Charity reserves: building resilience

June 2010 (updated January 2016)

Contents

1. Introduction

1.1 What is this guidance about?

This guidance is written for trustees of charities of all sizes and types, whether they are companies, trusts or associations. It explains:

- what the trustees' duties are towards the interests of their charity
- what is meant by the term 'reserves'
- the importance of a reserves policy
- how to develop a policy on reserves for smaller and larger charities
- how trustees must report their reserves policy in their annual report in a way that meets the requirements of the Charities SORP and the requirements of the Regulations

Definitions of technical terms used in this guidance are given in section 6.

1.2 Must and should: what the commission means

In this guidance:

- 'must' means something is a legal or regulatory requirement or duty that trustees must comply with
- 'should' means something is good practice that the commission expects trustees to follow and apply to their charity

Following the good practice specified in this guidance will help you to run your charity effectively, avoid difficulties and comply with your legal duties. Charities vary in terms of their size and activities. Consider and decide how best to apply this good practice to your charity's circumstances. The commission expects you to be able to explain and justify your approach, particularly if you decide not to follow good practice in this guidance.

In some cases you will be unable to comply with your legal duties if you don't follow the good practice. For example:

Your legal duty	It's vital that you
Act in your charity's best interests	Deal with conflicts of interest
Manage your charity's resources responsibly	Implement appropriate financial controls Manage risks
Act with reasonable care and skill	Take appropriate advice when you need to, for example when buying or selling land, or investing (in some cases this is a legal requirement)

Trustees who act in breach of their legal duties can be held responsible for consequences that flow from such a breach and for any loss the charity incurs as a result. When the commission looks into cases of potential breach of trust or duty or other misconduct or mismanagement, it may take account of evidence that trustees have exposed the charity, its assets or its beneficiaries to harm or undue risk by not following good practice.

2. Key messages for trustees

As the regulator of charities in England and Wales, the commission expects trustees to decide, publish, implement and monitor their charity's reserves policy so that they can comply with their legal duties to:

- act in the interests of their charity and its beneficiaries
- protect and safeguard the assets of their charity
- act with reasonable care and skill
- ensure their charity is accountable

In practice, this means that trustees should:

- develop a reserves policy that:
  - fully justifies and clearly explains keeping or not keeping reserves
  - identifies and plans for the maintenance of essential services for beneficiaries
  - reflects the risks of unplanned closure associated with the charity's business model, spending commitments, potential liabilities and financial forecasts
  - helps to address the risks of unplanned closure on their beneficiaries (in particular, vulnerable beneficiaries), staff and volunteers
- publish the reserves policy (even if not required to by law) and ensure it is tailored to the charity's circumstances – it should not be just a standard form of wording. It should explain to funders, beneficiaries, the public and the commission exactly what reserves are kept (or not kept) for and when they are to be used
- larger charities are required to publish their assessment of the risks that the charity faces and how to manage them in their annual report
- make sure that their reserves policy is put in place and operated
- regularly monitor and review the effectiveness of the policy in the light of the changing funding and financial climate and other risks

3. Understanding reserves and the need for a reserves policy

3.1 What are reserves?

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, although holding such funds may influence a charity's reserves policy. Reserves will also normally exclude tangible fixed assets such as land, buildings and other assets held for the charity's use. It also excludes amounts designated for essential future spending.

Reserves also exclude funds which have particular restrictions on how they can be used. Trustees should consider for what purpose restricted funds are held and how they are being used in order to identify those resources that are freely available to spend.

Unrestricted funds

The starting point for calculating the amount of reserves held will normally be the amount of unrestricted funds held by a charity. However, part of the unrestricted funds of a charity may not always be readily available for spending. For example:

- Tangible fixed assets

  The Charities SORP specifically allows funds held as tangible fixed assets for charity use to be excluded from reserves - this recognises that certain assets will be used operationally and their disposal may adversely impact on a charity's ability to deliver its aims

- Programme-related investments

  Where a charity makes programme-related investments solely to further its charitable purposes, then such investments can be excluded from reserves

- Designated funds

  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 - in such cases the reserves policy should explain the nature and amount of the designation and when the funds set aside are likely to be spent; it is never acceptable to set up designations simply to reduce the stated level of reserves

Restricted funds

Restricted funds fall outside the definition of reserves, but the nature and amount of such funds may impact on a charity's reserves policy. Where significant amounts are held as restricted funds the nature of the restriction should be considered, as such funds may reduce the need for reserves in particular areas of the charity's work. These factors and their potential impact on the reserves policy are explained in Annex 2 of this guidance.

Reserves held by subsidiaries

A charity may carry out activities through one or more trading subsidiaries and, in such cases, group or consolidated accounts may be required. Group accounts show the activities and resources of the charity and its subsidiaries. Where group accounts are prepared, the annual report will provide a narrative of the group's activities. In particular, the amount of reserves stated must take account of the net assets of subsidiaries.

