Last updated: 12-Apr-21

Policy on Reserves

Background

Unlike the other guidance leaflets in this series, this leaflet is not so much a “template” for a Reserves Policy as guidance on how to create a Reserves Policy and a suggested layout.

Brief Statement of the Charity's Policy on Reserves

Here you should include a short summary of the charity’s Policy on Reserves as it will appear in the relevant section of the Trustees’ Annual Report & Financial Statements.

What Are “Reserves”?

Section 3.1 of the Charity Commission’s guidance document CC19, Charity Reserves, Building Resilience[1] defines *“Reserves”* as:

> *Reserves are that part of a charity’s unrestricted funds that is freely available to spend on any of the charity’s purposes. This definition excludes restricted income funds and endowment funds.*

In other words: this definition means that, after taking out any unspent restricted funds *(this leaflet is written on the assumption that most small charities will not have any endowment funds)*, ALL of the money that the charity has at any point in time are its “Reserves”.

But then in Annex 1, *“A simple approach to developing a reserves policy”*, of the CC19 leaflet the guidance adopts a different “definition of *“Reserves”*, by suggesting *“... 3 questions ... designed to help guide trustees of smaller charities through the issues that ..... might need* {them} *to hold back some funds as reserves”*.

So now it seems that the definition being used is more like the normal understanding of the word *“Reserves”*, namely:

> *The amount of money that a charity holds unspent as a buffer against those “rainy days” where, for a variety of reasons, the charity finds that its payments are outstripping its receipts in a way that, without reserves, the charity would be unable to pay its bills on time.*

The confusion and ambiguity in the guidance (which, unfortunately, is more common than one would wish in Charity Commission guidance) is not helped by the fact that it doesn’t seem to understand that the reasons for holding reserves differ quite markedly and cannot just be lumped together as if they were all the same. There are actually 4 different types of reasons (the “4 Cs”) why a charity should hold reserves to cover:
(1) **C**ontingency: unexpected expenditure in the event of an emergency;
(2) **C**ash-flow: situations where a bill has to be paid before the money to cover it has been received;
(3) **C**ommitment: a commitment to expenditure which cannot be covered by the annual income;
(4) **C**losure: the charity becomes financially unsustainable and has to be wound up.

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1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/589406/CC19.pdf

The Charity Commission implicitly recognises those four categories of reserves in its list of "... *issues that ..... might need {Trustees} to hold back some funds as reserves"*. But it doesn't explicitly identify them.

The things for which a small charity might need to hold reserves, as listed by the CC19 guidance leaflet, are:

a) *The risk of unforeseen emergency or other unexpected need for funds, eg an unexpected large repair bill or finding 'seed-funding' for an urgent project. {**C**ontingency}*

b) *Covering unforeseen day-to-day operational costs, eg employing temporary staff to cover a long-term sick absence. {**C**ontingency}*

c) *A source of income, eg a grant, not being renewed. Funds might be needed to give the trustees time to take action if income falls below expectations. {**C**ontingency} {**C**losure}*

d) *Planned commitments, or designations, that cannot be met by future income alone, eg plans for a major asset purchase or to a significant project that requires the charity to provide 'matched funding'. {**C**ommitment}*

e) *The need to fund short-term deficits in a cash budget, eg money may need to be spent before a funding grant is received. {**C**ash Flow}*

Note: *The relevant "**C**-word" for each item has been added for clarity.*

And those confusions and misunderstandings are exacerbated by the guidance including designated funds in its list of Reserves items (in para-d, above) when it had previously stated:

> *"Where unrestricted funds are earmarked or designated for essential future spending, for example, to fund a project that could not be met from future income alone they can be excluded from reserves"*

The Charity Commission presumably justifies this "apparent" contradiction by the use of the phrase *"...**can** be excluded..."* to suggest that the inclusion or exclusion of "Designated" funds from Reserves is just "optional" rather than a requirement.

