

SORP and reserves - discussion briefing

Prepared by: Charities SORP-making body, May 2021

Purpose of the briefing paper

To assist the engagement strands and SORP Committee reflect on the current approach to reserves within the SORP and to undertake a problem solving exercise to identify:

- the option(s) for changing what the SORP says about reserves, if any and if so,
- a preferred option with a recommendation as to what the change to the SORP should be, if any.

Reflection - what does the SORP say about reserves?

Within the Module 1 on the Trustees' Annual Report, the current SORP requires the following of all charities:

1.22 The charity must explain any policy it has for holding reserves and state the amounts of those reserves and why they are held. If the trustees have decided that holding reserves is unnecessary, the report must disclose this fact and provide the reasons behind this decision.

For larger charities (those with income of more than £500,000), the following requirement exists for the financial review within the Trustees' Annual Report:

1.48 The review of the charity's reserves should:

- *state the amount of the total funds the charity holds at the end of the reporting period;*
- *identify the amount of any funds which are restricted and not available for general purposes of the charity at the end of the reporting period;*
- *identify and explain any material amounts which have been designated or otherwise committed as at the end of the reporting period;*
- *indicate the likely timing of the expenditure of any material amounts designated or otherwise committed at the end of the reporting period;*
- *identify the amount of any fund that can only be realised by disposing of tangible fixed assets or programme related investments;*
- *state the amount of reserves the charity holds at the end of the reporting period after making allowance for any restricted funds, and the amount of designations, commitments (not provided for as a liability in the accounts) or the carrying amount of functional assets which the charity considers to represent a commitment of the reserves they hold; and*
- *compare the amount of reserves with the charity's reserves policy and explain, where relevant, what steps it is taking to bring the amount of reserves it holds into line with the level of reserves identified by the*

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trustees as appropriate given their plans for the future activities of the charity.

In addition, within Module 10 in relation to the balance sheet, the following is also stated:

10.91.....A charity may choose to disclose the amount identified in its reserves policy statement as its reserve fund under a sub-heading of its unrestricted funds provided that this amount is positive.

And lastly, within the glossary definition of a designated fund, it states,

Designated funds continue to count as part of the unrestricted funds of the charity, but the trustees may choose to exclude designated funds from the calculation of the charity's reserves.

There is currently no glossary definition for reserves – the entry refers the reader to the module on the Trustees' Annual Report.

For context, the 2005 SORP also contained a definition of reserves within the glossary as follows:

GL 51 Reserves

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

51.2 This definition of reserves therefore normally excludes: (a) permanent endowment funds; (b) expendable endowment funds; (c) restricted funds; and any part of unrestricted funds not readily available for spending, specifically: (d) income funds which could only be realised by disposing of fixed assets held for charity use and performance related investments.

51.3 Individual charities may have more or less reserves available to them than this simple calculation suggests for example: (a) expendable endowments may be readily available for spending; or (b) unrestricted funds may be earmarked or designated for essential future spending and reduce the amount readily available. 51.4 For further information, see the Charity Commission's publication CC19 on Charities' Reserves.

Reflection – what else is said about reserves within legal requirements for charities preparing receipts and payments accounts?

In Scotland, the requirements for the form and content of receipts and payments accounts are set out in secondary legislation and it may be helpful to note for context that these requirements state that the Trustees' Annual Report for such charities must include:

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A description of the policy which has been adopted by the charity trustees for the purpose of determining the level of reserves which it is appropriate for the charity to maintain in order to meet effectively its purposes, including the level of reserves held, why they are held and quantifying and explaining the purpose of any designated funds and the likely timing of any expenditure that has been set aside for the future.

What is the reporting difference between 'all' and 'larger' charities?

As outlined above, the SORP requires larger charities to provide greater detail about the reserves that they hold and how the reserves held compare with the charity's policy, including steps that the charity is taking to bring the level of reserves into line with the policy where relevant.

FRS 102 and the scope for changing the SORP to accommodate a different approach to reserves

There is no requirement within FRS102 in relation to reserves so there are no barriers to changing the requirements within the SORP on this topic.

Engagement strand feedback during the exploration stage

User of the accounts perspective:

Four strands (S&IE, PTS(B), MFDGPB, PTS(A)) identified reserves disclosure as a key issue and thought that there should be greater clarity as to how reserves are calculated and there should be a greater emphasis on performance against the reserves policy.