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.

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.

In more detail

Deciding the level of reserves that a charity needs to hold is an important part of financial management and forward financial planning. Failure to do this may result in reserves levels which are either:

- higher than necessary and may tie up money unnecessarily. Holding excessive reserves can unnecessarily limit the amount spent on charitable activities and the potential benefits a charity can provide
- too low, increasing the risk to the charity's ability to carry on its activities in future in the event of financial difficulties, and increasing the risks of unplanned and unmanaged closure and insolvency

All charities need to develop a policy on reserves which establishes a level of reserves that is right for the charity and clearly explains to its stakeholders why holding these reserves is necessary.

A reserves policy provides essential accountability to funders, donors and other stakeholders. A good reserves policy will explain how reserves are used to manage uncertainty and, if reserves are held to fund future purchases or activities, it will explain how and when the reserves will be spent. A reserves policy provides assurance that the finances of the charity are actively managed and its activities are sustainable.

In particular, a reserves policy will:

- give confidence to funders by demonstrating good stewardship and active financial management
- demonstrate the charity's resilience and capacity to manage unforeseen financial difficulties to beneficiaries, funders and the public
- give voluntary funders, such as grant-makers, an understanding of why funding is needed to undertake a particular project or activity
- give assurance to lenders and creditors that the charity can meet its financial commitments
- manage the risk to a charity's reputation from holding substantial unspent funds at the year-end without explanation

Developing a reserves policy is also an important part of the internal financial management of a charity. Developing a reserves policy is likely to:

- assist in strategic planning, for example considering how new projects or activities will be funded
- inform the budget process, for example is it a balanced budget or do reserves need to be drawn down or built up?
- inform the budget and risk management process by identifying any uncertainty in future income streams

The commission recommends that charities develop their reserves policy and their planning at the same time, recognising that strategic and financial planning informs the development of reserves policies and vice versa. For example, the budgets will identify peaks or troughs in cash flow and the reserves policy will need to ensure the troughs in funding can be met from reserves held.

3.3 How should a reserves policy be developed?

There is no single method or approach to setting a reserves policy. The approach adopted will vary with the size, complexity of activities, legal structure and the nature of funds received and held by a charity. However, for all charities, setting a reserves policy will involve:

- consideration of the nature of the funds received and held by the charity - are the funds unrestricted or restricted income? Is an endowment an expendable endowment or permanent endowment? Understanding the nature of the funds allows trustees to identify unrestricted funds which can be spent on any purposes of the charity
- larger charities are likely to have a formal risk management process but all charities need to think about uncertainties they may face in the future; they should therefore consider the need to hold some reserves to meet an unexpected call on funds or opportunities that may present themselves
- larger charities are likely to have strategic and operational plans - but all charities need to think about their future budgets and future projects or spending plans that cannot be met from the income of a single year
- trustees choosing to adopt a 'zero level' reserves policy must say in their annual return that they have adopted such a policy and should explain why; such a policy can create heightened financial risk from the possibility of unforeseen expenditure, sudden closure, trustee liability, a shortfall in income or an inability to control costs, unless the trustees have a workable alternative to holding reserves for addressing these risks

By working through these steps the trustees will be well placed to identify why reserves might need to be held and to decide the amount of reserves needed to operate effectively.

Once a reserves policy is set, it should not be regarded as a static policy. The circumstances of a charity or the environment in which it operates will change with time and trustees should review their policy at least annually as part of a charity's planning processes. The amount held in reserves should also be monitored during the course of the year as part of a charity's budgetary processes.

Annex 1 of this guidance sets an approach to setting a reserves policy that can be used by smaller charities which do not hold significant amounts of endowed funds, property or operate a defined benefit pension scheme or carry out activities through trading subsidiaries.

Annex 2 of this guidance sets out an 'integrated approach' for larger charities with more complex activities and structures. An integrated approach to setting a reserves policy means the development of the development of a reserves policy at the same time as doing strategic, operational, and budgetary planning.

3.4 What level or range of reserves is required?

Short answer

There is no single level, or even a range of, reserves that is right for all charities. Any target set by trustees for the level of reserves to be held should reflect the particular circumstances of the individual charity. To do this, trustees need to know why the charity should hold reserves and, having identified those needs, the trustees should consider how much should be held to meet them.