Small Charity Support suggests that a bit of "pragmatic common sense" be applied here.
ie: that "Reserves" are regarded as those funds being held by the charity under one (or more) of the **C**-categories described above. And that INCLUDES any funds set aside as "pump-priming" funding for future activities or projects (*ie:* which fall in the *"**C**ommitted"* category, above) whether or not they are *"...designated for future spending described as **essential**..."*.

Then, any budgeted surplus (*ie:* money left, or expected to be left, in the bank after all the budgeted activities have been complete) which is not part of the Reserves Policy is, effectively, "hoarded money" (money being held for no specific purpose).

Why Are Charities Required to have a Reserves Policy?

The Charity Commission takes the view – as do most people who donate to charities (and, particularly, big charity funders) – that monies donated to charities should be spent promptly on the charitable purposes for which it was given.
So hoarding money "just in case", or to spend on some "bright idea" that the Trustees MIGHT come up with in the future, is frowned upon (and, in many cases, is contrary to the Charities Act).

The purpose of a charity's Reserves Policy is to explain to the Charity Commission, major funders & donors, the charity's beneficiaries and the public at large why the charity is holding unspent charitable funds (whether a bank or deposit account, or other form of investment) instead of spending it on promoting the charity's charitable activities for the public benefit.

Charities which depend on soliciting funds – whether as grants or individual donations – as their prime source of income will need to be able to explain convincingly to their funders/donors why they

are asking for more money when they already have significant amounts in their bank/deposit accounts or other assets.
And the Reserves Policy is particularly useful when a charity with low reserves wants to justify setting operational budgets which create a net surplus in order to generate the funds which need to be added to its reserves year-on-year until the required level of reserves is reached.

What Charity Money is NOT Recognised as “Reserves”?

Restricted Funds

Money which is given to support a particular sub-set or aspects of a charity’s activities are Restricted Funds. Charity law requires that Restricted Funds (and any interest or Gift Aid income which they generate) can only be spent in accordance with the wishes of the donor(s).

For that reason, Restricted Funds must be accounted for separately from other funds in order that the charity can demonstrate convincingly that the money has bee used strictly in accordance with the terms under which it was given to the charity.

So, where there are restricted funds unspent at the end of the financial year that has to be identified and explained so that they do not get mixed up with the charity’s Reserve Fund and can be carried forward to the next year.

For that reason, even though unspent Restricted Funds fund have much in common with Committed Reserves (inasmuch as they are money being held unspent to meet future commitments to the donors) they are not part of the charity’s Reserves.

It is useful to have notes about the charity’s Restricted Funds included in the charity’s Reserves Policy. That’s because the presence of Restricted Fund may have a direct bearing on the Reserves Policy.
For example: in order to fulfil the charity’s commitments to a particular restricted grant/donation the charity might have to commit some of its own unrestricted funds to support the relevant activities. It is therefore important that the charity has put aside reserves to meet those commitments.

Hoarded Funds

Unspent charity funds which are surplus to the agreed budget and are not being held for an identified purpose (one or more of the 4-Cs) are hoarded funds.

Realistically, a charity cannot expect to always end its financial year exactly on budget.
Small surpluses can, of course be ignored as “immaterial” and simply absorbed into the following year’s budget.
Large surpluses will need a little explaining within the Financial Review section of the Trustees’ Annual Report – including how they will be managed in the following year.

Unexpected Large Donations

Large surpluses can unintentionally become a problem for a small charity if it is fortunate enough to receive an unexpected large donation – typically as part of a legacy from the will of a former supporter. Small Charity Support has a suggested policy to cope with that situation (which can damage a small charity’s financial stability in more ways than one if not managed sensibly).
The example policy can be found elsewhere on the Small Charity Support model policies webpage:
http://www.smallcharitysupport.uk/index.php/what-s-available/12-about-small-charity-support/9-example-policies-procedures

Creating a Reserves Policy

The Charity Commission recognises that it is legitimate for a charity to keep some of its charitable funds “to one side” (*ie:* in un-spent reserves) to meet those “4 C’s” of special expenditure:
(1) **C**ontingency; (2) **C**ash-flow; (3) **C**ommitment; (4) **C**losure.

