

A CONCISE GUIDE ON

# NGO RESERVES



## About The Hong Kong Council of Social Service

The Hong Kong Council of Social Service (“HKCSS”) is a federation of non-government social service agencies of Hong Kong representing more than 490 Agency Members that provide quality social services through their 3,000 operating units in Hong Kong.

HKCSS’s vision is to build a welfare sector that is highly accountable, efficient, effective and responsive to social needs, safeguarding the long-term sustainable development of society and the well-being of citizens. For more information about our organisation, *please visit :*

<http://hkcss.org.hk/?lang=en>

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# PREFACE

HKCSS conducted the “Survey on Financial Reserves of Social Service Agencies”<sup>1</sup> in 2019 and has noted that the NGOs, among other things, need more support and guidance to enhance their financial governance with respect to reserve management. With the objective of strengthening NGOs’ knowledge in this regard, this concise guide is prepared, comprising the following three sections:

## **Section I : General Explanatory Notes**

Section I provides a brief discussion of the basic principles relating to reserves management to give readers an overview of the important areas they should be aware of. This section is written in plain language and has avoided the use of professional jargons, to the extent possible.

## **Section II : Sample Reserve Policy Statement**

Section II is a sample reserve policy statement and has been prepared in the form of a template to serve as a practical tool for those in need. While it has included all the key elements of a typical reserve policy statement, it can be tailored, shortened or expanded to suit the purpose and circumstances of the NGOs. In addition, certain suggested parameters are included in the template to illustrate how the policy works. It should be noted that they are not standard requirements and NGOs must exercise their own discretion when determining their own thresholds.

## **Section III : Resources and Reference Materials**

Section III is a list of additional reference materials which NGOs may find useful and of interest.

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<sup>1</sup> Website of the “Survey on Financial Reserves of Social Service Agencies” Report : <https://governance.hkcss.org.hk/node/360>

This concise guide on NGO reserves is intended to help enhance NGOs' knowledge on managing reserves and identify areas where further advice or assistance may be needed. It is acknowledged that the relevance of this guide to NGOs may vary according to their size and maturity. When using this guide, due consideration must be given to the NGOs' own situation, including but not limited to their operating environment, mode of services, financial condition and governance structure, etc.

In case of doubt, consultation should be made with professional advisors.

# SECTION I

## General Explanatory Notes



### What are Reserves

In financial accounting, reserves usually refer to a part of shareholders' equity. In nonprofit accounting, reserves are that part of an NGO's unrestricted funds that is freely available to spend on any of the NGO's purposes. In general, reserves are built up over time by setting aside a portion of the unrestricted surplus generated from the normal operation of the NGO. Some NGOs include a line item in their budget in order to build up a reserve.

Some or all of the unrestricted funds of an NGO may not be readily available for spending, and should not be counted when determining the amount of reserves available for use by the NGO. They include:

- funds held in the form of tangible fixed assets used to carry out the NGO's activities, such as land and buildings;
- programme-related investments held solely to further the NGO's purposes;
- designated funds set aside to meet essential future spending, such as funding a project that could not be met from future income; and
- commitments that have not been provided for as a liability in the accounts.

When an NGO has unrestricted funds available for spending, it is a good practice to lay down policies and criteria on how they can be spent and maintained under different designated reserve accounts, with the primary objective of better financial management and planning for future needs.



### Operating Reserve

An operating reserve is an amount of unrestricted fund set aside to stabilise an NGO's finances by providing a cushion against unexpected cash flow shortages, expenses or

losses arising from its ongoing operation. These might be caused by delayed payments, unexpected building repairs, or economic conditions.

Operating reserve should not be used to make up for long term or permanent income shortfalls, unless the organisation has a plan to replace the income or reduce expenses in the near-term future. The purpose of the operating reserve is to help solve temporary problems, not structural financial problems.

An NGO should determine the level of operating reserves in accordance with its own financial situation and needs. The survey conducted by HKCSS in 2019 showed that the NGOs participated in the study on average maintain a general and non-designated reserves which would be able to support approximately 11.2 months of the agencies' expenditures on non-Lump Sum Grant funded services. Among this group, NGOs not receiving recurrent funding hold a higher reserve covering 12.7 months of the operational expenditures in comparison to 7.7 months maintained by those with recurrent funding<sup>2</sup>.

Each organisation should set its own reserve goal based on its cash flow and level of expenses. In general, the operating reserve level for NGOs that have regular income with reliable payment pattern will be less than those primarily relying on periodic grants, fundraising events or campaigns, or seasonal activities.



