3.5 million - about two months' invoices.

The Notes advise "In order to manage its operations on an economic and stable basis, Rathbone incurs financial commitments - especially for leases and staffing - which go beyond the current financial year. As a matter of financial prudency, the Designated Reserve has been established to provide for these future commitments under agreements existing at the year end."

The Designated Reserve is, in effect, a Base Reserve.

Note that there are not sufficient reserves remaining to represent either a Fixed Asset Reserve or a Working Capital Reserve, and the Designated Reserve was built up years ago. Charities mainly in the contract culture may find it very difficult to accumulate what they may feel to be an adequate level of reserves, making them especially vulnerable to late payments or bad debts.

Appendix three: Different types of designated funds and reserves

The Charity Commission uses the term "reserves" to describe that part of a charity's income funds that is freely available for its general purposes. As previously explained, provided each designation can be justified and is explained, charities are free to designate such part of their reserves as may from time to time be appropriate for their activities. Note that in some instances a designated fund may supplement an existing restricted or endowment fund. Please refer to Chapter 16 regarding how and where to explain the policy, and also to SORP (paras 43 and 44) regarding reconcilations and transfers between funds.

Capital or tangible fixed assets fund
Charities very often have Tangible Fixed Assets in their Balance Sheets. In some cases, for example a hospice or school or railway preservation society, these assets may even account for most of the funds, whether those funds are restricted or not.

In recognition that funds already spent in this way are not available for further work without selling off the tools-of-the-trade, so to speak, many charities now create a fund equal to the net book value of some or all of them. A note is then included to explain that this fund represents money already spent. The fund is adjusted each year for sales, purchases and depreciation of tangible fixed assets.

Usually treated as Designated Funds

Endowments or project maintenance funds
In addition to Endowments, some charities set aside additional funds - which may be either restricted or unrestricted - to provide resources for part or all of their remit. Funds may be given at the time an asset or project is taken on: in other instances the charity might set aside money as it is able to, or funds are given or raised. The funds might provide, for instance, an income towards maintenance of a building or preservation of some historical equipment, or to pay for a commitment such as a University Chair.

Unrestricted Funds set aside in addition to Endowment or Restricted Funds would be Designated.

Emergency response fund
Part of the work of some organisations requires the charity to respond to an emergency before funds from an appeal are received. An Emergency Response Fund sets aside money which can be used quickly and then repaid as new money is received.

Usually treated as Designated Funds

Working capital reserve

Just as a business needs working capital to finance stocks and debtors and payroll, less of course the benefit of unpaid creditors, so too do many charities. This finance may be needed to avoid recourse to a bank overdraft - should this even be possible! - if income pattern is irregular or unpredictable, or grants or payments for services do not come through on time. It may also include start-up funding for regular activities, and prepayments for expenses for large fundraising events or direct mail campaigns.

A Working Capital Reserve differs from a Base Fund in that it protects against fluctuations whereas a Base Fund provides against actual loss of income or irregular costs.

Although a Designation could be created, this would normally be considered to be part of the Reserves calculation and explanation.

Base or continuity reserve

This is usually computed in relation to certain defined risks to some or all future income or expenditure. It is designed to protect the ongoing work of the organisation against unexpected downturns in income or increases in expenditure.

The principle can be extended - especially for charities involved in the contract culture - to include provision for redundancy or other costs which might follow the loss of a contract or cessation of an activity.

Although in the past this was considered by some charities to be designated, it should now be treated as part of Reserves.

Appendix four: case studies

Case Study one
The Village Hall Charity was set up some years ago. Its assets consist mainly of the hall, some equipment, and a few small Investments.

In the early years after the hall was built, maintenance was slight. In recent years however, repair costs have begun to rise, though they vary considerably from year to year. Consequently, some years' Accounts show a surplus whilst - increasingly - other years show a deficit. The local builder has warned that window frames will need to be replaced in two or three years' time at a cost of at least £50,000.

The Balance Sheet at 1st January was:	£'000
Fixed Assets - Property (at cost)	500
Equipment (after depreciation)	22
Investments	13
Net Current Assets	45
	580
Funds	580

Some new villagers have seen the Accounts and have suggested that some of the "Funds £580" be used to pay for the new windows, and that some more be used to subsidise the price of the beer! After all, why does a little local charity need to hold over half a million pounds in its funds? The trustees don't feel able to go along with either of these suggestions, but are having difficulty in explaining why they shouldn't.

