Charity Thoughts: Reserves Policy? Where's the Budget!

Small Charity Support *{Registered CIO 1161963}*

This leaflet is designed so that it can also be used both as guidance for those setting up a new charity and as an Induction Leaflet for new Trustees at any stage in the life of the Charity
Your comments and suggestions *(to comments@smallcharitysupport.uk)* on how these leaflets could be improved to make them clearer and more useful would be much appreciated.

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This leaflet is just one of many produced by Small Charity Support.
A full list of the leaflets currently available can be found on the Small Charity Support website, *https://www.smallcharitysupport.uk/index.php/downloadable-leaflets* or downloaded ***HERE***.
Please read the Notices on the last page of this leaflet.

Reserves Policy? Where's the Budget?!

Overview

Struggling ?

Struggling to put together a coherent and meaningful "Reserves" policy which doesn't come out sounding rather superficial and irrelevant? **Join the club !**

Why must charities have a Reserves Policy ?

Annual independent reviews of public trust in charities – carried out on behalf of the Charity Commission – consistently show that a top priority of the general public is for reassurance that a high proportion of the money donated to charities has actually been used for the purposes for which the money was donated.

Consequently, the Charity Commission expects charities to explain why unspent charitable funds aren't being hoarded – *ie:* haven't yet been spent on their charitable objects for the public benefit;

The Problem ?

Like most charity financial management & reporting guidance, the guidance for charity "Reserves" policies is an adaptation of the practices of financial reporting in the commercial sector.

But the commercial sector is in the business of using its current financial resources in ways which will generate even more financial resource as profits for its shareholders.
While the charity sector is in the business of spending its donated financial resources in ways which will generate social benefits for its beneficiaries in particular and the wider public in general.

It is therefore inevitable that the contradiction between the objectives of the charity and commercial sectors results in contradictions in perceptions of what constitutes good "Reserves" policies to justify the unspent money held by charities at any specific point in time (*eg:* the end of their financial year).
ie: it is hardly surprising that the Charity Commission's definition of "Reserves" is, confusingly, almost a complete contradiction of the typical dictionary definition of the word.
Charity "Reserves" are funds *"freely available to spend on any of the charity's purposes."* Funds set aside (*ie:* "reserved") for specific purposes are excluded (*eg:* restricted & designated funds, creditors).

Hardly surprising that many (most) trustees of smaller charities are confused by that contradiction and so struggle to create a coherent and meaningful "Reserves" policy for their charity.
A recent review by Small Charity Support of the Reserves policies in 100 Trustees' Annual Reports & Account of smaller charities (annual incomes less than £250,000) randomly selected from the public Register of Charities showed that: **!** over half either made no reference at all to having one, or said they felt they didn't need one; **!** a further quarter muttered something rather vague and unhelpful; **!** leaving just a quarter with something resembling a "policy" on their "Reserves".

A Possible Solution ?

Small Charity Support's "Reserves" policy is:

1. to manage its received donations, grants and other financial resources (*ie:* its "Reserves") **E**fficiently, **E**ffectively & **E**conomically to deliver charitable activities which are value for money, and **E**thically, **E**quitably and **E**cologically to generate charitable outcomes of social and community value for its beneficiaries in particular and for the wider public benefit in general;
2. by preparing and publishing pragmatic annual budgets, and by monitoring & reporting regularly (including externally where appropriate) on the charity's performance against those budgets to reassure donors and the public that its charitable funds are, or will be, properly spent as intended.

In More Detail

What are "Reserves" ?

Dictionary Definitions of Reserves

Reserve *noun, often attributive* *{Merriam-Webster Dictionary}*

1: something reserved or set aside for a particular purpose, use, or reason

2: something stored or kept available for future use or need

Reserve *noun* *{The Free Dictionary}*

1: something kept back or saved for future use or a special purpose

2: an amount of capital that is not invested or otherwise used in order to meet probable demands, such as withdrawals by bank depositors.

Reserve *noun* *{Cambridge Dictionary}*

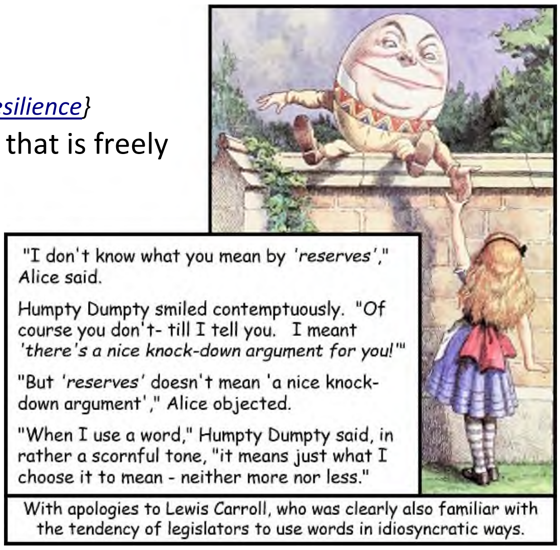
***** the act of keeping something or a supply of something until it is needed.

The above definitions represent the every-day understanding of the word "reserves" of the "persons on the Clapham omnibus" – *eg:* the typical unpaid volunteer non-accountant trustee of "small" charities, running their charity "hands on" as "head cooks & bottle-washers" in their spare time.

Charity Definition of Reserves

3.1 What are reserves? *{CC19 – Charity Reserves: Building Resilience}*

Reserves are that part of a charity's unrestricted funds that is freely available to spend on any of the charity's purposes.



With apologies to Lewis Carroll, who was clearly also familiar with the tendency of legislators to use words in idiosyncratic ways.

Unfortunately, the charity definition of "reserves" appears to have been created by "Humpty-Dumpty" financial bureaucrats living in their own "Wonderland".

Because it is the opposite of the dictionary definition !

And, consequently, creates a great deal of confusion and uncertainty amongst the non-Humpty-Dumpty trustees trying to run their charity effectively in "the real world", not in a bureaucratic "Wonderland".

And, to clarify the "*nice knock-down argument*" definition of "Reserves", section 3.1 goes on to "explain" all the "funds" that are NOT part of a charity's "Reserves":

? tangible fixed assets used to carry out the charity's activities, such as land and buildings

? programme-related investments those held solely to further the charity's purposes

? designated funds set aside to meet essential future spending, such as funding a project that could not be met from future income

? commitments that have not been provided for as a liability in the accounts

most of which the "persons on the Clapham omnibus" would probably define as being "Reserves".

Why Do Charities Have to Have a "Reserves" Policy ?