It is suggested that you use those categories as the basis for creating your charity’s Reserves Policy.

Managing Reserves – Your Reserves Policy

It is suggested that you review your financial risks under each of the **4-C**s categories and for each one write a mini-sub-policy outlining: (1) the reason & category of the risk; (2) the level of reserve required; (3) the other risks, if any, with which the reserve for that risk could be shared; (4) for Contingency, Cash-flow and Closure risks, the likelihood of the risk occurring and for Commitment risks the time-scale when the reserve fund will be utilised.

When you’ve done that, review them for over-laps -ie: where the provisions needed for one risk effectively covers, or partly covers, the provisions for others. In those cases in may be appropriate to reduce the overall level of reserves required. Then put them all together as the final Reserves Policy.

Cash Flow:

Everyone is aware from their everyday personal experiences that money coming in (Receipts) and money going out (Payments) does not always occur regularly, or at times which synchronise receipts with payments. So there can be times when there is insufficient money “in the till” to pay the bills on time even though the necessary funds are due to the charity and will be received – eventually. It’s the classic “pay day loan” scenario.

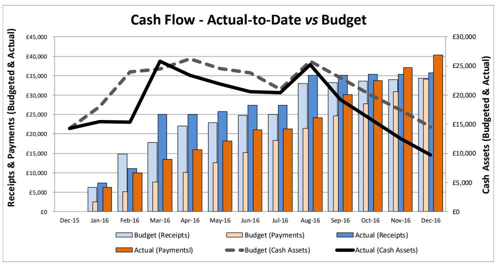
Sensible budgeting can do much to identify and avoid unnecessary cash-flow problems. By identifying in advance when the charity expects to receive money (subscriptions, grants, donations, Gift Aid, etc) and when it expects to pay out money (both regular bills such as salaries, utilities, insurance; and ad hoc payments such as start-up costs for a new activity) charities can do much to avoid cash-flow problems – eg: by rescheduling an ad hoc payment till after a block of receipts have arrived, or bringing forward a fund-raising activity.

Better Living Charity **Budget Report: 31-Dec-16**

RECEIPTS	Prev Yr Out-turn	This Yr Budget	Budget to 31-Dec-16	Actual To 31-Dec-16	Variance
R1-VOLUNTARY INCOME					
R1-Membership	1,230	2,500	2,500	2,550	50
R1-Donations	1,904	3,000	3,000	2,864	-136
R1-GiftAid	0	800	800	0	-800
	3,134	**6,300**	**6,300**	**5,414**	**-886**
R2-INCOME GENERATION					
R2-Fundraising	0	240	240	0	-240
	0	**240**	**240**	**0**	**-240**
R3-INVESTMENT INCOME					
R3-Interest-Bank Accounts	0	12	12	0	-12
	0	**12**	**12**	**0**	**-12**
R4-CHARITABLE INCOME					
R4G-GENERAL FUNDS					
R4G-ConfRegistrations	0	0	0	1,350	1,350
R4G-Miscellaneous	0	0	0	0	0
	0	**0**	**0**	**1,350**	**1,350**
R4R-RESTRICTED FUNDS					
R4R-SafeAtHome	7,759	11,250	11,250	11,832	582
R4R-BetterEating	15,460	12,500	12,500	12,500	0
R4R-HealthMatters	11,810	4,000	4,000	3,905	-95
	35,029	**27,750**	**27,750**	**28,238**	**488**
R9-ADVANCE RECEIPTS					
R9-ReceiptsInAdvance	0	12	12	160	148
	0	**12**	**12**	**160**	**148**
TOTAL RECEIPTS	**38,163**	**34,314**	**34,314**	**35,162**	**848**

The Small Charity Support Simple Accounts Spreadsheet (which can be found on its website2) contains a built-in facility for budgeting and monitoring cash-flows “in real time” on a month-by month basis (ie: the budget and cash-flow reports update automatically as financial transactions are entered). This means that up-to-date monthly budget and cash-flow reports can be produced “at the click of a button” whenever required for Trustees (and others).

