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Guidelines on Reserves Policies for Charities

A guide for individuals and groups

1. What are charity reserves?

For the purposes of this document reserves can be understood as income which is available to the charity and which can be spent at the discretion of the Board of Directors (or Trustees) to further any of the charity's objectives ('general purpose' income), but which is not yet spent, committed or designated for any specific purpose. It is 'free' for use for any of the charity's purposes.

This excludes the following:

- Permanent endowment;
- Expendable endowment;
- Restricted funds;
- Designated funds;
- Funds that could only be realised by disposing of fixed assets held for charity use, for example donated premises.

All of the technical terms are explained in S9 below.

2. Why have a Reserves Policy?

There are a number of reasons why charities may hold reserves. These will depend on the type of activity undertaken by the charity, how it operates and funds its operations.

In general, reasons why charities hold reserves can be summarised as follows:

- To fund working capital;
- To fund unexpected expenditure, for example when projects overrun or unplanned events occur;
- To fund shortfalls in income, when income does not reach expected levels.
- To accumulate funds for a major project or event such as a new building, or to hold a major event held once every, say, three years.

A helpful way for charities to view reserves is to see them as the funds they will use to cover their working capital requirements e.g. to cover any time lag between spending and when grants come in, and/or to "buy some time" in the event of reduced income or changes in circumstances.

In planning its budget each year, a charity should review the timing of the likely cash flows in and out as well as the levels of income and spending. If for example, grants are only paid in arrears, is the charity able to fund this out of reserves?

A charity may foresee that there is a possibility that funding from a particular source will be cut. The charity will need reserves to fund committed expenditure whilst they source alternative funding. The judgment as to of how long they will need to find alternative funding will help determine the size of the reserve needed for this purpose.

For example, the charity may assess that it would need six months to replace a major source of funding. The reserves level to cover this contingency would therefore need to be the equivalent of the relevant six months' expenditure.

3. The benefits of developing a Reserves Policy:

- Charities like all other organisations, need to plan for their future activities and direction, and the reserves policy is a key element of this. Without a clear idea of the reserves needed it may not be able to meet your commitments, or start new activities which are considered vital for your charity's purpose.

- It feeds into the budgeting and decision-making process – the policy will act as a benchmark to ensure that it uses your funds to good effect. If it does not have the necessary level of cash available to meet its needs as they arise, it may have to cancel projects in a hurry. It may be forced to be reactive rather than plan constructively. If funds are left in the reserves which could be safely used, the charity will be delivering less to its beneficiaries than it could do.

- It focuses your fundraising activities and can be fed into fundraising plans. It is often easier to fundraise for specific items or amounts.

- It is necessary for communication with those external to the charity – the reserves policy helps to demonstrate that the charity's money is being used to good effect. Funders, beneficiaries, members and the wider public are entitled to know this and that the charity has good reasons for maintaining or seeking to establish certain levels of reserves.

Charities should devote attention to providing accounts that are clear and transparent. They should ensure that they include a reserves statement that conveys to donors and others what the position is and why the charity needs reserves. This is particularly important because many funders automatically look at the fund balances shown in annual accounts when deciding whether to approve applications for funding.

It is generally assumed that organisations which have a CHY number should not hold onto charitable funds for a long time, since the organisation was granted those funds to provide charitable services. This is clear for charities that are raising funds for meeting immediate needs. But many charities are involved in providing for short term and longer term needs. They raise and are given funds for both short and longer term purposes. They need to plan and balance how they spend funds for both today and the future, and to carry reserves for future needs. The balancing of these competing needs should be seen as part of the risk management process that all Boards should engage in.

4. Setting up a Reserves Policy

There is a temptation to say, "We have got enough reserves to carry us through three months of activities - let's make that our reserves policy", rather than stepping back and making a genuine estimate of reserve needs and setting a plan to achieve that reserve. This temptation should be avoided.

