# SAVING FOR A RAINY DAY: CHARITY RESERVES

Charles Mitchell[1]

## A. Introduction

Charity trustees are generally free to decide for themselves how to pursue their charitable objects. Hence they are generally free to decide how much they want to spend on staff, equipment, premises, and other outgoings. The questions can therefore arise in practice, whether their expenditure is appropriately targeted towards the fulfilment of their purposes, and whether they have obtained good value for money[2] — and they may run into trouble with the Charity

---

1 Reader in Law, King's College, London. A draft of this article was discussed at a staff seminar at the University of Newcastle Law School in February 2002, and I am grateful to Alison Dunn and the other seminar participants for their valuable comments. My thanks also go to Simon Boyd for helpful background information, and to Jonathan Garton for his research assistance.

2 Some services cost more than others; expensive services may or may not be worth more to a charity's users than cheap ones; the provision of cheap services to many people may or may not be as socially valuable as the provision of expensive services to a few people. Undertaking a value for money analysis can help charity trustees to make strategic decisions by calculating the unit subsidy required for each of the services which their charity undertakes, but ultimately these decisions must also rest on their perception of the social value of the services in question: M Hudson, *Managing Without Profit: The Art of Managing Third-Sector Organisations* 2nd edn (Penguin: Harmondsworth, 1999), 131. Hudson describes how "an organisation of people with disabilities carried out a review of the cost of services" which yielded the following figures:

| | Income £000s | Expenditure £000s | Subsidy £000s | Users | Unit subsidy |
|---|---|---|---|---|---|
| Holiday service | 15 | 55 | 40 | 200 | £200 |
| Help line | — | 25 | 25 | 2500 | £10 |
| Residential care | 100 | 120 | 20 | 10 | £2,000 |
| Employment advice | 50 | 60 | 10 | 400 | £25 |
| Equipment loan | 10 | 25 | 15 | 500 | £30 |

Commissioners if they spend too large a percentage of their income on wages and overheads, particularly if they are personally benefited by this expenditure.[3] The purpose of this article is to consider a rather different question, however, namely what charity trustees should do if they find that their income outstrips their immediate spending needs, and they would like to put some of it aside for a rainy day. Obviously, many charity trustees do not find themselves in this happy position, but for those who do, the question arises, whether they are free to set up a reserve fund, or whether the law, as interpreted by the Charity Commissioners, places limits on their freedom to do this. Writing twenty years ago, Michael Chesterman wrote of charities which accumulate reserves that "the principal issue posed by this process of accumulation is whether, and if so, at what point, it may contradict a charity's role as a spender, not a saver of donated resources with a view to improving social welfare".[4] The aim of this article is to cast some light on this question by examining why charity trustees might wish to build up their reserves in practice, and by considering some of the

---

He writes that "as a result of the review, the board agreed a strategy of: expanding employment advice because it was providing excellent value for money; reducing the holiday service because similar holidays were available from other charities at a lower cost; negotiating increased fees from local authorities to reduce the unit subsidy of the residential care home".

3 D Kennedy and T Baldwin, "Charity is Wound Up During Investigation", *The Times*, 26th Nov 1999: the Adlearn Foundation was wound up by the trustees and £3.9 million distributed to other charities, when the Charity Commission initiated an inquiry into the charity's activities after checks raised concerns over employee remuneration among other matters; R Savill, "Children's Charity Officials Suspended", *The Daily Telegraph*, 8th February 2002: four officials of the Care and Action Trust for Children with Handicaps were suspended by the Charity Commissioners pending the outcome of an investigation which revealed that some 80% of the charity's income was spent on wages and overheads, and that only £262,000 of the £1,318,000 raised for the charity in 2001 was spent directly on its service users. In their leaflet on *The Hallmarks of a Well-Run Charity* CC 60 (Charity Commission: London, 2001), the Commissioners consider that "it is a false economy to cut administration below the level needed to manage the charity properly. But every charity should be able to show that it has kept administrative costs to the minimum consistent with high standards of management." For discussion of the related problem of charities incurring excessive fundraising costs, see A C Burgess, *Tolley's Charity Investigations* (Butterworths Tolley: Croydon, 2000), 201-2; Charity Commission, *Charities and Fund-Raising*, leaflet CC 20 (Charity Commission: London, 2001), esp para 5: "some forms of fund-raising can be costly and it is important to be sure that the costs will be justified in terms of a realistic return." See too the Charity Commission's reports of its inquiries under the Charities Act 1993, s.8, into the following organisations, available on-line at http://www.charity-commission.gov.uk: Baby Assist; Foundations for Nephrology Ltd; People Care North West; and Prize Promotions Ltd.

4 M Chesterman, *Charities, Trusts, and Social Welfare* (Weidenfeld & Nicholson: London, 1979), 377.

reasons why they should encouraged to do so, and some of the reasons why they should not.

