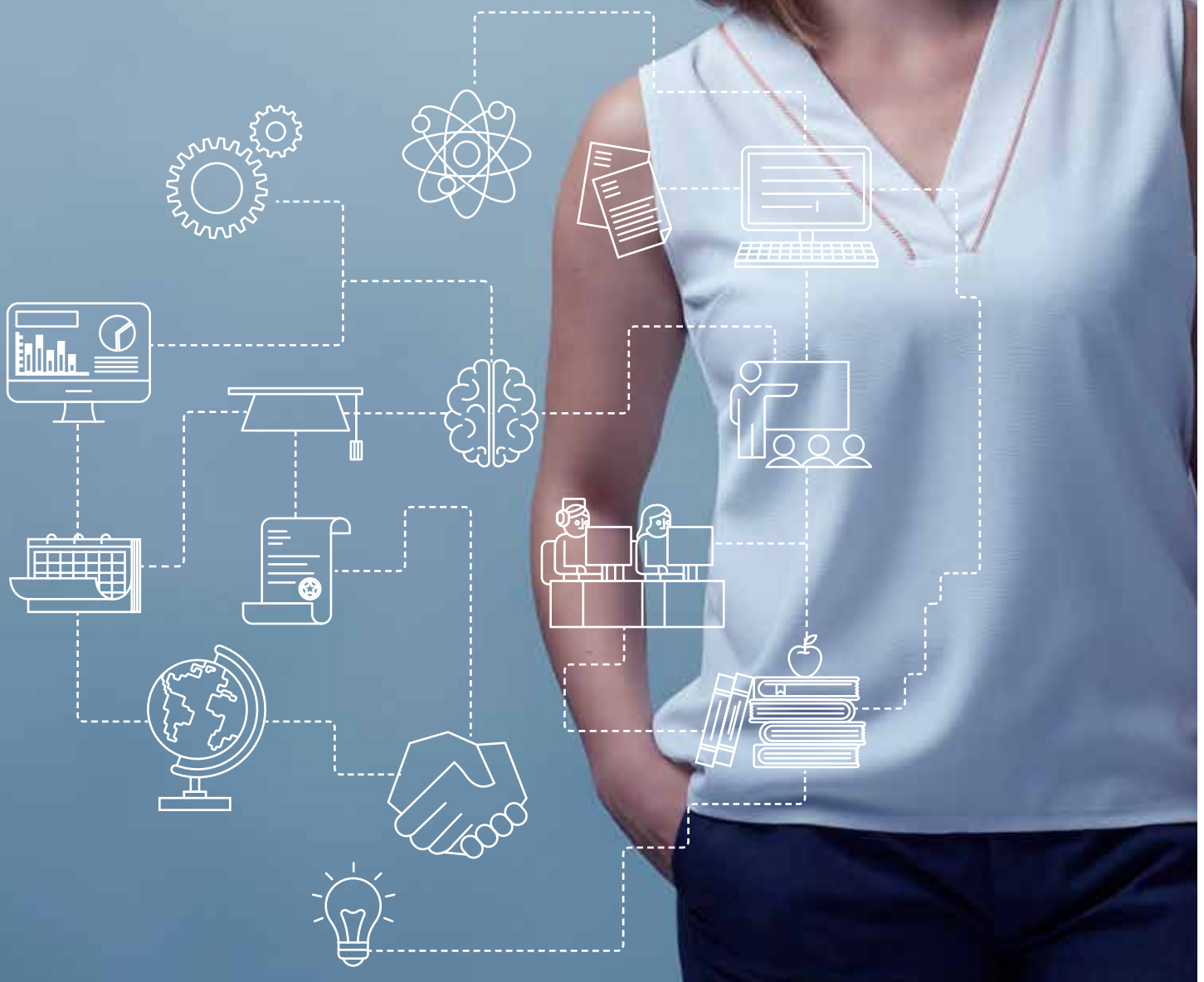


Reserving the future

Financial policies in independent schools



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Foreword

Affordability and financial uncertainty continue to be the key challenges facing the Independent School sector alongside the need to meet the requirements of public benefit. This is coupled with increasing scrutiny on the charity sector overall and a focus by the media and charity regulators on financial governance.

A robust reserves position is fundamental to a school's financial planning and should provide a clear link to the governors' strategy.

RSM's review of 60 schools gives a clear message that this is an area many schools need to focus on and that there is clear room for improvement.

In particular schools need to improve how they communicate their reserves strategy and target level of reserves to parents and other stakeholders.