## Restricted Funds

Contrary to unrestricted funds, restricted funds are grants and contributions that have been received for specific programmes or projects. NGOs are obliged to spend the funds in a specific way or for a specific purpose as specified in the grant agreement or donor's instructions. Restricted funds cannot form part of the reserves due to restriction imposed on their use.



## Other Types of Reserves

In addition to operating reserve, an NGO may establish other reserves to build up financial resources for purposes such as fixed assets acquisition, building repair and replacement, supporting specific initiatives and future development. When establishing these reserves, the purposes must be clearly stated, together with the expected amount to be created and the source of funding.

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<sup>2</sup> Report of the "Survey on Financial Reserves of Social Service Agencies", 2019, The Hong Kong Council of Social Service, P.9



## Lump Sum Grant Reserves

There are specific requirements for an NGO supported by Social Welfare Department's Lump Sum Grant ("LSG") to determine and account for its surplus arising from activities using LSG<sup>3</sup>. LSG reserves should be kept separate from reserves arising from activities/operations supported by other funding sources. NGOs receiving LSG should be familiar with the requirements and ensure full compliance.



## What is a Reserve Policy

A reserve policy explains to existing and potential funders, donors, beneficiaries and other stakeholders why an NGO is holding a particular amount of reserves. All NGOs need to develop a policy on reserves which establishes a level of reserves that is appropriate for them and clearly explains to its stakeholders why holding these reserves is necessary.



## The Importance of a Reserve Policy

A good reserve policy will explain how reserves are used to manage uncertainty and, if reserves are held to fund future services or activities, how and when the reserves will be spent. A reserve policy provides assurance that the finances of the NGO are actively managed and its activities are sustainable. It also helps demonstrate good governance, and enhance both accountability and transparency.



## Developing a Reserve Policy

The approach adopted to develop a reserve policy varies with the size, complexity of activities, legal structure and the nature of funds received and held by an NGO. In all cases, setting a reserve policy will involve:

- analysing the nature of the funds received and held by the NGO to identify unrestricted funds which can be spent on any purposes of the NGO;
- identifying uncertainties that may arise and the need to hold some reserves to meet an unexpected call on funds; and
- assessing the likelihood that future projects or spending plans cannot be met from the income of a single year.

By working through the above steps, an NGO will be able to confirm the need to hold reserves and to decide the amount of reserves required to operate effectively.

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<sup>3</sup> Website of the Lump Sum Grant Manual :  
[https://www.swd.gov.hk/en/index/site\\_ngo/page\\_subventions/sub\\_lsgmanual](https://www.swd.gov.hk/en/index/site_ngo/page_subventions/sub_lsgmanual)





## Level of Reserves

The level of reserves to be held should reflect the particular circumstances of the individual NGO. The NGO's target level of reserves can be expressed as a target figure or a target range and should be determined with reference to:

- its forecasts for the level of current and future year income, taking into account the reliability of each source of income and the prospects for developing new income sources;
- its forecasts for the current and future year expenditure on the basis of planned activities;
- 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; and
- its assessment of the likelihood of a shortfall arising and the potential consequences of not being able to make up the shortfall.

If an NGO decides to keep a reserve at zero or low level, whether due to its affordability or not, the NGO must consider critically its long term financial sustainability. In addition, the NGO should ensure there is a strategy for an orderly closure in the event of an unplanned shutdown and insolvency; where there are vulnerable beneficiaries, how they will be taken care of.



## Use of Reserves and Authorisation

Most NGOs allow the agency head to access reserves with approval from the Finance Committee ("FC") and/or Treasurer when the amount is below a defined limit and/or the payback period is within a set number of months. When requests are above those thresholds, the agency head would need to seek approval from the Board of Directors (the "Board") or Executive Committee.

When there is a need to use the reserves, the agency head and finance staff should identify reasons for accessing the specific reserves and confirm that the use is consistent with the purpose of the reserves. As a part of the process, the agency head should analyse the reason for the needed funds, assess the availability of any other sources of funds before using reserves, evaluate the time period that the funds will be required, and also the time and resources for replenishment.

Approval from the FC/Treasurer or the Board should be obtained in writing and properly documented in the minutes of the Committee/Board meeting where approval is given.



## Reporting and Monitoring

The agency head is responsible for ensuring that the reserves are maintained and used

in accordance with the NGO's reserve policy. Upon approval received for the use of reserves, the agency head and finance staff should maintain records of the use and plan for replenishment. Regular report should be provided to the Board of the usage and progress to restore the reserves amount to the target minimum level.