In more detail

The charity's target level of reserves can be expressed as a target figure or a target range and should be informed by:

- its forecasts for levels of income for the current and future years, taking into account the reliability of each source of income and the prospects for developing new income sources

- its forecasts for expenditure for the current and future years on the basis of planned activity
- its analysis of any future needs, opportunities, commitments or risks, where future income alone is likely to fall short of the amount of the anticipated costs
- its assessment, on the best evidence reasonably available, of the likelihood of a shortfall arising which means that reserves are necessary, and the potential consequences for the charity of not being able to make up the shortfall
- if the reserves policy is set at zero or a low level, its strategy for an orderly closure in the event of an unplanned shutdown and insolvency and particularly where there are vulnerable beneficiaries, the care of its beneficiaries

Trustees who hold (or do not hold) reserves without attempting to relate their need for reserves to factors such as these will have difficulty in satisfactorily explaining why they hold (or do not hold) the amount of reserves that they do.

3.5 What steps should trustees take to maintain and monitor reserves at the target level?

Short answer

Reserves are held to help the charity operate effectively. Trustees should keep their reserves policy and the level of reserves held under review. Trustees should also monitor the level of reserves held throughout the year. In this way trustees will be aware of the buildup of excess reserves or of reserves being unexpectedly or rapidly depleted.

In more detail

Having set the reserves level or range in which it is desirable to operate, trustees should monitor the reserves actually held to establish the reason for any significant difference with the target level set. If reserves during the year are below target or exceed target, the trustees should consider whether this is due to a short-term situation or a longer-term issue. Action may be needed to replenish or spend reserves.

The trustees' monitoring of reserves should not just be a year-end procedure. How the level of reserves changes during the year can be a good indicator of the underlying financial health of the charity and can be an indicator of potential problems. The level of reserves should be monitored throughout the year as part of the normal monitoring and budgetary reporting processes.

In particular, trustees should:

- identify when reserves are drawn on so that they understand the reasons and can consider the corrective action, if any, that needs to be taken
- identify when reserve levels rise significantly above target so that they understand the reasons and can consider the corrective action, if any, that needs to be taken
- where the reserves level is below target, consider whether this is due to short-term circumstance or longer term reasons which might trigger a broader review of finances and reserves
- regard the ongoing review of the reserves target, the reserves level and the reserves policy as part of managing the charity
- ensure that the reserves policy continues to be relevant as the charity develops or changes its strategy and activities
- review the statement on reserves in the trustees' annual report where there have been significant changes in the reserves policy or level of reserves held

Charities with very low or no reserves which face financial difficulty should read the commission's guidance Managing a charity's finances: planning, managing difficulties and insolvency (CC12).

4. Explaining reserves in the annual report

4.1 Explaining the charity’s reserves policy in its annual report

The Charities SORP requires all charities preparing accruals-based accounts, other than those charities following a more specialist SORP, to set out their reserves policy in their annual report. The regulations also require a charity that does not have a reserves policy to state this fact in their annual report.

The Charities SORP requires trustees to include in their annual report:

- a statement of their policy on reserves
- the level of reserves held and an explanation of why they are held
- where material funds have been designated, the amount and the purpose of the designation should be explained
- where designated funds are set aside for future expenditure, the likely timing of that expenditure

These requirements of the Charities SORP are given legal force by the Regulations, which also require a statement in the event of a charity not having a reserves policy.

4.2 The charity has no reserves or has excess reserves

Whatever the trustees’ policy is, beneficiaries, funders and the commission as regulator should be able to see how it has been justified.

No or insufficient reserves

In some cases, a charity may decide to operate without any reserves. Some trustees budget to spend all the income received each year on the charity’s activities. Other charities may find thatthe terms of some sources of fundingdo not allow the funds to be set aside as a reserve.

Having no reserves can create financial risk from the possibility of unforeseen expenditure, a shortfall in income or an inability to control costs. Trustees choosing to adopt a ‘zero level’ reserves policy should consider the financial and other risks inherent in such a policy and must explain their policy in the trustees’ annual report.

Trustees should base their reserves policy on the risks that a charity and its beneficiaries might face and how to manage them. A charity’s reserves policy should justify why it doesn’t keep any reserves or how it is managing insufficient reserves. Whatever the trustees’ policy is, beneficiaries, funders and the commission as regulator should be able to see how it has been justified.

Some charities will be able to justify holding a certain level of reserves but will be unable to build up reserves to that level, or perhaps to any level at all. Many recently established charities in particular, will be in that position. While the commission accepts that some charities will simply not have had the resources to establish a reserve, the commission still expects such charities to have a reserves policy.