I would recommend all schools undertake the analysis for themselves and utilise RSM's practical approach to formulating the right reserves policy for them.

David Woodgate

David Woodgate is Chief Executive of the Independent Schools Bursars' Association (ISBA) and Chair of Governors at Plymouth College an HMC school



Part 1: Reserves matter

Reserves are much more than a statement about the financial health of your school. A robust reserves position will send a clear message to parents and other stakeholders that you are well-led, well-managed and well-run.

"Independent Schools don't have free reserves"

While it may be true that many Independent Schools invest their surpluses back into school facilities and as such do not generally have excessive free reserves, this does not mean that schools should neglect creating a robust reserves policy or seek to build up reserves.

Ultimately, it is up to the governors to work out how much your school needs to keep in reserves. A balance must be struck. Too little, and you could be exposed to shifts in pupil numbers and other income. Too much, and questions could be asked about whether your fees are too high or if you are managing resources in the best interests of the current pupils.

Reserves are that part of a charity's unrestricted funds that is freely available to spend on any of the charity's purposes. **Charity Commission**

But how much you have in reserves is just one side of the equation. As charities, Independent Schools must also publish and implement a robust reserves policy that sets out a target level of reserves and a plan for how to get there.

As well as complying with the Charities SORP, governors must consider the expectations of stakeholders and how to effectively communicate with them. Parents, banks and other lenders, alumni and other potential donors and the Charity Commission will all have an interest in the school's reserves strategy and levels.

Yet RSM's analysis shows many schools are struggling to deliver this effectively.

Our review of 60 Independent Schools reveals significant gaps in how governors calculate their reserves position and how they communicate their plans with internal and external audiences. 82 per cent of schools sampled required at least some improvement.

It is critical these shortfalls are tackled. In turbulent times, financial resilience will help Independent Schools to stay flexible and adaptable to unexpected changes in pupil numbers or to manage unplanned costs. A largely fixed cost base and large staff bill make it difficult for schools to quickly reduce outgoings in response to falling income. Equally funds may be needed at short notice to fund unexpected building repairs.

At a time of significant economic and political uncertainty facing the sector, a well-thought-out reserves policy is now more important than ever before.

Part 2: How Independent Schools measure up

Our analysis looked at a sample of 60 of the largest schools based on total income (from the latest published financial statements).

The schools were selected to cover a distribution geographically across England and Scotland as well as across the type of school (day, boarding or both) and age of pupils (prep, senior and all-through).

Total funds held by individual schools ranged from £7m to over £300m with unrestricted funds from as low as £500k up to £120m.

Two thirds of schools in the sample had endowment funds, and almost all schools (95 per cent) had some restricted funds.

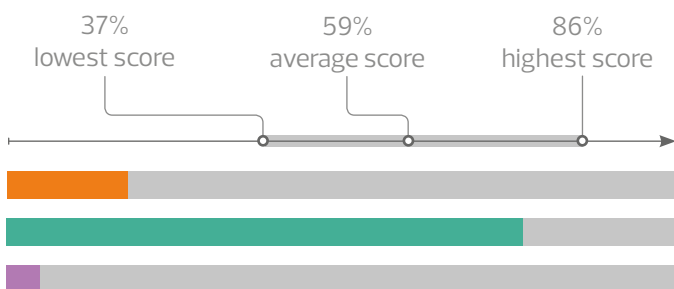
All of the schools reviewed had positive levels of unrestricted funds.

Methodology

Schools' reserves policies were assessed against 24 criteria – see Appendix 1 for details. The questions considered the disclosure and explanations relating to reserves funds, as well as the overall effectiveness in communicating the policy statement. A total of 37 points were available across the full survey.

Room for improvement

No school scored full marks on the survey, suggesting that improvements are needed across the board.



- 18%: Significant improvements needed
- 77%: Some improvements needed
- 5%: Improvements needed in specific areas

How schools across the sector measure up

Average scores were fairly consistent across the sector.

Average policy scores by type of school (out of 37)

23 Day Schools
21 Boarding Schools
22 Day and Boarding Schools

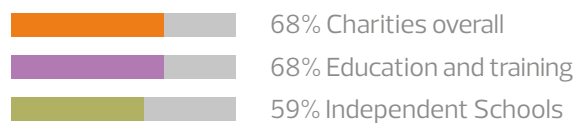
Senior Schools scored slightly better than prep and all-through schools.