The Charity Commission has, for many years, commissioned reviews of public trust in charities. The review published in 2016 reported that:

> *…the overall level of trust and confidence in charities has fallen to 5.7 out of 10.*
> *This is a significant decrease from a headline figure of 6.7 in 2012 and 2014*

and went on to say:

> *"Statistical analysis reveals that trust in the charitable sector is driven by five 'key drivers':"*
> of which the first was:
> *"Ensuring that a reasonable proportion of donations make it to the end cause"*

Section 3.2 of the Charity Commission's *Guidance on Charity Reserves, CC19* explains:

3.2 Why is a reserves policy important?

A reserves policy explains to existing and potential funders, donors, beneficiaries and other stakeholders why a charity is holding a particular amount of reserves. A good reserves policy gives confidence to stakeholders that the charity's finances are being properly managed and will also provide an indicator of future funding needs and its overall resilience.

and goes on to say:

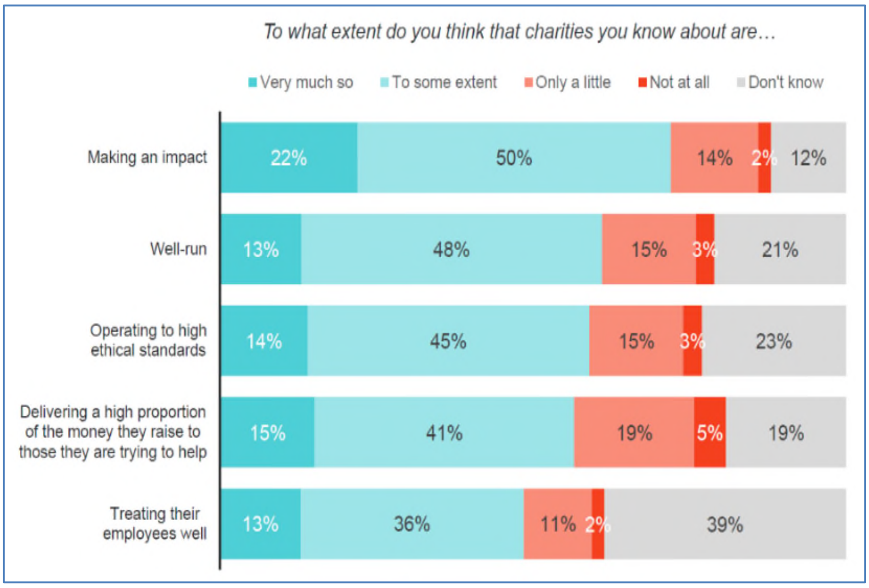
The Charities SORP requires a statement of a charity's reserves policy within its annual report. In addition, if a charity operates without a reserves policy, the regulations require this fact to be stated in the annual report.

But later, section 6: *Technical terms used in this guidance*, the guidance then blandly says:

The accounting recommendations of the SORP do not apply to charities preparing receipts & payments accounts.

without any explanation of the implications of that on what Reserves Policy should be reported.

The 2021 review of Public Trust in Charities reported that: "*Ensuring that a 'high proportion of the money a charity raises goes to those it is trying to help' remains by far the most important and firmly-held expectation for how a charity should operate.*"



But the 2022 review of Public Trust in Charities took a different approach, reviewing instead the extent to which the public felt that the charities were achieving what the public expected of them.

Although the effective use of charity funds was the most important public expectation in the 2021 review, in the 2022 review it was rated as only fourth in public confidence that their expectations were actually being delivered. Just 56% of the public said they were *"very"* or *"to some extent"* confident that charities were *"delivering a high proportion of the money they raise to those they are trying to help"* while a significant 24% of the public was *"only a little"* or *"not at all"* confident.

It seems that, as at the 2022 review, the requirement that all charities must include a "Reserves" Policy in their Trustees' Annual Report & Financial Statements has not yet been resoundingly successful in promoting public confidence and trust that charities are *"delivering a high proportion of the money they raise to those they are trying to help"*.

The Elephant in the Room

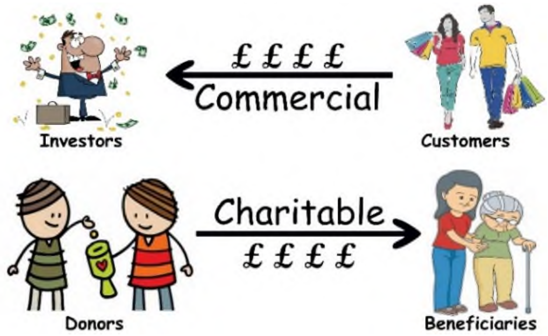
Are you confused? Head spinning?! **Join the club !!**

It's so blindingly obvious that it is easily (and, sometimes, "conveniently") overlooked !

The inconsistencies and contradictions in the guidance and rules for charity financial reporting are the inevitable consequences of being based on the guidance and rules for commercial financial reporting.

Good practice in financial management and reporting in the charity and commercial sectors do, of course, have some key elements in common. No organisation can operate **E**fficiently, **E**ffectively & **E**conomically *(the **EE&E** of delivering "value for money" – to which the charity sector often adds **E**quitably, **E**thically and **E**cologically)* if it doesn't know (a) how much money it has in the bank at any point in time, and (b) whether that amount is sufficient to allow the organisation to meet all its financial obligations as they become due.

But the underlying objectives of the two sectors are fundamentally incompatible.
Commercial organisations are "in the business" of using their financial resources to create and **sell** goods and services to clients in a way that generates as much income (and, hence, profit) as possible. *ie:* **maximising** *"…the unrestricted funds that are freely available to spend on any of the organisation's purpo*ses…", and ensuring that a high proportion of the money the organisation generates goes as profits/dividends to its "beneficiaries" (*ie:* its "investors") in commercial "Wonderland".



By contrast, charities are "in the business" of using their financial resources to create and provide goods and services to beneficiaries who wouldn't otherwise be able to afford them. *ie:* **minimising** *"…the unrestricted funds that are freely available to spend on any of the organisation's purposes…"* – by ensuring that as much as possible of the charity's income is spent on providing goods and services to those it is trying to help'.

Hence, the "Reserves" policies of commercial organisations and charities might both be about explaining the "surplus" – *ie:* unspent – money held by the organisation at the end of the financial reporting period. But "Reserves" policies in the commercial sector are about the organisation explaining to its investors why all that "lovely money" in the bank ISN'T available to distribute as dividends, interest on loans, or bonuses to employees. While in the charity sector the focus is on the charity explaining why it hasn't yet succeeded in spending all of its income and donated funds on charitable activities for its beneficiaries and the public benefit.

It is therefore hardly surprising that financial Humpty-Dumpty-ism – requiring charities to use accountancy jargon out of context with idiosyncratic meanings – creates misunderstandings and confusion. And when words are misused – *ie:* abused – in that way it is often the case that those who find themselves confused feel that it must be they who are the ones who must take the blame for not having sufficient knowledge and expertise to understand what is being said.