Where a charity hasn't got the reserves it thinks it needs, it is exposed to greater risk and the commission expects the trustees to be addressing this actively by, for example, planning how to:

- implement their reserves policy
- raise the necessary funds
- diversify their funding base
- mitigate the risks that might arise if the charity has to close suddenly

Where a charity's reserves appear to be too high

A charity's level of reserves or unspent funds can appear to donors, beneficiaries or the commission to be too high and this is generally for two reasons:

> First, because the trustees have not explained fully the reasons why they are keeping reserves. If this is the case, they should review their policy and ensure that it fully justifies why funds are being kept in reserve. If, for example, a charity is using a standard form of reserves policy wording, it is not likely that it will tell the charity's story or explain why the charity has the level of unspent income that it does.
>
> Second, because they are having difficulty in using their funds. A charity with excess reserves or unspent funds should consider whether they could be effectively spent on the charity's purposes. If a charity has more resources than it needs to fulfil all of its purposes then the trustees must consider whether the purposes of the charity should be amended to enable the charity to operate more effectively..

5. Other questions about reserves

5.1 Can a charity invest its reserves?

Short answer

Yes, reserves can be invested. However, by their nature, reserves tend to be resources that may be needed in the short to medium term. Trustees therefore should ensure that reserves are invested in a way can be readily realised as cash, when needed.

In more detail

When significant resources are held in reserves from year to year, the trustees should consider whether some or all of the reserves can be invested to obtain a financial return for the charity. In making the investment decision, the trustees should consider when the reserves might be needed (liquidity of the investment) and the acceptable level of investment risk.

The investment policy adopted will need to reflect the trustees' assessment of the likelihood that some or all of the reserves held may need to be accessed at short notice. Certain investments are more appropriate as long-term holdings and may be unsuitable or too high risk when it is known that a specific amount of cash will be needed in the short-term or at short notice to meet urgent need.

For charities with small sums to invest their investment policy for reserves may be very straightforward, such as holding any surplus funds with a UK bank or building society in an interest bearing account linked to the charity's current account allowing for same-day money transfer.

Where the amount of reserves held is large and the trustees decide to invest all or part of those reserves in a wider range of investments than simply on deposit, then a more detailed analysis of why the reserves are held and how quickly those reserves may need to be accessed may be required. This should involve a more detailed consideration of the risks for which the reserves may be needed and the time frame in which cash might be required. Investing reserves in assets other than cash also involves a greater degree of investment risk. For example, investing in shares and corporate bonds offers the potential of a higher investment return but also carries a greater risk of loss.

Charities subject to statutory audit are required by the Charities SORP and the Regulations to set out their investment policy, including their investment objectives and the performance of the investments against those objectives in the trustees' annual report. This requirement also applies to invested reserves.

For further advice on investments refer to the commission's guidance Charities and investment matters: a guide for trustees (CC14) - more detailed guidance is also available on GOV.UK for those that require it.

5.2 What is the legal basis for holding and reporting reserves?

Short answer (legal requirement)

Some charities have a power to hold reserves in their governing document – all others can rely on powers implicit in the law. Trustees can use these powers where they are satisfied that to do so is in the best interests of the charity: their charity's reserves policy should reflect their reasoning. When making this decision, trustees of unincorporated charities should weigh it against the general trust law principle that funds received as income should be spent within a reasonable period of receipt of the funds.

In more detail

Charity trustees have a general legal duty to spend income within a reasonable time of receipt. Trustees may spend this income to fund charitable activities, in acquiring assets to use in the charity's work, and in meeting the day to day running costs of the charity. To hold income in reserve rather than spending it, trustees rely on an explicit or implicit power to hold reserves and they must use that power in the charity's best interests.

The charity's governing document may, in some cases, explicitly give the trustees an express legal power to hold income in reserve instead of spending it promptly. This power is not common but it is still worth checking the governing document in case there is such an express power to hold reserves.

The more common situation is that trustees will have to rely on their implied power to hold reserves. An implied power will not be written into the governing document but is a power implicit in trustees' duties enabling them to take actions which are necessary for the charity to function properly.

Trustees are justified in exercising their power to hold income reserves, whether express or implied, only if in their considered view it is necessary to do so in the charity's best interests.

The power to hold reserves needs to be used appropriately by trustees. If the power is used without justification then the holding of income in reserve might amount to a breach of trust. A failure to report on the reserves policy adopted can indicate that trustees have not exercised their legal power correctly; good reporting of a charity's reserves policy can help to demonstrate the legal power to hold reserves has been properly used.

5.3 Can trustees accumulate income funds?

A power to accumulate income by adding income to the capital of an endowment fund should not be confused with holding income as reserves. A small number of charities have a power in their governing document to add income of the charity to capital of an endowment fund. Income cannot be accumulated in this way unless the trustees have an express power that allows them to do so.

If funds are accumulated without a power to convert them to endowment, then they continue to be income funds. Such accumulated income funds are unrestricted and count as reserves; they must be reported as such in the annual report.

5.4 What are the tax issues involved in holding reserves?

The justifiable retention of reserves should not have any adverse tax implications.

