IVAR we listen, and learn together

Thinking about … charity reserves

A research report into charity reserves management in Scotland

October 2022

Commissioned by:

Scotland Funders' Forum

Authorship and acknowledgements

This report has been written by Chris Mills, Richard Hopgood and Ben Cairns, based on interviews and desk research carried out by the authors.

We would like to thank the charity trustees and staff that give up their time to take part in the research and for sharing their experiences and ideas.

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Foreword

The sudden threats to their income caused by the Covid lockdown of 2020 turned the question of how much money charities held in reserve from what can sometimes seem like a paper exercise into a very material concern.

Beyond the importance of financial reserves in ensuring survival and continuity in the short term, their role in enabling charities to adapt, recover and remain resilient in future also became clear. Many organisations lacked the financial flexibility to navigate those turbulent times with confidence. Others were reluctant to commit to spending carefully accrued savings despite the exceptional circumstances.

Yet this also presented an opportunity: a chance to understand more deeply, and perhaps question, the purpose of reserves; to challenge some assumptions from both a funder and charity perspective; and to think about their relevance and importance in a post-Covid world.

Towards the end of 2020, a group of funders together with representatives of accountancy bodies, Scottish Government and OSCR began meeting to consider what might need to change if reserves are to better support a dynamic and resilient third sector in future. We were concerned about how organisations could operate with the protective financial buffer they needed, but also wondered if more of the sector's money could be unlocked to support change and development rather than sit tied-up in reserve funds.

We believed this required a *conversation* within the sector – recognising that charities, funders and policy-makers all have a role to play in the financial ecology that determines how the sector manages and deploys funds available to it. We started this conversation at a number of events across the year where charities in Scotland came together. We then commissioned IVAR to conduct this research – exploring current attitudes and practice as well as barriers and opportunities.

We are grateful to the Scotland Funders' Forum for funding this work and to all those who gave up time to participate in it.

IVAR's report helpfully identifies opportunities for all of us with an interest in a thriving third sector to make reserves function more effectively.

We welcome the report's suggestions for how funders and charities can move towards an environment where organisations are empowered to do this and to determine their own, forward-looking reserves policies based on their specific strategies and circumstances. At the same time, we recognise the need to maintain proportionate expectations of smaller charities that lack specialist financial staff or trustees, and for support bodies and infrastructure organisations to guide and build the capacity of organisations of all sizes to manage reserves effectively.

We are excited by the glimmers of innovation uncovered and suggested by the research, especially around lines of credit, the link between reserves and repayable investment, and ways of sharing risk. We think these could offer opportunities for some organisations to operate confidently in a more fluid way with lower reserves, and would welcome conversations with anyone interested in piloting or exploring these ideas further.

As we write, the emerging cost of living crisis is creating a new challenge to the sector's finances even as we continue to deal with the effects of the pandemic – not least in the way inflation is eroding the real value of reserves.

This demonstrates the continued relevance of this topic. We hope this report will provide a basis for further discussion and collaboration in the cause of ensuring Scotland's third sector can fulfil its potential to contribute to a flourishing future for Scotland's people, places and communities, despite the challenges ahead.

Elaine Wilson, Corra Foundation
Lynn Hendry, Hunter Foundation
Nick Addington, William Grant Foundation

The Scotland Funders' Forum *is a gathering of funders in Scotland, including statutory bodies and independent grant-making trusts, who are committed to best practice in funding the voluntary and community sector and to maximising the impact of funding for the benefit of Scotland. We come together to share information, to identify and address areas of common interest and to share best practice and learning.*

Executive summary

Introduction

The Scotland Funders' Forum commissioned IVAR '*to understand how charity reserves can contribute to a dynamic and resilient third sector*' and explore '*how charities can manage reserves for stability, but also how they can make reserves work harder*'.

The work has proved timely, given the critical role of reserves in managing the challenges (and opportunities) of living in increasingly volatile times. It has revealed positive examples of charities using reserves more creatively; and also highlighted the barriers which many charities face in seeking to sustain, let alone grow, their reserves because of the nature of their work and how it is currently funded. We hope this report will provide practical guidance as to how reserves can be managed more strategically, and what funders and regulators can do to help that happen.

Focus and process

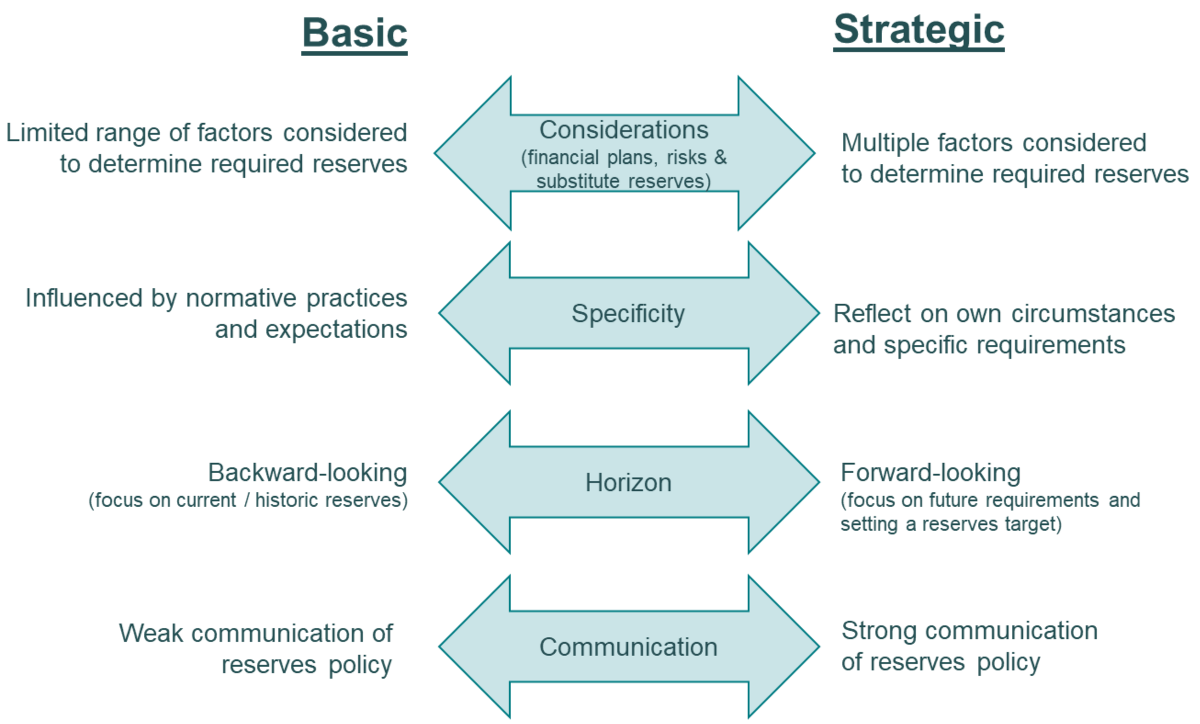
Our research focused on four key questions:

1. What is/are the purposes of charity reserves?
2. How do charities currently build, maintain and deploy reserves?
3. How could charities manage reserves better (e.g. what are the opportunities)? What are the barriers to better reserves management?
4. What can funders, commissioners and other sector organisations do to support effective management of charity reserves?

We reviewed academic and practitioner literature on charity reserves; analysed data from the published annual reports and accounts of 40 Scottish charities; undertook semi-structured interviews with representatives from 13 Scottish charities; and ran a focus group with Scottish funders and policy makers. We then presented our interim findings to audiences at the Chartered Institute of Fundraising's Scottish Conference and the SCVO's The Gathering (where a workshop attracted an audience of 80 delegates).