Reporting "Reserves Policies"
From The Register of Charities

A recent review by Small Charity Support of 102 Trustees' Annual Reports & Financial Statements (TAR&FSs) of "small" charities (incomes in the range £25,000 to £250,000) randomly selected and downloaded from the Charity Commission's public Register of Charities demonstrated widespread confusion and inconsistency in the way that trustees report their charities' Reserve Policies.

More than half – 51% – of the sample TAR&FSs either included no reference at all to having a Reserves Policy or said that they didn't need one. Of the others, 22% just provided a rather vague policy the purpose of which seemed to be more about "ticking the box" to say that they have one, than explaining why they are holding "Reserves". That left just over a quarter of charities which had provided a more explicit explanation of how much "reserves" they were holding, and why. The detailed results, further broken down by income bracket, are shown in the table.

Review of Reserves Policies in Trustees' Annual Reports

Reserves Policy Type	Charity Annual Income Range				
	£25K-£50K	*£50K-£100K*	*£100K-£200K*	*£200K-£250K*	*Total*
Specific	3	4	1	0	8
Period	5	5	7	2	19
Vague	9	5	8	1	23
None	5	2	0	0	7
NoRef	20	11	13	1	45
Total	42	27	29	4	102

Specific: *ca.***8%** of the sample TAR&FSs included a specific value for the "Reserves" held by the charity at the date of the financial report. In some – but not all – cases that included an explanation of the way the "Reserves" figure had been arrived at.

Period: *ca.***19%** of the sample TAR&FSs included a statement of the trustees' policy for setting the charity's level of "Reserves" at the date of the financial report – typically as the funds necessary to maintain the charity for a specified period of time – *eg:* 3 months – but not the actual amount.

__Note:__ In only one of the "Specific" or "Period" examples of Reserves Policies was any consideration given to making provisions for the costs of having to close the charity permanently (eg: staff salaries & redundancy payments, discharge of any ongoing contracts such as rent) in the event of the charity becoming unsustainable.

__Vague:__ *ca.***22%** of the sample TAR&FSs included just a very vague statement of the trustees' "Reserves Policy" which did not include sufficient information to assess the actual amount of "Reserves" being specified by the "Policy". eg: *"It is the policy of the Charity to maintain unrestricted funds at a level which the Trustees consider appropriate after taking account of its future commitments."*
ie: such statement were, apparently, intended to enable the trustees to "tick the box" of the charity being compliant with the requirement to "have a Reserves Policy" without having to include any meaningful information about what "Reserves" the charity actually had.

__None:__ *ca.***7%** of the sample TAR&FSs stated that the trustees thought that a "Reserves Policy" was not needed – usually because they had no ongoing or future financial commitments for which a "Reserves" provision was needed.

__NoRef:__ *ca.***44%** *{by far the largest group}* of the sample TARAs made no reference at all to the charity having (or not having) a "Reserves Policy", even though it is a statutory requirement for all TAR&FSs.

The Independent Examination of Reserves Policies

Small Charity Support's review of TAR&FSs also looked at the Independent Examiner's statement on the TAR&FS, in particular whether it specifically referred to the Examiner having "….followed all the applicable Directions given by the Charity Commission….", eg: in accordance with the Charity Commission guidance, *Independent examination of charity accounts: Directions and guidance for examiners (CC32)*, which explicitly says, in sections 9.3 & 9.4:

9.3: All registered charities must disclose their reserves policy in the trustees' annual report or the trustees' reason(s) for not having one…..
9.4: …..The examiner should ask the trustees about the charity's reserves policy and the adequacy of those reserves and check if there is a material discrepancy between the accounts and the level of reserves referred to in the trustees' annual report (see Direction 12)

Nevertheless, of the 77 professionally qualified IEs in the review, 21 (*ca.*27%) had signed their report stating that they had complied with the Charity Commission's Directions even when the TAR&FS made no reference at all to the charity having a Reserves Policy.

And a further 11 (*ca.*14%) of the professionally qualified IEs had signed a report which made no reference at all to having complied with the Charity Commission's Directions.

Review of IEs' Compliance with Directions on Reserve Policy

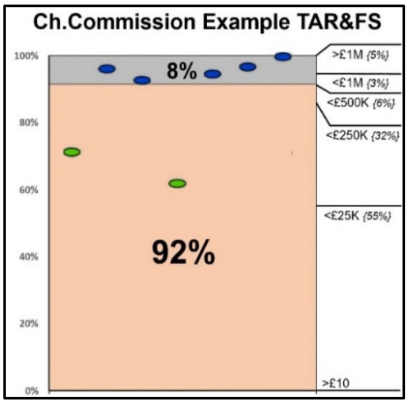
IE Refers to Directions	*FCIE*		*CA*		*Other*		*Comp*		*NG*		*No IE*	*Totals*	
	Y	*N*	*Y*	*N*	*Y*	*N*	*Y*	*N*	*Y*	*N*	*..*	*Y*	*N*
Specific	1	0	4	2	0	0	1	0	0	0	0	6	2
Period	1	0	9	0	4	0	0	1	4	0	0	18	1
Vague	2	0	15	0	2	0	1	2	1	0	0	21	2
None	0	0	3	1	0	0	2	0	1	0	0	6	1
NoRef	0	0	11	3	5	0	5	2	11	4	4	32	13
Total	4	0	42	6	11	0	9	5	17	4	4	83	19

Independent Examiner's Qualification
FCIE = Fellow of the Assocn. Charity IEs
CA = Chartered Accountant, eg: ACA, FCA, FCCA
Other = Other accounting profession, eg: CIMA, MAAT
Comp = Signed as Accountancy Company not Individual
NG = No qualification given

It was also noticed that, of the charities which reported Reserves Policies as a calculable *(eg: as a percentage of annual expenditure)* or specific amount, one simply reported its "Reserves" as its end-of-year cash balances. In all other cases the charities' end-of-year cash balances were greater than what had been specified in their Reserves Policy – sometimes substantially. The amount of the "excess Reserves" ranged from 40% to 2400% with a median of 180% – *ie:* an end-of-year bank balance nearly 3 times greater that specified by the Reserves Policy.
But if the Independent Examiner had asked the trustees about the discrepancy between the charity's Reserves Policy and its end-of-year cash balances (Clause 9.4 of the Charity Commission's Directions) it was not apparent in the IE's report to the trustees in any of the TAR&FS reviewed.

The Charity Commission Examples

The issues are further exacerbated for the trustees of typical "small" charities who turn to the Charity Commission's example Trustees' Annual Reports & Financial Statements (TAR&FSs) to see examples of "Reserves Policies in practice".