Much of the income received by charities is exempt from Income Tax and Corporation Tax provided that the money is used for charitable purposes only. More information is available from HM Revenue & Customs.

5.5 Fundraising, applying for grants or contracts if a charity has reserves

Short answer

It is important when fundraising that trustees maintain the confidence of the public in their charity by being open and transparent about their charity's need for funds. If the charity has excess reserves, the trustees should ensure that they do not misrepresent the urgency or need for funds.

When a charity is applying for a grant or is bidding for a contract, it is important that the funder understands the charity's reserves policy and that the policy explains and justifies the reserves held.

In more detail

Every charity is responsible for ensuring that its appeals do not misrepresent the charity's financial position. This is the case whether the appeals are for voluntary public donations, corporate donations, legacies, grants or any other form of income, and whether they are made by advertising, direct mail, in person, or by any other method.

If a charity is widely believed to have large reserves, further appeals for funds may provoke resentment against the charity for apparently seeking funds it does not need. In wording its appeals, and in dealing with any reaction to the appeals, trustees should take care not to give anyone the wrong impression about the extent or urgency of their charity's need for funds.

Some charities can have difficulties with the way their reserves are viewed by funders. If the reserves appear too large, there may be an assumption that the charity does not have a need for additional funds. If the reserves appear too low, there could be a refusal to fund on the basis that the charity's finances are unstable and the charity may be at risk of financial difficulty or insolvency.

Trustees should ensure that they can explain their reserves policy to funders by showing that:

- the reserves held are based on a policy and a clear understanding of what the money is to be used for
- the charity is operating with sufficient reserves to avoid financial difficulties
- reserves are an essential element of strategic, operational and budgetary planning
- the charity is being transparent about the level of reserves

Where trustees are seeking grants or contracts from funders they should ensure that they:

- understand the funder's policy towards applicants' reserves
- seek opportunities to explain to the funder their charity's reserves policy and reasons for the level of reserves held
- present the charity's reserves policy and reserves level in a positive way that can be clearly understood

6. Technical terms used in this guidance

The following terms are used throughout this guidance and should be interpreted as having the specific meanings given.

Annual report: the trustees' annual report prepared under the Charities Act.

Charities SORP: the Statement of Recommended Practice: Accounting by Charities published by the commission and revised in 2005. It sets out the recommended practice for the purpose of preparing the trustees' annual report and preparing accounts on an accruals basis. The accounting recommendations of the SORP do not apply to charities preparing receipts and payments accounts.

Designated funds: part of the unrestricted funds which trustees have earmarked for a particular project or use, without restricting or committing the funds legally. The designation may be cancelled by the trustees if they later decide that the charity should not proceed or continue with the use or project for which the funds were designated.

Endowment funds: funds which the trustees are legally required to invest or to keep and use for the charity's purposes. Endowment may be expendable or permanent.

Expendable endowment: an endowment fund where the trustees have the power to convert the property (ie land, buildings, investments or cash) into 'income'. It is distinguishable from 'income' by the absence of a positive duty on the part of the trustees to apply it for the purposes of the charity, unless and until this power to convert into 'income' is actually exercised.

Governing document: any document which sets out the charity's purposes and, usually, how it is to be administered. It may be a trust deed, constitution, conveyance, will, memorandum and articles of association, Royal Charter or scheme of the commission.

Income and income funds: all incoming resources that become available to a charity and that the trustees are legally required to spend in furtherance of its charitable purposes within a reasonable time of receipt. Income funds may be unrestricted or restricted to a particular purpose of the charity.

Material or materiality: a material fund is one which the trustees or their auditor or independent examiner judge to be of such importance that its omission or misstatement would affect the reader's understanding of the accounts. Materiality depends on the size, amount or importance of the fund in relation to the total unrestricted and restricted funds managed by the trustees.

Permanent endowment: property of the charity (including land, buildings, cash or investments) that the trustees may not spend as if it were income. It must be held permanently, sometimes to be used furthering the charity's purposes, sometimes to produce an income for the charity. The trustees cannot normally spend permanent endowment without the commission's authority. The terms of the endowment may permit assets within the fund to be sold and reinvested, or may provide that some or all of the assets are retained indefinitely (for example, in the form of a particular building).

Programme related or social investment: not 'investment' in the conventional sense of a financial investment. Conventional investments involve the acquisition of an asset with the sole aim of financial return which will be applied to the charity's objects. Programme related or social investments, by contrast, are made directly in pursuit of the organisation's charitable purposes. Although they can generate some financial return, the primary motivation for making them is not financial but the actual furtherance of the charity's objects.

Regulations: the Charities (Accounts and Reports) Regulations 2008 (SI 2008 No. 629) which set out the required form and content of the trustees' annual report and the scrutiny and accounting arrangements for charities. These regulations apply to the annual reports of charitable companies incorporated under company law and non-company charities for accounting periods beginning on or after 1 April 2008.

