Assessing the financial reserves of English and Welsh charities on the eve of the Covid-19 pandemic

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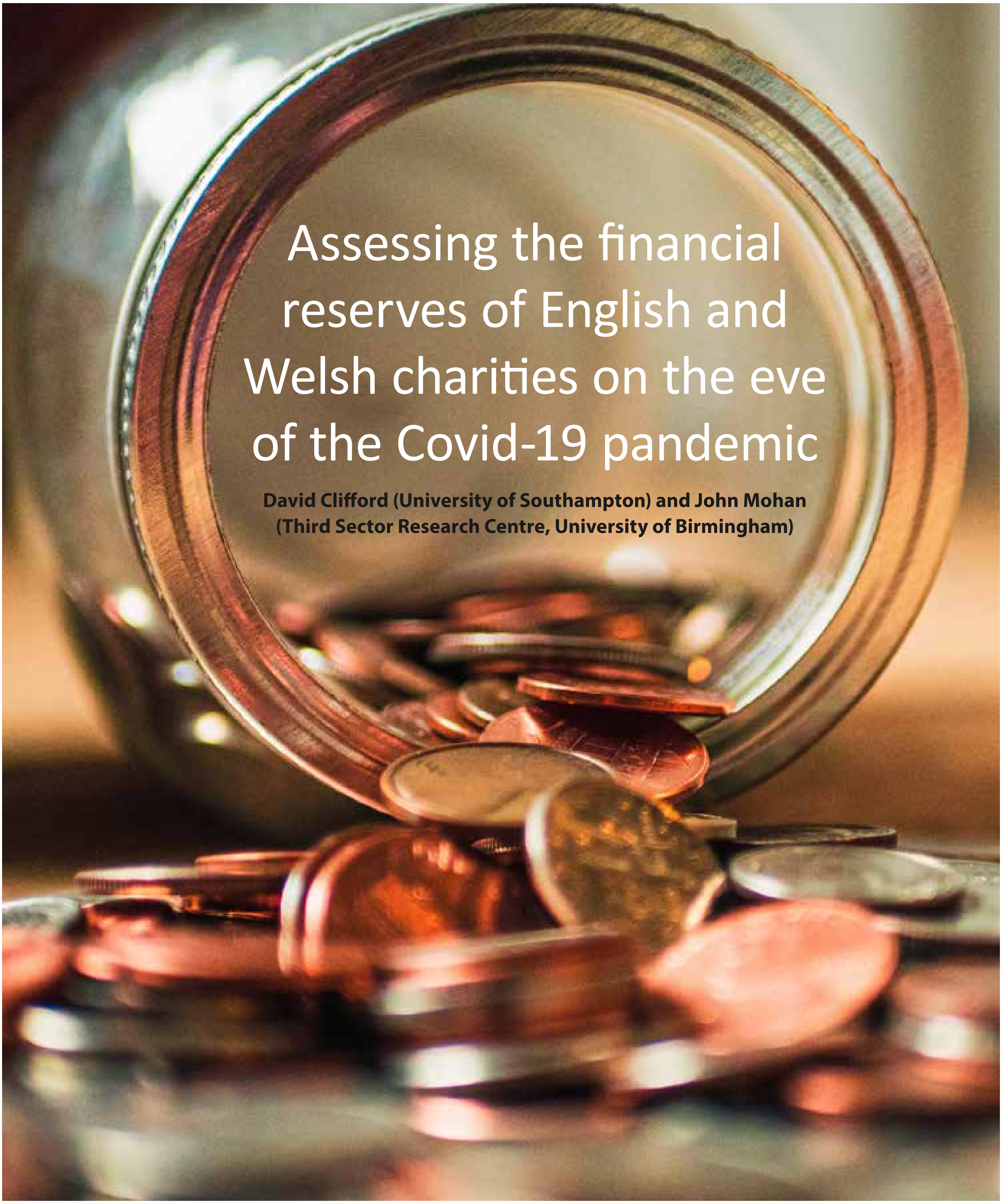

Key findings

We analyse over 12,000 sets of charity accounts and look at the relationship between reserves and expenditures.

