How to manage strategic reserves

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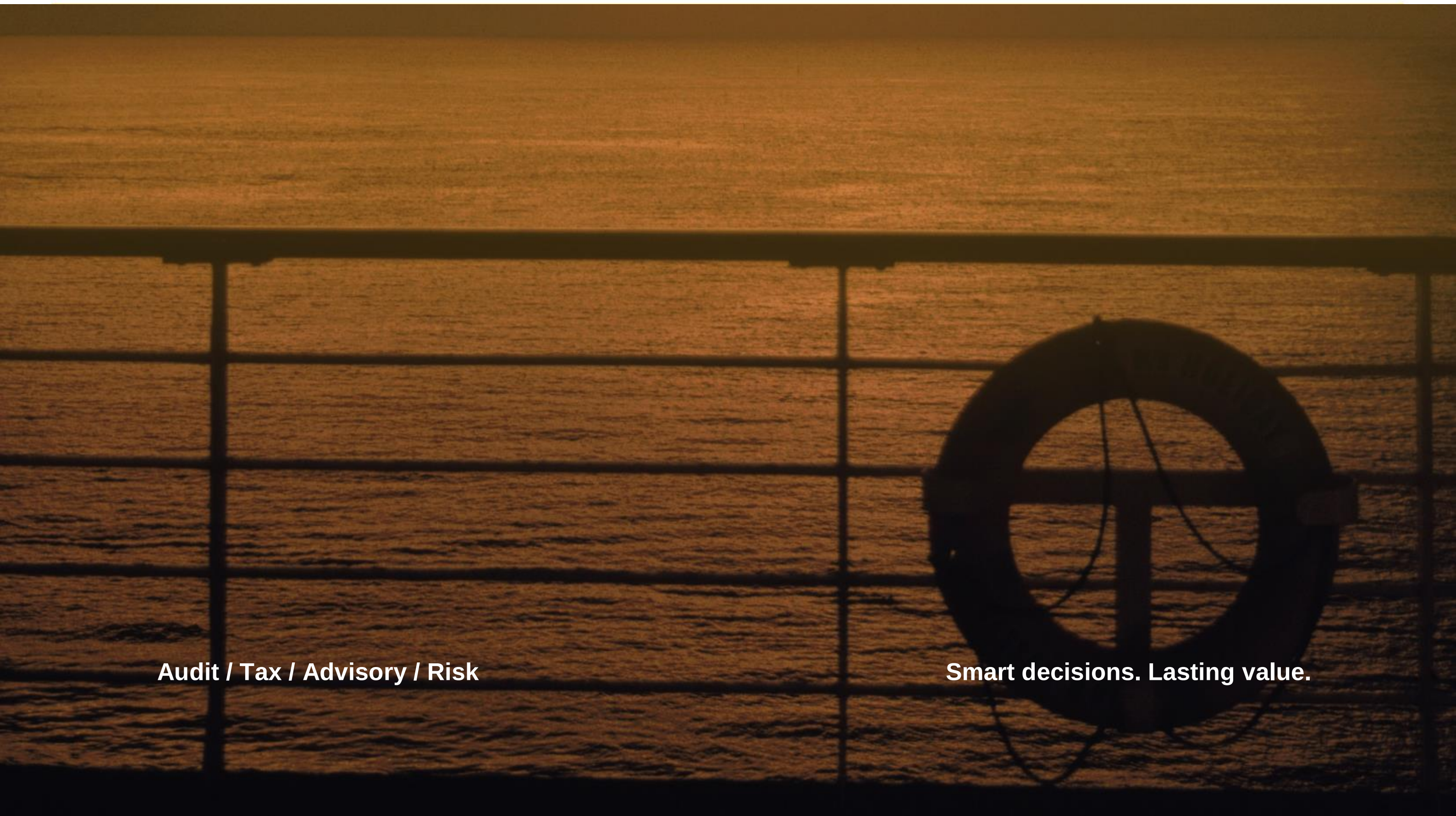

Strategic reserves are back on the agenda

Discussion around reserves has, once again, risen up the agenda – some would argue it has never dropped off, but from the conversations around boardroom tables recently there has been a renewed focus on how to manage strategic reserves. In many cases this is wrapped up in the wider conversations around FRS102 and SORP 2015 but I would hope accounting standards do not drive operational realities. Focus on the management of strategic reserves should be built into your charity’s planning cycle. Even though we have moved out of the black clouds of recession, life continues to be a challenge. Decisions around whether, when and how much to invest, the financing of restructuring plans, concerns around the stability of funding and an increasingly competitive landscape are understandably leading to a renewed emphasis on understanding and managing strategic reserves.

As noted in the ACEVO report Beyond Reserves, reserves are just one part of the complex financial management you and need to consider alongside things such as fundraising strategy, risk assessments and future business planning. In developing the reserves policy, your charity should ensure there is a link with the risk management and forecasting process. There needs to be a consideration of the reasons why it might be necessary to dip into reserves and operating realities must be taken into account. The last step is to ensure there is an analysis of the available options following the initial assessments.

Understanding the financial model of the charity allows trustees to plan ahead and incorporate their need for reserves into their planning. Reserves planning should form part of the overall strategic planning of your charity so it is understood how reserves will be used to enable the organisation to reach its goals.

