GUIDANCE ON RESERVES HELD BY VOLUNTARY AND COMMUNITY ORGANISATIONS

Introduction

1. Most organisations are keenly aware of the need to secure their viability beyond the immediate future. In order to be able to provide reliable services over the longer term, organisations must be able to absorb setbacks and to take advantage of change and opportunity. Many provide for this by putting aside, when they can afford it, some of their current income as a reserve against future uncertainties.

2. This guidance relates to all voluntary and community organisations. It may be relevant to any public bodies or independent funders who support the voluntary and community sector in terms of what a funder might expect to see in a well governed organisation. This guidance is expected to be applicable to all organisations in the voluntary and community sector in Northern Ireland but in itself has no legal authority.

3. The purpose of this guidance therefore is to provide organisations with best practice advice in respect of reserves and how the holding of reserves should be justified through the development and agreement of a reserves policy. In Positive Steps the government gave a commitment to consider specific Northern Ireland guidance on an organisational reserves policy. It made clear that guidance from the Charity Commission for England and Wales would be useful in developing the policy and as such, much of the detail in this document comes from guidance from the Charity Commission for England and Wales. Clearly the Draft Charities (Northern Ireland) Order 2006[1] and specifically the commitment to establish a Charity Commission for Northern Ireland[2] may impact on the status of this guidance over time.

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[1] *The Draft Charities (Northern Ireland) Order 2006*
http://www.dsdni.gov.uk/dsd_charities_review.pdf
[2] *The Draft Charities (Northern Ireland) Order 2006*
http://www.dsdni.gov.uk/dsd_charities_review.pdf Part II

Definition of reserves

4. For the purposes of this advice the term “reserves” is applied to that part of an organisation’s income that is freely available for its general purposes. Reserves are the resources the organisation has or can make available to spend for any or all of its purposes once it has met its commitments and covered its other planned expenditure. SORP 2000 defines reserves as income which becomes available to the organisation and is to be spent at the trustees or committee members discretion in furtherance of the objects of the organisation (sometimes called “general purpose income”) but which is not yet spent, committed or designated (i.e. is “free”).

5. This definition excludes unspent money from restricted grants, ie, where a funder has specified what the money must be spent on and the trustees or committee members do not have the power to spend the money on anything else. In terms of Charity Commission/SORP guidance it excludes the following (see Annex A for a glossary of terms):

   i. Permanent endowment/capital
   ii. Expendable endowment/capital
   iii. Restricted income Funds
   iv. Designated income Funds
   v. Income funds which could only be realised by disposing of fixed assets held for charity use.

   Although there are no legal restrictions on the use of designated income funds or expendable endowment as reserves this is generally not recommended by the Charity Commission. If part of an unrestricted fund is ear-marked for a particular project it may be designated as a separate fund. Funds could be designated for a project that the organisation is seeking to build resources for, such as refurbishing their building. Designation does not restrict the trustees or committee members, they can change their minds. But their initial decision should be a genuine one, not a method for hoarding funds. The designation should be recorded in the minutes of a board meeting as should any subsequent re-designation. It will be important that a policy providing for any transfer between funds and allocations to or from designated funds[3] as well as the reasons for setting up a fund are explained (specifically in the notes to accounts).

Why hold reserves?

6. Any organisation which enters commitments – through the agreement to deliver services, the employment of staff, the rental of premises, the purchase of goods or services etc - must ensure that it has sufficient resources. Even when an organisation operates in the most stable of environments where future income streams and expenditure requirements can be identified there will remain an element of uncertainty as to the absolute timing of each individual transaction and also the possibility that unforeseen expenses or liabilities will emerge. Against this background it is considered good practice for organisations to seek to build some financial reserves which will allow them to meet future commitments or unforeseen expenses without a negative impact on their ability to deliver their services or develop their businesses in the manner planned.

7. Voluntary and community sector organisations that hold reserves are able:
    a. to absorb set backs and to take advantage of change and opportunity;
    b. to demonstrate that they have thought through how they might secure their viability beyond the immediate future and provide reliable services over the longer term;

[3] Charity Commission (2005) *Accounting and Reporting by Charities: Statement of Recommended Practice (SORP) 2005* http://www.charity-commission.gov.uk/Library/publications/pdfs/sorp05text.pdf

c. to demonstrate to potential funders that they are effectively managing their resources, and have given consideration to their long-term plans and viability.

Reserves policy

8. Organisations may find their decision to hold reserves is subject to scrutiny or comment in the public arena. Documentation, in the form of a reserves policy, provides the public and existing or potential funders with a clear explanation of the nature and purpose of any reserves held. For this reason it is strongly recommended that a reserves policy is developed and documented. The essential point here is that it can demonstrate publicly to donors/funders the reasons to retain a particular level of income as a reserve.

9. The amount of detail contained within an organisation's reserves policy should be proportional to the scale and complexity of the organisation's affairs. A small organisation, or one with a stable pattern of receipts and payments, few if any commitments, and little susceptibility to outside influences should be able to address the matters contained in their reserves policy quickly and briefly. Conversely if an organisation's income is volatile or insecure, it has high commitments, and its business is highly susceptible to factors outside its control, it may find that the classifications, scope and level of reserves it would wish to hold are more detailed and its reserve policy should reflect this.

10. In certain circumstances it might be acceptable for an organisation not to hold reserves, but this should be the result of a considered decision as demonstrated in their reserves policy. The reserves policy cannot be formed in isolation and needs to be seen in the context of the overall financial position including assets managed.