We find that:

1. many charities have low levels of reserves, equating to less than one month of expenditure for over one fifth of organisations with one tenth of charities having a few days reserves, or less;
2. there are variations by size, with organisations in the £500k – £1Mn range being slightly better placed than the very largest organisations;
3. reserve levels are likely to be lower for organisations whose main income source indicates a reliance on sales of services and contracts, rather than on fundraising or donations;
4. longer established organisations have higher levels of reserves;
5. the field in which charities operate matters – for example, charities that operate internationally tend to have lower levels of reserves than charities involved in research or in housing.

About this project

Our research is being funded by the Economic and Social Research Council as part of the UK Research and Innovation call for studies that can contribute to understanding and alleviating the social impact of the pandemic. The project will provide an analysis of the variegated impacts on charities of the very severe financial constraints they will experience due to the immediate and longer-term economic effects of the Covid-19 crisis. Building on our extensive prior research on the finances, distribution and exposure to risk of charities we will utilise large-scale databases constructed since 2008 to assess the distribution of financial vulnerability across the population of charities. The project is a collaboration between the universities of Birmingham, Southampton and Stirling, and the National Council for Voluntary Organisations (NCVO).

Introduction

Charities in the UK are on the front line of supporting communities and individuals during the Covid-19 crisis. Those organisations face rapidly-increasing demand for support at the same time as their incomes have been shrinking dramatically.

Charities raise funds from a range of sources, which have been affected by both the economic effects of Covid-19 and by the measures taken to minimise the spread of the disease. For example:

1. Community fundraising events – events that often take place in the spring and summer – have been cancelled;
2. Earned income has reduced through the enforced closure of charity shops;
3. Social distancing measures mean that organisations with buildings can no longer generate income from renting property either to community groups or from running conferences;
4. For charities that hold financial assets, investment returns may be reduced due to the effects of the economic shock;
5. There are concerns that the economic downturn will adversely affect individuals' earnings; individual donors may also choose to support other causes (notably, at present, health-related causes).
6. The largest peacetime increase in government borrowing is likely to have consequences for future levels of charities' public funding.
7. The precise effects on individual organisations will vary depending on their funding mix. Nevertheless the challenge for the charitable sector is 'consistent and widespread' such that there is concern about the implications for the individuals and communities that charities serve (House of Commons, 2020, p.5).

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Reserves, risk and resilience

The level of reserves that charities hold is an important aspect of their resilience. Reserves provide 'financial flexibility' to charities affected by a shock to their charitable income. Measuring the level of reserves helps capture how well charities are able to sustain expenditure and activity in the face of a sudden loss of income. Charities with low levels of reserves may be thought of as 'financially vulnerable' to the extent that they are more likely to resort to immediate reductions in service delivery when they experience a financial shock. In contrast charities with higher levels of reserves are more resilient; they can smooth out imbalances between income and expenditure, and thereby maintain existing levels of activity.

Policy guidance

In England and Wales, Charity Commission guidance advises that a charity's reserves policy should be informed by an appropriate assessment of financial risk. This is regarded as an aspect of good governance. Guidance from the Charity Commission acknowledges that an appropriate level depends on the unique circumstances of each charity. There is a tradeoff. Resilience requires that financial resources are strategically accumulated, so as to minimise the risk of unplanned closure and to ensure that mission-related activities can be maintained. On the other hand there is a need to ensure that financial resources are not excessively tied up: this would unnecessarily limit the benefits that a charity provides.