A policy on charity reserves should cover:

- The reasons why the charity needs reserves;
- The level (or range) of reserves the charity needs;
- What steps the charity is going to take to establish or maintain the reserves at the agreed level (or range);
- Arrangements for monitoring and reviewing the policy.

5. Fixing a reserve level

There is no absolute level of reserves that an organisation must have and it may help to benchmark against other organisations. To determine the right size of reserves, Board members need to look at their current and future incoming and outgoing resources and ask:

- How likely is it that our main sources of income will change?
- How would we cope if it did?
- How would our beneficiaries be affected?

Research conducted in the UK discovered that the most popular techniques used to establish an appropriate level of reserves were:

- Through a cash flow analysis;
- Discussions with the management team, treasurer or members of the finance committee;
- Through an examination of past trends.

As a minimum the organisation should:

- Forecast its income and its likely timing(this should in any case be done as the most basic part of financial planning);
- Forecast planned activities and their associated costs and when they will need to be paid;
- Consider future needs and opportunities, for example, expansion possibilities;
- Consider various scenarios - asking "What if x happened?". For example, what if there is a change of government / Minister affecting their area of operations?

Once the organisation has an idea about what level of reserves it should have, it can compare these with current actual reserves. Most organisations are likely to be facing a shortfall, and will need to plan on increasing them perhaps over a few years. It is possible that a long established charity might have, quite literally, "an embarrassment of riches". It will be in a position to expand key activities by using the additional resources, while also ensuring that it maintains an appropriate level for the future.

6. Summary

The essential steps in developing a reserves policy are as follows:

1. Review existing funds.
2. Analyse income streams.
3. Analyse expenditure and cash flows.
4. Analyse the need for reserves in the light of your objectives, strategy and plans.
5. Calculate the reserves level.
6. Formulate reserves policy which should be agreed by the Board.
7. Present the reserves policy in the form of a reserves statement which can be made available to any stakeholders upon request. An appropriate form of this reserves statement should form part of the Directors Report in the annual accounts.

7. Is there a problem with a charity having reserves?

Charity reserves can be a controversial issue. The media has criticised some large charities for apparently accumulating large reserves while at the same time conducting additional fundraising appeals. As the level of reserves will generally relate to the level of activity among other things, it is likely that large charities will have larger appropriate reserves.

The Revenue Commissioners’ [1] view is that the income raised by an organisation with a CHY number should be spent by the charity on furthering its charitable purpose. Accumulation of income is possible, for example, to save funds for a future project like the construction of a building or to save money for future requirements, in accordance with an appropriate reserves policy. In principle, however, income needs to be spent promptly in line with prudent management of the finances.

The Revenue Commissioners are mostly concerned with "free reserves" (that is, not permanent endowments or restricted funds) and they require a justification for their level. The best way to do this is to develop a reserves policy and associated reserves statement and to include this in the audited accounts. Any significant changes to the policy or the practice related to this should be brought to the attention of the Revenue Commissioners.

Generally, the Revenue Commissioners will take the approach that a charity needs to think through its reasons for accumulation of funds: the organisation needs to articulate clearly what it is doing in this regard and why. (It needs to communicate the existence of a reserves policy in its annual accounts and to note that it is reviewed annually. It should also have a more detailed policy statement for internal use.)

[1] Section 207 Taxes Consolidation Act 1997 under which charities seek tax exemption covers income that is applied for a charitable purpose only. If a charity has income which is not being applied for a charitable purpose then the tax exemption will not apply to the body and all of its income is taxable.

In essence, the rationale behind the accumulation of funds must be written down, approved by the board, be strongly linked to good governance practice or saving for future expenditure purposes and must be available to the Revenue Commissioners upon request. Once the Revenue Commissioners see evidence of these, and if they agree with the analysis, they tend not to put obstacles in the charity's way.

8. Example of a reserves policy statement

A formal policy on reserves was agreed / reviewed at the _____________ meeting of the executive committee/ Board / etc.