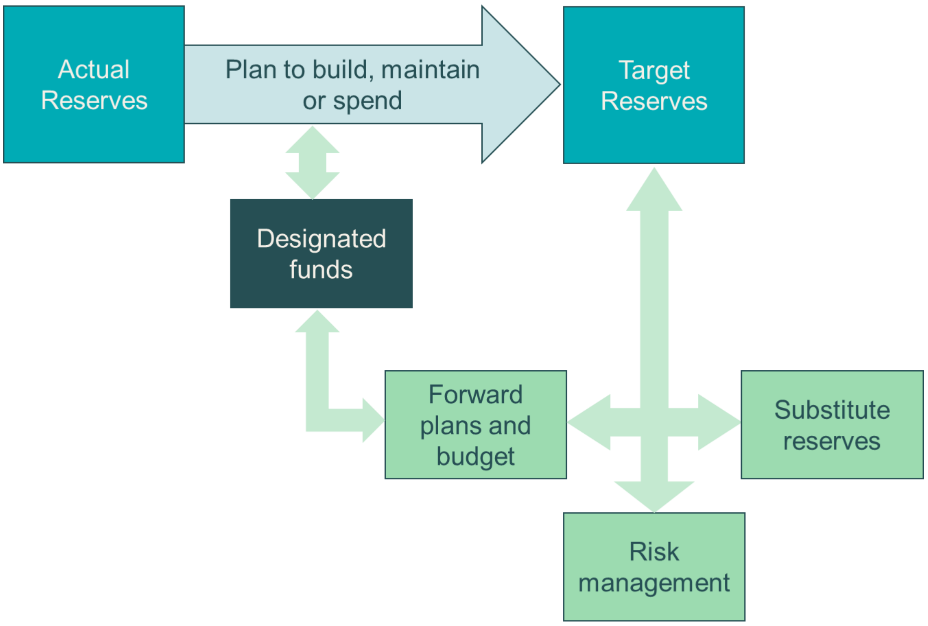
Key findings

Not surprisingly, our research revealed considerable variation in charities' reserves management practice. We identified four key dimensions and how practice varied across each of them, along a spectrum from ‘basic’ to ‘strategic’:



At the strategic end of the spectrum, the practices are similar to those advocated by regulators and accountants (Sayer and Smith, 2012; Charity Commission, 2016; BDO, 2020). They enable charities to respond and adapt to changing environments and to develop the capacity to build and spend reserves when needed. This is illustrated in the diagram below.

Strategic charity reserves management



This strategic approach included examples of charities using reserves both to underpin financial stability and service continuity during periods of volatility, and to provide funding for urgent new approaches arising from a mission-driven opportunism. Others reflected the ability to build future plans into reserves policy, and the confidence to build up and spend down reserves accordingly.

Where reserves management was closer to the basic end of the spectrum, there was a risk of policies more geared to external norms and perceptions of funder attitudes than to the priorities of the work and mission, with potentially damaging consequences for service delivery and organisational stability. Where reserves were unnecessarily high, it could undermine the confidence to spend down to lower levels. In thinking about the conditions required to enable charities to develop more strategic reserves management, we identified three key barriers/opportunities:

- Access to finance management skills
- Funding practices and income types
- Trustee caution and confidence

Although the funders commissioning this study had hoped to unearth new and different (or 'innovative') ways of using reserves to deliver transformation, we found limited examples of such practice. Perhaps this is unsurprising given the context of: the timing of this research (i.e. an exhausted sector, grappling with the legacies of the Covid-19 pandemic and the challenges of the cost of living crisis); and prevailing funder practices (especially restricted grant-making) which have influenced more basic approaches to reserves management. However, while it may be more immediately productive to focus on 'getting the basics right' than rushing towards more 'innovative' practices, we did note the use of various financial mechanisms used as alternatives for operating reserves, suggesting that there may be opportunities for focused experiments to allow charities to hold lower levels of reserves.

Issues for consideration

Building on our research findings, we envisage a sector in which charities have greater financial stability supported by a cushion of reserves, and an enhanced ability and agility to adapt to meet the changing needs of the communities and causes they serve. Strategic reserves management is a core element of achieving this, and charities, funders and regulators can all act to help make this happen. Wider adoption of such practice could, over time, provide the bedrock for the kind of developments envisaged by the commissioners of the study. It has the potential to contribute to a more resilient and dynamic sector, as well as diminish concerns about charities holding unjustifiably excessive or inadequate reserves.

Funders have a critical and central role to play in creating the conditions that encourage more strategic reserves management, in particular through the provision of more flexible funding and the adoption of more nuanced approaches to due diligence and scrutiny of charities' reserves. A high inflation and low interest environment, which erodes the value of money, might also encourage funders to consider how charities can better access lines of credit, or other substitute reserves, which could both provide an alternative to holding reserves and potentially free up some existing reserves for spending.

Regulatory bodies can also make an important contribution by offering more practical guidance and training to charities. Charities themselves can take immediate steps to implement strategic reserves management, including:

- Accessing training and support
- Reviewing reserves policies more regularly, in concert with their budgeting and risk management processes
- Where possible, by encouraging their funders towards providing more unrestricted income.

Outline of the research

Introduction

The tension between charities holding insufficient reserves or hoarding is long-standing. Almost 20 years ago, the Charity Commission published a research report, in which it noted how too low reserves put charities at risk and too high reserves tie up money unnecessarily (Charity Commission, 2003). The challenges faced by some charities in determining an appropriate level of reserves are ongoing and have been brought into sharp relief again by recent events.

Between 2020 and 2022, the Covid-19 pandemic brought about unexpected and turbulent events that had a significant impact on everyone in society, including charities. It led to unprecedented government policy interventions, including the periodic lockdown of society and the economy. Voluntary sector commentators predicted that reduced incomes would have dire consequences for charities (McDonnell et al., 2022). Yet, there has not been an increase in the charity closure rates in Scotland (Rutherford and Duggan, 2022) or in the UK (Mohan et al, 2022), despite over a quarter of charities having less than three months of expenditure in reserves going into the pandemic. Policy interventions (some unprecedented) such as the furlough scheme and emergency grants, allied with activity constraints that limited expenditure, helped charities to survive. Nevertheless, the experience was a reminder of the risk of unexpected events and their potential impact on charity finances (and there is no guarantee that such a range of special funding measures would be available again).

Charities are now facing another period of turbulence. Russia's invasion of Ukraine and rapidly rising inflation are beginning to exert new pressures on charities, with increased operational costs, rising demand for services and declining charitable donations. Managing charity finances is not becoming any easier.

Covid-19 and the onset of inflation serve as a reminder for charities to engage fully with the topic of reserves. Charities need sound reserve policies and to manage reserves appropriately.

At the same time, we must be cognisant of the everyday realities faced by charities. The conditions in which they operate and how they are funded critically influence their capacity to manage reserves. We must ask whether funders and policy makers are behaving in ways that promote the sound management of reserves.

Research objectives

The two, inter-related objectives for our research were:

- To understand how charity reserves can contribute to a dynamic and resilient third sector
- To explore how charities can manage reserves for stability, but also how they can make reserves work harder

To this end we focused our research on four key questions:

1. What is/are the purposes of charity reserves?
2. How do charities currently build, maintain and deploy reserves?
3. How could charities manage reserves better (e.g. what are the opportunities)? What are the barriers to better reserves management?
4. What can funders, commissioners and other sector organisations do to support effective management of charity reserves?

The first three questions are addressed in Parts One and Two (Literature Review and Findings); the fourth question is covered in Part Three (Key Issues for Consideration).