The Charity Commission (2018, p.7) advise that, in weighing these differing objectives, a charity's assessment of an appropriate level of reserves should be informed by a combination of the following:

- 'its forecasts for levels of income for the current and future years, taking into account the reliability of each source of income and the prospects for developing new income sources'
- 'its forecasts for expenditure for the current and future years on the basis of planned activity';
- 'its analysis of any future needs, opportunities, commitments or risks, where future income alone is likely to fall short of the amount of the anticipated costs';
- 'its assessment, on the best evidence reasonably available, of the likelihood of a shortfall arising which means that reserves are necessary, and the potential consequences for the charity of not being able to make up the shortfall'.

The wording of this guidance is significant. The reserves policy should be informed by 'its forecasts for levels of income for… future years' and 'the best evidence reasonably available….of the likelihood of a shortfall arising which means that reserves are necessary'. In setting their reserves policy, a charity might consider changes in the economy, changes in government funding, and longer-term changes in the preferences of donors, and set these against what they know about either their own financial trajectories, or those of broadly comparable fields of activity, to provide an indication of the likely variability in annual income.

However, none of this 'best evidence' would have encompassed the circumstances of a global virus pandemic or the associated public health measures designed to mitigate its impact. The scale, pervasive impacts and rapid onset of the Covid-19 crisis are beyond the scope of many charities' assessment of risk. This increases charities' financial vulnerability: in the present context, the level of reserves held by many charities may not be sufficient to ensure service continuity.

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Data and Method

We use data from the Charity Commission to describe patterns in the level of charities' reserves. The level of charitable reserves is defined in accordance with the Statement of Recommended Practice, which provides guidance on the preparation of charitable accounts. Charitable reserves relate to the amount of 'unrestricted funds' that are freely available for use in furtherance of the charity's objectives. They therefore exclude 'restricted funds' that can only be used for particular purposes which may have been specified by a donor. They normally exclude endowments held for the benefit of the charity with an aim to provide a longer-term income. They also exclude fixed assets, including property, that cannot be easily sold without affecting the operation of the charities' activities. They may also exclude 'designated funds' set aside for a particular use.

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For each charity, we consider the ratio of reserves to their headline expenditure, and we examine how many months of expenditure their level of reserves represents. We consider how the distribution of this ratio varies according to the size of the organisation, its main income stream, the age of the organisation, and the subsector of charitable activity in which it operates (health, social care etc). The distribution of the reserves/expenditure ratio is highly positively skewed **(Figure 1)**, with a long tail such that a small number of charities have very high levels of reserves in the context of their annual expenditure. Therefore, as a measure of the average reserves/expenditure ratio, we use the median, since the mean is sensitive to the small number of large outlying values. The median figure better represents the reserve levels of the 'typical' charity.

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More generally we consider how a range of percentiles (a measure of the percentage of observations that fall below a point in the distribution) of the reserves/expenditure distribution varies according to our covariates (or independent variables, such as characteristics of the charities); we thereby describe the wider distribution of charitable reserves rather than focusing on the average alone. This is because there is particular substantive interest in measures beyond the average: indeed, given the focus on charities that may be most vulnerable to the circumstances associated with Covid-19, there is a particular interest in charities at the lower tail of the distribution with relatively low levels of reserves. Therefore – alongside considering the median (the 50th percentile) and the 75th percentile – we consider how the 10th and the 25th percentile of the reserves distribution varies according to our covariates. We present our results graphically using boxplots (see **Figure 2** for a key to interpreting these).

