Review of the Charities Act – Accumulation of Funds

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This article is in continuation to our last article regarding the post- implementation review of the Charities Act 2005 ('the review'). In this update we visit the topic of "accumulation of funds" and the ability of charities to build up reserves.

Department of Internal Affairs (DIA) poses two questions to consider in relation to this:

1. Should charities be required to be more transparent about their strategy for accumulating funds and spending funds on charitable purposes (e.g. through reserves policy)? Why? Why not?
2. Should certain kinds of charities be required to distribute a certain portion of their funds each year, like in Australia?

We do not support the suggestion raised in the Discussion Document that charities should be required to distribute a certain portion of their funds each year. In our experience charities generally operate in the medium-long term and need to accumulate funds to purchase much needed capital assets for example.

Requiring charities to distribute a pre-determined portion of their funds each year may prevent charities from doing so.

This article explains key considerations that charities need to consider in relation to the accumulation of funds.

We also consider the scope of the review and how you can have your say.

Our not-for-profit reporting expert, Stephanie Wylde, and our National Technical Manager, Nicola Hankinson, provide some interesting commentary with regards to the accumulation of funds.

We welcome feedback on this article or any topics you would like us to cover in future.

Background

Public consultation on the review of the Charities Act 2005 is open until 31 May 2019. You can view the Discussion Document and find out how to have your say here.

This article focusses on one of the topics raised in the Discussion Document, the ability of charities to accumulate funds. The Discussion Document states that:

“Some charities may accumulate considerable funds (or other assets) over many years. There may be good reasons for this, like managing and growing a charity’s assets for current and future generations. In other cases, a charity may accumulate funds over many years with no clear rationale.”

This article explores why charities accumulate funds and how the appropriate accumulation of funds can be encouraged through adoption of a reserves policy and regular reporting of performance against the policy.

Why do charities accumulate funds?

As with most businesses, charities need to set aside funds to deal with both expected and unexpected events, such as an unexpected drop in income or providing emergency relief. Some charities may accumulate considerable funds (or other assets) over many years. There are often good reasons for this. For instance, a charity may accumulate funds:

- for a specific purpose, like a new community facility, by fundraising over a long period;
- to grow a charity’s own business enterprise so that it can provide future income for the charity; or
- to ensure the charity can provide benefits to future generations, by managing and growing their assets (including iwi and hapū charities that hold settlement assets).

In other cases, a charity may accumulate funds over many years with no clear rationale. Saving for a rainy day. While charities must use their funds for charitable purposes, the Act does not limit the amount of funds a charity can accumulate before doing so.

Charities reporting in tiers 1-3 must report annually on the funds they have accumulated. These charities also need to disclose their reserves, the funds set aside for a particular purpose, and describe any restrictions on their use and/or intended purposes for using these reserves. Tier 4 charities do not need to report on accumulated funds but must report on the amount of cash they have and any other resources they own.

Holding accumulated funds without clear explanation may cause public concern that a charity is not using its funds for charitable purposes. For example, concerns have been raised regarding charities with businesses that apply very little or no funds to charitable purposes. Accumulating funds in a business or other investment over a long time can increase the risk that charitable funds may be lost if the business fails.

Businesses can be an important income source for charities. However, businesses can also put charitable funds at risk because the charity may not get back the money used to support the business.

Charities may run 'unrelated businesses', where the service or product does not directly contribute to a charitable purpose (e.g. food and drink retailers or hotels). The test is whether income from those business activities is ultimately applied to charitable purposes. The Act allows charities to raise funds to support their work, while providing certainty that charities are only undertaking business activities to further charitable purposes and no individual is profiting.

The review team want to hear your views on:

- What, if any, registration requirements should be required for 'unrelated businesses'? (ie requirements to report on these annually as part of the Annual Return)
- How should charities report on the success (or failure) of their business operations and business subsidiaries?
- Currently, Charities Services requires that for an organisation with an unrelated business to register as a charity, it must show that:
- the business is capable of making a profit to further its to charitable purposes; and
- the organisation does not provide resources to its business operations at less than market rate

What should your charity do?

We consider that charities should be able to build up sufficient reserves to fund future operations or projects (such as development of a new community facility, contingencies, asset replacement, special projects and/or factoring in an inter-generational and future income approach where appropriate).

However, this needs to be weighed up with the factors outlined above, including public perception and the reason the charity was established in the first instance.

For charities, it is critical that reserves are well managed, balancing the need for a contingency fund with a focus on delivering upon the organisation's mission. Reserves should allow the charity to weather unexpected financial disasters, make investment decisions and to have a budget deficit in order to achieve their charitable purpose.

Key controls that can help charities to achieve this balance include adequate oversight and monitoring at a governance level and development of a reserves policy to guide the accumulation of funds.

What should we consider in developing a reserves policy?

A reserves policy should include the following aspects:

- Purpose of the policy
- Definition of key terms
- Provide linkage between the organisation's mission/constitution and its financial reserve requirements, along with links to other key finance and investment policies
- Specify the various reserve categories including their minimum and target levels (e.g. Contingency Reserve and Special Projects Reserve and whether the reserves are described in dollar terms, or as a percentage of turnover or expenditure?)

Establish the criteria for use of, monitoring of and reporting on reserves

A reserves policy should be flexible enough to accommodate a significant increase or decrease in the organisation's turnover or expenditure and allow for the policy to be reviewed within a short timeframe rather than waiting for the next annual review date.

Charities could set contingency reserves to cover operating costs for a defined period (such as 3-12 months). The period would depend on the board's risk appetite. Alternatively, a minimum reserve could be established as the amount the board considers is suitable to cover unexpected operating events.

Other points you might want to consider in developing a reserves policy include:

- Cash vs net asset reserves: For an organisation that holds only one asset (cash) and has no liabilities, the bank balance shows their reserve level. However, most organisations hold other assets and have obligations or liabilities to satisfy. For these organisations, the bank balance does not necessarily equal the net value of reserves. Therefore, in drafting a reserves policy, it is useful to distinguish between cash and net asset reserves.
- Setting the level of reserves: Could you find ways to further your cause with access to more reserves? Each organisation will have a different level of what they believe to be an 'excess' of reserves. Minimum and target reserve levels could be established:

- A minimum net asset reserve level provides clear direction to management.
- Regularly monitoring actual reserves against this amount allows a board to easily gauge whether intervention is required.
- A target level of reserves, made up of a contingency amount and allowance for special projects, could be set. Once the target level of reserves is exceeded, an organisation could consider whether value is obtained by building up further reserves.

What do I do once a reserves policy is implement?

Regularly review the reserves policy to ensure it is still appropriate.

Regular financial reporting which incorporates actual reserves and tracking against minimum and/or target levels. Reporting could be aligned around key funding calendar dates and be presented graphically.

If your plan is to accumulate funds, consider what strategies will be pursued to achieve this, and what level of risk is acceptable to your organisation?

For more information on the Charities Act Review visit: http://www.dia.govt.nz/charitiesact