The following discussion will be divided into five parts: some preliminary comments on the Charity Commission, and on terminological difficulties, will be followed by discussion of the three main reasons why charity trustees might wish to build up reserves in practice.

**B. The Charity Commission**

As readers of this journal will surely be aware, the Charity Commission is a non-ministerial Government department charged with the oversight of charitable activities in England and Wales. Its particular duties include the maintenance of a public Register of charities; the investigation and remedying of misconduct by charity trustees and the abuse of charitable assets; the provision of advice to charity trustees to make the administration of their charity more effective; and the making of Schemes and Orders to modernise the purposes and administrative machinery of charities and to give trustees additional powers.[5] In execution of their advisory function, the Charity Commissioners have published many informative leaflets targeted at charity trustees, including one which is particularly relevant to the present discussion, on the subject of *Charities' Reserves*.[6]

Like other Government departments, the Charity Commission must implement the ongoing Open Government initiative, by extending public access to official information and responding to reasonable requests for information by members of the public.[7] One of the ways in which the Charity Commissioners have done this is to publish the operational guidance notes on various aspects of the

---

5 For background information on the Charity Commission's status and activities, see H Picarda, *The Law and Practice Relating to Charities* 3rd edn (Butterworths: London, 1999), 374-387 and 578-601; C Mitchell, "Reviewing the Register", in C Mitchell and S Moody, *Foundations of Charity* (Hart Publishing: Oxford, 2000) 175, 176-188; P Luxton, *The Law of Charities* (OUP: Oxford, 2001), 421-482.

6 Charity Commission, *Charities' Reserves* CC19 (Charity Commission: London, 2001) (hereafter, "*Charities' Reserves*").

7 The Government's *Code of Practice on Access to Government Information* is available on-line at: http://www.lcd.gov.uk/foi/ogcode982.htm. The Charity Commission's operational guidance notes on Open Government can be found at: http://www.charity-commission.gov.uk/supportingcharities/ogs/index045.asp.

Commission's activities which are circulated to Commission staff,[8] and as part of this programme they have recently published their operational guidance notes on *Charity Income Reserves*.[9] These notes also give a valuable insight into the Commissioners' views on the subject.

The Commissioners have now also announced that they are in the process of writing a Regulatory Report on the subject of Charity Reserves, which:[10]aims to explore the way in which charities balance keeping a reserve with providing for their current beneficiaries. It will provide hard evidence on the true incidence of reserves in the sector, illustrate the range of reserve levels in operation and how charities have calculated them. We are not seeking to set a ratio or a desired reserve level but will explore the range and quality of different disclosure policies and examine the effects of these policies on wider concerns such as obtaining funding from grant making institutions.

It is hoped that the discussion in this article will inform the debate that will undoubtedly be generated within the charity sector when the Charity Commissioners' report is published.

## C. Defining "Charity Reserves"

Unfortunately, there is no generally agreed definition of the term "charity reserves", and this has tended to inhibit the general understanding of the law and policy issues in this area. The Charity Commissioners use the term in their operational guidance notes to describe "that part of a charity's income funds that is freely available for its general purposes after it has met its commitments and covered its other planned expenditure", but they concede that the term "has no legal definition in relation to charities and [is] … used differently outside of the Commission":[11] for example, "in accounting, 'reserves' is often used very

---

8 Charity Commission, *Operational Guidance*, available on-line at: http://www.charity-commission/supportingcharities/ogs/ogexplan.asp.

9 Charity Commission, *Operational Guidance: Charity Income Reserves* (hereafter, "*Charity Income Reserves*"), available on-line at: http://www.charity-commission.gov.uk/ogs/index043.asp.

10 Announced on the Charity Commission web-site at: www.charity-commission.gov.uk/enhancingcharities/reserve.asp.

11 *Charity Income Reserves*, above n 8, A1, para 1.

widely indeed" and is likely to include many of the funds which the Commissioners themselves exclude from their definition.[12]

The Commissioners use the term "charity reserves" in the same way in their leaflet but, as they concede there, this definition does not take in two types of funds that arguably should be counted as reserves as well, namely expendable endowment funds — i.e. capital funds which the trustees are entitled to convert to income — and designated income funds — i.e. funds which have been earmarked by the trustees for a particular project without restricting or committing the funds in a legally binding way. Arguably both these types of funds should be counted as reserves because "in each case the trustees are free to regard the funds, if they so choose, as available for general purpose expenditure".[13] However, the Commissioners exclude expendable endowment funds from their definition because "in reality many charities with an expendable endowment depend on the income it produces to fund core or continuing activities ... [and] endowment cannot be regarded as free if a charity has that degree of dependence on income from it",[14] an argument which excludes from consideration those charities who do not depend on expendable endowment for the purposes described. They also seem to exclude designated funds from their definition because they expect that in practice the trustees will use the funds for the designated purpose, and they stress that "a charity will not be justified in creating, or transferring resources to, a designated fund where the main purpose of doing it is to allow the charity to show a reduced level of reserves".[15] But for all that, the Commissioners still accept that "the designation may be cancelled by the trustees if they later decide that the charity should not proceed or continue with the use or project for which the funds were designated",[16] suggesting that the policy concerns which arise in connection with general purpose income arise with scarcely diminished force in connection with designated income funds.[17]

---

12 *Charity Income Reserves*, above, n 8, B1, para 1.