Restricted funds: funds subject to specific trusts, which may be declared by the donor(s) or with their authority (eg in a public appeal) or created through legal process, but still within the wider objects of the charity. Restricted funds may be restricted income funds, which are spent at the discretion of the trustees in furtherance of some particular aspect(s) of the objects of the charity, or they may be endowment funds, where the assets are required to be invested, or retained for actual use, rather than spent.

Risk: used in this guidance to describe the uncertainty surrounding events and their outcomes that may have a significant financial impact. Risk may affect any area of a charity's operations.

Statutory audit: this refers to the requirement in charity law for an audit to be carried out where the charity's gross income and/or assets exceed the relevant threshold. An audit must be undertaken by a person who is eligible for appointment as auditor of a company, or a person approved by the commission in accordance with the regulations.

Subsidiary trading company: any non-charitable trading company wholly owned, or the majority of which is owned, by a charity to carry outtrading activities on behalf of the charity.

Trustee: a charity trustee. Charity trustees are the people who are responsible for the general control and management of the administration of the charity. In the charity's governing document they may be collectively called trustees, the trustee board, managing trustees, the management committee, governors or directors, or they may be referred to by some other title.

Unrestricted funds (including designated funds): income or income funds which can be spent at the discretion of the trustees in furtherance of any of the charity's objects. If part of an unrestricted income fund is earmarked for a particular project it may be designated as a separate fund, but the designation has an administrative purpose only, and does not legally restrict the trustees' discretion to spend the fund.

Annex 1: A simple approach to developing a reserves policy

The following 3 questions are designed to help guide trustees of smaller charities through the issues that need to be considered when developing their reserves policy. Trustees managing charities with more complex activities or structures may find that this approach does not go into enough detail and should look at the guidance given in Annex 2 instead.

Question 1. Why might you need reserves for the charity to be effective?

The basis of a good reserves policy is thinking through exactly why you might need to hold back some funds as reserves. In a small charity, with a simple structure and uncomplicated activities, the reasons might include:

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.

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

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.

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'.

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.

If, after considering the above, you think that reserves are needed please go to question 2. If you conclude that your charity does not need to hold any reserves, then you must explain that in your annual report.

Question 2. How much do you need in reserve?

The reserves level may be a target amount or a target range. For example, for each reason set out in question 1:

a) An amount might be needed to meet an unforeseen emergency or other unexpected need - consider risks and how much might be needed for such contingencies; this will involve judgment of events that may occur and their likelihood.

b) Look at your expenditure budget - do you need a small contingency fund to meet unforeseen operational costs?

c) Uncertainty over future income might mean having reserves equivalent to a number of weeks of income equivalent to a range of £x to £y, to allow time to develop new sources of income or to cut-back on related expenditure.

d) A planned spending commitment which cannot be met from future income would imply a need for a specific sum to be set aside - often this amount will be included within designations in accounts.

e) An amount might be needed to cover 'troughs' in the cash budget - review budgets to ascertain how much might be needed.

In summary, the financial risks you identify should influence the amount of reserves you target to hold and be explained in your reserves policy.

Question 3. Have you got any funds in reserve at the end of the year?

The final step is to compare what you might need in reserve with what you actually hold. You should:

- calculate the amount of any reserves according to the definition of reserves given in section 3.1 of the guidance
- state the amount of reserves held and compare with the target amount or target range set for reserves
- explain any shortfall or excess in reserves against target set
- explain any action being taken or planned to bring reserves into line with your target

Where the difference is small, no action may be needed.

Information about the reserves policy and the level of reserves held must be included in the trustees' annual report.

Annex 2: An integrated approach to developing a reserves policy for a charity with more complex activities and structures

Trustees of charities with more complex activities and structures need to take into account a broader range of factors when developing their reserves policy. These charities will be undertaking a greater range of activities or be funding a scale of operations much greater than that of charities with simpler affairs. For example they may be undertaking primary purpose trading or providing goods or services under contract. They are likely to hold a number of restricted funds, employ staff and may own buildings or operate trading subsidiaries.

Setting a reserves policy is not a task undertaken in isolation. A reserves policy is a product of a charity's strategic planning, budgeting and risk management processes. These processes provide trustees with the information they need to establish exactly why they might need reserves and to help them quantify that need. The steps involved in these processes are interrelated with the outcome of one process informing another. For example, identified financial risks will inform both budgeting and the reserves policy. Setting a reserves policy can be approached in different ways. This annex presents one approach and is set out as steps in a process, but it is important to remember each of these steps is connected.