Five strands commented on the presentation of reserves information, with points raised as follows:

- We would like to see Fixed Asset Reserves shown in the Designated Reserves section for all charities. Currently funders find these anywhere in the Reserves section and sometimes not included at all, and more often there are no details as to how they have been calculated. (MFDGPB)
- More communication is needed on why different charities carry different reserves. (L)
- Reserves could be usefully tied into existing disclosures such as future developments in the business. (L)
- A reserves calculation together with a reconciliation to the primary statements could be included in the notes to the accounts. (PTS(A))
- A definition of reserves could be included in the SORP; this should be linked to explaining the liquidity position of the charity and to going concern disclosures. (PTS(A))
- Reinstate requirement that charities provide an explanation about why their actual reserves differ from stated reserves policy. (PTS(A))

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- Reserves are often not calculated correctly. A lack of understanding of reserves can have a knock-on impact on the quality of a charity's financial review (PTS(B))
- A new note should be introduced requiring charities to report their 'free' reserves with appropriate guidance on how to calculate these. (PTS(B))
- Requirement to report cash balances and forecasts as well as reserves. (T)

Furthermore, in relation to going concern, one strand suggested that there should be some narrative around the specific requirements of each charity to ensure that it is a going concern

User of the SORP/preparer of accounts perspective:

Issues relating to reserves were raised by 5 of the 7 engagement panels:

Defining free reserves

The main issue raised related to the calculation of 'free reserves' and the perceived lack of consistency in how reserves are identified and the need for more definitive guidance on this in the existing SORP.

"Reserves (also known as free reserves) are often not calculated correctly.....A lack of understanding of reserves can have a knock-on impact on the quality of a charity's financial review." (PTS(B))

It was thought that more guidance was needed on how to prepare/calculate freely available reserves (L), for example, a definition of reserves could be included in SORP (only on larger charities disclosures in the current SORP). (PTS(A)).

Review of the terminology and supporting definitions used in reference to reserves would make it simpler to understand and implement by trustees and would help trustees to develop a reserves policy which reflects the circumstances of the charity. (T)

Financial sustainability and linking reserves to other disclosures

The definition of reserves should be linked to explaining the liquidity position of the charity and to going concern disclosures. (PTS(A)). Alternatively, reserves could be more than just an assessment of going concern and could usefully be tied into existing disclosures such as future developments in the business. (L)

Reserves note to the accounts

Some strands put forward the idea of having a Reserves note to the accounts with more guidance on how these should be calculated. (Currently 'free reserves' are only included in the TAR which is not subject to audit.)

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“A new note should be introduced requiring charities to report their ‘free’ reserves with appropriate guidance on how to calculate these.” (PTS(B))

It was recognised that it could be difficult to include the reserves figure from the TAR within the funds note to the accounts for a charity which has complicated figures, for example, in terms of funds and fixed assets.

“As an alternative, a calculation together with a reconciliation to the primary statements could be included in the notes to the accounts.” (PTS(A))

More narrative

The requirement that charities provide an explanation about why their actual reserves differ from their stated reserves policy could be re-instated. (PTS(A))

Consideration should be given to a requirement to report on cash balances and forecasts as well as reserves. (T)

Observations from the SORP Committee:

At the December 2020 meeting when SORP Committee members were invited to share their key conclusions on topics that had arisen during the exploration stage and that should inform the reflection stage, reserves reporting was noted as requiring review.

Two SORP Committee meetings were held during February 2021 which considered the feedback from the engagement strands in relation to the user of the accounts and the user of the SORP. The discussion from the user of the SORP perspective simply agreed that reserves was a topic that should be taken forward from that perspective. The following was noted from the discussion on the user of the accounts perspective:

The committee felt that the key issues regarding reserves were relating to financial sustainability and free reserves i.e. how long could a charity exist if its income streams were no longer available. There is a general understanding of the usefulness of free reserves but how are these reserves defined? What does the charity mean with regard to its free reserves policy?

The Charity Finance Group had issued guidance ‘Beyond Reserves’ which was deemed to be useful, but the committee commented that how reserves should be calculated should be clear.

The committee questioned whether there was a link between reserves and going concern reporting. Is there scope to link reserves to financial sustainability? Free

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reserves are how much a charity has until the money runs out and this is a 'stress' test many charities are currently having to consider.