Average policy scores by age of pupils (out of 37)

21 Prep Schools
21 All-through Schools
23 Senior Schools

Compared with the wider charity sector

Independent schools fell well below the overall charity sector and other education and training charities. This is a clear indicator that the independent school sector needs to improve to bring it into line with the voluntary sector standard.



In particular, Independent Schools fall behind in the areas of communicating their reserves strategy and their target levels.



Strategy

50% Independent Schools
70% Charities

Source: Charity reserves | resilience in 2018, a survey carried out by RSM of 66 charities.

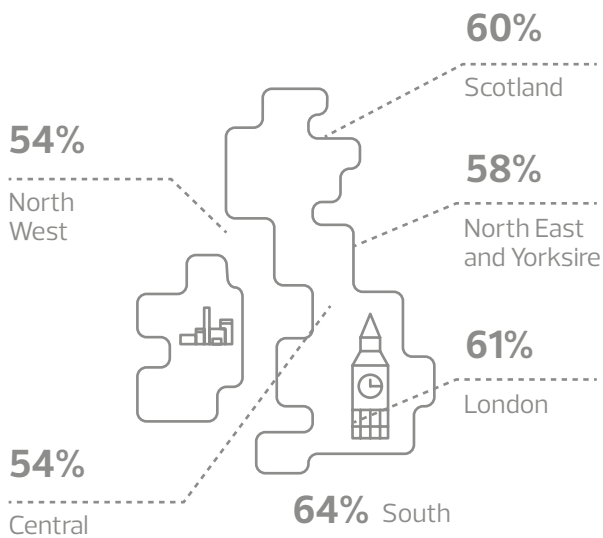


Target levels

48% Independent Schools
67% Charities

Regional differences

Independent Schools in the south of England have developed the most effective reserves policies.



The South was also the strongest region for general charities (73 per cent) compared with an average score of 67 per cent.

Bigger is better?

Our analysis also considered some of the larger groups of schools (with between 10 and 25 schools in each group), between them responsible for the operation of over 50 schools across the UK.

The strongest area of this subset was in reporting of target levels, a result that is in contrast with the broader sample, which on average struggled in this area.



Target levels

71% Independent School groups
48% Independent Schools overall

However somewhat surprisingly, the larger groups scored considerably behind the overall average in the section relating to clearly defining their funds' strategy. In particular, school groups were not able to satisfactorily address how their strategies had been updated or re-defined from previous years nor what considerations were made relating to potential future risks.



Strategy

33% Independent School groups
50% Independent Schools overall

Part 3: Designated funds

Governors can choose to set aside reserves for a particular purpose, such as funds used for buildings, funding bursaries and scholarships, or towards particular educational areas

Funds marked by governors for a specific use are known as designated reserves.

31 of the 60 Independent Schools reviewed had designated funds.

This means that 48 per cent of Independent Schools have not formally designated their unrestricted funds. These schools will likely have financial plans and a strategy for these funds but have not formally agreed or communicated them via the use of designated funds.

Identifying designated funds may be helpful when explaining the charity's reserve policy and the level of reserves it holds. **Charities SORP**

Almost half of Independent Schools that had designated funds had done so for school buildings, either maintenance or future capital projects.



23% of Independent Schools had designated funds for buildings



22% of Independent Schools had designated funds for bursaries

42 per cent of Independent Schools with designated funds had set aside funds for bursaries and scholarships. As the economic environment continues to put pressure on fee levels and limits increases, the ability for schools to fund bursaries from current year fee income will reduce. At the same time, schools face pressure to provide more bursary support to meet public benefit requirements.

It is unsurprising that buildings and bursaries are the main designated funds seen in the sample being two key financial challenges facing the sector.

45 per cent of schools with designated funds had earmarked the funds for other purposes including curriculum developments and extra-curricular programmes. Designating funds in this way and clearly explaining the nature of the plans in the annual report gives the readers a good insight into the direction the school is heading and can be a useful way of articulating the school's culture to current and future parents.

However, in some cases the nature of the designated funds was overly broad and the purpose of designation was unclear. While planning for contingencies and a 'rainy day fund' may be part of the school's financial strategy, designated funds still need to be specific, measurable and time constrained.

... the reserves policy should explain the nature and amount of the designation and when the funds set aside are likely to be spent; it is never acceptable to set up designations simply to reduce the stated level of reserves.

CC19 Charity reserves: building resilience



Part 4: Developing an effective reserves policy for your school

What does an effective reserves policy look like? And where should governors begin?

The starting position is to work out your school's existing levels of reserves. This needs detailed consideration. Yet we know that many do not follow the right process. This lack of precision means governors often arrive at the wrong answer, exposing the school to future surprises.

