Reserves

Your Guide to creating a Plain English NFP Reserves Policy

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Introduction

Reserves – How Much and What to Do?

NFPs need reserves to fund organisation change, improvements and provide a buffer for potential events that will adversely affect the organisation.

One of the most common questions asked by a Not-For Profit (NFP) sector governance Board, is, is what Reserves level should we have, and what should we do with them? This then leads to other questions, such as.

- Is it Ok to have a deficit and use some of our Reserves?
- How should we calculate and display them?
- Should we have a Reserves policy?

This document will hopefully provide you with a guide to enable you to answer these questions. We provide an example of

- An example policy statement on Reserves
- An example of the types of Reserve you may wish to establish, with an explanation of what the Reserve could be used for, plus
- An example calculation for determining your Reserves
- Example of how other organisations have displayed their reserves including a simple table that projects expected reserve levels at the end of the current financial year

This document is a guide and each NFP entity will have its own drivers and not all Reserves we have shown here may be appropriate for each circumstance.

What is a Reserves Policy?

Why does a Reserves Policy exist?

A Reserves Policy is designed to outline

- Why each Reserve exists
- How the respective Reserve level “targets” are calculated
- The current overall Reserve levels, and
- Provide commentary about how the Reserves policy interacts with the annual budgeting process, longer term forecasts and any other process (such as a Professional fee setting process).

Reserves Policy Statement

An example policy statement may look like the following

> *The NFP Entity Governing Body will retain sufficient financial reserves to deliver (over its lifetime) the operational and strategic activities to meet its obligations set out in the New Zealand Not for Profit Act including general fiduciary duties.*

It should incorporate the drivers and objects of the NFP entity, including any Law or Act that it is required to abide by, as well as meeting its general fiduciary, Trustee and or solvency duties.

What Reserves you may need?

What Reserves do you need, how much and why?

A Reserves policy is driven from the other important documents of your NFP – being

Strategic Plan

What "big ticket" risks or opportunities have been identified for the next 1-3 years. How likely are these events to happen and what impact could they have.

This information would also drive your annual plan and risk management high level considerations.

Annual Plan

Do any of the shorter term plans, risks and opportunities need to be considered in setting or resetting our reserve levels?

Often desired Reserve levels are a function of

1. How likely is the event to happen
2. What would be the impact if the event did happen

We detail below common Reserves that an NFP entity may wish/need to have.

They are:

- Ceasing Operations
- Financial Resilience
- Disciplinary
- Transformation/Projects
- Budgeted / Expected Annual Deficits

An overview of the Reserves follows, and Appendix B sets out more discussion of the details.

Ceasing Operations

This Reserve considers what is a prudent level of reserves to enable an orderly and fully funded process if the NFP ceases to operate.

This "wind-down" may arise from events such as

- The NFP decides to resettle its assets on a similar organisation
- The purpose of the NFP is no longer required
- Funding or other event has occurred
- A law change/Government directive and the NFPs obligations are taken up by another entity, or
- A law change/Government directive and the NFPs is merged with another NFP requiring shared services.

It is important that sufficient funds are available to meet the needs of all costs of a transfer or cessation.

Areas to consider could include

- Ongoing property lease obligations
- Ongoing licence costs for software obligations
- Costs of ceasing employment contracts/agreements, and
- Contingency costs of “wind down”

Financial Resilience

This Reserve is to help smooth cashflow needs or respond to unknown events.

Sector Specific

This Reserve is to fund specific activities that is unique to your NFP. It could be for legal cases, or disciplinary actions but the uncertainty is such you need a buffer for when they happen.

Transformation/Projects

This Reserve is to set aside funds for any large transformation projects that are necessary to meet the NFP’s long term capability to fulfil its duties. Most organisations will have a series of ongoing projects that are designed to meet changing stakeholder needs, technology or operating environmental changes.

Budgeted / Expected Annual Deficits

While the NFP creates a budget for a year ahead, it may also forecast out a further two/three/five years as well. If any of these years expected annual result is a deficit (loss), then this loss must be funded by Reserves.

Calculating Current Reserve Levels

How do we calculate the Reserves levels?

The level of Reserves held by the NFP is not the Equity displayed in the Statement of Financial Position in the Annual Financial Statements as this accounting figure includes fixed assets and software/intangibles.

Fixed assets and software/intangibles are excluded from a Reserves level calculation, as whilst they may have value while being used in the ongoing ‘*business’* of the NFP, they could not be sold to generate cash.

Reserves levels are effectively what cash the NFP can quickly access after paying its immediate liabilities.

We recommend that the level of reserves is called Uncommitted Cash Reserves as opposed to equity or reserves.

Uncommitted Cash Reserves

We recommend that a calculation of uncommitted cash be made, to determine the level of cash reserves that are available to the NFP.

We detail a sample calculation in the attached Appendix A. The key points to consider are.