The website also contains a guidance leaflet with more detailed suggestions for budgeting and monitoring cash flow.



But where predictable cash-flow issues cannot be resolved by rescheduling receipts and/or payments then incorporating appropriate provisions into the charity’s Reserves Policy is an alternative solution.

2 http://www.smallcharitysupport.uk/index.php/what-s-available/12-about-small-charity-support/6-simple-is-beautiful

Contingencies:

A well-managed charity will have carried out a Risk Analysis and will regularly review it. And the Risk Analysis should include not just the likelihood of the risk occurring but also a review of its impacts and the likely costs of mitigating them. That information will form the basis of what funds the charity needs to keep "on hand" – *ie:* its contingency reserves – to cope with the risk it should occur.

But contingencies are, by their nature, unpredictable – both their likelihood of occurring and their cost if they should occur. So while we hope they never occur, and the reserve remains unused – similarly the chance of them all occurring simultaneously is negligible . So obviously the charity's reserves do not have to be sufficient to cover the sum of the costs of all identified contingencies. In practice, therefore, the contingency reserve will normally be based on the costs of mitigating the most "expensive" contingency.

The usual perception, for obvious reasons, is that the most "costly" contingency is something that so adversely affects the charity's long-term sustainability that it leaves the charity no longer financially viable (*eg:* the loss of a major grant or donor support; or loss of a major resource, such as premises or volunteers; of an unavoidable increase in outgoings, such as utility costs). So it is common for a charity's Reserves Policy to be based on the costs of an enforced closure, which is dealt with in the later section on the fourth "**C**", **C**losure.

Commitments

There are two types of Commitments – (i) Must-Do's & (ii) Would be Nice to Do's.
Both types of Commitments are the opposite of Contingencies in that both are forward looking plans by the Trustees. So, in a properly managed charity, both the cost and the timescale of Commitments are known in advance and, to some extent, both the costs and the timing may also be controllable (eg: costs mitigated, timings advanced or delayed).

The difference between the two types of Commitment is that "Must-Do" commitments are major undertakings which the Trustees can only avoid to the detriment of their charity while "Would be Nice to Do" are a bit more speculative and more of a disappointment than a disaster if lack of funding means that they are delayed or are unable to go ahead at all.
So "Must-Do" commitments are what the Charity Commission guidance refers to as "Designations" and, therefore, suggests should be outside of the Reserves Policy while "Would-be-Nice-to-Do" commitments fall into the murky realm of ambiguity – *"to include or not to include? that is the question"* (with apologies to Shakespeare).

Given the ambiguity and self-contradiction within the Charity Commission guidance it is suggested that you treat BOTH types of commitments – "Must Do" and well as "Would be Nice to Do" – as falling **WITHIN** the charity's Reserves Policy. That way, the policies for holding funds against future needs are all managed together, consistently and coherently, thereby avoid potential confusions and the risk of some needs being over-looked or ineffectively managed because they do not fall clearly into within or outside of the Reserves Policy.

In creating your Reserves Policy, the likelihood and impact of the proposed commitment not being able to go ahead because of insufficient reserves should be noted in the policy. In that respect, creating Reserve Policies for "Must-Do" commitments have something in common with creating a Reserves Policy for Contingencies and the commitment will (should) have only been taken on if the Trustees were confident that the funds required to cover the costs of the commitment will be available.

"Would-be-Nice-to-Do" commitments are a bit less demanding. In the event that they are unable to go ahead – *eg:* the charity is unable to raise enough reserves to make the commitment viable, or a change in circumstances makes the commitment no longer appropriate – the funds can be reallocated to other activities. However, Trustees should take heed of the advice in the Charity Commission guidance:

> *Designations which are never used, or the nature of which are frequently changed without funds being spent, risk bringing the charity into disrepute with donors and financial supporters. If a complaint is made to the commission about a charity's reserves, the inappropriate use of designated funds may attract regulatory attention.*

Closure:

Unless the Trustees have decided that, for reasons other than insurmountable contingencies, their charity has come to the end of its useful life and needs to be closed down, the presumption is Charities producing their accounts on a Receipts & Payments basis are not required to be able to make any formal statement in their financial review that their organisation is a "going concern".