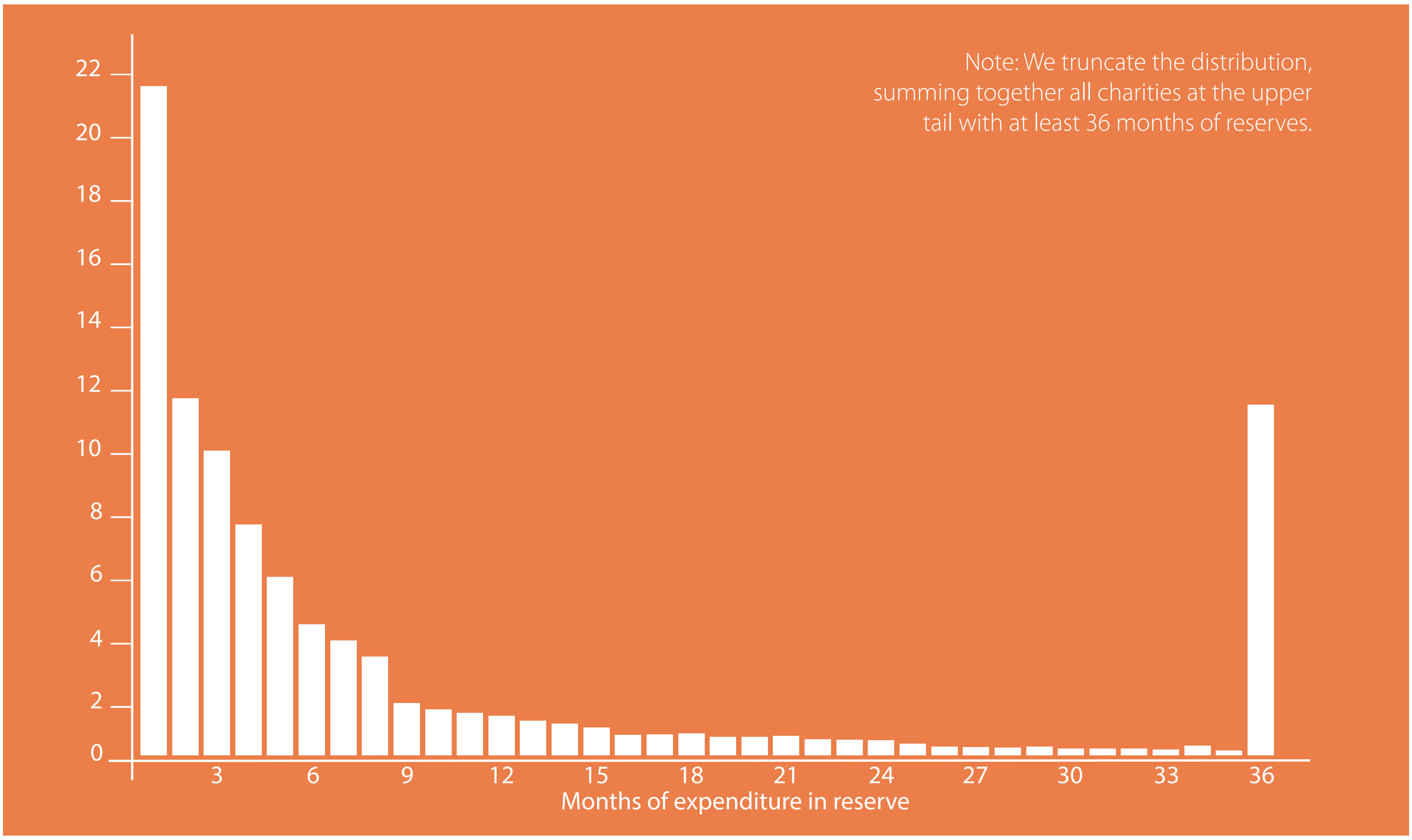
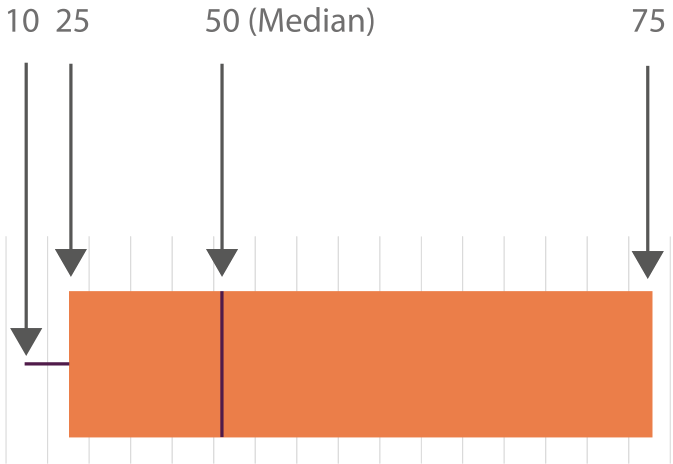