13 *Charities' Reserves*, above n 5, para 12.

14 *Charities' Reserves*, above n 5, para 16.

15 *Charities' Reserves*, above n 5, para 22.

16 *Charities' Reserves*, above n 5, para 19.

17 Cf A Poffley, *Financial Stewardship of Charities* (Directory of Social Change: London, 2002), 67: "To conclude unilaterally that all designated funds are not reserves is too crude a judgment. Consideration needs to be given as to why the designation has been made, and in what form such funds are held. Ignoring designated funds that could be used by the trustees in extreme circumstances would encourage the trustees to build higher reserves than are necessary".

For these reasons, and because their own definition is confusingly and unnecessarily different from that employed by many charities,[18] the Charity Commissioners would do better to adopt a wider definition which would take in general purpose income funds, designated income funds, and expendable endowment. So, for example, they could usefully say that their policies on "reserves" extend to cover all "resources which are not needed immediately to fund agreed projects, but which carry no restriction for use as necessary in future".[19] This definition would not take in permanent endowment funds — i.e. restricted funds whose capital value must be held permanently as part of the charity's capital, and the income from which must be used for the purpose specified by the donor[20] - and restricted income funds — i.e. money given to the charity on the basis that it will be spent on a particular restricted purpose, such as money raised from a specific disaster appeal, for example.

### D. Future Income Fluctuations

One reason why charity trustees commonly wish to save reserves is that they wish to protect themselves against unpredictable dips in their future income, particularly where they are heavily reliant on donations and grants, but also where they hold funds in forms which might lose value as a result of inflation or movements in the market.[21] So, to take two well-known examples of charities

---

18 See e.g. the Guidelines on Charity Reserves issued by the Baptist Union of Great Britain for the benefit of Baptist churches (available on-line at: htttp//:www.baptist.org.uk): "By reserves, we mean those funds which could be available for use quickly to meet an emergency situation where a significant source of income has gone or been reduced. The definition of reserves does not include for example assets held for capital purposes or whose use is restricted by the conditions imposed by the donor. It may include funds designated by the charity for particular purposes since this designation can be reversed by the church if necessary and appropriate."

19 A definition proposed by M Drewett, "Special Report on Charity Fund Management: How To Avoid Confusion Over Reserve Funds", *The Daily Telegraph* 5th July 1995.

20 But note that the rules with regard to the investment of permanent endowment and the application of the income realized from it are being loosened up as the Charity Commissioners come to accept the concept of "total return investment" for charities: in this connection, see Charity Commission, *Operational Guidance: Endowed Charities: A Total Return Approach to Investment*, available on-line at: http://www.charity-commission.gov.uk/supportingcharities/ ogs/index083.asp.

21 J Claricoat and H Phillips, *Charity Law A to Z: Key Questions Answered* 2nd edn (Jordans: Bristol, 1998), 2, noting that "Trustees sometimes express the wish, particularly in inflationary times, to be permitted to invest part of their income systematically as a matter of course in order to protect the value of their capital". See too A Poffley, *Financial*

with large reserves,[22] the Guide Dogs for the Blind Association and the RNLI have both frequently justified their policy of amassing large reserves on the ground that their annual income might fall away in the future.[23]

The total assets of the RNLI are currently worth around £516 million, of which its invested funds are worth £345 million; its average annual gross income exceeded its average annual expenditure between 1st January 1997 and 31st December 2000 by around £17.5 million; and its projected gross income and expenditure for 2001 were both around £100 million. Nonetheless, according to the RNLI, "a much more useful measure and one used by the Charity Commission for comparative purposes is the level of free reserves in relation to annual expenditure ... [and by] this measure the RNLI would be able to support its volunteer crews for no longer than 20 months if it were to cease fundraising".[24] The RNLI's accounts for 2000, meanwhile, state that the RNLI's "reserve is set at a level to withstand any short-term setback, whether operational, in the investment markets, or in key sources of income, such as

*Stewardship of Charities* (Directory of Social Change: London, 2002), 65: "Charities need to hold reserves in ord er to ... protect the charity's funds from loss in value of the asset form in which they are held. If the charity's trustees choose to hold the funds placed in their trust in a form that can lose value as well as gain it, such as market investments, it must have contingency funding available so that in the event of the former happening the fund value can be restored."