- Can I turn the asset into cash whilst still operating the business, and
- Do I need to pay back all the liabilities?

When should you calculate the Reserve levels?

The Reserves’ levels should be revisited / refreshed on the following trigger points

- Annual budgeting process
- Part year reforecasting process
- Finalisation of the year-end financial statements
- Events that have a significant event on the Reserve’s calculations assumptions
    a. like signing a new property lease,
    b. setting fees
    c. significant Disciplinary case
    d. significant outside event

If the Reserve levels and / or future projected Reserve levels are significantly above or below the Policy targets, the NFP may then wish to prepare an action plan to remedy this situation.

Displaying Your Reserves

Having Reserves is not just good financial risk practice, it is also a useful tool to tell a story to stakeholders.

We recommend that your NFP displays its Reserves at least once a year – normally as supplementary information to your audited Financial Statements. - see the example in Appendix A

Making this information public and simple is useful because

- it can articulate to stakeholders (including funders and members) why the NFP has the cash on its balance sheet that it has. Sometimes funders or donors are reluctant to provide funds to a NFP that has “too much” cash
- It can demonstrate that the NFP is on a journey to reach a require level of reserves and make a case for further funding (contracts, donations or membership increases?)
- It demonstrates that the NFP has considered its risks and opportunities carefully and has made plans
- Most people find reading and understanding financial statements difficult – often a well displayed reserves section will give more contextual, digestible information that formal reporting does

We recommend the reserves information is included as supplementary information rather than being a formal part of your audited Financial Statements. This means that the auditors will review the information for consistency with the financial statements, but you are not restricted in how you display or comments you make.

Appendix C sets out an excellent real world example (and publicly available) from the NZ Public Sector Association.

Appendix A – Examples

Calculating your Reserves

Calculation of Reserves & Uncommitted Cash Reserve	$	$	Reserve Target Level $	Reserves Actual Level Surplus/(Deficit) $
Ceasing Operations Reserve				
6 months - Lease obligation whilst operating	150,000.00			
Estimated Full lease obligations if no new tenant	600,000.00			
Redundancy payments	153,847.00			
Software licence transfers	50,000.00			
Sundry windup/make good costs	50,000.00			
		1,003,847.00	1,003,847.00	-
Financial Resilience				
Estimated at Two Weeks Normal Cash spend (i.e. excl depreciation)		140,385.00	140,385.00	-
Disciplinary				
Funding tagged to cover additional costs not funded by levy		250,000.00	250,000.00	-
Transformation/Projects				
Capex not funded from amortisation/depreciation charge		-		
Budgeted / Expected Deficits		-		
Total Reserves		1,394,232.00	1,394,232.00	-
Excess Uncommitted Cash Reserve		**105,768.00**	**-**	**105,768.00**

Displaying your Reserves internally

Example of the Cash Reserve(s)	**$**
Reserves/Equity at Prior year-end	4,000,000.00
Full Year Forecasted Surplus/(Deficit) Before Tax	1,200,000.00
Less Tax Expense	(50,000.00)
Full Year Surplus/(Deficit) after Tax	1,150,000.00
Add Back Non-Cash Depreciation and Amortisation	240,000.00
Less Estimated CAPEX	(350,000.00)
Cash impact of CAPEX	(110,000.00)
Cash Surplus less CAPEX & Tax	1,040,000.00
Projected "Near" Cash Reserves Full year-end	5,040,000.00

Appendix B – Reserve Examples

Ceasing Operations

Ongoing Property Lease obligations

Typically, one of the most significant costs of an NFP's cessation is it obligations with its property leases.

Many NFP's will sign leases for its offices for multiple years – broken into renewal periods. Even if the NFP is no longer operating, it would have a legally enforceable obligation to pay the lease costs until

- It could give notice ahead of a renewal date
- It could find a replacement tenant(s)

If the NFP could find a replacement tenant, any shortfall in what the new tenant would pay, and the original lease amount would be the NFP's responsibility.

Each year this Reserve's target level would change depending on the duration to the next lease renewal date (or indeed lease overall expiration) – that is – the Reserves needed four years away from the lease renewal option date would be more than the Reserves needed one year away from the lease renewal option date.

Ongoing licence costs for software obligations

In a similar way that an NFP signs up to future obligations on its property leases, it also contracts to paying for the use of the software that is used by the NFP in its operations.

This element of this Reserve assumes that if the NFP's duties is ceased, that the work required would continue with another entity. To this end, this element assumes a cost of transferring the licences and database to the new entity rather than the software licences ceasing.

Costs of ceasing employment team

Whilst many NFP employment agreements may not include provisions for redundancies, the NFP may need to estimate notice periods, legal fees and other costs that would be required on wind down. Funding of an average of four weeks of the normal annual salary costs may be a base estimate.

Contingency costs of "wind down"

Ceasing or transferring an NFP's operations is likely to be a complex matter so it is recognised that there will be other costs that are difficult to describe in detail. A common-sense amount is included to cover those unknown elements.