## Policy Review

It is the responsibility of the Board of an NGO to keep the reserve policy and the level of reserves held under review. The Board should also monitor the level of reserves held throughout the year. Appropriate actions should be taken when there are signs that the NGO is building-up excess reserves or its reserves are being unexpectedly or rapidly depleted.



## Investing Reserves

When significant resources are held as reserves from year to year, the Board should consider whether some or all of the reserves can be invested to obtain a financial return for the NGO. In making the investment decision, the Board should consider when the reserves might be needed and the acceptable level of investment risk.

The investment policy<sup>4</sup> adopted will need to reflect the Board's assessment of the likelihood that some or all of the reserves held may need to be accessed at short notice. Certain investments are more appropriate as long-term holdings, they may be unsuitable when it is known that a specific amount of cash will be needed in the short-term or at short notice to meet urgent need.



## Related Policies

NGOs shall maintain the following Board approved policies, which may contain provisions relevant to the creation, sufficiency and management of the reserves:

- Governance code or manual
- Financial policy
- Budget policy
- Contingency or crisis management plan
- Investment policy

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<sup>4</sup> Reference can be made on "A Concise Guide on NGO Investment", 2020, The Hong Kong Council of Social Service. Website: <https://governance.hkcss.org.hk/node/429>

# SECTION II

## Sample Reserve Policy Statement

**Note** - The following is a sample reserve policy statement for reference. NGOs should make their best endeavor to tailor it to suit their own situation.

*[Name of NGO]*

Statement of Reserve Policy

Approved by the Board of Directors on *[Date]*

### 1. Purpose

- 1.1 This policy statement documents the objectives and policies regarding reserves establishment and maintenance of *[NGO]* to ensure the stability of its mission, programmes, employment, and ongoing operations and to provide a source of internal funds for organisational priorities. This policy statement also defines the types of reserves to be set up and their intended usage.
- 1.2 This reserve policy will be implemented in concert with the other governance and financial policies of *[NGO]* and is intended to support the goals and strategies contained in these related policies and in strategic and operational plans.

### 2. Definitions and Goals

#### 2.1 Operating Reserve

- 2.1.1 The operating reserve is intended to provide an internal resource for situations such as a sudden increase in expenses, one-time unbudgeted expenses, unanticipated loss in funding, or uninsured losses. Operating reserve is not intended to replace a permanent loss of funds or eliminate an ongoing budget gap. It is the intention of *[NGO]* for its operating reserve to be used and replenished within a reasonably short period of time.
- 2.1.2 The operating reserve fund is defined as a designated fund set aside by action of the Board of Directors (the “Board”). The minimum amount to be designated will

be established in an amount sufficient to maintain ongoing operations and programmes for a set period of time, usually measured in months. It will be subject to periodic review and adjusted in response to both internal and external changes.

- 2.1.3 The target minimum operating reserve is equal to **[# 6 months OR other time interval as approved by the Board]** of average operating costs. The calculation of average monthly operating costs includes all recurring, predictable expenses such as salaries and benefits, occupancy, office, travel, programme and ongoing professional services. Depreciation, in-kind and other non-cash expenses are not included in the calculation.

**Note** - In determining this threshold, reference can be made to the “Survey on Financial Reserves of Social Agencies” report published by HKCSS in 2019 , and the own circumstances of the NGOs.

- 2.1.4 The minimum amount of the operating reserve target will be determined each year after approval of the annual budget by the Finance Committee (“FC”) /Board.

## 2.2 Other Reserve Funds

**Note** - Add the following paragraph(s) if applicable:

### 2.2.1 Lump Sum Grant Reserves

*Surpluses arising from activities supported by grants under the Lump Sum Grant (“LSG”) Subvention System are accounted for under LSG reserves, determined in accordance with the requirements of the LSG Manual and Circulars issued by Social Welfare Department.*

### 2.2.2 Building and Capital Asset Reserve

*Building and capital asset reserve is intended to provide a ready source of funds for acquisition or repair of buildings, leaseholds, furniture, fixtures and equipment necessary for the operation of the organisation and programmes.*

*The target amount of the building and capital asset reserve will be determined with reference to and after approval of the **[NGO]**'s medium term capital expenditure plan by the FC/Board.*

### 2.2.3 Development Reserve

*Development reserve is intended to provide funds to meet special targets of opportunity or further the mission of the organisation, which may or may not have specific expectation of incremental or long-term increased income. It is also intended as a source of internal funds for organisational capacity building such as staff development, research and development, or investment in infrastructure that will build long-term capacity.*

*The target amount of the development reserve will be determined with reference to the [NGO]'s medium term development strategy and plan as approved by the Board.*

### 3. Accounting for Reserves

- 3.1 The reserve funds will be recorded in the financial statements as Board-designated reserves and maintained in a segregated bank account or an investment account, if permitted under the investment policies of [NGO].