Observations
There are two fundamental issues here:

-making the Accounts "talk" to the members , *and*
-the lack of a reserves policy to address both the maintenance issue and the fact that most of the charity's assets are tied up in its buildings and equipment.

Communicating the information in the Accounts to non-accountants is especially important for charities, who rely so much upon the goodwill of their supporters.
Brevity here has led to a lack of understanding, and a little more detail - using appropriate terminology - should help to make the Accounts a little more user-friendly, as encouraged in the Introduction to SORP.

Property and equipment
Over ninety percent of the charity's funds have already been spent on Fixed Assets.
To the casual reader this may not be evident unless it is set out on the face of the Accounts.

This is easily done by creating a specific designated Capital Fund representing the Tangible Fixed Assets' net book value shown on the other side of the Balance Sheet. This fund will be adjusted each year by the value of purchases, sales and depreciation of the assets.

Note that it is not mandatory to create a Capital Fund, (sometimes referred to as a Tangible Fixed Assets Fund) but by doing this it is possible to immediately see what Reserves exist.

Conclusions of the Committee
That three Designated Funds be set up as follows:

1) Capital Fund. The value at 1 January will be £522, as in the Balance Sheet.

2) Cyclical Maintenance Fund. It is felt (say) that an annual provision of £10 should be sufficient. The fund will have an Opening Balance of £20, representing the trustees' view that the charity is two years into the cycle.

3)Major Maintenance Fund. It is felt (say) that an annual provision of £8 should be sufficient. The fund will have an Opening Balance of £32, representing the trustees' view that four years' accumulation is appropriate.

The balance of the Funds will remain Unrestricted, i.e. Reserves.

The purpose of these Funds, and how they will operate, will be explained in Trustees' Report.
The annual amounts set aside will be regularly reviewed.

During the year to 31 December, there were purchases of equipment amounting to £6, and no sales or revaluations. There were no purchases or sales of investments, the valuation of which at the end of the year had increased by £4.

The Accounts at 31 December 199y will now read: **VILLAGE HALL CHARITY**

Statement of Financial Activities for the year ended 31 December 199y **£'000**
(Incorporating Income and Expenditure Account)

	General Fund	Designated Funds	Total 199y	Total 199x restated
Incoming Resources				
Lettings	20		20	
Subscriptions	5		5	
Fundraising	42		42	
Investment Income	1		1	
Total Income	68		68	
Resources Expended				
Direct Charitable Expenditure:				
Maintenance of Hall	46		46	
Fundraising	10		10	
Administration and Other	9		9	
Total Expenses	65		65	
Net Incoming Resources before Transfers	3		3	
Transfers between Funds:				
Increase in Property and Equipment Fund	(1)	1		
Increase in Major Maintenance Fund	(3)	3		
Net Outgoing Resources of the year	(1)	4	3	
Unrealised Gains on Investment Assets	4		4	
Net Movement in Funds	3	4	7	
Balances brought forward - 1 January	6	574	580	
Balances carried forward - 31 December	9	578	587	

Note that as there was no movement in the Cyclical Maintenance Fund there is no need to show it in "Transfers between Funds".

The Notes to the Accounts will contain the following information:

DESIGNATED FUNDS (£'000)

Capital Fund.

As at 31 December 199y the trustees designated the following values, representing the cost of the hall and the cost of equipment less depreciation, as a Capital Fund. The value represented by this fund is therefore no longer available for other work of the charity.

Balance at 31 December 199x		-
New designations:		
Buildings	500	
Equipment	23	
		523
Balance at 31 December 199y		523

The second part of this Note will be set out in subsequent years in the following way:

	Balance 199x	Purchases	Depreciation	Balance 199y
Property	500			500
Equipment	22	6	(5)	23
	522	6	(5)	523

Maintenance Funds

A similar Note to that explaining the Capital Fund will appear. The second part of the Note in subsequent years will show:

	Balance 199x	New Designations	Spent	Balance 199y
Cyclical	20	10	(10)	20
Major	32	8	(5)	35
	52	18	(15)	55

and the funds will be totalled to agree with the Balance Sheet:

574	24	(20)	578

Analysis of Net Assets between Funds

	Reserves	Designated Funds	Total
Fixed Assets		523	523
Investments		17	17
Net Current Assets	11	36	47
	11	576	587

The Balance Sheet will now become:

		£'000			
		199y		199x restated	
Fixed Assets					
Tangible Fixed Assets	- Property	500		500	
	Equipment	23		22	
			523		522
Investments			17		13
			540		535
Net Current Assets			47		45
Net Assets			587		580
			===		===
Funds:					
Amounts designated for particular purposes:					
Capital Fund		523		522	
Cyclical Maintenance		20		20	
Major Maintenance		35		32	
			578		574
Reserves		9		6	
		587		580	
		===		===	

Case study two

ChildCare is a fundraising/grant-receiving charity whose concerns are underprivileged children and young people in this country and abroad. It has a database of regular donors and supporters which it seeks to expand and develop through appeals and fundraising activities. Wherever possible, it rents or leases its premises and equipment.

Some of its projects are entirely under its own discretion, and others are undertaken solely according to grant funding received from various agencies. Projects may be short-term in response to emergencies or longer-term and include development work.

The trustees are considering a fresh approach to evaluating the funds which they believe need to be retained, and tying their perceived requirements directly to their future planning. In addition to a designated Fixed Assets Equivalent Fund, they are debating revising their Operating Reserve - representing nine months' anticipated net voluntary income - to one related to the perceived risks attaching to various strands of income and expenditure.

Net voluntary income for next year(£'000) is budgeted at 8000, so under the old basis the Operating Reserve would have been 6000.

In evaluating the risks, the following are considered relevant:

1 Personal donations and covenants from known supporters for ongoing activities are more predictable than those from the general public.

2 Special Appeals are launched for particular emergencies. This money is obviously earmarked, but sometimes it is necessary for it to be supplemented from general funds, and frequently there is the need to pump-prime ahead of responses. Appeals vary in response according to several factors, and thus can range from low to high risk.

3 Fundraising activities fall into two categories - low and high risk. The budget endeavours to keep a balance between the two.

4 Trust income for general activities can be irregular, depending upon factors outside the control of the charity, and is considered moderate to high risk.

5 The charity's budgeting for legacy income is considered to be conservative (following under-performances in the past due to slow property sales). The risk attaching to budgeted legacy income is therefore considered to be low-level.

6 Certain projects are undertaken solely from specific grants. If the funding is not renewed, the project will be discontinued. The ending of one of these grants would result in unfunded winding-up costs equivalent to two months' costs for the programme

7 The allowance for administration attached to grants varies from one funder to another.

8 Employment costs in the UK are mainly for established positions, which would require between 1 and 3 months' compensation should there be a need to reduce staff levels. A reduction of 20% is considered the maximum without longer notice.

9 Other UK commitments are minimal.

10 Emergencies Expenditure can vary considerably, due to the nature and locations of the work.

11 Tangible fixed assets acquired in connection with an emergency are considered to be a sunk cost. Therefore no adjustment is to be included in the evaluation.

12 Most projects do not incur significant local legal commitments (though there is a strong moral intention to complete the work). From a risk assessment therefore it is not considered that provision is necessary.

Risk Evaluation

	Budget	Risk %age		Evaluation	
		Min	Max	Min	Max
	£000			£000	£000
INCOME STRANDS:					
1a Database support	2000	7.5	12.5	150	250
b New Supporters	600	17.5	30	105	180
2 Appeals Income	2500	15	60	375	1500
3 Fundraising: low risk	1000	5	15	50	150
(net) high risk	600	20	50	120	300
4 Trusts	500	20	40	100	200
5 Legacies	800	5	12.5	40	100
	8000				
EXPENDITURE:					
6 Programme Closure	700	10	20	70	140
7 Grant Administration	300	5	20	15	60
8 Employment costs	300	10	20	30	60
9 Other UK costs	400	5	15	20	60
10 Emergencies Expenditure	2500	25	80	625	2000
Total Risk				1700	5000

The revised requirement would therefore range from 1700 and 5000, represented by a designated Rapid Response Fund and unrestricted Reserves. The Appeals Income and Emergencies Expenditure would comprise the Rapid Response Fund, which would be available as the name implies, subject to planned replenishment.

As the charity's Operating Reserve of nine months equated to 6000, the trustees could therefore consider a reduction ranging from the significant to the draconian! They might though wish to take into account any planned growth indicated in the Three Year Plan (since this would of itself require increases in Reserves) as part of any phased reduction.

The concept of the new basis and the effects of its introduction, including how and over what timescale any surplus might be applied, would appear in the Treasurer's Report, with appropriate references in the Notes.