22 Another less frequently cited example is the Bransby Home of Rest for Horses, whose total investments are currently worth £15 million, whose gross income outstripped expenditure by £2 million over the years 1999 and 2000, and whose spokesman stated in 1999 that the charity "needed significant reserves to ensure that it had adequate funds to fulfil its role": quoted in J Ungoed-Thomas, "Pet Charities Face Probe on Hoarded Cash", *The Sunday Times* 3rd January 1999. (Financial information taken from the Charity Commission web-site, and from the Charities Direct web-site: http://www.charitiesdirect.com.)

23 In addition to the information given in the text, see too: unnamed spokesman for RNLI, quoted in J Shaw, "Special Report on Business in Charity: Spend, Spend, Spend, or Invest Prudently?" *The Daily Telegraph* 1 June 1993: "It's sensible we shouldn't find ourselves with 210 lifeboat stations to maintain and no money if income goes down."; A Radevsky (spokeswoman for the Guide Dogs for the Blind Association), quoted in P Myers, "Charity Millions Face 'Guidance'", *The Guardian* 17th October 1994: "we are proud of the fact that we have considerable reserves. Our policy on reserves has been to invest legacies in order to ensure that clients can be guaranteed a guide dog throughout their life"; J C Oxley (Director General of Guide Dogs for the Blind Association), letter to *The Independent on Sunday*, 23 October 1994: "our reserves are not 'spare' but exist to safeguard our long-term commitment to provide replacement guide dogs".

24 "The RNLI's Financial Reserves", statement published on the RNLI's web-site at: http://www.rnli. org.uk. Information also taken from The Charity Commission web-site and the Charities Direct web-site.

legacies. The Trustees believe that this reserve should be set in the range of two to five years' cover of annual charitable expenditure".[25]

The total assets of the Guide Dogs for the Blind Association are currently worth around £192 million, of which invested funds are worth £167 million,[26] but its expenditure has outstripped its income every year since 1992 and its average annual gross income between 1st January 1997 and 31st December 2000 was just under £40 million, while its average annual expenditure over the same period was just under £49 million.[27] It states on its web-site that it keeps "a cushion of funds equivalent to two years' overheads to protect the guide dog service", and that the remainder of its reserves are "earmarked for new services"[28] - although it does not tell us whether these "earmarked" funds are simply designated funds which the trustees are legally free to apply as they please.

Whether it is really necessary for these particular charities to keep such large funds in the bank against the prospect of a future income fluctuations might be questioned,[29] but still it is evident that there are good reasons in principle why they and other charities should be entitled to keep *some* reserves in hand for this

---

25 Available on-line at: http://www.rnli.org.uk/downloads/aa2000.pdf.

26 Information taken from the Charities Direct web-site.

27 Information taken from the Charity Commission web-site.

28 "Facts about Guide Dogs", published on-line at: http://www.gdba.org.uk/aboutus/ facts.htm.

29 For the view that it is not, see e.g. Robert Sheldon MP, quoted in J Gerard and R Sylvester "Dogs Charity Faces Probe on Cash Reserves" *The Sunday Telegraph* 19th November 1995: "It is unbelievable that Guide Dogs for the Blind could be sitting on that much money. Charities should be raising money for a purpose - if they haven't got anything to spend it on, they should not be raising it." See too A Reed, "Charities: False Economy", *The Guardian* 12th Nov 1997: "The fact remains that [the RNLI] consistently spends less than it receives, and the public's continuing generosity is merely adding to reserves which increase hugely year on year." See too the open letter by the independent group Ethical Audit to the RNLI, quoted in S Parker, "Charity's £200m Surplus Revealed", published on the Society Guardian web-site, 3rd December 2001: "few of the generous public are actually aware of the RNLI's vast and unused reserves; many certainly would not make donations if they knew of them."

purpose.[30] These are aptly summarised in the Charity Commissioners' operational guidance notes as follows:[31]

Reserves which are too low may:

> present a risk of insolvency;
>
> hamper proper medium-term planning and the ability to take advantage of change and opportunity;
>
> cause charitable funds to be used inefficiently — for instance, in solving crises which could, and should, have been avoided; in entering into short-term contracts for the supply of goods and services when a longer term contract would have been cheaper and more efficient;
>
> create insecurity among beneficiaries, supporters and employees of the charity; [and/or]
>
> force the charity to disrupt or abandon aspects of its work as a result of a temporary drop in income or an unexpected expense.

The Commissioners also recognise that "a charity may need to maintain reserves at a certain level in order to protect against a decline or interruption of future sources of income, ... provide for regular fluctuations in income and expenditure, ... ensure continuity in the provision of a service, ... assimilate a

---

30 Cf J Claricoat and H Phillips, *Charity Law A to Z: Key Questions Answered* 2nd edn (Jordans: Bristol, 1998), 1: "Then there are charities which are not well endowed and which have to rely on funds which they generate themselves or raise from the public from year to year. The trustees of these charities often feel the need to set aside funds "for a rainy day", and most people would say that this was reasonable. Then there are the large charities with substantial operations which frequently rely heavily on public goodwill for their money. They, too, often feel the need for substantial reserves, and who would say that this was imprudent? Whatever the type of charity, there is widespread caution among trustees about spending rashly, and they rightly feel they could be criticised (at least by the public) if they sailed too closely to the wind financially".