"Going Concern" is a widely used expression in the commercial sector and means:

> *The going concern principle is the assumption that an entity will remain in business for the foreseeable future. Conversely, this means the entity will not be forced to halt operations and liquidate its assets in the near term at what may be very low fire-sale prices[3].*

But just because there is no legal obligation on small charities to demonstrate that they are a "going concern" DOESN'T mean that Trustees are under no legal obligation to ensure that their charity is managed in a sustainable way. Nobody wants charities to be incompetently managed so that they run out of money and collapse in disarray, causing staff to lose their jobs (and their pensions); suppliers to be left with unpaid bills; and, most importantly of all, beneficiaries suddenly finding that services on which they were relying are abruptly withdrawn (*eg:* the Kids Company debacle).

So a charity needs to keep in Reserve (ie: have a Reserves Policy which describes) the amount of money that it will need in order to be able to keep on going while it completes all its obligations and can close down in good order, with nobody being left "out of pocket".

Although it is common to see charities saying that their Reserves Policy is to keep enough money in hand to enable it to continue operating for 9 months (or sometimes 6 or 12 months), all charities are different and there is no hard-and-fast rule.

Some points to bear in mind:

Winding up a charity can incur a lot of additional costs on top of the ordinary day-to-day running costs. For example:

☹ if the charity has staff who will lose their jobs on closure of the charity there may well be redundancy payments to be covered (which can be quite considerable for staff who have been with the charity for many years). And there may be other such factors to take into account, too: *eg:* salary in lieu of annual leave payments where the winding up of the charity does not allow staff to take the annual leave to which they would otherwise be entitled;

☹ if the charity rents property there might be a long notice period for which the rent still has to be paid even if the charity no longer uses the premises. And there might be a requirement to restore the property to its original condition (*eg:* involving redecoration, replacement of furnishing and fittings, making good any damage or alterations);

☹ a similar situation may apply with ongoing payments for services (gas, electricity, water, telephone, broadband, maintenance, etc).

So, even if it is possible "operationally" to close the charity down in, say, 3 months, that DOESN'T automatically mean that the charity's reserves need only be 25% of its annual turnover.
In deciding on their reserves policy, Trustees MUST make sure that they have taken all such "additional costs" into account. This might mean that the Trustees have no choice but to consult a

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3 https://www.accountingtools.com/articles/2017/5/14/the-going-concern-principle

Human Resources specialist for advice on statutory payments to staff; or to a lawyer for guidance on the financial implications of any service contracts held by the charity which would have to be terminated before their expiry date.

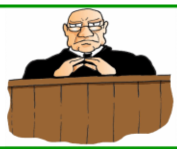
Where a charity has committed (designated) reserve funds it is likely (but not inevitable) that if the charity is facing closure the purpose(s) for which those fund(s) is(are) being held will not materialise. In that case the money in those committed fund(s) (which, legally, are part of the charity's unrestricted general fund) will contribute to the "Closure" reserve fund.

But restricted funds – money given for, and protected for, a specific purpose agreed with the donors, CANNOT be transferred to the general fund to cover wind-up costs without the explicit permission of the donors.   So restricted funds CANNOT be counted as part of the Reserve Policy.

Restricted funds which carry a commitment on the charity to deliver charitable services for a specific period of time (*eg:* the next 12 months) can create a particular problem if completing that specific project is dependent on the charity being able to provide background (*eg:* administrative) support. In that case, even if it were – in the absence of the restricted funds project – practical to wind up the charity over a period of 6 months, the charity's reserves would have to be sufficient to cover the next 12 months in order to be able to meet its commitments to the restricted project.

Change Record

Date of Change:	Changed By:	Comments:
dd/mm/yy	XX	Policy approved by the Trustees



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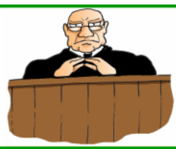

Small Charity Support *(CIO No: 1161963)* - Supporting Small Charities & Voluntary Organisations

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