### 4. Funding of Reserves

- 4.1 The operating reserve will be funded by unrestricted operating surplus. The Board may from time to time direct that a specific source of revenue (such as one time gifts or bequests, special grants, or special appeals) be set aside for operating reserve.

**Note** - Add the following paragraph(s) if applicable:

- 4.2 *The building and capital assets reserve will be funded by setting aside funds received from specific campaigns or appeals designated to raise funds for this reserve, AND/OR setting aside annually an equivalent amount of cash equal to a certain percentage of the depreciation charge, OR using other appropriate basis, to build up sufficient fund for purchasing new capital assets and replace existing assets at the end of their useful lives.*
- 4.3 *The development reserve will be funded by special occasional fundraising events/activities for the purpose of building this reserve and/or occasional special designations made by the Board.*

### 5. Maintenance of Target Reserve Level

- 5.1 The agency head, supported by the finance manager/staff, is responsible for ensuring that the reserve funds are properly maintained. Proper records of the use and plan for replenishment should be kept and a report should be provided to the Board on the status of the reserve funds. Appropriate action should be taken, in case there is a significant shortfall, to restore the fund to the target minimum amount.
- 5.2 If the operating reserve falls below [# 90% OR other percentage as approved by the Board] of the target minimum operating reserve level, the finance manager and finance team should report this to the agency head and the Treasurer as soon as possible.

## 6. Use and Management of Reserve Funds

- 6.1 The agency head and the finance manager/staff are responsible for identifying the need to use the reserve funds and confirm that the use is in compliance with the policy. Formal request in writing to use the reserve should be submitted to the FC/Board together with the analysis and recommendation to use the funds and plans for replenishment.
- 6.2 The authority for use of reserves is delegated to the agency head, who should consult with the Treasurer and/or Chairman of the FC before exercising the authority. The use of reserves should be reported to the Board at the next Board meeting, together with an analysis and determination of the use of funds and plans for replenishment. The agency head must obtain prior approval from the Board if the reserves will take longer than 12 months to replenish.
- 6.3 The Board should review the target and actual reserve level regularly [*# e.g. on an annual basis*] and may make appropriate adjustments according to the changing need of the [*NGO*].

## 7. Investing Reserves

- 7.1 Depending on the nature of the reserve funds, the risk preferences and short term cash needs of the [*NGO*], the amount of the reserve funds can be held in the form of investment other than cash or cash equivalents to generate additional income. The investment should be made in compliance with a separate investment policy approved by the Board.

## 8. Policy Review

- 8.1 This policy statement may be reviewed and revised at any time, but it must be formally reviewed by the Board at least once in every financial year. No modification may be made without the explicit approval of the Board.
- 8.2 Any discussion and decision in the above regard shall be properly documented in the minutes of the meeting of the Board, and this policy statement shall be updated accordingly.

# SECTION III

## Resources and Reference Materials

The documents listed below are useful reference related to NGOs' reserves. Organisations working on a reserve policy statement should be familiar with their contents as appropriate:

- (a) Lump Sum Grant Manual, October 2016, Social Welfare Department
- (b) Lump Sum Grant Circular No. 9/2003 - Use of Lump Sum Grant and Lump Sum Grant Reserve, Social Welfare Department
- (c) Tax Guide for Charitable Institutions and Trusts of a Public Character, 2020, Inland Revenue Department
- (d) CPAs for NGOs: Quick Guide Series - Governance & Accountability, The Hong Kong Institute of Certified Public Accountants (HKICPA)
- (e) CPAs for NGOs: Quick Guide Series - Reserve Policy, HKICPA
- (f) CPAs for NGOs: Quick Guide Series - Internal Control & Audit, HKICPA
- (g) Sample Code of Conduct for Board Members & Staff of Non-governmental Organisations in Social Welfare Sector (Full Version), 2015, Independent Commission Against Corruption & The Hong Kong Council of Social Service (HKCSS)
- (h) A Concise Guide on NGO Investment, 2020, HKCSS

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