31 *Charity Income Reserves*, above n 8, A1, para 3.

large legacy or donation which cannot be spent all at once, ...[or] assimilate an abnormally large dividend."[32]

Having said this, however, there are also some good reasons in principle why charity trustees should not be permitted to amass large reserves which they do not really need to protect themselves against income fluctuations. Pre-eminent among these is the fact that charities receive very significant tax advantages, and in particular they do not pay income tax on their investment income, because it is understood that they will use this money for publicly beneficial purposes — yet saving their income without ever spending it does not enure to the public good. Thus, in the words of one Charity Commission spokesman, "accumulating funds for no good reason is not a charitable thing to do".[33] The Charity Commissioners also note that:[34]

Reserves which are too large may:

> indicate inefficient administration — income funds which could be used to further the objects of the charity may be retained out of habit or unwarranted caution rather than with a definite end in view;
>
> cause public concern and bring that charity, or even charity generally, into disrepute — particularly where the charity continues to fundraise;

---

32 *Charity Income Reserves*, above n 8, C1, para 6.2.

33 Quoted in J Gerard and R Sylvester "Dogs Charity Faces Probe on Cash Reserves" *The Sunday Telegraph* 19th November 1995. See too S Lee (director of the Institute of Charity Fundraising Managers), quoted in S Lonsdale, "Whatever Tugs at the Heartstrings" *The Observer* 2nd October 1994: "Donors give money to charity in the expectation that it will be spent on the services provided by that charity, not to sit in a bank account"; *Charities' Reserves*, above n 5, para 2: "underlying much public discussion of charity reserves is the belief that holding significant amounts of reserves is tantamount to hoarding". In their Report of their inquiry into Baby Assist under the Charities Act 1993, s 8, the Commissioners state that they "warned the trustees that simply accumulating charitable funds and not applying them to its charitable objects is not acceptable, and that if this continued the Commission would consider removing BA from the register of charities" (para 7): the report is published on-line at: http://www.charity-commission.gov.uk/inquiryreports/baby.asp. However, it is questionable whether the Commissioners have the power to remove charities from the Register on the ground that they have been mismanaged by their trustees: in these circumstances, the proper steps for the Commissioners to take would be the removal of the trustees and/or the imposition of a Scheme.

34 *Charity Income Reserves*, above n 8, A1, para 3.

> cause conflict with other charities who may find it difficult to raise funds in a similar field but with a lower public profile, or for a less immediately emotive cause.

It follows from all this that the question whether it is appropriate for charity trustees to accumulate reserves against future income fluctuations and, if so, how much it is appropriate for them to accumulate, can vary widely according to the nature of the charity's purposes, current financial situation, and future financial prospects. This is recognised by the Charity Commissioners when they state that "if a charity can demonstrate to donors and others that it has good reasons to retain a particular level of income as a reserve ... then we consider that it is acting responsibly."[35] Charity trustees are required by SORP 2000 to state their reserves policy in their annual report even when their charity has little or no reserves,[36] although the Charities (Accounts and Reports) Regs 2000 make this mandatory only if the trustees already have a policy to disclose.[37] Even if they fail to justify and explain their reserves policy, the Commission has adopted as a very broad guideline the propositions that reserves may be "excessive" if they are in excess of three years' gross expenditure, or if the expected income return on unrestricted investments is more than twice as much as the charity's current gross annual expenditure.[38]

---

35 *Charity Income Reserves*, above n 8, B2, para 2.

36 Charity Commission, *Accounting and Reporting by Charities: Statement of Recommended Practice (revised 2000)* (Charity Commission: London, 2000), para 31(e). See too Charity Commission, *Charities SORP 2000 - What Has Changed* CC 62 (Charity Commission: London, 2001), para 10. See too the Commissioners' Report of an Inquiry into the Marc Fitch Fund Ltd, where they state at para 11 that they advised the trustees "that to justify the holding of reserves, the trustees should develop a reserves policy, based on a realistic assessment of their need for reserves, in accordance with the guidance set out in the Commission's leaflet" on the subject. The requirement that charity trustees form a reserves policy is consistent with the rule in equity that a trustee must make an active decision to exercise a power, whether it be a power to accumulate income or any other power: *Re Hay's ST* [1982] 1 WLR 202. A charity trustee which simply fails to distribute income without considering whether it should be accumulated therefore commits a breach of trust: P Luxton, *The Law of Charities* (OUP: Oxford, 2001), 640.