Unfortunately, while 92% of charities in England & Wales have "lower" annual incomes (*ie:* less than £500K) only 2 (29%) of the Charity Commission's 7 examples of TAR&FSs are from charities in that "lower" income range. The other 5 examples (71%) are from the 8% of charities in the "higher" income range.

Furthermore, one of those two examples is of a Parochial Church Council. A "curious" choice, given that PCCs are also subject to Church of England reporting standards and oversight by their local Synod, hence the TAR&FS of a PCC is hardly the most "typical" examples of small charities TAR&FSs.

Both example TAR&FSs do state a Reserves Policy, and in both cases their primary criterion for their level of Reserves is a portion of their annual general fund expenditure – in one case 3 months of expenditure, the other 4 months of expenditure. So both TAR&FSs qualified for a "tick in the box" of having a Reserves Policy. But neither statements of Reserves Policies gave any justification for the period of expenditure chosen. And the other elements of the elements of the two policy statements were similarly obfuscational *(ie: less clear and harder to understand, especially intentionally)*.

A more detailed consideration of the two example TAR&FSs and their Reserves Policies in relation to their Cash in Hand at the end of the reporting period is given in the Appendix.

Not Fit for Purpose ?

Such a high level of non-compliance with Charity Commission guidance/regulations cannot be dismissed as an "abnormal" or "atypical" problem confined to Reserves Policies. Nor can it be dismissed as bias or prejudice by Small Charity Support. The Charity Commission's own Charity Accounts Monitoring Reviews, the most recent publication of which was in 2019, reported that 63% of a sample of the TAR&FSs of 100 charities with incomes in the range £25K-£250K similarly failed to meet the Commission's benchmark standards. The review itself even commented *"The Commission is concerned that so many accounts submissions did not meet our benchmark"*.

As the introduction to its report "Charity Financial Reporting Standards: Not Fit For Purpose?" points out, Small Charity Support is not alone in thinking that such extensive failure to comply with the guidance and regulations cannot be blamed on the ignorance or incompetence of the typical non-accountant volunteer trustees trying to do their best for their community in their "spare time". Both the Charity Commission and the Charity Finance Group have publicly expressed concern about the appropriateness – *ie:* the **IN**appropriateness – of the current financial reporting standards, particularly as they apply to "small" charities.

Amidst the muddled confusion of the guidance on Reserves Policies for charities, this – and other – reviews clearly highlight 4 important points:

- When it comes to responding to requests for donations, grants and other funding to charities, donors' top priority is for clear – and credible – assurance that as much as possible of the money (and, presumably, other resources too – *eg:* time, expertise, goods, services) donated to charity will actually get to the charity's beneficiaries – those the charity is supposed to be helping – *ie:* rather than being squandered on unnecessary administration/bureaucracy costs or being hoarded unused for an unspecified "rainy day";
- Across the sector as a whole (individual charities will, inevitably, vary considerably), charities are not doing nearly enough to reassure donors in particular and the public in general that their donations to a charity WILL end up helping the charity's beneficiaries, as intended;

- Much of the confusion and inconsistencies in the current guidance on charity Reserves Policies is a consequence of the guidance attempting to "Shoehorn" the charity sector into financial rules, procedures and reporting standards that were designed to meet the requirements of the commercial sector, thereby undermining (rather than facilitating) the charity sector's ability to generate the reassurances that donors and the public are demanding;
- The current requirements and guidance for the charity sector to include in its pubic reports "Reserves Policies" based on the requirements of the commercial sector is a clear example of Einstein's well-known adage "*We can't solve problems by using the same kind of thinking we used when we created them."* operating in practice.

What are the Criteria for a "Good" Reserves Policy ?

The fundamental problem with trying to comply with guidance which is littered with inconsistencies and contradictions is that, no matter how hard one tries, the criteria of what constitutes a "good" Reserves policy will always be either inconsistent and/or self-contradictory, or so vague as to be meaningless (as illustrated by the review of Reserves Policies downloaded from the Register of Charities).

However, skipping the main body of the Charity Commission CC19 guidance and going straight to the Annex finds a reasonably pragmatic and understandable summary of the key "ingredients" ("criteria") for a credible financial management policy which will be able reassure donors, and the public, that "*a high proportion of the money a charity raises goes to those it is trying to help"*.
ie: It's the "recipe" for putting those ingredients ("criteria") together which is the problem – not the "ingredients" (criteria) themselves.

The problem is not a new one, or restricted to the charity sector, as pointed out in a recent article on Harry Frankfurt's best-selling book entitled "On Bullshit".

Reserves Policy ? .... Where's the Budget ? !

As pointed out in the Charity Commission's CC19 guidance (but relegated to an Annex !) the charity's budget is the ideal starting point for formulating a policy on how much unspent money the charity should be holding at any point in time – *ie:* not just at the end of the year for inclusion in the Trustees' Annual Report.   Because the charity's budget is (or should be !) an integral part of its Programme Plan for the coming year(s).

That "budget" should be dynamic – reflecting **and "accommodating**" – the expected variations in the money coming into and going out of the charity during the course of the year – *ie:* **not** a bland statement of just the anticipated total income and expenditure for the year.

How "dynamic" the budget should be will depend on the size of the charity and the complexity of its charitable and financial activities.   For many "typical smaller charities" a monthly dynamic budget will probably be sufficient.   But for charities which have more complex activities a weekly budget might be needed.   But in either case the approach will be similar.

Preparing A Budget & Cash-Flow Forecast

More information on putting together an effective budget can be found in a separate Small Charity Support guidance leaflet – "Budgets & Cash Flow".

In outline:

- ✓ Review the financial reports for the previous year and identify which categories of income and expenditure will continue essentially unchanged in the coming financial period – and adjust for inflation as appropriate;
    - ✓ for income & expenditure which are essentially consistent throughout the financial period (*eg:* salaries, utility bills, committed donations) the monthly budget allocations will be the expected annual amounts divided by 12 *(or by 52 for weekly amounts;   4 for quarterly amounts;   etc)*;

- ✓ for income & expenditure which are periodic the monthly budget allocations will be the expected annual amounts split into the months in which the income is expected to be received or the expenditure incurred (*eg:* annual subscriptions; grants; the cost of, and income from, specific fundraising events; the cost of, and any income from, charitable activities);

✓ for income & expenditure which are expected to change significantly during the year (eg: where new activities are planned to start, or current activities are expected to come to an end) the new monthly budget allocations will be added to, or subtracted, from the allocations brought forward from the previous year's income and expenditure.