Financial Resilience

This Reserve may set out a minimal amount (say two weeks of normal annual costs) given

- The timing of the NFP's income may be "lumpy" and received many months in advance, or
- The level of the other Reserves – it may be reasonable to assume that not all Reserves would be needed at once – i.e., the Ceasing Operations Reserve would not be needed at the same time this Reserve

Disciplinary

This area is inherently difficult to assess a target Reserve level. It includes “prosecutions” for example, and the number of “cases” that may exceed the current year’s disciplinary “levies” collected.

Setting this Reserve at the historic level of disciplinary levies collected less costs in this area (as at the most recent financial year-end) may be appropriate.

The target Reserve level would also consider any known large events “on the horizon”.

Transformation/Projects

Projects can be difficult to forecast and budget for. Sometimes the costs for a project may span over multiple years or involve purchase of an asset (software) that is written off as an expense over two to three years.

This Reserve is for when there is an identified stream of work (or streams), and the cash outlays will exceed the normal annual budget for both project costs and amortisation/depreciation.

This Reserve therefore will potentially change each year

Budgeted / Expected Annual Deficits

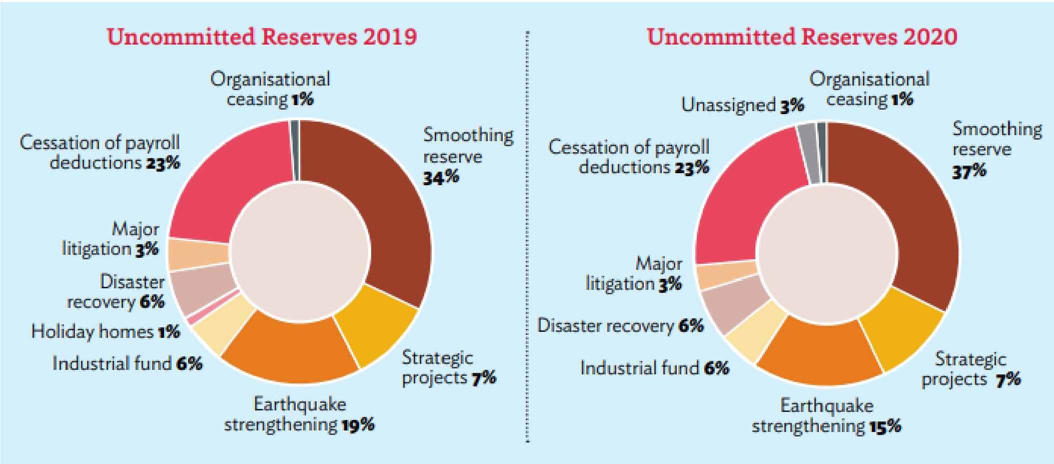
One of the challenges of arbitrarily measuring financial performance of an NFP on a yearly basis is that some years there will be a deficit and in other years, a surplus.

These surplus years can help build reserves while the deficits reduce reserves.

It may be acceptable to have a deficit if it is known that longer term there is a move back to a surplus. Therefore, it is sensible to forecast out several years and create a budget for a year ahead, but also forecast out a further two/three or five years as well.

This Reserve will likely change each year and as each budget and further forecast is completed. The Reserve may also change if there is large changes mid-year from how the expected results are progressing.

Appendix C – Display Example



Reserve	Reason for reserve	Basis	Target 1 April 2019	Actual 31 March 2020	Target 1 April 2020	Actual 1 April 2020	Usage 2020
Smoothing reserve	Used to smooth sudden cash flow deficits during a normal operating year	% of operating expenses	6,500	6,500	7,400	5,919	
Strategic projects	To fund one-off projects set up to further the PSA's strategic goals	Fixed $ amount	1,750	1,168	1,750	1,750	To fund staffing and equal pay projects
Earthquake strengthening	To fund bringing PSA house up to code	Fixed $ amount	3,248	2,673	2,673	2,673	For design and prerequisite work for earthquake strengthening
Industrial fund	To support members during prolonged industrial action	Fixed $ amount	1,000	1,000	1,000	1,000	
Holiday homes	To fund ongoing expansion of holiday homes.	Fixed $ amount	140	-	-	-	Towards purchase of new home in Mangawhai
Disaster recovery	To fund disaster preparedness and recovery	Fixed $ amount	1,000	1,000	1,000	1,000	
Major litigation	To fund any major legal action	Fixed $ amount	500	500	500	500	
Cessation of payroll deductions	To fund the loss of income & costs to change to alternative fee collection methods	Fixed $ amount	4,100	4,100	4,700	4,700	
Organisational ceasing	To fund the obligations (leases, redundancies) if the PSA ceased to operate	Fixed $ amount	250	250	250	250	
Unassigned			-	601	-	-	
			18,488	17,792	19,273	17,792	

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