37 SI 2000/2868, reg 7(4)(k). For comment, see A Pianca and G Dawes, *Charity Accounts: A Practical Guide to the Charities SORP* 2nd edn (Jordans: Bristol, 2002), 79-83 and 262-3.

38 *Charity Income Reserves*, above n 8, C1, para 6.4. This recommendation is followed by the Clatterbridge Centre for Oncology, for example, whose reserves policy is published on-line at: http://www.wirralhealth.org.uk/ public_site/corporate/cco/reserves.shtml. The trustees reported in May 2001 that: "To ensure the financial viability of the fund and its ability to meet its ongoing commitments the charity will endeavour to maintain, on average, sufficient reserves to cover three years' expenditure. Management action will be required should the value of the fund exceed five times the annual expenditure, or fall below one years annual

In practice, reserves policies are usually expressed by relating the level of a charity's reserves to the level of its expenditure, a reflection of the fact that "the main rationale for holding reserves is to counter the risk to expenditure from uncertain funding", as Adrian Poffley remarks.[39] So far as formulating a reserves policy is concerned, he observes that "determining the appropriate size of reserves - sufficient *and* necessary - must be related to the [charity's] ... objectives".[40] One risk against which the trustees might wish to guard is that "funds held in asset forms might lose market value", and here "the need for judgement comes in when assessing how big a possible market drop to protect against."[41] Likewise, "calculating how much funding will be needed to finance expansion ... or pay for the replacement of fixed assets ... ought to be uncomplicated, based on a rudimentary business plan outlining what will need to be purchased and the anticipated costs of doing so."[42] However, he continues:[43]

---

expenditure."

39 A Poffley, *Financial Stewardship of Charities* (Directory of Social Change: London, 2002), 71.

40 *Ibid*, 67.

41 *Ibid.*

42 *Ibid.* Saving for capital-intensive projects is discussed in part E below.

43 *Ibid.* At 70, Poffley gives the following example of a simple matrix laying out a three-stage process of identifying a sample charity's funding requirement, identifying its secured funding, and calculating its funding risk in monetary terms:

| | A | | B | C = A - B | D | E = C x D |
|---|---|---|---|---|---|---|
| Activity | Total funding required £000 | Income source | Secure funding £000 | Total at risk £000 | Degree of risk % | Risk £000 |
| Specific activity 1 | 200 | Funder X | 120 | 80 | 30 | 24 |
| Specific activity 2 | 100 | Restricted fund Y | 100 | 0 | 0 | 0 |
| General activity 3 | 300 | Funder Z | 200 | 100 | 50 | 50 |
| **TOTAL** | **600** | | **420** | **180** | | **74** |

> "determining the exposure to unexpected falls in income ...is more difficult. Gillingham and Tame[44] propose a number of ways to consider this including actuarial forecasting, risk assessment and scenario planning. Each has its merits although most charities would find the risk assessment or scenario planning approached most logical and practical to undertake, and suitable to quote when explaining the level of reserves held or targeted. Relatively crude judgments can be made; this does not have to be a complicated, scientific exercise. After all, the aim of the exercise is only to give the charity an indicative feel for the size of funds it ought to put to one side in case an uncertain event happens in the future."

## E. Capital Intensive Projects

As the Charity Commissioners recognise, another reason why charity trustees might wish to save surplus income is that they wish to build up funds in order to pursue a particular capital-intensive project that they cannot fund out of a single year's income - a church spire appeal, for example. So, the Commissioners list the following as valid purposes for saving reserves:[45]

> a repairs and renewals fund where there is an asset or group of assets clearly identified and the amount is reasonable in relation to the expected repairs account;
>
> a fund to save for an event which takes place every so often — for example, a conference taking place every ten years;

---

44 S Gillingham and J Tame, *Not Just for a Rainy Day* (NCVO: London, 1997).

45 *Charity Income Reserves*, above n 8, C1, paras 5.5 and 6.2, and also E6, where the Commissioners give a specimen example of a charity whose trustees have resolved to build up a fund to purchase patient care equipment for a hospital once it has opened. See too Law Commission, *The Rule Against Perpetuities and Excessive Accumulations* (Law Com No 251, 1998), para 9.32, discussed in P Luxton, *The Law of Charities* (OUP: Oxford, 2001), 68-9. In practice, a charity might well put money for purposes such as these into a designated fund, but in principle the trustees are equally entitled to treat the money as free income reserve, and, as previously discussed, the legal consequences of either step will be the same.

> money put aside for a building project that is planned to be carried out in the future but for which the resources needed cannot be found all at once.