Figure 1: Histogram of charities according to their months of expenditure in reserve

Figure 2: Key to reading percentiles from boxplots



The analysis in this paper has its limitations. First, our analysis is restricted to the c.12,700 charities with an annual income of at least £500,000, the level at which mandatory reporting of levels of reserves is required in a charity's annual return to the Charity Commission. Second, we examine data for financial years ending in 2018 and 2019. Charities have ten months following their financial year end to submit their annual return, so we do not yet have data for financial years ending in 2020. Third, there is the possibility of variations in the interpretation by charity accountants of what funds 'are freely available for use' which may affect the consistency of the reporting of these data to the Charity Commission.

Key findings

Many charities have low reserve levels

Figure 1 presents a histogram of the distribution of charities, with an income of at least £500,000, according to their level of reserves. 21 per cent of charities have less than one month of expenditure in reserve; a third (33 per cent) of charities have less than two months; 43 per cent of charities have less than three months. Meanwhile there is a long upper tail in the distribution such that 10 per cent of charities have reserves of at least 41 months of expenditure.

A significant proportion of charities report having virtually no reserves: the 10th percentile of the reserves distribution is 0.02 months of expenditure. The 25th percentile is 1.32 months. The median charity has 3.92 months of reserves. So even among these larger organisations, which all have an income of at least £500,000, nearly one quarter could only operate for approximately 5 weeks solely on the basis of their reserves.

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In general, larger charities have lower levels of reserves

Considering variations by charity size, in general larger charities have lower levels of reserves as measured by months of expenditure. For example, the median charity with an income of between £500,000 and £1m has 4.21 months in reserve; the median charity with an income of between £1m and £10m has 3.78 months in reserve; the median charity with an income of between £10m and £100m has 3.30 months in reserve, and the median charity with an income of more than £100m has 2.86 months in reserve. However, importantly, irrespective of size we find a lower tail of charities with very low reserve levels: for all size categories below £100m, the 10th percentile of reserves is less than half a week of expenditure (0.00 months, 0.07 months and 0.05 months respectively); for charities above £100m, the 10th percentile is less than two weeks (0.28 months).

The distribution of reserves also varies according to the charities' majority income stream

We classify charities according to whether they receive the majority of their income through 'voluntary' donations (gifts and donations including legacies; grants that provide core funding), through 'generating funds' (fundraising events; shop income; providing goods and services other than for the benefit of the charity's beneficiaries), through their 'charitable activities' (sale of goods or services as a charitable activity; grants and contracts for the provision of goods or services as part of charitable activities), through investment; or through 'other' income streams. The results show that charities whose main income comes through their charitable activities tend to have the lowest reserve levels, with a median of 3.31 months of expenditure. Charities whose main income comes through generating funds have a median reserve level of 3.77 months, though we would expect fundraising activities to be particularly circumscribed by Covid-19, so that the position may look different a year or two from now. Again, in each of these groups of charities the 10th percentile of reserves is less than one week of expenditure.

Older charities usually have a higher average level of reserves

Figure 3 examines the distribution of reserves according to the age of the charity. In general older charities, which have had longer to accumulate funds and diversify their financial base, have a higher average level of reserves. A typical charity registered at least 50 years ago has 6.53 months of expenditure in reserve; for charities registered between 25 and 50 years ago the figure is 4.28 months. In contrast, for charities registered more recently, reserve levels would typically cover 3.5 months of expenditure or less.