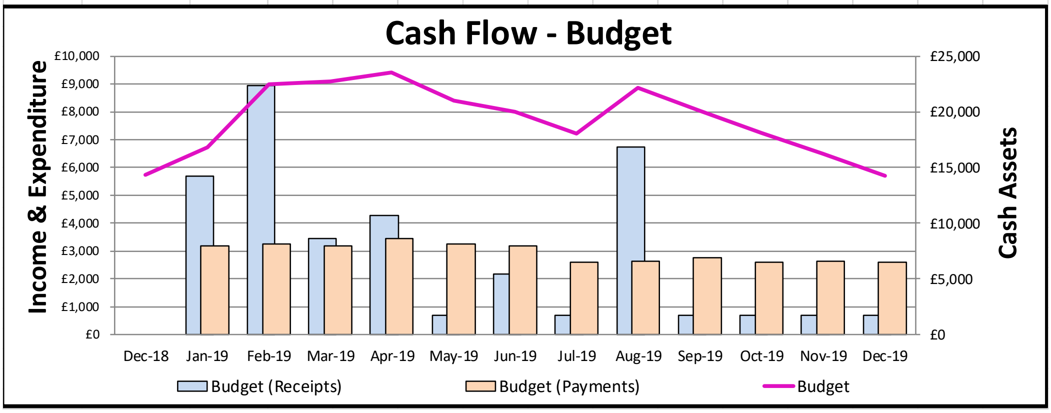
It is important to be REALISTIC !

Be neither over-optimistic nor over-pessimistic about what you hope your charity will achieve. The "wobble-factors" – *eg:* unexpected fine weather boosting the annual fund-raising event, or unexpected illness putting up the costs of an activity – are dealt with separately.

The monthly budget allocations for the year can be incorporated into a table, from which a cash-flow chart for the year can be produced to illustrate how the charity's unspent cash assets are expected to fluctuate throughout the year.

Example: Better Living: Cash Flow

		Opening	Cash Flow - FYE: 31-Dec-19											
		Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Budget	Receipts		5,692	8,942	3,442	4,292	692	2,192	692	6,742	692	692	692	692
	Payments		3,209	3,247	3,209	3,459	3,247	3,209	2,609	2,647	2,784	2,609	2,647	2,609
	Net		2,483	5,695	233	833	-2,555	-1,018	-1,918	4,095	-2,093	-1,918	-1,955	-1,918
Budget Balance		14,319	16,802	22,497	22,729	23,562	21,007	19,989	18,072	22,167	20,074	18,157	16,202	14,284



The illustration *(taken from Small Charity Support's "Proof of Concept" accounts spreadsheet for small charities)* demonstrates how easily this can be done in practice. The chart columns show the charity's budgeted (*ie:* expected) income & expenditure on a monthly basis and the line shows how the charity's unspent cash assets are predicted to vary throughout the year

In this example the Better Living charity received a grant award in January and most of its membership subscriptions in January & February. Accordingly it had budgeted for a surplus of income over expenditure in the first three months of its financial reporting year starting in January. So it actually needed minimal "spare cash in the bank" (*ie:* "Reserves" in financial reporting jargon) at the end of the previous financial period to be able to meet its budget targets in the coming year.

But had the charity's financial reporting period instead commenced in April, the budget shows that the charity would need to have carried forward at least £3,500 of "spare cash" from the previous period (*ie:* to 31 March) to be able to meet the budgeted deficit incurred over the period April to December until it again received its grants and membership subscriptions in January & February.

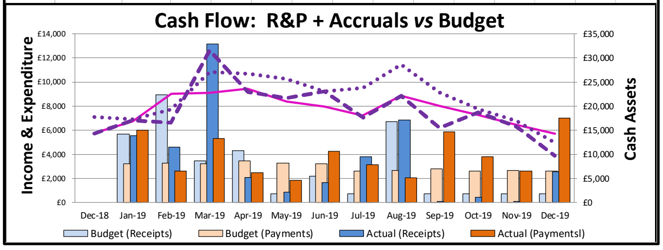
EE&E+EEE Financial Management & Reporting

In addition, the Small Charity Support's "Proof of Concept" unequivocally demonstrates that, with appropriate budget & cash-flow criteria and software, it is simple and intuitive to report on, and therefore dynamically manage, actual cash-flow throughout the year. That, in turn, enables the charity to ensure (and demonstrate when appropriate) that the maximum amount of donors' money is being spent on charitable activities for the public benefit and that the amount of unspent money at any point in time is no more than that which is appropriate to safeguard the financial sustainability of the charity.

The spreadsheet illustration shows simultaneously, from one set of financial records, on a month-by-month basis, and in real time:

Example: Better Living: Cash Flow

		Opening	Cash Flow - FYE: 31-Dec-19											
		Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Budget	Receipts		5,692	8,942	3,442	4,292	692	2,192	692	6,742	692	692	692	692
	Payments		3,209	3,247	3,209	3,459	3,247	3,209	2,609	2,647	2,784	2,609	2,647	2,609
	Net		2,483	5,695	233	833	-2,555	-1,018	-1,918	4,095	-2,093	-1,918	-1,955	-1,918
Accruals	Receipts		5,497	3,794	13,086	2,098	862	5,334	112	6,862	112	2,239	112	1,711
	Payments		2,799	3,983	3,974	1,903	2,796	3,273	2,460	2,800	6,750	3,596	2,546	8,194
	Net		2,698	-189	9,112	195	-1,934	2,061	-2,349	4,062	-6,638	-1,356	-2,434	-6,483
R&P	Receipts		5,530	4,579	13,146	2,098	862	1,672	3,774	6,862	112	412	112	2,551
	Payments		6,020	2,585	5,317	2,474	1,843	4,282	3,130	2,033	5,890	3,800	2,623	6,999
	Net		-490	1,994	7,829	-376	-982	-2,611	644	4,829	-5,778	-3,389	-2,512	-4,448
	Budget Balance	14,319	16,802	22,497	22,729	23,562	21,007	19,989	18,072	22,167	20,074	18,157	16,202	14,284
	Accruals Balance	14,319	17,017	16,613	31,608	22,924	21,628	23,068	17,641	22,134	15,529	18,718	15,723	9,718
	R&P Balance	17,740	17,250	19,244	27,073	26,697	25,716	23,105	23,749	28,578	22,800	19,411	16,900	12,451



- ✓ in columns, both the budgeted and actual ("Cash"-R&P) income & expenditure;
- ✓ as lines, the budgeted, actual ("Cash"-R&P) & committed (Accrued) financial status of the charity.

The ability to compare the charity's financial status simultaneously and in real time is particularly useful because it visually indicates where differences are due to short-term issues (*eg:* award of a grant has been confirmed but payment has been delayed) or long-term (*eg*: an expected grant application had been declined).