Into this category we might also place some of the costs of expanding the charity's activities, for as Adrian Poffley writes, "if the charity is to grow, it needs injections of money to finance investment in fundraising for example".[46]

One commentator who is troubled by the phenomenon of charities amassing unnecessarily large reserves has proposed that all charities should be granted tax relief at the time when they spend their money rather than the time when they receive it.[47] In his view, this would encourage them to spend their money rather than sit on it, and give them the benefit of public subsidy only at the point when their activities actually benefit the public. Against this, however, it might be argued that encouraging charities to spend money for the sake of spending it, simply in order to obtain tax reliefs, might not be a very positive step, particularly in the case of charities with long-term plans which they feel compelled to abandon for the sake of short-term gains.

An unusual example of a charity which has been building up funds for a one-off event which it hopes will happen in the future, but which has recently run into trouble with the Charity Commissioners, is the Panacea Society. The Panacea Society was founded in 1926 for the purpose of advancing the Christian religion, interpreted in accordance with the teachings of Joanna Southcott, a Devonshire farmer's daughter who lived from 1750 to 1814.[48] As readers familiar with the background to *Thornton v Howe*[49] will know, Southcott predicted the Second Coming of Christ, and subsequently came to believe that she herself would give birth to the Messiah. In 1813, when she was sixty-four, she claimed to be pregnant, but in the event she did not bear a human baby, although the members of the Panacea Society believe that she did bear a "spiritual child". On her death

---

46 A Poffley, *Financial Stewardship of Charities* (Directory of Social Change: London, 2002), 65.

47 A Reed, "Charities: False Economy", *The Guardian* 12th Nov 1997.

48 Information drawn from: J King, "Watch Out, There's A Charity About", *The Spectator* 28 October 2000; Charity Commission press-release, "Healthy New Chapter for Panacea Society", 11th July 2001; S Bates, "Mystic Society Charitably Sells Off the Followers' Silver", published on the SocietyGuardian web-site on 13th July 2001 (http://www.society.guardian.co.uk); A Martin, "A Long Wait", *The Sunday Telegraph Magazine*, 26th Aug 2001.

49 (1862) 31 Beav 14.

the following year, Southcott left a sealed box containing divine messages which she stipulated should be opened by the Archbishop of Canterbury in the presence of twenty-four Church of England bishops, but to date the Society's members have been unable to persuade the Anglican bishopric to convene for this purpose.[50] The members of the society are now few in number. The society owns twenty-nine properties in Bedford and other assets which are now worth approximately £15 million. Between 1st January 1997 and 31st December 2000 the society's gross income was £2,785,158, and its total expenditure was £1,159,167.[51]

In recent years the society listed its religious activities in annual returns to the Charity Commission as "the acquisition of property and the accumulation of funds". This led the Commission to become "concerned" that the charity was not putting its assets to "effective use", and in 2001 the trustees were advised that if they wished the society to keep its charitable status, they must do something more with the society's assets. In response to this, the trustees agreed to sell off a large quantity of furniture which they had stored in Bedford for many years. They also agreed to a scheme dated 16th August 2001, amending the society's objects to include the relief of poverty and sickness and the advance of education in furtherance of Christian principles, and pursuant to their new powers they made charitable donations of £150,000 to Bedford Hospital and £100,000 to Bedford Child Development Centre.

It may be questioned whether the Charity Commissioners acted appropriately in this case. The members of the Panacea Society wish to accumulate funds against the time of the Second Coming because they believe that this is what they should do. If the Panacea Society is entitled to charitable status as a religion at all, then surely it is the members of the Society — and not the Charity Commissioners — who should decide whether or not amassing funds is an "effective" method of pursuing their religious objects.

---

50 Martin, above n 47, 24, reports that "throughout the 1930s the Society's ads carried a disclaimer saying that a certain box — opened in 1927 in the presence of just one bishop and found to contain nothing but a lottery ticket and a rusty gun — was the wrong one."

51 Information taken from the Charity Commission web-site.

## F. From Grant-Dependence to Financial Independence

A third reason why charity trustees might wish to build up reserves is similar to the first reason discussed above, but more radical: they do not merely wish to protect themselves from the adverse effects of future income fluctuations; they wish to transform the nature of their income stream altogether, by building up sufficient income-generating capital to free themselves from the need to fund their activities out of grants and donations. On one view, charity trustees should not merely be allowed to do this, but should be encouraged to do it because the present grant dependence of many charities compromises their independence from grant-making bodies — usually central or local government — to the long-term detriment of the voluntary sector.[52]

As matters currently stand, however, the Charity Commissioners do not regard the conversion of income into endowment as a legitimate goal for charity trustees to adopt when formulating their reserves policy. They state in their leaflet on *Charities' Reserves* that:[53]

> Trustees who make a regular practice of reinvesting some of their income with a view to building up the principal of their endowment will need to think very carefully about the justification for doing this, since the income should normally be spent.

And they add that:[54]

> Reinvesting income generated from capital funds does not have the effect, legally, of converting the income into extra capital. The reinvested funds remain income funds and must be treated as such: adding them to the principal does not overcome this obligation.