Reserve levels of organisations are related to the field of charitable activity in which they operate

We observe sizeable differences in reserve levels when comparing across different fields of charitable activity (**Figure 4**). We use the International Classification of Nonprofit Organisations (ICNPO) as a basis for categorising charities. Charities that are involved in culture and recreation, charities that operate internationally, and umbrella bodies (including infrastructure organisations that provide volunteering brokerage and support and advice to other voluntary organisations) are amongst the groups of charities with relatively low levels of reserves: each of these groups has a median reserve level of less than three months of expenditure. In contrast charities involved, for example, in research, and in housing, typically have higher levels of reserves, with median reserve levels of 5.7 months and 5.8 months of expenditure respectively.

Figure 3: Boxplot of months of expenditure in reserve, by age of organisation (years since registration)

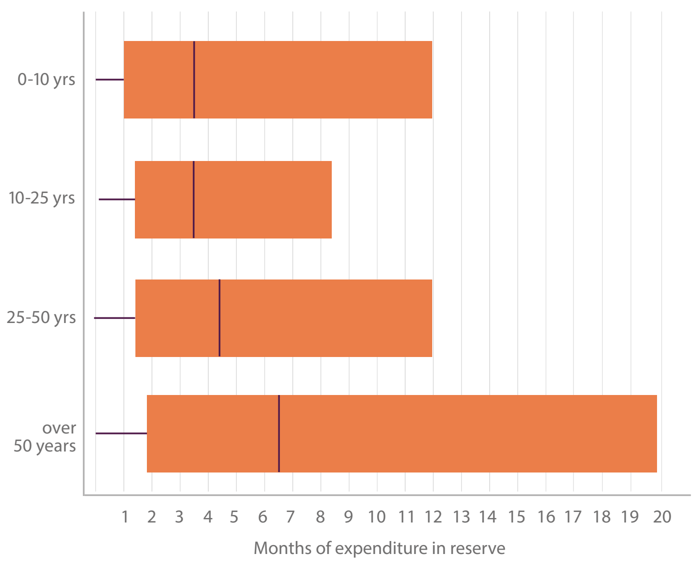
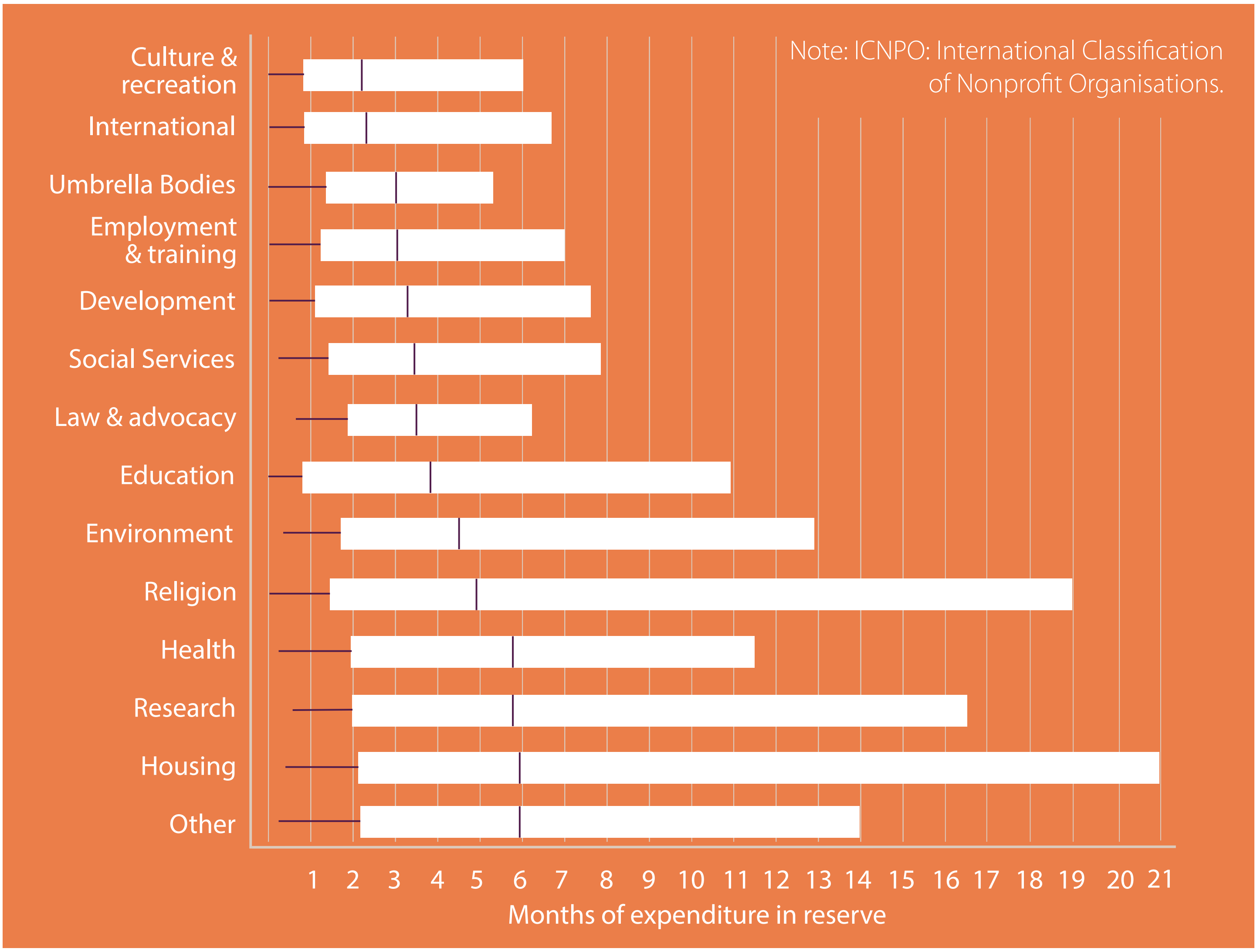