Ultimately, reserves show the financial strength of your school. But they do not just reflect how much money you have in the bank. Instead, they are the unrestricted funds that are freely available to spend on educational activities, after allowing for funds tied up in fixed assets and future spending plans.

The Charity Commission sets clear guidelines on what you should and shouldn't include in your calculations. Restricted income and endowment funds are excluded. Amounts earmarked for essential future spending and tangible fixed assets that are held for the school's own use are also usually left out.

	£'000*
Total funds	11,789
Less: Restricted funds	(148)
Less: Endowment funds	(450)
Unrestricted funds	11,191
Less: Unrestricted tangible fixed assets held for the school's own use	(6,600)
Less: Amounts designated for essential future spending	(80)
Available reserves – the starting point	5,511

*The figures provided in this table are for illustrative purposes only

Setting your policy

Now you can start compiling your reserves policy. This should cover five key areas: general reserves; restricted funds; designated funds; target levels; and strategy. Each should be communicated clearly and effectively. That is, governors need to get the fundamentals right.

A reserves policy is not a one-off exercise. As your school's circumstances change, so too must your reserves policy. The Charity Commission recommends that the document is reviewed at least annually. For schools undergoing a period of change, it is likely that the policy will need to be looked at more often.

Likewise, the amount held in reserves should also be monitored throughout the year. It is good practice to include this as part of your regular financial processes. This helps ensure your reserves policy is consistent with your overall strategic plan.

Excerpt from Charities SORP FRS 102

The review of the charity's reserves should:

- state the amount of the total funds the charity holds at the end of the reporting period;
- identify the amount of any funds which are restricted and not available for general purposes of the charity at the end of the reporting period;
- identify and explain any material amounts which have been designated or otherwise committed as at the end of the reporting period;
- indicate the likely timing of the expenditure of any material amounts designated or otherwise committed at the end of the reporting period;
- identify the amount of any fund that can only be realised by disposing of tangible fixed assets or programme related investments;
- state the amount of reserves the charity holds at the end of the reporting period after making allowance for any restricted funds, and the amount of designations, commitments (not provided for as a liability in the accounts) or the carrying amount of functional assets which the charity considers to represent a commitment of the reserves they hold; and
- compare the amount of reserves with the charity's reserves policy and explain, where relevant, what steps it is taking to bring the amount of reserves it holds into line with the level of reserves identified by the trustees as appropriate given their plans for the future activities of the charity.



Calculate your general reserves

76% – average score for general reserves

Reserves policies must set out the balance of general reserves that are available to spend on the school's charitable purpose. In theory, this is a simple calculation. Governors arrive at the answer by subtracting any restricted and designated funds from the total funds of the school.

It is critical that governors show their workings. This gives readers confidence that you have followed the right process to arrive at your general reserves figure. A clear, concise narrative should help put the numbers in context.

- Is the actual balance of funds ie general reserves disclosed?



Detail your restricted funds

61% – the average score for restricted funds

Donors often place conditions on how governors can use funds donated to the school. Restricted donations are commonly seen when fundraising for capital projects but can also cover funding towards bursaries or scholarships, or are directed towards a particular area of the curriculum.

These so-called restricted funds should not be included in the school's reserves calculation. But governors must still explain their restricted funds position in the reserves policy.

The definition of restricted funds is set out in law and accounting standards. It is good practice for governors to refer to this when setting out their total restricted funds. This gives annual report readers confidence that the school is properly protecting restricted funds and that governors understand the rules governing them.

The restricted funds total must be detailed in the reserves policy and the school's balance sheet. A clear link should be made between the two.

- Is the amount of restricted funds disclosed?
- Does the amount of restricted funds reconcile to the balance sheet?
- Is there any explanation why restricted funds do not form part of the general reserves?





Deal with designated funds

78% – the average score for designated funds

As already covered in part 3, governors can set aside funds for specific projects or future spend.

This part of the reserves policy should be quick and easy to complete. Decisions around designated funds are vested in governors. Board minutes or finance papers will offer a reliable record of any designation rulings over the past 12 months.

All reserves policies must make clear whether any tangible fixed assets or investments are designated. The total sum of designated reserves should also be set out. This information is critical to the governors' overall reserves calculation. It must be clearly marked.

Your narrative should set out the purpose of any designated funds, including specific details on how and when they will be used. Schools often overlook this. Governors must go beyond vague explanations and instead set out a clear plan for how designated funds will be drawn down and how long this will take.

