Weather protection?

Active reserves management is vital now the heavens have opened, says Pesh Framjee

The tough economic times are forcing charities to look hard at their reserves policy; with a particular focus on when and how they might need to draw down on reserves. Worryingly, a number have still not fully considered the level they really need, and have clearly been paying only lip service to the requirements to consider and state a reserves policy.[1]

The task of setting priorities remains as difficult as ever – matching the demands to satisfy short-term needs against pressure for the resources required to achieve long-term solutions. The operating environment for most charities is becoming more demanding and it has become self-evident that plans for future strategic development will have to take into account a number of new factors. It is a world in which priorities need to be constantly reassessed and the environment requires careful thinking about appropriate levels of reserves. This needs to be based on knowledge which is not just as accurate as possible but which incorporates analysis from different perspectives.

Charities must make a genuine attempt to formulate a reserves policy and understand how this will be impacted in the short term. Free reserves, or those reserves that are readily available, should be factored in.

What are free reserves?

The Charities (Accounts and Reports) Regulations 2008 defines reserves as:

'Those assets in the unrestricted fund of a charity which the charity trustees have, or can make, available to apply for all of any its purposes, once they have provided for:

1) the liabilities of the unrestricted fund; and
2) any commitments of the charity or other planned expenditure intended to be met from the assets of the unrestricted fund.'

Difficulties arise when this somewhat arbitrary legal definition of reserves is used to formulate and apply a reserves policy for a charity. Regrettably many charities take this to mean that they should focus only on unrestricted funds when considering their reserves and the funds they may have available for a rainy day.

The Statement of Recommended Practice on Accounting and Reporting by Charities (SORP 2005) does not help much either and explains:

'The term "reserves" has a variety of technical and ordinary meanings, depending on the context in which it is used. In this SORP the term "reserves" (unless otherwise indicated) describes that part of a charity's income funds that is freely available.

This definition of reserves therefore normally excludes:

a) permanent endowment funds;
b) expendable endowment funds;
c) restricted funds;

and any part of unrestricted funds not readily available for spending, specifically:

d) income funds which could only be realised by disposing of fixed assets held for charity use and performance related investments.'

This is based on the somewhat simplistic legal definition of reserves which is also repeated in the Charity Commission's publication on reserves (CC19).[2] It is disappointing that CC19 continues to steer charities towards such a narrow definition and it is hoped that a revision will advise a more holistic approach. This would consider expendable endowment, designated funds and also restricted funds.

SORP 2005 does move towards recognising that the definition of free reserves referred to merits further thought and explains that:

'Individual charities may have more or less reserves available to them than this simple calculation suggests for example:

a) expendable endowments may be readily available for spending; or
b) unrestricted funds may be earmarked or designated for essential future spending and reduce the amount readily available.'

My concern is that excluding designated funds may be inappropriate, particularly when charities create designated funds which would normally be seen as part of the cash available in times of need. If reserves are for a 'rainy day' then most charities will agree that in the present times many are likely to be caught in a thunderstorm. They should be looking as a matter of urgency at all their funds and not just 'free reserves', as defined in CC19.

Restricted funds too are not always as sacrosanct as the definition of 'free reserves' implies. In some cases restrictions may be so wide as to mean that the cash represented by the restricted funds are tantamount to being 'freely' applied for the wide purposes. Many charities find that they are able to meet many of their fixed and ongoing costs from restricted funds. In effect, although they are legally restricted the operational realities would mean that they are comparable to free funds.

The nature of the restriction will dictate whether the restricted fund seriously impacts on how the funds can be used. This will identify if, based on the charities' plans, the restriction really creates a barrier to meeting expenditure. For example, if a charity normally spends 80 per cent of its total income on research the fact that 30 per cent of its total income was specifically restricted for research will have little bearing on its spending plans. In practical terms the 30 per cent of restricted income need not figure as restricted income in the reserves decision, as in the circumstances it can be applied as easily as unrestricted funds. On the other hand if income is received for a very specific purpose which is not part of the planned spend then it must be viewed differently; additional new expenditure may be required to use the funds.

Careful reading of CC19 also highlights that the Charity Commission has recognised this point:

'A charity must use restricted funds for their specified purpose. However there is still a positive duty on the trustees to spend those funds within a reasonable time of receipt otherwise they may be in breach of trust. Trustees may cite proposed expenditure that could properly be met from restricted funds as part of their justification for holding a particular level of unrestricted income reserves. This will not normally be acceptable.'