Step 1: Understanding the nature of charitable funds held

Step 2: Identifying functional assets

Step 3: Understanding the financial impact of risk

Step 4: Reviewing sources of income

Step 5: Impact of future plans and commitments

Step 6: Agreeing a reserves policy

When taking each of these steps, trustees should reflect on the guidance and think through how it applies in the circumstances of their own charity. From this they can develop their reserves policy. Not every factor will apply to every charity. Similarly, some factors may have a greater influence than others in shaping the trustees' thinking in developing their reserves policy.

Step 1: Understanding the nature of charitable funds held

Reserves are that part of a charity's unrestricted income fund that is freely available to spend on any of the charity's purposes. To set a reserves policy, it is vital for trustees to understand any restrictions on the use of the charity's funds. In certain circumstances holding restricted funds may reduce the need to hold reserves for particular purposes.

Restricted funds can only be used for particular purposes of a charity that are narrower than the overall charitable purposes of the charity. Restricted funds include endowments and restricted income funds are excluded from the definition of reserves. However, the nature and amount of restricted funds may influence the amount of reserves held by a charity.

For example, an overseas aid charity may operate on a worldwide basis but have a restricted income fund for the area of Asia. A restricted income fund for Asia, which is not otherwise limited in its use, means that any of the activities and programmes in Asia can be funded from that restricted income fund. This flexibility can reduce or remove the need for the charity to hold unrestricted funds in reserve for its activities in Asia.

Expendable endowment is excluded from the definition of reserves. Nevertheless, expendable endowment offers trustees considerable flexibility in how they may use the funds, and this may influence the amount of reserves trustees choose to hold. Expendable endowment, when invested, can provide a relatively secure stream of income but the trustees also have the option of spending all, or part, of the endowment. This freedom may reduce the need for reserves, especially where the charity is not wholly dependent upon the investment income provided by the expendable endowment to fund its activities.

However, where charities with an expendable endowment depend on the investment income to fund core or continuing activities, then the need for reserves may be greater. Trustees are less likely to be willing to spend the expendable endowment if this will reduce the income available to fund future activities.

A permanently endowed fund cannot be spent as income and so the capital is invested to produce income for the charity. If the terms of the permanent endowment do not restrict its use then the income is unrestricted and can be spent on any of the purposes of the charity. The relative security of the investment income from an endowment fund will be a factor that may influence the need for reserves. The Charities Act also introduced amendments which give many charities greater flexibility to spend some or all of their permanent endowment in certain circumstances.

A total return approach to investment allows trustees greater flexibility in how investment returns can be allocated to income funds. The commission is able to make an order that permits the investment of permanent endowment on a total return basis. Total return is an investment management approach which considers the overall return from the investment, both capital gains (and losses) and any income. The trustees then decide how much of the total unapplied return can be allocated to income and how much is retained for future spending. In making this decision, the trustees must consider the needs of current and future beneficiaries.

The flexibility of the total return approach can enable charities with significant permanently endowed funds to a hold a lower level of reserves than similar charities without such a power. Total return gives trustees the flexibility to spend funds held as part of the unapplied total return when needed and so can reduce the need for reserves.

Step 2: Identifying functional assets

The identification of unrestricted funds is a vital initial stage in the development of a reserves policy. However, certain functional assets used operationally by a charity might be essential to the implementation of their operational strategy. The Charities SORP specifically allows funds held as tangible fixed assets for charity use to be excluded from reserves. This recognises that certain assets will be used operationally and their disposal may adversely impact on a charity's ability to deliver its aims.

Where the trustees consider functional fixed assets to be essential to the delivery of the charity's aims then the value of such assets can be designated and excluded from the calculation of reserves. However, it is important for trustees to ask why particular fixed assets are held. For example, could a high value administrative office be sold and rented accommodation used if funds were needed? Some trustees might regard such an asset as part of their reserves which could be realised, if necessary, to support their operational work. This situation might, for example, be contrasted with a care facility where its sale might interrupt the care of beneficiaries and obtaining alternative specialist facilities on a rental basis might prove difficult.

Similarly, where a charity makes programme related investments solely to further its charitable purposes then such investments can be excluded from reserves.

Step 3: Understanding the financial impact of risk

Identifying and managing risk is an important part of good charity governance. Certain risks, if they occur, will have a financial impact and will be considered as part of the budgetary process. Identified financial risk will also influence and inform a charity's reserves policy. Holding reserves may form part of the charity's strategy for managing the impact of an identified risk should it occur.

The commission's guidance Charities and risk management (CC26) identifies the key risks which most charities should consider. Whilst risk is broader than just financial risk, in working through the guidance on risk management, trustees should consider the financial impact on the charity of the identified occurring and ask whether reserves are needed to help manage the financial impact.