Reserve planning: saving for a rainy day

In thinking about reserves, we should first consider the ‘what’ and ‘why’ of operating reserves. In terms of the ‘what,’ an operating reserve can be described as a rainy day fund. It represents income received in previous years but not spent. In terms of the ‘why’ we can think of it as providing shelter from the storm – supporting fulfilment of your charity’s mission and fostering strategic decisions. It can provide financial flexibility to respond to emergencies, it can improve cash management and reduce stress. It can cover specific liabilities or be used to generate income and, perhaps most importantly, it can enable the charity to respond to unanticipated opportunities.

But what happens if there is no operating reserve? You will feel as if you are in the middle of the storm – cash flow stress, distraction from good long term decision making, too much focus on expensive short term crisis based decisions and ultimately the termination of programmes or delivery. Not a place many charities want to find themselves.

But once we have understood the ‘what’ and the ‘why’ the next question is ‘how much.’ My answer – it depends. This brings us to the crux of the issue and is why every charity should ensure it effectively manages its strategic reserves and establishes its own reserves policy which defines what adequate reserves are and the rationale adopted to define the level.

CC19 states:

“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.”

If the reserves level is set to high, money is tied up when it should and could be spent on charitable activities – your charity may be perceived as ‘sitting’ on money where there is a beneficiary need. If reserves levels are too low, there is a risk your charity may not be able to continue if put under stress and potential funders may be hesitant to provide funds to a charity whose viability appears threatened.

So what are the matters to consider in managing your strategic reserves?

Income

Firstly, it is important to understand income both in term of its volatility and the risk to income. For example, longer term income may be more predictable whereas short term funding and reliance on specific events increases the risk of the loss of funding. In looking at income, understanding the associated cash flows is also important. For example, a project may be fully financed, but money may be receivable in arrears and so require pre-finance. This will significantly impact the charities view on how to manage reserves and requires a focus on careful cash management.

Expenditure

Expenditure is the second key area to consider. Understanding the split between fixed and variable costs, as well as taking into account how quickly the tap can be turned off are all considerations. A common response to a reduction in income is to cut expenditure, but an ability to react quickly and stop or change direction is not possible in many cases with serious financial implications. In some instances the choice of accounting policies may impact the year end reserves position. For example, a grant maker may account for multi-year grant commitments as a liability in year one, whilst others only account for the current year expenditure. This accounting policy choice should not impact on the decision as to how to manage reserves, which should be based on economic realities.

Nature of reserves

Thirdly, it is important to understand the nature of reserves, including their ability to be realised and the impact of doing this. A charity may have different classes of funds and trust law places constraints on how these funds may be expended or accumulated. It is important to understand what the reserves represent and the ease with which they can be made available in times of need. For example a charity may be asset rich and cash poor. It is also important to understand, for example, donor imposed restrictions, which can often affect the type and level of services a charity can deliver.

Sensitivities and risk

Finally, sensitivities and risk associated with the assumptions made should be taken into account. Asking 'what if?' Forecasts include a number of assumptions. Challenging the validity of these assumptions, considering different scenarios and the nature of associated action plans is an important final step.

It is also necessary to distinguish between the internal analysis behind the management of strategic reserves and the detail required for external disclosure. SORP 2015 is much clearer in its requirements around reserves disclosures – in particular, it is explicit in stating that charities should consider all the funds they hold at the end of the reporting period. If the funds are designated, restricted or committed in some other way, they should be noted with an explanation as to the likely timing of expenditure. This deals with the concern that charities may create designated funds that would be considered as funds available in times of need, and moves away from the concept of 'free reserves' which in many instances resulted in charities creating a policy to meet the level of reserves disclosed rather than considering all reserves.

Additionally, in some cases, restricted funds may not be as restricted as the name implies. For example, many charities are able to meet a not insignificant proportion of their fixed and ongoing costs from restricted funds, so in operational terms they are comparable to free reserves. In other cases, restrictions may be so wide that the funds are tantamount to being 'freely' applied for the wider purposes of the charity.

SORP 2015 disclosure requirements:

1. Your charity must explain any policy it has for holding reserves and state the amounts of those reserves and why they are held. The report must disclose if and why no reserves are to be held.
2. State the amount of the total funds your charity holds.
3. Identify the amount of any funds which are restricted.
4. Identify and explain material funds designated or otherwise committed.
5. Note the likely timing of the expenditure of any funds which are restricted.
6. Identify funds that can only be realised by disposing of tangible fixed assets or PRI.
7. State the amount of reserves your charity holds after making allowance for these.
8. Compart the actual target level and explain the steps to align them.

In conclusion, it is important for charities to consider the management of strategic reserves, ensuring review is not undertaken in isolation from the charity’s strategy, risks and operational realities. All funds should be considered including the availability of funds. Most importantly, it is crucial to be alert to signs and trends and ensure the charity is nimble in its decision making and able to respond swiftly.

Key points

1. Strategic reserves are a vital resource for charities and should always be considered during the planning cycle.
2. Reserve planning should always be considered in the context of the charity's strategy, risks and operational realities.
3. Determining the amount held in reserve can be challenging, and therefore must be well thought out and justified.
4. When managing your strategic reserve the following key elements must be taken into consideration:
   - Income
   - Expenditure
   - Nature of reserves
   - Sensitivity and risk
5. External disclosure of reserves should be clear and thorough, utilising the guidelines laid out in SORP 2015.

Notes

Start the conversation

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