Figure 4: Boxplot of months of expenditure in reserve, by field of charitable activity (ICNPO)



Conclusions and implications

These figures suggest that if charities have to rely solely upon their reserves then relatively small numbers would be able to do so for any length of time. There are also important variations between types of charities depending on their age, or the subfield of activity within which they operate. We need to be aware of these variations when looking at both the impacts of Covid-19, and also at how charities may be supported in the future. The point at which an individual charity has to fund its activities entirely through using its reserves will vary depending on the availability of income from other sources. Charities have a diverse income profile and some funding streams, notably those relying on large-scale events, sponsored collective activities such as marathons,

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or trading (such as through charity shops) will have almost completely dried up for most of the period since March 2020. Other income streams may not – funding supplied by direct debits from individuals may be a case in point, especially if many regular donors have not experienced reductions in incomes. Various grant aid schemes being developed by the government and other funders will also limit the effects of Covid-19. For these reasons, predicting exactly when organisations may run out of funds is hazardous. In further work on this project, we re-use data gathered on large samples of charity accounts to assess which organisations might be most exposed to risk arising from negative effects on specific income streams.

The most notable feature of the analysis is the consistent evidence, across age, size and subsector of organisation, that a significant minority of organisations have very limited reserves. Initial findings from other work we are doing on reserves – not shown here – suggest that the reserves position of charities had gradually improved in the ten years after the financial crash of 2008-9.

The present period is a much more substantial economic shock than that of a decade ago, and we would anticipate that reserves will be drawn upon by charities to a degree to sustain their activities. This is also likely to mean that restoring a resource buffer that will insulate charities against future adverse events will take time.

References

Charity Commission (2018) Charity Reserves: Building Resilience (CC19). London: Charity Commission for England and Wales.

House of Commons Digital Culture Media and Sport Committee (DCMSC) (2020) The Covid-19 Crisis and Charities. London: House of Commons.

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