The Commission recommends that trustees treat each restricted income fund as if it were a separate charity and consider what, if any, level of reserves they need to hold. This indicates that restricted funds should not be automatically excluded from the thinking to establish a reserves policy and the guidance needs to be more explicit about this.

Many charities have come to recognise that there is a need to consider all income/expenditure streams, the nature of *all* reserves and the uncertainties and demands of the charity's operating environment.

Selecting and implementing a reserves policy

The reserves policy should link with the risk management and forecasting process and an understanding of why the organisation needs reserves and what the appropriate level is. To do this properly a full understanding of any problems forcing the organisation to dip into its reserves is required, and operating realities must be considered. Analysis of the options open to the organisation when dealing with the actual problem in hand should follow.

There are many factors that must be considered when a charity is trying to decide what level of reserves is appropriate. But the essentials boil down to these four:

1) Income – how volatile is it and what is the level of at risk income?
2) Expenditure – what is its nature and can it be cut back easily?
3) The nature of the reserves – what is their ability to be realised and what is the impact of doing this?
4) Sensitivities and risk associated with assumptions made.

Income

An analysis of the sources of income is vital. This analysis should show how much of the income is fixed and how much is variable, distinguishing between income which is committed so that the charity has reasonable assurance that it will be received, and one-off volatile income which is more irregular. In essence, it is important to understand the at risk income.

To do this it is relevant to consider the detailed analysis of income streams. For example, consider charities that receive a substantial proportion of their income from legacies. Those that have a few high value bequests are probably more vulnerable than those with many lower value items because the financial impact of not receiving one legacy will be far greater in the former case. Also, charities which get large residuary legacies will find that falling property and stock market prices will result in a negative impact whereas those receiving smaller pecuniary legacies are much less likely to feel the same pain.

When considering income it is really important to understand its associated cash flows. Knowing that the income will be available when it is needed is important – even where charities have fully funded projects they often need to prefinance. In effect, the unrestricted funds may be used to make payments in advance of funds actually being received and charities should ensure that they focus on careful cash management. There are a number of easy wins. For example, many charities continue to have delays in receiving grants simply because they have not completed the paperwork although they have incurred the expenditure – this needs addressing! Cash is king, so the timing of income and expenditure streams becomes even more important.

Expenditure

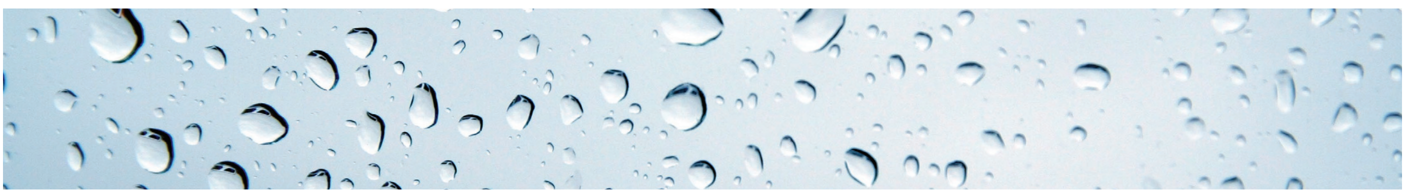
As with income it is important to analyse the expenditure and see how much of it is fixed and how much is variable. It is also vitally important to consider the nature of a charity's activities and its operating structures and policies when considering the nature of expenditure. Expenditure must also be compared with the volatility of income. For example, a charity which receives income and pays it out as one off grants may not require a high level of reserves since it may be quite easy for the charity to change gear. If there is a drop in income it could be possible for there to be a commensurate saving in expenditure.

When charities recognise a reduction in income, they may attempt to cut back expenditure – unfortunately the speed of reaction is often very like that of a super tanker. Some charities have a long lead time before they can respond to an instruction to stop or change direction; the expenditure often has to continue, with disastrous financial implications.

While it may be easy for a charity making one-off grants to reduce the next round of its grant awards, it may be very difficult to make a similar expenditure reduction in a charity where the bulk of the costs come from staff, or in a charity which has committed itself to some form of long-term development expenditure.

This is not to say that grant makers do not need to be concerned. Some grant making charities commit themselves to continuing grants and must ensure that they have sufficient resources, either by way of future income streams or current reserves, to meet their obligations.

The accounting policies adopted will colour the presentation of reserves. For example, some charities account for multi-year grants commitments as a liability in year one whereas others only account for the current year expenditure (*see Caritas*, February 2008, issue 3, page



10). Whatever the accounting policy this should not impact on the reserves decision; this should be based on the economic realities facing the charity.