Research methods

Literature review

We started our research by reviewing academic and practitioner literature on charity reserves. The review, which is presented on pages 12 to 13, helped us to understand what was already known about charity reserves.

Data collection

We wanted to capture the everyday realities of managing charity reserves, including official and hidden practices. We were also interested in exploring alternative approaches.

We collected qualitative data in the following ways:

- **Reviewed the published annual reports and accounts of 40 Scottish charities.**

  The accounts were selected randomly from the register of the Scottish Charity Regulator (OSCR). The sampling included charities of all sizes, ranging from an annual income of £27k to £117m. The content of each charity's reserves policy statement was recorded, along with other relevant material from the accounts.

- **Semi-structured interviews with representatives from 13 Scottish charities.**

  We selected charities for interview from among those included in the review of accounts. We also conducted further purposive sampling to interview charities with a range of perspectives on charity reserves management. Interviewees included trustees and treasurers, chief executives, and finance managers. The interviews explored each interviewee's understanding of reserves; how charities developed their reserves policy; how they built, spent or maintained reserves; the role of funders; and the future of reserves management.

- **A focus group with Scottish funders and policy makers.**

  Representatives from nine Scottish funders and four public sector and policy-making organisations participated in the focus group. We discussed funders' perceptions of charity reserves management and what funders could do to support reserves management. We held a further discussion with commissioners from a local authority.

Data analysis

We applied grounded theory coding techniques to analyse the data, using initial open coding to systematically categorise the data and focused coding to identify the codes of most interest (Charmaz, 2014). Coding allowed us to sort and synthesise the data and analyse how practitioners involved in running charities understand and manage reserves, and how funders and policy makers influence charity reserves management.

We sense-checked preliminary findings by presenting them to audiences at the Chartered Institute of Fundraising's Scottish Fundraising Conference and SCVO's The Gathering in June 2022 (where we ran a workshop to an audience of 80 delegates). We used these conferences to obtain feedback on our findings and to gather further ideas on potential opportunities to improve charity reserves management practice.

Definition of charity reserves

Charity reserves are funds that a charity can freely and readily spend on any of its charitable purposes. The three common criteria used to define charity reserves are funds that are unrestricted, liquid and not designated for another purpose (NORI, 2016; Sloan et al., 2016; Charity Commission, 2016; OSCR, 2017). The diagram below illustrates this definition.

Charity Reserves
Funds that a charity can freely and readily spend on any of its charitable purposes.

Unrestricted	Liquid	Not Designated
Not restricted or endowment funds.	Held as cash or other current assets. Not tied up as tangible fixed assets.	Funds not designated for another purposes.

Terminology around charity reserves can sometimes get confusing. Other phrases are occasionally used, including 'rainy day funds' and 'free reserves'. There are also other concepts similar to, but not necessarily the same as, charity reserves. For example, 'working capital' (current assets less current liabilities) has similarities but is different because it takes fund designations and restrictions into account. For clarity, we use the term charity reserves in line with the definition noted above. However, as noted later, designated funds can play an important role in the wider context of reserves management.

Expressing reserves

Most academics and practitioners tend to express the level of a charity's reserves through the 'operating reserves ratio' (Grizzle et al., 2015; NORI, 2016; Irvin and Furneaux, 2021). This ratio is expressed either as the percentage of annual costs held as reserves or, more commonly, as the equivalent number of months of annual expenditure:

$$\text{Operating reserves ratio} = \frac{\text{Charity reserves} \times \text{12 months}}{\text{Total annual expenditure} - \text{annual depreciation}}$$

Part One: Literature review

By providing an important buffer against unexpected events, reserves have long been understood as an essential contributor to charities' financial stability and resilience (Charity Commission, 2003; Charity Commission, 2016; OSCR, 2017). The importance of charity reserves is reflected in the UK Charities Statement of Recommended Practice (Joint SORP-Making Body, 2019), which requires charities to disclose and explain their reserves policy in the trustees' annual report.

Although the importance of reserves is firmly established, there is less consensus on the level of reserves charities need. Extensive consideration of this issue by a US-based Nonprofit Operating Reserves Initiative Workgroup led to the suggestion that reserves equivalent to three months expenditure was a useful baseline benchmark (NORI, 2016). Various academics have since used this as an indicator of healthy reserves (Booth et al, 2017; Cortis and Lee, 2019; Rutherford and Duggan, 2022; Mohan et al, 2022).

> Although reserves equivalent to three months expenditure is a commonly used benchmark for minimum reserves, uncritical acceptance of this rule of thumb may lead charities to adopt inappropriate reserve levels.

Recognising the limitations of a one-size fits all benchmark, Irvin and Furneaux (2021) tried to generate more tailored requirements. They analysed Australian charity financial data to suggest ideal reserves levels for different types of charities. Their analysis concluded that three months is a fair ballpark figure for large charities, but smaller charities, especially those with volatile incomes, may need up to 12 months' cover. Yet, even Irvin and Furneaux's approach appears overly generalised and mechanistic, and only considers a limited number of variables.

> Many charities operate with low levels of reserves.

In Scotland, at the onset of the Covid-19 pandemic, over a quarter of charities had less than three months expenditure in reserves and a tenth had just one month of reserves (Rutherford and Duggan, 2022). The position of Scottish charities is consistent with non-profit organisations globally, where reserve levels are also low (Blackwood and Pollak, 2009; Calabrese, 2011; Grizzle et al., 2015; Mohan et al, 2022).

The ability and necessity to build reserves vary across charities. Longer-established charities tend to have higher reserves than those established for less than five years (Grizzle et al., 2015; Cortis and Lee, 2019; Clifford and Mohan, 2020; Rutherford and Duggan, 2022). This is probably because younger charities have insufficient time to accumulate reserves. Charities with donations and fundraising as their main source of income are more likely to hold higher levels of reserves, whereas charities dependent on the sale of services, government contracts and grants are more likely to hold lower reserves (Blackwood and Pollak, 2009; Cortis and Lee, 2019; Clifford and Mohan, 2020).

In part, this may be because donors to the former occasionally make unexpectedly large donations, which can be used to build reserves. It may also be because it is difficult for the latter to build reserves when the value of government contracts and restricted grants rarely exceed the full cost of service delivery. Another potential explanation is that charities are willing to hold lower reserves if they have access to long-term contracts because they provide reliable and stable income. Thus, even when we can observe correlations, it can be difficult to determine cause and effect.

Charities often struggle to accurately report their reserves, which raises concerns about the validity of the quantitative research. BDO recently reviewed the annual accounts of the UK's top 50 charities and found significant variations in the methodologies used for calculating reserves (BDO, 2020). The review found notable areas of non-compliance and concluded that the real level of reserves reported was, according to prescribed calculation, substantially lower than actually reported.

Quantitative research on the adequacy of charity reserves also relies on historical income and expenditure data. Yet reserves are held to cover future events, not the past. Research has rarely considered how charities determine what level of reserves they need and whether they believe their reserves provide adequate protection for the future.

Charities have been urged to take an active role in determining reserves (Sayer and Smith, 2012), although few qualitative studies have delved into charities' actual considerations and choices about reserves. One such study noted how charities occasionally consider 'substitute reserves' when determining reserve levels (Sloan et al., 2016). Substitute reserves are financial mechanisms used as alternatives for operating reserves and include lines of credit (e.g. pre-arranged bank overdraft); established donor networks (e.g. long-standing donors that charities can call on in times of trouble); and designated funds. The presence of substitute reserves suggests that research looking purely at quantitative data may well misunderstand what provides adequate protection for charities with access to those, as it may enable them to manage with lower levels of reserves.