11. To justify the holding of reserves, a reserve policy should be based on a realistic assessment of need and should cover as a minimum:

    i. the reasons why the organisation needs a reserve or does not;

    ii. what level (or range) of reserves the organisation believes it needs;

    iii. what steps the organisation is going to take to establish or maintain reserves at the agreed level (or range); and

    iv. arrangements for monitoring and reviewing the policy.

Setting a reserve level

12. An organisation's reserve policy should be informed by:
    a. its forecasts for levels of income in future years, taking into account the reliability of each source of income and the prospects for opening up new sources;
    b. its forecasts for expenditure in future years on the basis of planned activity;
    c. its analysis of any future needs, opportunities, contingencies or risk; and
    d. its assessment, on the best evidence reasonably available, of the likelihood of each of those needs and risks arising and the potential consequences for the organisation of not being able to meet them.In particular circumstances this may have to involve some consideration of wind up arrangements and the financial consequences arising although it is recognised that the accounting arrangements involved will be different here.

13. Trustees who hold reserves without making any attempt to explain their need in terms of these factors will probably have great difficulty explaining in any convincing way why they hold those reserves.

14. The Charity Commission does not prescribe a ‘correct’ level of reserves. It recognises that each organisation’s position is different and it is impossible to set a formula for reserves levels that will suit all organisations at all stages of their development. As noted a reserves policy has to be seen in the wider financial position of an organisation as set out in paragraph (12).

15. As a general guide, an acceptable level of free reserve might be considered to be:

    i. sufficient free reserves to provide cover for between <u>3 – 6 months</u> in relation to known liabilities

    ii. a smaller additional provision of free reserves for unforeseen liabilities

16. It is also possible that the organisation may hold an amount in respect of designated reserves. This along with the 2 areas listed above are clearly inter-related and should be considered together. It is also important to note that departments have no obligation to directly fund reserves. Organisations may be able to raise money, for example through direct fundraising or events, raise income from the sale of services including contracts for public services or the expertise of staff or the rental of unused space in accommodation they own.

<u>Reporting on reserves</u>

17. SORP requires trustees to include in their annual report information about their reserves policy and the level of reserves they hold. They should:
    - describe the reserves policy
    - explain why they hold or do not hold reserves and, if they do, in respect of what future needs, opportunities, contingencies or risks; and

- give the level of reserves at the last day of the financial year to which the report relates.

Reserves – impact on funding

18. An organisation will normally require a minimum level of reserves to fund its working capital requirements and provide funding for contingencies identified in its management statement. Therefore the existence of reserves (money held in an account not currently being used for operational or project needs) can be a sign of good resource management. In this regard and following Charity Commission guidance to funders[4] any future accreditation scheme for organisations in the sector may require evidence of a reserves policy as a prerequisite for accreditation.

19. Organisations should not be penalised for exercising proper governance in the creation of reasonable reserves to meet organisation liabilities. As long as there is a clear documented policy and this is considered to reflect the organisational needs, then this should not adversely affect any funding application.

20. Where an organisation is considered to hold reserves in excess of that justified by its reserves policy a funding department may decide to require the organisation to provide a further justification of the level of funding held or adjust the timing of the funding awarded. This should always be documented and explained in writing to the applicant organisation

[4] Charity Commission (11 January 2007) *Operational Guidance – Charity Income Reserves* http://www.charitycommission.gov.uk/supportingcharities/ogs/g043b002.asp at section 5.

Reserves policy – timing

21. An organisation's reserves policy should be reviewed every two or three years in cognisance of its strategic planning, it should not be seen as a 'bolt on' task to be dealt with by those who compile the accounts. The reserves policy should also be updated at the end of each financial year to take account of any change in circumstance and to recalculate the percentage free reserve based on the year end balance. This should be completed in advance of any applications for funding in the new financial year.

Annex A

GLOSSARY OF TERMS

Refer to SORP 2005 Paragraphs 65-76:

http://www.charity-commission.gov.uk/investigations/sorp/sorp05docs.asp

Unrestricted Income Funds (Including Designated Funds)

Nearly all charities have a fund which is available to the trustees to apply for the general purposes of the charity as set out in its governing document. This is the charity's "unrestricted" fund (sometimes called a **"general" fund**) because the trustees are free to use it for any of the charity's purposes. Income generated from assets held in an unrestricted fund will be unrestricted income. The trustees may earmark part of the charity's unrestricted funds to be used for particular purposes in the future. Such sums are described as **"designated funds"** and should be accounted for as part of the charity's unrestricted funds. The trustees have the power to re-designate such funds within unrestricted funds and then include in reserves. When a designation has been made at the balance sheet date, the amount of the designation may be adjusted subsequent to the year end if more accurate information becomes available.

Restricted Funds

Many charities hold funds that can only be applied for particular purposes within their objectives. These are restricted funds and have to be separately accounted for. The restriction may apply to the use of income or capital or both. Income generated from assets held in a restricted fund (eg interest) will be legally subject to the same restriction as the original fund unless either:

(a) the terms of the original restriction specifically say otherwise (for example, the expressed wishes of a donor or the terms of an appeal), **or**

(b) the restricted fund is an endowment fund, the income of which is expendable at the discretion of the trustees.

Permanent and Expendable Endowments

One form of restricted fund is an “endowment”, which is held on trust to be retained for the benefit of the charity as a capital fund. Where the trustees must permanently maintain the whole of the fund it is known as **permanent endowment.** Such a fund may consist of investment assets and/or assets that are used for the purposes of the charity. Such a fund cannot normally be spent as if it were income. In some instances the trustees may have a power of discretion to convert endowed capital into income in which case the fund is known as **expendable endowment.** The initial gift and subsequent increases and decreases in the amount of any endowment funds should be shown in the Statement of Financial Activities as part of those funds.

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