Charities should be responsive to beneficiary needs and for some charities this can arise urgently and unexpectedly. Again, charities should consider the need to hold reserves in response to such events or whether it can rely on an appeal to the public where urgent need arises.

Step 4: Reviewing sources of income

The stability of future income is a key factor in the financial health of a charity. The assessment of the stability and certainty of future income sources will form an important part of a charity's assessment of risk and will feed into both budget setting and reserves policy. Some of the issues trustees should consider include, whether:

- the charity's income is from a single or multiple sources
- the charity is particularly vulnerable should there be a sudden or unforeseen decline in a particular source of income
- the charity relies on a single contract or grant for a significant part of its funding which is subject to tender or review in the near future
- any major donor has indicated a change in their planned giving
- appeals or fundraising activities provide a stable funding source
- certain sources of income are particularly vulnerable to the general economic situation

In reviewing the stability of income, trustees should consider:

- how much notice of a change in income would the charity get
- the key dates at which major contracts or grants are due for review or renewal
- the impact of any other organisations seeking funding from the same sources
- the strength of the charity's relationships and communications with its donors and financial supporters about explaining its financial needs

If a charity has stable or predictable income this may reduce the need for reserves. Alternatively, if a charity's income is volatile or insecure, or is vulnerable to factors outside of its own control, this may justify holding more reserves. Trustees should also consider if the charity's reserves are sufficient to protect it from the risk of insolvency or serious disruption to its charitable work.

Step 5: Impact of future plans and commitments

When setting the operational plan for the year, trustees will have considered how that plan will further the charity's aims for public benefit. The operational plan brings together the activities that the charity will undertake with the resources at its disposal.

Usually the operational plan is then expressed in financial terms as a budget with the expected income identified by source and the expected costs identified by planned activity. In setting a budget, consideration will need to be given to any restriction on the use of particular funds and uncertainty associated with predicting future income. The cash budget will help identify peaks and troughs in the charity's cash flow and will give a warning of when reserves might need to be called on.

Commitments and designations

Commitments made in previous and current financial years will also impact on cash budgets. For example, where commitments have been made to pay grants over a number of years then reserves may need to be built up to meet these costs if future income streams are uncertain.

As part of a charity's strategic planning, the trustees will also look beyond the annual operational plan and annual budget. This will be particularly important in identifying projects or capital spending plans that cannot be met from anticipated future income alone. Where planned expenditure cannot be met from a single year's income alone then this may point to the need to build up reserves to meet future expenditure. If reserves are to be built up in this way, then budgets will need to reflect these plans.

Often the funds set aside to meet future commitments and plans will be held as designated funds. By identifying a need and setting funds aside in a designated fund, trustees can build up the funds needed over a period of time and help manage the financial risk of a project. In this way they spread the burden over several years. When calculating the amount of reserves stated in an annual report, trustees may exclude the amount properly designated from the reserves total. The amount and nature of the designations should be explained in the annual report as should the likely time of their expenditure.

Designations relate to future plans that exist at a point in time. The annual report explains the year end position of a charity and therefore no new designations can be set up retrospectively after the year end to disguise the true level of unrestricted funds held in reserve. 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.

Defined benefit pension schemes

Where charities have employees who are entitled to defined benefit pensions (final salary pensions), there are particular issues that arise in relation to the obligations of the charity to the pension scheme which may affect the charity's reserves.

Where a charity operates, or is a member of, a defined benefit pension scheme, trustees should read the guidance Charity reserves and defined benefit pension schemes. The defined benefit pension scheme may be a multi-employer scheme or the charity's own scheme. Depending upon the balance of assets and liabilities within the scheme, the charity may have a pension asset or liability.

Where the pension asset or liability is material, the reserves policy statement should separately consider the impact on the charity's financial position and reserves. The cash flow implications of making good any pension liability will influence the reserves policy and the reporting of the reserves.

Where there is a pension asset, this is normally designated and not counted as part of the charity's reserves because it is not available to the charity's trustees to spend. Where there is a pension liability this may require some or all of the available unrestricted funds that are otherwise uncommitted to be designated to meet all or part of that liability. The decision on whether to designate funds to meet a pension liability will depend upon the charity's ability to finance that liability out of its current and future income.

Trustees should explain to the charity's stakeholders the impact on its reserves policy of a defined benefit pension scheme. Trustees should pay particular attention to explaining clearly and simply how the pensions accounting disclosures should be interpreted in the context of the charity's finances.

Step 6: Agreeing a reserves policy

After considering the issues described in steps 1 to 5 the trustees can make an informed decision about holding reserves and the amount to be held. Where the trustees agree that reserves are needed these should be explained in the reserves policy along with a justification of the planned level of reserves and a statement of the reserves currently held. Trustees should also provide an explanation if the reserves held differ significantly from the target they have set for reserves.