Overall, quantitative analyses of charities' reserves within our literature review have helped us to understand trends in the level of charities' reserves, but they rarely get to grips with how charity trustees and managers think about and manage reserves. Each charity has its own unique circumstances, and trustees and managers will interpret and cope with these in idiosyncratic ways. They may consider things that are not reflected in the data. More research is, therefore, needed to understand how individual charities approach, interpret and apply charity reserves management. This report aims to make such a contribution.

Key points from the literature review

- Many charities operate with low levels of reserves. A significant minority of charities have reserves equivalent to less than three months expenditure.
- It is difficult to make generalisations about required levels of reserves. Each charity is different, and a one-size-fits-all approach does not work.
- Research has rarely studied how charity trustees and managers think about and manage reserves. Understanding this is essential if we are to improve charity reserves management and ensure charities hold appropriate amounts.

Part Two: Findings

In this section, we present findings from our research. We look at the reasons charities hold reserves, reserves management practices, and the enablers and barriers to good practice.

The purpose(s) of charity reserves

Through our analysis of charity accounts, we noted the reasons charities gave for holding reserves. We also asked interviewees to describe the purpose of reserves.

Mission driven – sustaining activities in difficult times

There was one common and overriding reason why charities held reserves, and that was *to sustain activities and services in difficult times*. In the event of adverse financial or operating conditions, charities said that reserves would enable them to continue to fulfil their charitable objectives.

The financial and operating difficulties described by charities might take several forms, including:

- A significant unexpected fall in income
- A significant unplanned and unavoidable expenditure
- Cash flow issues that would make it difficult to pay for operational expenditure

The principal rationale for holding reserves was to sustain activities. This was especially strong among those charities working with people in need of immediate or emergency assistance, as charity failure would leave them going without vital support. We also found that charities need to be prudent with their reserves to ensure they could survive unexpected events and short-term difficulties.

People rely on the foodbank. If we don't have the funds to help them, they suffer real poverty. We can't ethically take away our support, so our reserves enable us to continue supporting them."

During our research, we encountered two cases of charities that almost became insolvent during the pandemic. They entered it with low levels of reserves and, as income dropped rapidly, had to drastically cut costs and staff. Although they survived, service delivery was badly affected. Reflecting on their experience, they both concluded that reserves are more essential than they had realised and that their charitable mission had been put at risk:

> *'The Covid-19 pandemic created the perfect storm and, because our reserves were too low, we had to make some tough business decisions. We made three-quarters of our staff redundant, which had massive implications for our service users.'*

Mission driven – financing new and innovative work

Several charities said that reserves provided a source of flexible funds to take advantage of opportunities, particularly for financing new projects. Reserves were, therefore, useful in facilitating high risk and innovative work. This represents a significant mission-driven use of reserves that has not always been recognised in academic and practitioner literature.

Having reserves to fund innovative work was important because funders could be slow to process applications and risk averse:

> *'Funders may say that they are interested in innovation but, in reality, they are risk averse. Reserves provide finance for us to do the genuinely new and innovative work.'*

Other reasons for holding reserves

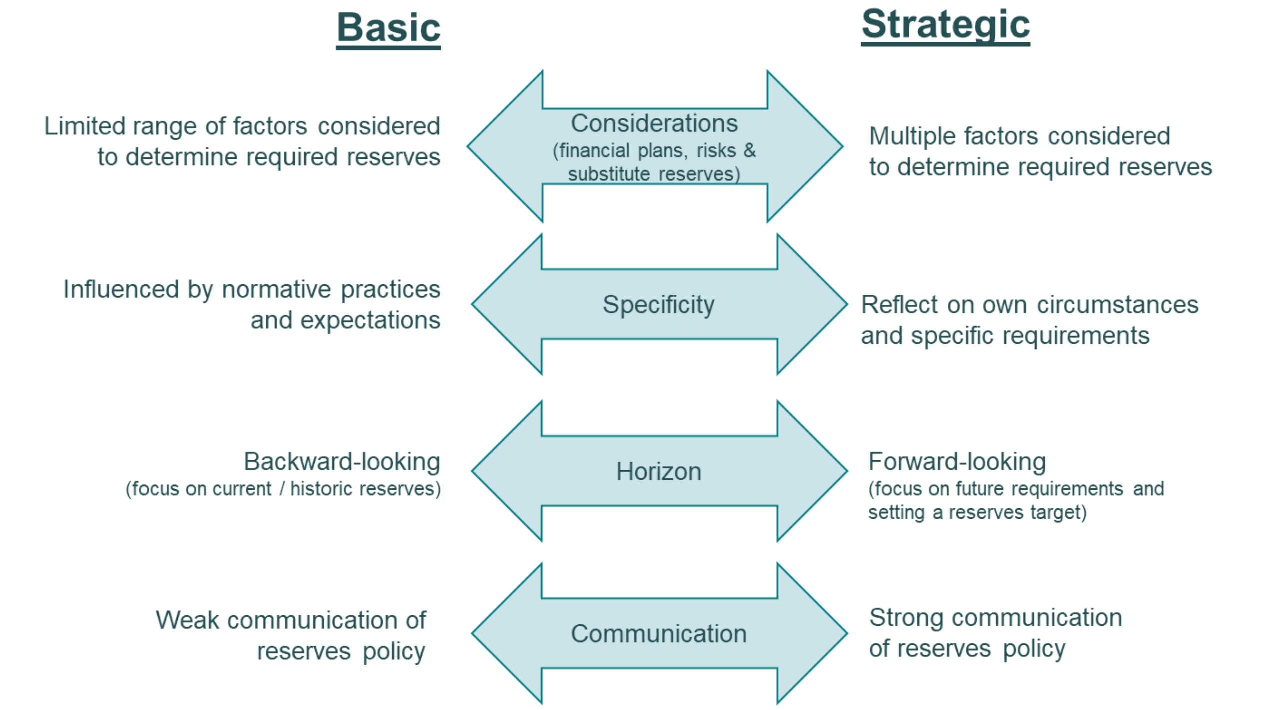
Charities occasionally shared other reasons for holding reserves, with a significant minority mentioning the need to cover the costs of winding down the charity in an orderly fashion in the event of closure and meet outstanding financial obligations such as redundancy and legal costs.

Some interviewees said charity reserves were important because they gave confidence to funders and donors: without adequate reserves, a charity's ability to remain a going concern may be questioned. Later in this report, we return to the theme of charities' concerns about how their reserves might be perceived by external stakeholders.

Charity reserves management practice

Through our research, we identified considerable variation in charity reserves management practice. By analysing qualitative data from charity accounts and interviews, we developed a framework to understand these variations. The framework identifies four dimensions to characterise charity reserves management practice. For each dimension, there was a spectrum of practice, from 'basic' through to 'strategic'. The framework is presented in Figure 1 below; each dimension is then discussed further.

Figure 1: A framework for understanding variation in charity reserves management practice



Dimension 1: Considerations to determine required reserves

Through our review of the reserves policy statements in charity accounts and by talking to charity trustees and staff, we noted substantial variation in how much consideration charities gave to determining their required level of reserves. In some cases, charities considered multiple factors in depth; in others, charities gave limited consideration to just one or two factors. We describe the most common factors below.

The financial plan and budget

Many charities noted that reserves were needed to cover unexpected eventualities. As such, they logically needed to start the process of determining their required reserve levels by identifying expected income and expenditure. This meant formulating an operating plan and budget.