The nature of the reserves

Broadly, a charity can have different classes of funds and trust law places constraints on how these funds may be expended or accumulated. A charity may maintain or increase the level of its overall funds but it may have received income earmarked for a particular purpose or the funds may not be easily available. Therefore, overall reserves may go up although there may be significant decrease in funds available to meet ongoing expenditure. Although the charity may be generating surpluses it may in fact be running into difficulties.

Donor-imposed restrictions often affect the types and levels of services the charity can deliver. Consequently, information about the change in the nature of its reserves is most useful in assessing a charity's ability to respond to short term needs. This requires a more holistic approach than simply segregating restricted and unrestricted funds and looking at what assets and liabilities represent the different funds is important. The SORP requires that the reserves of a charity should be grouped according to the restrictions on their use but equally important in difficult times is an understanding of the nature of the assets that underpin the different funds of the charity. For further information on fund accounting *see Caritas,* October 2008, issue 11, page 13.

Therefore, it is important not to lose sight of what the reserves represent and the ease with which they can be made available in times of need. If they are made up of tangible fixed assets then their availability for use will be different from stock market investments. If it is identified that funds may be needed to manage cash requirements then the issue is how is the reduction in reserves going to be managed. Are funds going to be obtained by borrowing, selling investments or drawing down on cash balances?

In addition to awareness of restrictions and the availability of reserves the impact of crystallising them needs to be considered very carefully. If plans are not put into place early enough charities can end up making decisions that are forced upon them, but are far less satisfactory both in the short and long term. For example, some charities are reliant on investment income and are forecasting a significant reduction in this income – they have no option but to draw down on reserves to meet necessary expenditure.

They are faced with the difficult dilemma of what they should be doing with their funds which may be invested in the stock market. If they draw down on these funds for operational purposes they have a double whammy – selling when the market is down and a further reduction in investment income. Rather than sell their investments some have chosen to borrow against investments and property. Others recognising that this might be needed are already talking with sources of finance. Contrary to popular misconception there are lenders that are more than willing to lend against the charity's assets and the more enlightened recognise why a charity may not want to liquidate those assets even if they have them. Being asset rich and cash poor is not uncommon and looking beyond the obvious is needed.

Sensitivities and risk

The charity should also consider how 'sensitive' its income and expenditure are to factors which are outside its direct control. This would entail a form of 'what if?' analysis. What if income fell by 15 per cent? What if expenditure went up by 5 per cent? What if our free office space was no longer available?

Uncertainty is a key factor in present decision making. Charities have to forecast based on assumptions and expectations – these have inherent risk and their validity must be rigorously examined.

It is important to consider both the 'what if?' and 'how likely?' questions. Look beyond the obvious and recognise that although the expected impact on income generation may be some distance away, a drop in income can occur suddenly. There should be action plans for different scenarios and it is useful to set and monitor trigger points along with trend analyses to enable the charity to decide when plan A or plan B needs to be implemented. For example, if income looks like it is going to drop by X we will do Y.

Bear in mind that there is very little precedent for what is being experienced and the charities that will succeed through the recession are those that remain alert and nimble to their own circumstances – real knowledge about managing reserves is essential.

Summary of key points

- It is important to revisit the reserves policy in the light of the new challenges.
- This requires a review of all funds including restricted and designated funds to consider what resources can be used to meet necessary expenditure.
- When deciding what is the appropriate level of reserves it is important to consider:-
  Income: how volatile is it and what is the level of at risk income?
  Expenditure: what is its nature and can it be cut back easily?
  The nature of the reserves: how easily can they be realised and what is the impact of doing this?
  Sensitivities and risk associated with assumptions made.
- The forecasts and budgets should incorporate trigger points so that an agreed action or contingency plan is activated by something happening or not happening – for example an x per cent reduction in forecast income will lead to plan B being put into place.
- Make sure you have a plan B
- Cash is king and plans should factor in the actual availability of funds as well as detail – when and how reserves can be crystallised to minimise any negative impact of having to dispose of assets at the wrong time
- If borrowing may be needed, start discussions with possible sources of finance
- Be alert to signs and trends and ensure the charity is nimble in its decision making and is able to react swiftly.
- Plan early to avoid having to make knee jerk reactions.

1 *Para.55 (c) SORP 2005*
2 *www.charity-commission.gov.uk/publications/CC19.asp*

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