Appendix five: Calculating reserves by regression analysis

Regression analysis is the technique of estimating an equation that shows the contribution of independent variables to variations in the dependent variable. It tests an hypothesis that there is a relationship, or correlation, between two or more variables and measures the strength of that relationship. When one independent variable is involved, the statistical procedure is called simple regression; when two or more independent variables are involved, the procedure is called multiple regression.

To measure, or obtain a forecast value for, a dependent variable the correlation co-efficient of the dependent variable and one or more independent variables is measured using the Regression Statistic available in spreadsheet packages (such as Excel or Lotus 123). The values of the independent variables are multiplied by their respective correlation co-efficients and summed to give a value to the dependent variable.

The equation is $Y = X1 + X2$ when Y is the dependent variable, and X1 and X2 are independent variables. It results in giving the expected value of Y for given values of X, or, put another way, for the value of $X1 + X2$ what can we expect the value of Y to be?

A dependent variable is a factor which may be caused to vary by the effect of other factors (eg the level of expenditure, which depends on the level of actual income and/or level of budgeted income). An independent variable is the factor whose variations over time or space might contribute to the variations in the dependent variable. Using the regression statistic (R) contained in a spreadsheet package will show the strength of the relationship between two or more factors. R is the correlation co-efficient and is given as the square root. R squared expresses the statistical correlation between the dependent and independent variables in percentage terms. Thus a high value of R means there is a strong correlation between the factors. A value in excess of about 49% is needed for the variances to be explained by the correlation.

The more figures which are available to enable the correlation to be tested the better. For example, use data for the last five to ten years for actual income, actual expenditure, budgeted income and budgeted expenditure and run the regression statistic to show the strength of the relationship of budgeted income against actual expenditure. A figure of 95% means that all but 5% of expenditure can be explained by budgeted income. Multiple regressions, such as running both sets of income figures against actual expenditure, can refine down the correlation and show what percentage of the expenditure is explained by actual income. By running actual expenditure against reserves it can be seen whether the unexplained variability is sufficient to have a significant effect on reserves.

Appendix six: Glossary

MEANINGS OF TERMS USED IN THIS GUIDANCE

"capital" and "expendable endowment"

Capital means resources which become available to a charity and which the trustees are legally required to invest or retain and use for its purposes. Capital may be permanent endowment, where the trustees have no power to convert it into income and apply it as such, or expendable endowment, where they do have this power. (Expendable endowment 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). (SORP, appendix 1, para. 2)

"fixed assets for charity use"

All assets of material value held for use on a continuing basis in the charity's activities (SORP, para. 183)

"income"

All resources which become available to a charity and which the trustees are legally required to apply in furtherance of its charitable purposes within a reasonable time of receipt (the exercise of a power of accumulation is an application). Income includes all trading and investment income and some legacies, donations, grants, gains from disposal of fixed assets and investments, and asset revaluation gains. (SORP, appendix 1, para. 13)

"market value"

Market value is the price at which an asset could be, or could be expected to be, sold or acquired in a public market between a willing buyer and willing seller. For traded securities in which there is an established market, the market value basis that is to be used in the valuation for the Balance Sheet is defined as the mid-point of the quotation in the Stock Exchange Daily Official List or at a similar recognised market value. For other assets it is the trustees' or valuers' best estimate of such a value.

"permanent endowment"

Permanent endowment has a statutory definition (s.96(3) Charities Act 1993) and is explained more fully in SORP. We give the first part of the SORP explanation: a capital fund where there is no power to convert the capital into income is known as a permanent endowment fund, which must generally be held indefinitely. (SORP, appendix 3, para. 7)

"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), but still within the objects of the charity. Restricted funds may be restricted income funds, which are expendable at the discretion of the trustees in furtherance of some particular aspect(s) of the objects of the charity, or they may be capital funds, where the assets are required to be invested or retained for actual use, rather than expended. (SORP, appendix 3, para 2.) Some trustees have power to declare specific trusts over unrestricted funds. If such a power is available and is exercised, the assets affected will form a restricted fund, and the trustees' discretion to apply the fund will be legally restricted. (SORP, appendix 3, para. 1).

"unrestricted funds" and **"designated funds"**
Unrestricted funds are funds expendable at the discretion of the trustees in furtherance of the objects of the charity. If part of an unrestricted 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 apply the fund. (SORP, appendix 3, para 1).