A budget was also important because it helped charities to understand their cost base. The extent to which their costs were either fixed or variable would determine how adaptable the charity might be in responding to unexpected events:

> *'We employ freelance tutors, which means we don't have too many long-term fixed costs. But we must be able to commit to a term's budgeted expenditure and have enough reserves to be able to do that.'*

We noted how, as part of the planning and budgeting process, some charities used the designation of funds to manage reserves strategically. They could plan for known and expected items of expenditure that could not be readily funded out of day-to-day income. They had set aside funds for future capital expenditure; the development of new activities and services; investment to generate income; future rental dilapidation liabilities; and to cover final salary pension scheme liabilities.

We observed, however, that some charities did not have a budget and tended to rely on prior year income and expenditure to underpin decisions about their reserves. When charities made designations without clearly explaining the rationale for the sums set aside, this sometimes gave the appearance of the charity trying to hide high levels of reserves.

Risk of a significant unexpected fall in income

Most charities considered the risk of a significant unexpected fall in income when determining their required level of reserves. Indeed, this was by far the most mentioned consideration – both in charity reserves policy statements and in the interviews.

Some charities gave deep thought to the risk of an unexpected fall in income and considered the risk from multiple angles, including:

- The range and diversity of the charity's income sources
- The predictability and reliability of each income source
- The risk that their largest funder(s) might withdraw their support
- The length of grant and service delivery agreements and when funding arrangements were due to expire
- The risk that gaps may arise between funding arrangements ending and new ones beginning

A full exploration of these factors enabled some charities to develop a sound understanding of the risk of a significant unexpected fall in income. For example:

> *'We have some solid sources of income, such as our public funding and rental income. Other incomes are shakier and so we need to understand what would happen if that funding dried up.'*

Charities that perceived low income risk usually felt able to survive with lower reserves; whereas charities with high income risk wanted more reserves. Some charities recognised that they would need to reduce income risk to lower their reserve levels:

> *'We've managed to build our reserves up to between nine and 12 months of annual expenditure. We could drop back to six months, but only if we can develop more regular and long-term income streams.'*

Risk of unforeseen and unavoidable expenditure

A small number of charities mentioned the risk of unforeseen and unavoidable expenditure. For example, one interviewee noted that during the pandemic: *'We spent some reserves on equipping staff to work at home. We hadn't anticipated that, but it was a necessary expenditure'.* Another commented how they had not anticipated a dramatic rise in energy prices: '*We spend a lot on utilities and that is becoming much more expensive'.* Some charities recognised that they needed some protection from reserves to cover such uninsured eventualities, with the amount partly dependent on how much contingency was in the budget.

Access to substitute reserves

Sloan et al. (2016) introduced the idea of 'substitute reserves' to describe financial mechanisms used as substitutes for operating reserves. In our study, a small number of charities mentioned how such mechanisms enabled them to hold lower levels of reserves.

A couple of interviewees described how their charity had established donor networks and that they could call upon these in difficult times. They included long-term major donors and grant-making charitable foundations with whom the charity had strong and enduring relationships. Due to prior experience, the charities were sufficiently certain that these supporters would provide emergency donations if it ran into difficulties. Knowing that donors will step in if needed means charities feel more comfortable operating with lower levels of reserves.

Access to lines of credit was mentioned by a couple of charities. Lines of credit included pre-arranged bank overdrafts and secured debt that could be drawn down. These arrangements provided access to unrestricted cash if needed, enabling charities to operate with lower levels of reserves, with the proviso that their lenders were flexible and that they had appropriate unrestricted income streams capable of repaying the debt in the long term. Other research has found that non-profit organisations with access to debt tend to have lower reserves (Grizzle et al., 2015).

Asset ownership also provides opportunities to access substitute reserves. A couple of charities described how they owned property assets, which they could use to secure borrowing or sell in the event of difficult financial circumstances. With access to such assets, charities felt able to survive with lower levels of reserves:

> *'Our current reserve is not quite three months, but we have capital assets which we could deploy through sale or to secure borrowing.'*

Several charities had designated funds, which provided another potential source of funding in difficult times. Designated funds are unrestricted funds that trustees have set aside for a particular purpose. While intended for future use, charities could draw on these funds in the near term, if needed. Although drawing down funds would sacrifice their future intended use, they could help avert any short-term financial crisis. In this regard, designated funds were regarded as '*back-up reserves'*, and enabled charities to hold lower levels of reserves.

While substitute reserves were discussed in our interviews, they were rarely mentioned in reserve policy disclosures in charity accounts. In part, this may be because substitute reserves arrangements are often informal or off-balance sheet, and charities may not wish to record them in a formal published document.

Dimension 2: Specificity

Half of our interviewees said that their charity took into account 'normative' practice (that is, practice that is generally perceived as normal) when determining reserves policy. There was a common perception that three months was a generally acceptable minimal level of reserves. For example, one interviewee remarked: *'We have always set ourselves a three months reserves target because that's generally been regarded as a reasonable amount in the third sector for many year*s'. Some interviewees also mentioned upper limits, although there was less agreement on what constituted an acceptable limit. The maximum amount tended to vary from between six to 12 months.

Interviewees described how fitting in with normative expectations was important because it prevented challenge from funders and regulators. It was widely perceived that funders wanted to see charity reserves at a level consistent with normative practice. With less than three months reserves, funders may question a charity's financial stability. In the rare event of more than 12 months, funders may consider the charity to be hoarding funds. Some charities believed that their reserves level could have a detrimental impact on their ability to obtain funding:

> *'We want our organisation to come across as resilient and sustainable, but not too much.'*

High reserves were also thought to concern regulators. One interviewee was conscious that their charity should not hold too much in reserves because *'OSCR disapproves of too high reserves and encourages charities to spend surpluses'.*

From the list of considerations noted on pages 15 to 18 above, it can be seen that there are many issues to be considered by trustees when determining required levels of reserves. Our analysis suggests that determining the *right level* of reserves is complex and contingent on context. For this reason, it was a concern that some charities only seemed to consider one or two points and tended to revert to normative practice. Reserves of three months may be too much for a charity with diverse and highly reliable income streams and access to substantial substitute reserves. Whereas, for a charity with limited and unreliable income streams, a high proportion of fixed costs and highly vulnerable service users, three months may be wholly inadequate.

> Determining the right level of reserves is complex and contingent on context. Three months reserves may be entirely satisfactory for some charities but wholly inadequate for others.

Dimension 3: Forward or backward looking

Some charities appeared to approach charity reserves management with a backward-looking perspective. Indeed, most charities never referred to budgeted levels of expenditure in their reserve policy statements, even though reserves exist to cover future expenditure. A small number of charities were committed to the notion of a regular level of expenditure. For example, we noted charities reporting that they would hold reserves *'to maintain three months of normal running costs'* or *'to hold 12 months regular expenditure'.*

A backward-looking perspective can prove troublesome because it tends to focus attention on the level of reserves at a historic point in time (e.g. a balance sheet date). This could be particularly problematic if the reserves level had been affected by unusual events. For example, a couple of charities had received large legacies towards the end of their last financial year, which unexpectedly inflated their reserves. Similarly, another charity had highly seasonal income and, since its annual accounts were produced in the lean winter months, reserve levels always looked low. These examples illustrate how historic reserves levels cannot always be controlled.

Several interviewees talked about how trustees insisted on a balanced budget every year, which meant reserve levels could not be built or spent in a planned manner. As a result, reserves were determined by historic (and not always controllable) events.

Charities with a forward-looking perspective were less constrained by the past. For them, the practice of setting a reserves policy target was useful. It was usually set with reference to future strategic and operational plans and budgets. The target could, if necessary, be very different to the current level of reserves, providing a focal point towards which the charity could move; it created a rationale from which the charity could plan to build, maintain or spend reserves. Although we found limited instances of charities planning to build or spend reserves, we noted how liberating this practice was.