The consensus of the committee was that this is an issue that needs to be considered further.

Relevant SORP research findings

The topic of reserves also featured within the 2008-09 SORP research undertaken by Queen's University Belfast 'Charity Reporting and Accounting – Taking Stock and Future Reform'. Key findings from that research were that:

- Clear definitions of different types of reserves were needed, especially regarding the calculation of 'free' reserves
- Reserves can be a difficult area for many small charities that operate on something of a hand-to-mouth basis
- The use of designated funds is an important category in helping users to understand why a charity holds reserves and what its plans are for the future although there was some concern that designated funds may be used to 'massage' the reserves figure
- Details of free reserves are particularly important for funders in making their decisions.

Similarly, within the 2016 SORP research exercise, reserves was one of four suggested areas for review of the trustees' annual report recommended by the SORP Committee at the time. This area had the second lowest level of interest of the four suggested areas although 57% of written responses to this question agreed that reserves was an area that needed attention. Feedback from the consultation events also showed support for this area being reviewed.

Respondents who agreed and disagreed with this being an area for review believed the requirements and guidance offered in the SORP to be adequate, the key point about change was in relation to extra guidance. Respondents also expressed concerns about any additional requirements being mandated. A number of respondents considered maintaining a flexible approach around reporting on reserves to be necessary given the variety of the sector and the importance of maintaining trustee discretion in this area. A quarter of respondents felt that additional guidance was needed – this was mainly viewed as being provided outwith the SORP and taking the form of best practice examples and example accounts. Three specific suggestions came from respondents as to what this additional guidance might cover:

- Disclosures on the basis of the calculation of free reserves
- Disclosures of the breakdown of net assets between different types of funds
- The inclusion or exclusion of particular capital items within reserves

In March 2017, the SORP Committee discussed this area and the research responses. Two points were noted from this – that there is demand for greater

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information on why reserves are held and a link to the charity's future plans and that the SORP should be very clear on the requirement for a reserves policy to be in place.

Research undertaken in 2018 by the Charity Commission for England and Wales found reserves were poorly reported:

<https://www.gov.uk/government/publications/charity-reserves-policies-demonstrating-and-building-resilience/charity-reserves-policies-demonstrating-and-building-resilience>

In particular the study found that more than a third of the charities' explanations of their reserves policies did not provide all of the basic information required by the SORP and less than a quarter of the charities in the sample had stated the correct figure in their trustees' annual report. The study concluded that this was in part because a third of the charities in the sample did not include a figure for reserves. 'The main underlying reason why the reserves figures were incorrect appears to be that many trustees believe that reserves are the same thing as total unrestricted funds'.

What needs to be done now?

Step 1- Making the case for change - a 'basis for conclusions'

A need for change in relation to reserves has come through clearly from the engagement strand and SORP Committee discussions to date and from the findings of research. At this stage, clarity is required as to what changes are actually required and the reasons that support these changes. Without a case for change, no change will be considered because its rationale cannot be explained to those affected.

Step 2 - Advising the change required to the SORP

Having made the case for change, the detailed changes required to the SORP need to be set out. Consideration should be given in as much detail as possible for the reporting requirements for the trustees' annual report and the accounts and what else the SORP should include about reserves – for example, glossary entries. If no detail is given, the conclusion drawn is that the detail is left wholly to the discretion of the SORP Committee and SORP-making body.

Undertaking an assessment of the impact (savings or costs on the preparer and benefits or disadvantages to the reader)

The FRC will require an impact assessment but until the implications of change are worked through the SORP framework, the impact is unlikely to be clear and so this will be considered at the drafting stage of the process.

Step 3 - Recommendation

The case made by each strand or combination of strands will inform the deliberations of the SORP Committee and so there needs to be a clear recommendation.

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The SORP Committee will be having its own discussion about what needs to be done and taking the evidence and views from the process as a whole, the Committee will settle on a recommended approach for drafting the SORP based on the evidence presented.

Engagement strand abbreviations

Smaller charities and independent examiners	S&IE
Larger charities	L
Charity trustees	T
Academics and regulators and proxies for public interest	A&R&PPI
Professional, audit and technical strand A	PTS(A)
Professional, audit and technical strand B	PTS(B)
Major funders, donors and government and public bodies	MFDGPB