It states:

The Board has set a reserves policy which requires:

- Reserves be maintained at a level which ensures that [organisation name]'s core activity could continue during a period of unforeseen difficulty.
- A proportion of reserves be maintained in a readily realisable form.

The calculation of the required level of reserves is an integral part of the organisation's planning, budget and forecast cycle.

It takes into account:

- Risks associated with each stream of income and expenditure being different from that budgeted.
- Planned activity level.
- Organisation's commitments.

The following headings were used in the development of the policy:

- Introduction.
- Current Reserves Policy statement: (as outlined above).
- Risk assessment: against each category of income and expenditure.
- Future activity level: likely requirements on reserves.
- Organisational commitments.
- Statement of the desired reserves level, as a result of the above.

For [year], the Board/committee agreed that the most appropriate level of reserves should be kept at the level of € _______

9. Definitions

Funds given to charities can include money but can also include property and assets of any sort. The funds provided to charities will usually fall into one of the following two categories:

1. Restricted funds
2. Unrestricted funds

9.1 Restricted Funds

Restricted funds can be split into the following two categories:

A) Restricted income funds

Restricted income funds are funds which are often created by charitable trusts whereby the purposes are specified by that trust. The purpose will either be specified by the donor in a specific letter or the terms of a public appeal which may have been running at the time of the donation. Restricted income funds can only be used for the specific purposes for which they are given. If restricted income funds are used by a charity for any other purposes than those which were originally specified then this could amount to fraud or deception.

B) Endowment Funds

Endowment funds can be split into the two following categories:

1. Permanent endowment funds

Permanent endowment funds are funds which are given to a charity to be held as capital. In this case the donor has given no power to either the Board of Trustees for the charitable trust or the management company in charge of the trust to convert them to income. The capital must therefore be retained for the charity, however, this does not stop the investment income derived from it – for example the dividends from the shares – being available for the general purposes of the charity. However, in some cases this will not be possible as this will be expressly forbidden in the terms of the trust.

2. Expendable endowment funds

Expendable Endowment Funds are funds which are given to a charity as capital but there is no restriction on them being converted into spendable income. The discretionary power of whether or not to do this will rest with the Board of Trustees or the Management Company in control of the charity. The funds will remain as capital in nature until they are converted into income.

9.2 Unrestricted Funds

Unrestricted funds can be split into the two following categories:

1. **Non-designated or general funds**

These are funds which are available to an individual charity for the general purposes of that charity. These funds will be spent in whichever way that the Board of Trustees or the Management Company in charge of the charity sees fit in accordance with the stated objectives of the charity. These funds are not earmarked in any way or for any specific purpose meaning that the Trustees or the Management Company can set the priorities for the funds and how and when they are spent. When a charity fundraising event occurs which does not have a specific purpose but simply to raise money for a certain charity all funds raised will be regarded as non-designated or general.

2. **Designated Funds**

Designated Funds are also funds which are available for the general purposes of the charity however, they have been chosen by the Board of Trustees of the Management Committee in charge of the charity to be used for a specific purpose. A decision to designate certain funds for a specific purpose will be made at meetings by the Board of Trustees or the Management Committee of the charity. The Board of Trustees or the Management Committee will have the power to change decisions regarding funds designated for specific purposes and designate them to other purposes or simply leave them as non-designated or general funds.

Sources

The following documents provided the source material for the development of this guideline document:

'Reserves: an overview', NCVO,
www.ncvo-vol.org.uk/askncvo/index.asp?id=2586

'Reserves policies for smaller charities', NCVO,
www.ncvo-vol.org.uk/askncvo/index.asp?id=2585

'Drawing up a reserves policy', Sayer Vincent,
www.sayervincent.co.uk/render.aspx?siteID=1&navIDs=1,7,64

Irish Revenue Commissioners
www.revenue.ie

Charity Commission for England and Wales
www.charitycommissioners.co.uk