> *'Reserves are an accumulation of money, which can be retained for a rainy day, but it must be much more than that. Just because you get a surplus, it is not just for a rainy day. What is the long-term plan in terms of future aspirations? What are you trying to achieve? It should be more strategic.'*

Where we found charities planning to build reserves, they included plans to: budget for annual surpluses; build reserves over an extended period of time (e.g. three to five years); and develop more voluntary and earned income streams. One charity's reserves policy statement neatly demonstrated this approach. It stated that: '*The charity aims towards maintaining free reserves at a level sufficient to sustain three months operating costs'*, but because the charity's current levels fell well short of that, '*the board will continue to try and generate surpluses to meet this target*'. A couple of charities mentioned the importance of pursuing voluntary income, such as major donors and legacy income, because this had the potential to generate large, unexpected donations.

Where we found charities planning to spend down reserves, they included plans to: budget for annual deficits; spending down over an extended period of time (e.g. three to five years); and designating funds for future expenditure on items that could not ordinarily be funded from annual income (e.g. capital expenditure). For example, one interviewee told us: *'On the face of it, we look like we have large reserves. We've probably got two years* [of reserves] *to work with, but we're moving premises and that will absorb cash'.*

Dimension 4: Communication of reserves policy

From reading and analysing charity accounts, we noted considerable variation in how charities explained their reserves policy. There were examples of clearly articulated reserve policies, but also weak statements.

Where the communication was weak, charities tended to provide short and ambiguous statements, with little or no detail about: future plans and budgets; risks of a significant unexpected fall in income; risks of unforeseen and unavoidable expenditure; or access to financial mechanisms that could be used as a substitute for operating reserves. Some reserves policy statements misused common terminology or did not calculate reserves in line with OSCR definitions. Sometimes figures included in policy statements were at odds with those reported in the financial statements. For example, one charity said that it only had £70k in reserves and claimed this was in line with its policy of holding reserves equivalent to three months expenditure, yet the accounts showed unrestricted, liquid and undesignated funds of £250k. In these instances, readers were left to draw their own conclusions about a charity's level of reserves and whether they were adequate.

Where charities' communication of their reserves policy was strong, they tended to: provide a thorough commentary on how the charity had determined its target level of reserves; note some of the key issues and risks considered by trustees; refer to future plans and how reserves levels related to budgeted expenditure; and articulate how the charity intended to meet its reserves target, including plans to build or spend reserves if necessary. Such statements gave the reader a clear sense that trustees had considered the unique circumstances of their charity and reached a justifiable position:

> *'I write the report and its thoroughness reflects the culture of the organisation. What we do involves a complex model and that needs explaining properly. I think a detailed exposition is right and helpful for those who need to read it to understand us.'*

What enables or prevents strategic reserves management?

Further to analysing charities' reserves management practices, we looked at the data to consider what enables or prevents strategic reserves management. We identified several factors, including: access to finance management skills; funding practices and income type; and trustee caution and confidence – each of which is covered briefly below. These findings make an important new contribution to our understanding of why charities' reserves management practices do not always conform to recommended practice.

Access to finance management skills

The involvement of skilled finance professionals with experience in the charity sector was a common contributor to strategic reserves management. Larger charities, which employ qualified accountants, were often well-placed to manage reserves in a sophisticated way, and able to integrate reserves policy with financial planning and risk management:

> *'We employ a financial controller with excellent finance skills, and they are able to explain clearly to stakeholders, including funders, the current state of the charity's finances, future plans and the levels of reserves needed.'*

That said, charity size and strategic reserves management did not always correlate. We found some examples of small charities managing their reserves strategically, often because they had a skilled treasurer on their board. For example, we interviewed a retired corporate financier and accountant acting as a treasurer for a small charity who had transformed their reserves management. He had recognised the need to build reserves to achieve greater financial stability and implemented measures to generate more earned income.

For some charities with limited access to finance skills, charity reserves management was more challenging: it was difficult to deal with the complexity of risk and budgets, and far easier to revert to external 'norms'.

Funding practices and income type

Funding practices and income type were major factors influencing reserves management. Charities that relied heavily on grant and contract income often struggled to manage their reserves strategically. Restricted grants and public sector contracts gave little scope for charities to build reserves and could even erode them. This was especially the case when contracts and grants were short-term and restricted. Charities would often have to use reserves for unexpected costs that restricted funding would not pay for, and to cover gaps between one funding arrangement ending and another beginning. Where grants and contracts did not allow for full cost recovery, charities found themselves even more constrained because unrestricted funds had to be deployed to cover shortfalls:

> *'When you are struggling to balance the books, it is very challenging to put money aside into reserves. Our commissioned contracts barely wash their face. A lot of funders don't want to pay for management costs.'*

> *'Too many funders don't seem willing to support core costs. They just want to fund direct activities. They want money to be spent now and don't want any of their money going into reserves. This makes it very difficult to manage reserves.'*

Trustee caution and confidence

The extent to which charities could manage reserves strategically was influenced by whether trustees were cautious or confident. Several interviewees described how their board of trustees did not have an appetite for risk and seemed overly cautious around reserves management. The box below includes various comments made by interviewees about trustees' caution.

Trustees' caution on reserves

'The board of trustees like to see money in the bank and get twitchy when we use our reserves.'

'We currently have too much money. We have said we need to spend more but are innately cautious.'

'Two of our trustees say we have too much in reserves, but the rest disagree and feel we need to be careful. The treasurer and most of the Board are very cautious.'

Where charities had struggled to build reserves, trustees could be reluctant to use them. The pandemic and the cost of living crisis were also pushing some charities to become more cautious. One interviewee explained:

> *'Covid and the Ukraine war have illustrated how unexpected events do happen. It still feels like we are in very uncertain times.'*

Trustees had to find an appropriate balance between confidence and caution to manage their reserves strategically. The challenge was illustrated by one interviewee:

> *'There are two schools of thought in the charity at the moment. One feels the Covid pandemic underlines the importance of maintaining solid reserves. The other feels now is the time to use reserves and support as many young people as possible. This is quite difficult to manage in terms of bridging these two conflicting positions.'*

We heard how charity trustees needed confidence to spend reserves, usually from having a strategic and financial plan, as well as access to strong financial management skills. It also came from knowing that, if they did spend reserves, they could be replenished in the future, if required:

> *'The Trustees' view was that reserves are for a rainy day and the Covid-19 pandemic was a rainy day, so we should not cut costs, especially when demand was likely to go through the roof. We took confidence from having a healthy cash position. It was a moment when trustees were absolutely doing their jobs.'*

Summary of key findings

- Charitable mission is the key driving force for holding charity reserves. By holding reserves, charities can sustain activities and services in the event of adverse conditions and financial difficulties. Reserves can also provide a valuable source of finance for new, high risk projects and innovation.

- There is considerable variation in charity reserves management practices. At their best, charities adopt practices that facilitate strategic reserves management. These practices include:

  - Trustees considering multiple factors to determine required reserves
  - Reflecting on their own unique circumstances
  - Maintaining a focus on the future
  - Communicating their reserves policy effectively

- Determining reserves levels with reference to normative expectations is problematic because it potentially may lead to an inappropriate level of reserves which may put beneficiaries at risk.