Future Budget & Cash-Flow Prediction – 6 Criteria

There are 6 justifications ("Criteria" – "**6-Cs**") for why a charity should be holding un-spent funds at any time throughout its annual reporting cycle – *ie:* where its monthly (or weekly) expenditure differs significantly from its monthly (or weekly) income:

(1) **C**reditors: money held to discharge unpaid bills;

(2) **C**ash-flow: situations where bills or deposits have to be paid before the money to cover them has been received – *eg:* where there are delays in receiving committed grants or donations, or the income generated by charitable activities or fundraising;

(3) **C**ompletion: the completion of a project paid for by a specific donation (or donations) or grant – *ie:* restricted funds;

(4) **C**ommitment: a commitment to occasional significant expenditure which cannot be covered by the annual income, *eg:(a)* the maintenance or replacement of large physical assets, or (b) the proposed cost of an unusually large charitable activity – *ie:* designated funds;

(5) **C**ontingency: unexpected or unavoidable falls in the level of income and/or unexpected rises in expenditure, *eg:* in the event of an emergency;

(6) **C**losure: the charity becomes financially unsustainable and has to be wound up.

to which can be added an additional "**C**":

(9) **C**onservation: funds which the trustees cannot spend immediately without compromising their legal responsibilities to ensure that those funds – and other charity resources – are spent/used necessarily, reasonably and incidentally in fulfilment of their charitable objects;

Clearly, the level of un-spent funds relating to each of those criteria will vary – sometimes considerably – on a month-by-month basis. Nor will those variations necessarily be the same for all criteria at the same time (some will go up or down at the same time, others may move in opposite directions). A Reserves Policy which defines "appropriate reserves" as a range doesn't address that. A high (or low) – but within range – level of un-spent money might be entirely appropriate at one point in the year – and quite inappropriate at another point in the year.

The CC19 guidance leaflet explicitly excludes 2 of those **6-Cs** (**C**reditors & **C**ompletion) from being classified as "Reserves" on the grounds that they are not *"freely available to spend on any of the charity's purposes"*. And then, in self-contradiction, reverts back to the dictionary definition of "reserves" to identify the other 4 of those 6 categories of money which is **NOT** *freely available to spend on the charities purposes* because they are justifications ("**C**riteria") why Trustees "*…might need to hold back some funds as **reserves**"* ***? !***

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.* ***{Contingency}***
b) *Covering unforeseen day-to-day operational costs, eg employing temporary staff to cover a long-term sick absence.* ***{Contingency}***
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.* ***{Contingency} {Closure} {Cash Flow}***
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'.* ***{Commitment}***
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.* ***{Cash Flow}***

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

Any money left, or expected to be left, in the bank after all the budgeted activities have been accounted for (*ie:* un-budgeted surplus) which is not part of the **6-C**s is the charity's "Reserves", effectively, "hoarded money" (money being held for no specific purpose).

Why Have a Reserves Policy?

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 immediately on promoting the charity's charitable activities for the public benefit.

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).

Small Charity Support agrees with that view.

But, equally, avoiding the "hoarding" of surplus funds by "disposing" of them in ways which are not exclusively necessary, reasonable and incidental to the charity's purposes and charitable objects is also contrary to the Charities Act.

Confused Reserves Policies? Where's the Pragmatism !

Small Charity Support has therefore similarly taken the "Humpty Dumpty" approach and chosen to use the term "Reserves Policy" to mean:

"its operational budget plus the 6-Cs (Creditors; Cash-Flow; Completion; Commitments; Contingency; Closure) to justify the level of un-spent funds it holds at any point in time".

Any un-spent funds not covered by those 6-Criteria will be Conserved – ***ie:*** **held until they can be spent in ways which are reasonable, necessary & incidental to the charity's objects. And until such times Small Charity Support will not actively solicit any further unrestricted donations.**

In the view of the trustees this explains the reasons for holding those funds in ways which are clearer, more consistent and more understandable to its donors & funders past & future and also to any volunteers, supporters and staff who will, or might be, involved in either/both spending those funds or/and raising future funds to replace them.

But Small Charity Support recognises that other charities might prefer – or be obliged – to adopt different approaches to their Reserves Policies which are more appropriate/relevant to their activities or style of management. This leaflet is therefore NOT specific advice or recommendation of what approach charities should be taking to prepare and publish their own Reserves Policy. Merely a "point of view" for consideration as appropriate and relevant – or not.

APPENDIX
Review of Charity Commission Example Reserves Policies

Text formatted as <u>blue, italics, underlined</u> incorporates a hyperlink to the relevant online document or website.

All the illustrations in this Appendix are taken from the relevant example Trustees' Annual Report & Accounts, downloadable from the Charity Commission website *(Crown copyright, ©, acknowledged).*

Westbeach Youth Club

The example Trustees' Annual Report & Accounts for FYE-2016 of the fictional Westbeach Youth Club (WYC) includes a statutory statement of the charity's reserves policy

Financial review

Brief statement of the charity's policy on reserves	*Cash at bank at 31/12/2016 was £12k in unrestricted funds. The main financial risk to the charity is loss of funding from the Council and reduced donations. The funds are held to cover 4 months operational costs in the event of a loss of income and to meet any unforeseen expenditure that may occur.*

At the end of FYE-2016 the WYC had cash funds of £12,000. After deducting £529 for the only outstanding liability reported in Accounts, the remaining £11,471 is (conveniently?) just a little more than the £11,153 (*ie:* 1/3rd of the charity's £33,559 operational costs) specified by its Reserves Policy.

Section A Receipts and payments

	Unrestricted funds to the nearest £	Restricted funds to the nearest £	Endowment funds to the nearest £	Total funds to the nearest £	Last year to the nearest £
A4 Asset and investment purchases, etc.	4,784	-	-	4,784	10,500
Total payments	37,566	777	-	38,343	54,854
Net of receipts/(payments)	9,233	(100)	-	9,133	(1,307)
A5 Transfers Between Funds	-100	100	-	-	-
A6 Cash funds last year end	2,867		-	2,867	4,174
Cash funds this year end	12,000	-	-	12,000	2,867

But at the end of the previous reporting period (FYE-2015) the charity had spent £10,500 on a minibus, leaving only £2,867 in its General Fund – not 1/3rd, just a mere 1/15th of its operational costs in that year. We can't see what the charity's operational costs were in the prior period (FYE-2014), but it seems likely that the cash assets (£4,174) at that end-of-year were similarly significantly less than 1/3rd of the operational costs for that year.
The charity's Reserves Policy, it justified as the amount sufficient to cover "*4 months operational costs*" – but gives no explanation of why "4 months", rather than "2 months" or "6 months" or any other period.
If the charity had a similar Reserves Policy in those earlier years it clearly was not being adhered to.