---

52 For a different approach to the same problem, see M Hayday, "Kick-Starting a Capital Market for Charities", 4th Sept 2000, published on-line at: http//:www.cafonline.org, arguing for the creation of charity banks.

53 *Charities' Reserves*, above n 5, para 17.

54 *Charities' Reserves*, above n 5, para 18. But cf para 28, where the Commissioners note that "some trustees have in their governing document a power to convert income into capital, which is not the same as a power to hold income in reserve. Converting income into capital takes the converted resource outside the scope of reserves (since our definition of reserves does not include any capital funds)." On this point, see too *Charity Income Reserves*, above n 8, B2, para 1.3.

Again, in their guidance notes, they state that:[55]

> Reinvesting income generated from endowment funds does not have the effect legally of converting the income into extra endowment, unless there is a power or a duty to add the income to the endowment. The reinvested funds remain income funds, and need to be taken into account when deciding what is an appropriate level of reserves.

The duties of charity trustees when investing income were recently revisited by the Commissioners in the course of their Inquiry into the Schreib Trust, a grant-making charity which had invested some £3 million in connected companies in the form of loans, whose trustees had no formal reserves policy, and whose income for 1998 was £4.6 million whereas its expenditure on charitable activities during the same year was only £500,000.[56] The trustees were advised to obtain the Commissioners' prior advice before lending money to a connected company, and they were also advised that:[57]

---

55 *Charity Income Reserves*, above n 8, B1, para 3. See too *Charity Income Reserves*, above n 8, E8, where the Commissioners discuss a specimen example of a charity whose trustees adopt a reserves policy of coveting income into endowment, and comment that "building up funds to 'enhance income returns' is unlikely to satisfy the trustees" general legal duty "to apply charitable funds within a reasonable time of receiving them."

56 The Report of the Commissioners' Inquiry can be found at: http//:www.charity-commission.gov.uk/schreib.htm. Similar lessons are to be learnt from the Commissioners' Inquiries into Mayfair Charities Ltd and Integrate Services Ltd, also published on the Charity Commission web-site. It was said of the latter in Parliament that "the situation that occurred at Integrate — which, on an annual turnover of about £700,000, was building up a surplus almost equivalent to that of its successor organisation, which had national revenues of £22 million — cannot be allowed to occur again. It is a matter of ensuring that money given for the care of residents is used for that care, not to build up the assets of another charity" (Hansard, HC Debs, 2nd Nov 2000, col 942, Helen Jones MP). See too the Select Committee for Public Accounts' investigation of Motability, published as *Twentieth Report for the Session 1997-98* (available on-line at http//:www.parliament.the-stationery-office.gov.uk), para 37: "We note that reserves of £86.7 million had been accumulated. Of that, £35 million, mainly from surplus reserves, is held and invested by the Motability Anniversary Trust Fund to generate charitable income for Motability. ... We are concerned that the Motability Scheme has generated substantial surplus reserves of £61.9 million from the charges levied upon users, over and above the £19.3 million deemed necessary by the banks to safeguard the Scheme. We note that this meant that they had taken money from one group of disabled people and were using it to subsidise another. We urge Motability to ensure that if surpluses are generated in the future, they are identified and distributed as quickly as possible to those customers who contributed to them".

57 *Ibid*, "Outcomes", para 3.

they have a general duty to expend income in furtherance of the charity's objects, rather than invest these funds.

Finally, we may note that even if the Charity Commissioners were ever to accept that charity trustees might build up reserves with a view to increasing endowment, the transition from "grant-maintained" to "self-funding" status would very probably be a bumpy one in practice. The trustees would have to persuade the Inland Revenue that their retention of income for this purpose entitled the charity to exemption from income or corporation tax because it constituted an "application" of the money for charitable purposes as required by the Income and Corporations Taxes Act 1988, s.505(1).[58] Moreover, possession of a high level of reserves is often given as a reason by local authorities and other grant-making bodies why they will not make a grant to a particular charity.[59] Hence a charity might well have to move swiftly from holding a small to a large level of reserves, to avoid falling between stools: the worst thing that could happen would be that the charity would have sufficiently large reserves for grant-makers to turn it down, but insufficiently large reserves to fund itself out of investment income.

---

58 In this connection, note *IRC v Helen Slater Charitable Trust Ltd* [1982] Ch 49, discussed in P Luxton, *The Law of Charities* (OUP: Oxford, 2001), 75.

59 Smith & Williamson, *Newsletter: Charities: Autumn 2001*, published on-line at: http//:www.smith.williamson.co.uk. See too the Application Form for Grant Aid issued by Cambridgeshire County Council, published on-line at http//:www.camcnty.gov.uk/sub/grants/application.doc. This requires applicants to state their annual expenditure and their reserves at the end of the year, and stipulates that if an applicant's reserves are more than half its annual expenditure, "then the Council is likely to reduced the amount of grant awarded (if any)."