- Charities are more likely to adopt strategic reserves management practices when:

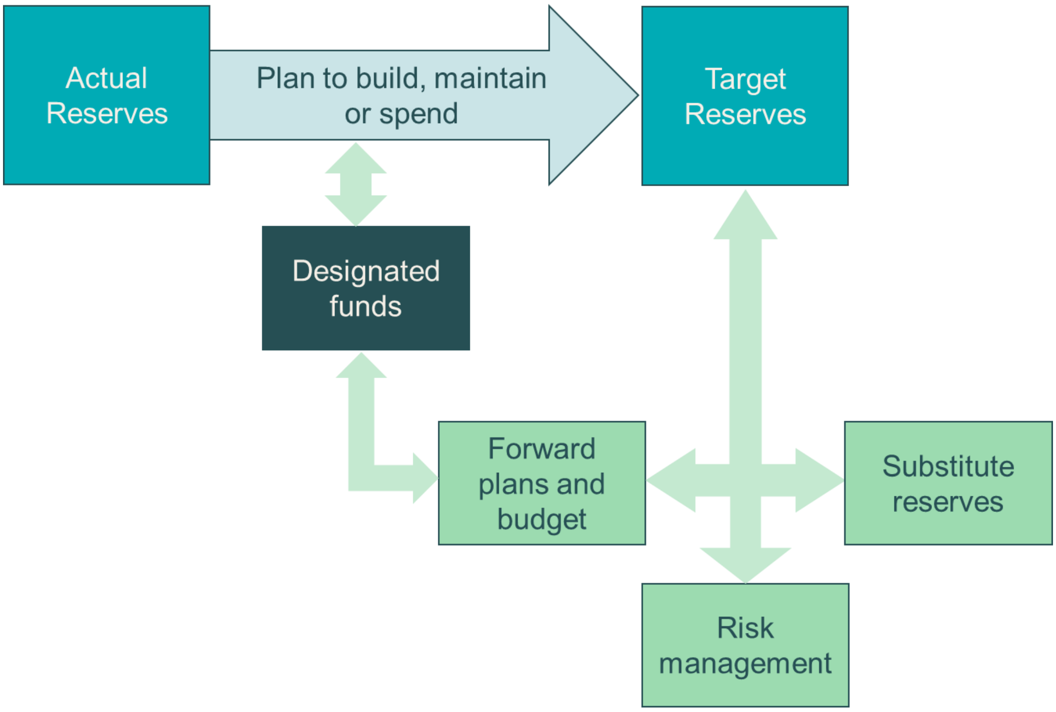
  - They have access to financial management skills
  - They receive income that they can use flexibly
  - Their trustees are confident in being able to spend and replenish reserves

Part Three: Key issues for consideration

What are the opportunities for strengthening charity reserves management?

Our analysis suggests that there is scope for more charities to move towards more strategic reserves management, as described in our findings above, and illustrated in Figure 2 below.

Figure 2: Strategic reserves management



By adopting strategic reserves management, a charity is more likely to:

- Hold a level of reserves that is appropriate for their organisation
- Respond and adapt to changing environments
- Have the confidence to build and spend reserves as required

Strategic reserves management (through full consideration of the factors listed on pages 21 to 23) can also help to:

- Identify risks, after which a charity can take action to mitigate them
- Ensure that funds are not tied up unnecessarily
- Support charities to remain financially stable
- Encourage charities to explore ways in which to operate with lower levels of reserves

What can charities do to manage reserves strategically?

Access training and resources

Guidance and support on reserves management is available for charities. OSCR has produced a *Charity Reserves Factsheet* (OSCR, 2017), which provides some basic guidelines. The factsheet also refers to the Charity Commission's *Charity reserves: building resilience (CC19)* publication, which provides more detailed guidance (Charity Commission, 2016). ACEVO, Charity Finance Group and the Institute of Fundraising have also commissioned useful guidance on making reserves work harder (Sayer and Smith, 2012). Based on our research, awareness of such guidance appears to be thin. Charities would benefit from looking at them:

> *'It would be good for trustees to get some training on financial management, especially those from a non-financial background, maybe through coaching and mentoring from the trustees with more financial experience.'*

We recognise that the availability of training and resources on charity reserves management is limited, and not always presented in an accessible manner. We address this with a further recommendation for policy makers on page 28.

Take an integrated approach

Charities may need to integrate reserves management with their strategic plans, budgets and risk management. They can also consider the availability of other financial mechanisms that may act as substitutes for reserves. Crucially, as plans and risks change, charities may need to flex their reserves as well.

Charities are at their best when they recognise that their environment and operating circumstances are constantly changing, and that reserves levels may need to change accordingly. Most charities would benefit from giving more time to consider their reserves requirements, and to do this alongside their annual budget and risk review processes. This could, at the very least, be done on an annual basis. As plans, budgets and risk management evolves, so too can a charity's reserves policy and practice.

Determine reserves policy to reflect own circumstances

Each charity is different, with its own operational situation, risks, aspirations and funding challenges. While it may be expedient to determine a reserves policy statement to satisfy normative expectations and funders, the uncritical adoption of these expectations may result in either the unnecessary hoarding of funds or, more likely, placing financial stability at risk. Both outcomes are undesirable because they ultimately constrain or put at risk the pursuit of charitable mission.

Try to access more unrestricted voluntary and earned income

Our research suggests that charities with voluntary and earned income find it easier to generate unrestricted funds, which promotes the flexible management of reserves. As one interviewee said: *'We have started to earn more income, which gives us more control'.* Charities that rely substantially on government contracts and short-term restricted charitable grants are likely to benefit from access to more earned and voluntary income, albeit that the extent to which this is really feasible at the current time is questionable.

We recognise that generating voluntary and earned income comes with significant challenges. As one interviewee told us: '*Poverty isn't a popular cause and so it's difficult for us to raise voluntary donations'.* Developing trading income can also be difficult and carry risks, as well as possibly itself require investment. So, charities need to approach this area with care.

What can funders and commissioners do to support strategic charity reserves management?

Provide funding that enables strategic reserves management

A major finding of our research is how inflexible funding places constraints on charities' ability to manage their reserves strategically. In this regard, charities were invariably clear on the solutions. They consistently told us that the problem could be remedied by funders adopting a more open and trusting approach to funding.

Unrestricted and long-term funding is hugely valuable to charities because it gives them the ability to plan and adapt to change, allowing money to be put into reserves if necessary:

> *'The most useful thing that a funder could do is to support us with multi-year unrestricted funding.'*

Furthermore, while charities welcomed three-year grants, some were also keen to see more five-year grants, as grants that could span a full strategic planning cycle to allow charities to plan with real confidence.

Funders need to be alert to charities that rely heavily on restricted funding and have limited access to unrestricted voluntary and earned income. Such charities find it particularly difficult to manage reserves in a strategic way, given the constraints associated with restricted grants. Access to more flexible funding can give charities the confidence that they will be able to build and spend reserves when needed.

Funders can also consider the needs of promising young charities that are looking to grow. Other things being equal, a charity with increasing expenditure will need to grow the value of its reserves. Funders could legitimately contribute to reserves in such scenarios because it can help to ensure the organisation remains financially stable during a period of growth.

Where funders feel compelled to provide restricted funding, they might consider adopting practices that can alleviate constraints around reserves management, for example, by providing sufficient funding to allow full cost recovery on all restricted funding and adding inflation to all multi-year grants. Other progressive options suggested by our research participants include: adding an unrestricted surplus to all restricted grants (e.g. an extra 10%); and, allowing charities to retain small underspends.

Informed assessment of reserves

Charities, especially those that rely heavily on grant funding and government contracts, are acutely aware that funders scrutinise their reserves. As noted in our research findings, many charities adapt their practices to satisfy what they perceive to be funder expectations. This invidious position is potentially harmful because it may result in sub-optimal reserves for the charity: '*we need to build up our reserves, but some funders can be reluctant to fund you if they think your reserves are high*'. It also risks giving funders false comfort from a charity's reserves being in line with their policy, despite the hidden shortcomings of their financial position.