Section A Receipts and payments

	Unrestricted funds to the nearest £	Restricted funds to the nearest £	Endowment funds to the nearest £	Total funds to the nearest £	Last year to the nearest £
A1 Receipts					
Sub total	46,799	677	-	47,476	53,547
A3 Payments					
Sub total	32,782	777	-	33,559	44,354

Less obvious is that the charity's **<u>operational surplus</u>** for the reporting year (*ie:* excluding purchases of fixed assets) was £47,476-£33,559 = £13,917.
The Trustees' Annual Report makes no reference to: (i) any plans for significant purchases of assets in, FYE-2017; (ii) any new development plans (*eg:* designated funds); (iii) or to any other significant liabilities.

So even if its annual income dropped by 29% in FYE-2017 while its operational expenditure remained the same the WYC would still "break even" leaving £12,000 "reserves" in the general fund at the end of the year. And the charity's income would have to fall by more than half – **<u>with no operational cost-savings</u>** made in response to that fall in income – to deplete its reserves to zero in the first 4 months of FYE-2017.

Section A Receipts and payments

	Unrestricted funds to the nearest £	Restricted funds to the nearest £	Endowment funds to the nearest £	Total funds to the nearest £	Last year to the nearest £
A1 Receipts					
Award entrance fees and Activities	5,531	-	-	5,531	11,419
A3 Payments					
Awards and Activity Costs	13,342	777	-	14,119	12,847

It is noted that in the previous financial period, FYE-2015, the receipts for "Activity Costs" were £11,429 while the payments for Activity Costs were £12,847. *ie:* those receipts contributed 89% of the Activity Costs, the remaining 11% being subsidised from donations to the charity's Restricted Fund. But in the reported period, FYE-2016, those Activity Costs receipts had fallen by almost 50% to £5,532 while the payments had risen by £1,272 (10%) to £14,119. *ie:* in FYE-2016 the Activity Costs receipts contributed only 39% of the Activity Costs payments, most of the remaining £8,588 (61%) being subsidised from the charity's General Fund.

The Trustees' Annual Report, in its *"Further financial review details: (Optional information)"* section says:

"We use general funds to subsidise award activity costs and hold a small restricted fund to subsidise award entrance and activity costs for individuals who would otherwise not be able to participate in the awards",

but offers no explanation of why in FYE-2016 it was decided to increase the level of subsidy – *ie:* its "operational costs" – from 11% to 61%, most of which came from the General Fund rather than from a Restricted Fund.

It is noted that, had the subsidy in FYE-2016 remained at the FYE-2015 level of 11% (*ie:* £1,553) of the Activities Costs payments for the year the additional contributions to Activity Costs (£7,035) required from participants would have increased the charity's operational surplus in FYE-2016 to £21,006, leaving its end-or-year Reserves at just over £19,000 – *ie:* more than 50% higher than its Reserves Policy.

But the potential for confusion and inconsistency doesn't end there**!**
Defining the WYC's Reserves Policy as "*….4 months operational costs….*" begs the question "*which 4 months?*" – a question which is left unanswered by the Trustees' Annual Report**!** Because if the WYC's activities (and, therefore, its operational costs) are seasonal – *eg:* higher (or lower) over busy (or quiet) periods such as the summer holiday, or Christmas, periods – then what constitutes "*4 months*" of Reserves will vary significantly depending on which "*4 months*" of the financial period are selected.

Section 3.4 of the Charity Commission's guidance, [CC19 Charity Reserves: Building Resilience](), says:

"The charity's target level of reserves can be expressed as a target figure or a target range ……"

and goes on to explain how such a "target" or "target range" might be identified.

Expressing a Reserves Policy as a "target range" rather than a static "target" doesn't necessarily create clarity for the reader of the TAR&FS. A charity's actual cash assets might be within range – but at the lower end of the Reserves Policy range. But that doesn't make those assets "appropriate" if, at the same time, the charity's operational costs are at the upper end of their range. And, conversely, actual cash assets at the upper end of the charity's Reserves Range would be "inappropriately" high at a time when the charity's operational costs were low.

Similar issues can occur when the charity's monthly receipts vary significantly throughout the year – *eg:* an annual grant paid as a lump sum. Such variations in receipts would exacerbate difficulties in managing the charity's Reserves when they occur out-of-sync with any variations in the charity's monthly payments.
For example: the model example TAR&FS for the WYC reported its previous financial year ending on 31-Dec-2015 with its cash assets at just £2,867 (significantly less than just ONE month of its average monthly operational costs for that year, ie: £3,696!). Presumably the WYC was expecting some significant grants/donations to arrive in January 2016 otherwise it would have been bankrupt by the end of that month But the WYC's Reserves Policy makes no reference to when its major grant from the local Council and other significant donations, are expected to be made, and how that influences its Reserves Policy. If those major grants and donations were similarly expected to be received in January 2017, why did the charity need to have a full 4-months (£12,000) of Reserves at the end of 2016?

There are other inconsistencies, too. For example:

? The WYC's accounts report an outstanding Gift Aid receipt at the end of FYE-16, but does not include the amount even though the TAR&FS was not signed off until April 2017. If the amount was insignificant, why mention it at all? And if the amount was significant why was it not reported? What self-respecting treasurer doesn't know the amount of an outstanding Gift Aid claim 3 months after the end of the financial year to which it relates?

? The WYC's accounts make no mention of the costs of winding up the charity if, having spent its 4 months of reserves due to "*…loss of income…*", it still hasn't found alternative sustainable sources of income.
It might be that it has no financial commitments on winding up – *eg:* redundancy obligations to employees; fixed term commitment on services contracts (*eg*: rent, utilities); an obligation to reinstate the rented accommodation on closure. Or perhaps it is felt that such costs would be covered by the sale of the charity's fixed assets which would no longer be required (*eg:* the minibus, computer suite).
That is just left to the reader to assume.

St.Emilion's Church – Parochial Church Council

Background note:
The choice of the Trustees' Annual Report & Account of St.Emilion's Church PCC (SEC-PCC) as an "example" for the guidance of charities preparing Receipts & Payments accounts is "curious".

It is true that Parochial Church Councils are a common form of charity in the UK (because there are quite a number of Anglican churches with PCCs in the UK). But the fact that they are "common" doesn't automatically make them "typical".

Unlike the majority of small charities:

* PCCs are subject to the jurisdiction of the Anglican Church in addition to the jurisdiction of the Charity Commission. Hence, the *"Administrative Information"* section of the example Trustees' Annual Report includes the statement:
  The PCC is a body corporate (PCC Powers Measure 1956, Church Representation Rues 2006) and a charity excepted from registration with the Charity Commission.
* PCCs – the equivalent of the Board of Trustees in typical charities – are usually chaired by the incumbent, often paid, vicar appointed by a complex Church of England procedure, rather than by the trustees or the charity's members.
* the financial management of the PCC is also subject to Church of England guidance and regulations. The Notes to the example
  financial Accounts open with the statement:
  The financial statements of the PCC have been prepared in accordance with the Church Accounting Regulations 2006 using the Receipts & Payments basis.