> It is vital that funders and commissioners adopt assessment practices that encourage good practice in reserves management.

As part of developing their own practice, funders might consider:

- Assessing each charity on its own respective, distinctive merits
- Avoiding 'rule of thumb' judgements on charity reserves: '*Look at the narrative and not just the figures'*

Funders and commissioners can reasonably expect to see comprehensive and well-justified reserves policies in charities' annual accounts and, if they are not available, it is reasonable to ask for them. Where funders and commissioners have doubts about a charity's reserves management, opening a dialogue seems like an appropriate and respectful approach. As one SCVO Gathering workshop attendee requested: '*Make space in the application process for conversation'*. Such an open dialogue may help to resolve any outstanding queries or concerns:

> *'It would help for funders to educate themselves in the realities of charity finance and be ready to understand applicants and grantees on a case-by-case basis, looking at what they do and how they are funded.'*

Charities themselves need to feel comfortable about disclosing reserves in excess of, or below, a target level, without fear of punishment. In this regard, funders could pay attention to the charity's plans to bring their reserves into line with their long-term target:

> *'It would help if charities could have conversations with funders about their reserves policy which would help them understand, rather than analysing reserves to 'make or break' their funding decision.'*

To achieve informed assessment of reserves, funders and commissioners need staff with sufficient skills. This may require training on charity finance and reserves policies for grant officers and commissioners. If funding staff were more knowledgeable about charity reserves, it could help to avoid some of the issues observed by one of our research participants:

> *'Some funders are intelligent and understanding. Others are naive and don't understand our funding model. It often depends on the grant manager. If they are*

inexperienced, they often don't understand charity finance … and you can encounter some strange views.'

Provide substitute reserves

Our research has shown how charities occasionally use 'substitute reserves' to achieve financial stability. The provision of such substitutes is an area where funders could contribute towards charity reserves management and perhaps help to free up charity reserves. Endowed charitable foundations have access to substantial financial assets that could conceivably be leveraged to underpin or guarantee funding or loans to charities in the event of a significant unplanned budget shortfall. Although the charities we spoke to rarely asked for this, we sensed some interest in this idea when presenting our findings at the Chartered Institute of Fundraising's Scottish Fundraising Conference and the SCVO Gathering. We present and discuss some options below, with the proviso that the ideas are nascent and require further thought and development.

What can regulatory bodies and policy makers do to support strategic charity reserves management?

Enforcing reserves policy reporting requirements

It is evident from our review of charity accounts that a substantial minority of charities do not meet the requirements of the Charities SORP or OSCR guidance when reporting their reserves policy. In this regard, our findings echo previous research that found low compliance among some of the UK's largest charities (BDO, 2020).

Auditors and independent reviewers have a responsibility to make appropriate enquiries of charities and to ensure statements meet SORP reporting requirements. Our evidence suggests that this is not always done to a high enough standard.

A charity that had recently experienced substantial financial difficulties and almost became insolvent reflected thus on their experience: '*Auditors and OSCR should scrutinise accounts more thoroughly and ask harder questions about reserves policies*'.

The SORP requirements could prescribe more clearly the method to calculate the level of reserves. As suggested by others, a table format for calculating reserves at the balance sheet date may aid consistency (BDO, 2020).

More practical guidance and training

OSCR and charity support organisations such as SCVO may wish to consider developing and promoting an accessible and practical guide to charity reserves management, as current guidance is limited and not grounded in everyday charity practice. A more practical step-by-step guide that incorporates lived realities (e.g. access to substitute reserves), with supporting case studies, may help charities, especially smaller ones, to manage their reserves more strategically. The guide could also include instructions on how to communicate a reserves policy.

It may also be opportune to complement practical guidance with a programme of training and support through the Third Sector Interface (TSI) Scotland Network.

Improving access to lines of credit

Our research findings suggest some charities may benefit from more accessible and affordable lines of credit. A line of credit is a financial arrangement that allows an organisation to borrow money when needed, up to a pre-agreed borrowing limit. Such arrangements are commonplace in business, but less so among charities. As noted by several research participants, the market for providing lines of credit to charities appears to be under-developed.

Credit might help relieve some of the pressure on charity reserves and, perhaps, allow some charities to operate with lower levels of reserves. This would be advantageous in a high inflation and low interest rate environment, where the real value of cash is eroded over time.

Based on some of the conversations we had during the research, lending schemes would need to address various barriers to enable charities to access lines of credit:

- **Provision of security**

  Lenders often require some security for the loans they make. Where charities own property or other assets, they may be well-placed to seek lines of credit. Where charities lack assets, there could be a role for charitable trusts and foundations, especially those with sizeable endowments. Investment assets could be offered as security. In effect, this would create 'funder-backed' loans or guarantees.

- **Affordable finance costs**

  Charities are understandably cautious about accessing lines of credit because of the finance costs involved. Money spent on servicing debt is funding lost to the charitable cause. Charities are unlikely to accept high finance costs. Again, there may be a role for funders here, by reducing lender risk (see above), subsidising finance costs through some form of social investment, or making finance costs affordable, e.g. low interest or interest-free.

- **Repayment**

  If charities are to access short-term finance, they will need the means to repay. This reaffirms the issue around flexible funding noted above on page 26. Unless charities are able to access sufficient unrestricted funding to be able to repay loans (and to do this without being penalised by funders), then they are unlikely to have the confidence to ever take one out.

Mutual opportunities

When discussing preliminary findings at the SCVO's Gathering, we heard various suggestions that charities could try to manage reserves on a mutual basis. These appeared to echo an idea previously raised around the pooling of reserves (Sayer and Smith, 2012). While recognising that charities are never likely to be able to put their own reserves at risk by making them available to others, there may be merit in exploring a mutual approach to setting aside funds and accessing them when needed.

A Friendly Society offers a potentially interesting model. The principle of Friendly Societies is that member organisations make regular payments into a mutual fund which allows them to access money when needed. To gain reserves protection (and conceivably operate with a lower level of reserves), charities could pay in a small percentage of annual income each year, which would entitle them to a payout in the event of specified adverse financial circumstances. In effect, this represents a form of insurance with the advantage that the Friendly Society would retain or distribute surpluses for the benefit of its members. If sufficient charities were interested in this approach, there may be merit in a feasibility study funded by supportive charitable trusts.

Summary of key issues for consideration

- If more charities can adopt strategic reserves management practices, we could be confident that more charities hold, or are moving towards, an appropriate level of reserves. Concerns about charities hoarding or holding inadequate reserves should then disappear.

- Charities can take steps to implement strategic reserves management. They are advised to:

    - Access training and resources on charity reserves management
    - Integrate reserves management with their strategic planning, budgeting and risk management processes, and do this more frequently
    - Reflect on their own circumstances (and resist uncritical acceptance of normative expectations)
    - Try to access more unrestricted voluntary and earned income

- Funders have a critical role to play to encourage strategic charity reserves management. They can do this by:

    - Providing flexible funding
    - Entering a dialogue with charities and making informed assessments about their reserves
    - Exploring options for increasing the availability of substitute reserves

- Regulatory bodies and policy makers can support more strategic charity reserves management by:

    - Strengthening reserves policy reporting requirements
    - Offering more practical guidance and training to charities
    - Exploring and developing ideas to improve charities' access to lines of credit
    - Investigating the feasibility of mutual models for charities to collectively manage financial risks that reserves might otherwise be expected to cover

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