And to complete the "curiosity", the SEC-PPC example accounts are for the year ended 31 December 2009, *ie:* significantly prior to the Charity Commission's current guidance CC16 dated 2013 (updated 2017) for the preparation of Receipts & Payments Accounts.

The example Trustees' Annual Report & Accounts for FYE-2009 of the fictional St.Emilion Church Parochial Church Council (SEC-PCC) includes a statutory statement of the charity's reserves policy, illustrated below.

> **Reserves policy**
>
> It is PCC policy to maintain a balance on unrestricted funds (if possible), which equates to at least three months unrestricted payments, equivalent to £15,000, to cover emergency situations that may arise from time to time. The balance of £4,900 held on unrestricted funds, after designations, at the year end did not match this target.
>
> The balance of £17,050 in the Fabric restricted fund is retained towards meeting the cost of the nave roof repairs detailed above.

The statement blithely comments that *"The balance of £4,900 held on unrestricted funds, after designations, at the year end did not match this target."*

Indeed it did not – it was less than 1/3rd (1 month's operational costs) of the target! The accounts do refer to £2,540 of outstanding cash assets, most of which were received shortly after the end of the financial period. But even with those included the SEC-PCC's reported "Free Reserves" were only £7,440 – still less than half of its Reserves Policy target. But no explanation was given of the SEC-PCC's policy to eliminate that significant short-fall in the future.

Less obvious is that the statement is misleading – a classic example of bureaucratic Humpty-Dumpty-ism. The TAR&FS's Financial Review section refers to a transfer to a so-called "designated" fund, NOT *"…set aside to meet essential future spending…"* but to pay a cost which has **already been incurred**! *ie:* an outstanding liability.

> unrestricted funds (including a receipt of £250 allocated to designated funds). A transfer of £2,000 was made to the designated organ fund to cover expenditure incurred towards the end of the year (paid in 2010). Adding bank and deposit

Excess of Receipts over Payments	2,600	250	3,650	-	**6,500**	9,500
Transfers between funds	(2,000)	2,000	-	-		
	600	2,250	3,650	-	**6,500**	9,500
Bank current and deposit accounts 1st Jan.	4,300	3,300	13,400	-	**21,000**	11,500
Bank current and deposit accounts 31st Dec.	4,900	5,550	17,050	-	**27,500**	21,000
STATEMENT OF ASSETS AND LIABILITIES						
Cash Funds						
Bank current account	400	-	-	-	**400**	350
CBF deposit fund	4,500	5,550	17,050	-	**27,100**	20,650
	4,900	5,550	17,050	-	**27,500**	21,000
Other Monetary Assets						
Local Authority grant for churchyard	300	-	-	-	**300**	-
Income tax recoverable (recd Jan. 2010)	2,240	-	-	-	**2,240**	-
	2,540	-	-	-	**2,540**	-
Investment Assets (note 3)						
20,000 CBF Church of England Investment Fund shares at market value		-	-	20,000	**20,000**	19,500
Assets retained for Church use (note 2)	59,000	-	-	-	**59,000**	59,000
Liabilities – Organ clean/tune Dec 2009	-	6,200	-	-	**6,200**	-

Not only that: even with the transfer, the amount held in the "designated" fund – £5,500 – is insufficient to cover the outstanding liability of £6,200. So, after liabilities (rather than *"after designations"*) the SEC-PCC's actual end-of-year "reserves" are £4,250, NOT £4,900.

And, like the WestbeachYC Reserves Policy (reviewed above), the SEC-PCC Reserves Policy makes no mention of covering any exceptional costs in the event that the SEC-PCC became financially or operationally unsustainable and had to be wound up. Presumably it was felt that, in such circumstances, the SEC-PCC's *"Assets retained for Church use"* (which do not have to be included in its Reserves Policy) would no longer need to be retained, and the amount generated by selling them would be more than sufficient to cover the costs of winding up.

Summary

The Reserves Policies in the Charity Commission's two "model examples" of Trustees' Annual Reports & Accounts prepared on a Receipts & Payments Accounts have been reviewed in the context of their respective Financial Statements.

- **?** In both "model examples" the Reserves Policy is expressed as a fraction of the charity's normal annual operational expenditure without giving any specific justification/explanation of how that fraction was arrived at.
- **?** Both "model examples" take no account of, or even make reference to, the possibility that seasonal variation in either, or both, normal operational expenditure levels or normal income levels would create seasonal variations in the appropriate level of reserves. In particular, there is no consideration that such seasonal variations in Reserves would be exacerbated if seasonal variations in income and expenditure did not occur in parallel.
- **?** Both "model examples" report occasions when the actual levels of reserves were significantly lower than the levels specified in their Reserves Polices. But neither Reserves Policy includes any reference to how the charity intends to deal with such situations – *eg:* implementing cost savings – other than hoping that additional income will be found from other sources.
- **?** Both "model examples" contain inconsistencies between their Reserves Statements and the movements of money in to and/or out of the charity during the year.
- **?** Neither "model example" addresses, or even refers to, the reserves necessary to enable the charity to be wound up in good order – *ie:* with all outstanding liabilities (legal and moral) discharged appropriately in the event of the charity becoming financially or operationally unsustainable.
  ie: neither "model example" incorporates the lessons learned (if any?) from the shambolic collapse of the Kids Company charity in 2015

Conclusion

Most readers of these two Charity Commission's "model examples" seeking guidance on how to prepare their small charity's Trustees Annual Report & Accounts on a Receipts & Payments basis will probably not analyse them at the level of detail used in this review.

But that does not mean that they will not recognise (subconsciously, if not explicitly) the superficiality – and, therefore, the level of obfuscation – in the two "model examples".

It is therefore hard to avoid concluding that the *"assistance to preparers" {of Trustees' Annual Reports & Accounts"}* – provided by the Charity Commission's two "model examples" is:

> It is only necessary for a charity's Reserves Statement in its Trustees' Annual Report to sound plausible for it to be sufficient to justify a "tick in the relevant box" that the charity has a "Reserves Policy" which is compliant with section 9.3 of the Directions for the Independent Examination of Charity Accounts (CC32).

It is noted that the Charity Commission's webpage of "model example" TAR&FSs also includes the *"get out of jail free"* statement:

> *"The examples are designed to assist preparers and are not a substitute for reference to the public benefit guidance or SORP 2005. Readers should not assume that the examples show the only way of presenting an item or that they include all the disclosures for a particular type of charity."*

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