- Is there an explanation of designated reserves and purpose?
- Is the amount of designated reserves disclosed?
- Is there either a designation of reserves for tangible fixed assets?
- Or, is there an explanation that these funds can only be realised on disposal?



Set and review your target level

48% – average score for target levels

Reserves policies need to set a target level of reserves, and highlight a plan for how this will be met. But how do you know what your optimum reserves position should be? While this is a matter of opinion and judgement, there are several considerations that will help governors arrive at a confident answer.

Governors should think about what the school wants to achieve. What is your overarching purpose and ambition? And do you have the financial strength to get there?

For example, if you're looking to increase your level of bursary support how will you go about this? Do you need to build up a certain level of funds in order to invest and generate a regular income stream?

By keeping this front of mind, governors will be better equipped to reach a confident decision about the amount of funding your school needs to keep in reserves. It will also ensure the reserves policy aligns with your organisational strategy. This is critical to its relevancy, accuracy and reliability.

Any assessment of a target reserves level should also consider any potential changes to the school's financial health. This includes considering how income and outgoings could flex. How volatile is the pupil roll and pipeline? How reliant is the school on other sources of income such as lettings or donations?

Have you considered the financial impact of additional public benefit requirements? Do you need a contingency fund to cover the possible impact of VAT on school fees or rates of relief withdrawal? Can you afford to provide support, say, to a local Academy Trust?

Very few schools hold the optimal level of reserves. This is only a problem if governors are unaware of the situation and fail to put in place a plan for how they will reach a more balanced reserves position. If you are below your target level, considerations could include how you will increase pupil numbers or reduce costs.

If you are operating above your target level, governors will need to explain whether excess resources could be effectively spent on the school's aims and objectives. This could include capping fee increases, increasing bursary levels or accelerating the timescale for a capital project.

A target is only valuable if governors continually review their progress towards it. Governors should make clear whether the target has been met each year, and explain any deviation from it.

- Is a target level for reserves specified?
- Does the report explain how the target level differs to actual levels held at the end of the financial year?
- If a 'zero level' reserves policy has been adopted, is this explained in the annual report and is the financial risk stated?
- If actual reserves are below the target level, how will governors take steps to close the gap?
- If actual reserves are above the target level, how will governors take steps to close the gap?



Link to your strategy

50% – average score for strategy

A reserves policy must align with the school's strategy. Neither should be developed in isolation. A well-considered strategy and robust budgeting and risk management processes will help you develop a sound reserves policy. Likewise, an understanding of business planning and risk will give governors the information they need to set target reserves levels.

- Does the report sufficiently explain the reserves policy set by governors?
- Is it clear that the governors have updated or re-confirmed the reserves policy since the last annual report?
- Does the policy refer to the current and future strategy?
- Does the policy cover risks, particularly those associated with the changing financial and political climate?
- If an endowment fund is present, has an allowance been made for any unrestricted income that will be generated?



Get the fundamentals right

64% – average score for fundamentals

Once a reserves policy is set, it must be effectively communicated internally and externally. This helps parents and other stakeholders understand the school's direction of travel, current income levels and the future funding needs.

Yet too often, a reserves policy ends up buried within a wider governors' report. We have seen critical information lost in the financial review of the year section or chapters on future developments. Without clear signposting, governors are making external and internal audiences work too hard to find the information they need.

Governors should instead seek to create a clear, standalone section on their school's reserves position and policy. Sub-headings can be a useful way to guide readers to the relevant information. Beyond this, the narrative should also state the total funds of the school to give a wider perspective of the financial position.

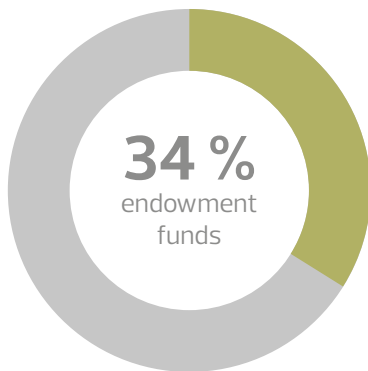
Finally, governors must put the numbers in context. It is critical that the disclosed total funds link to the balance sheet. This ensures the school's reserves position is not viewed in isolation, and readers are better able to understand how governors arrived at their conclusions. Avoid the temptation to use excessive terminology and jargon; the most effective reserves policies use plain English.

- Is there a defined section for reserves within the governors' report?
- Does the reserves section explain the total funds of the school?
- Do the disclosed total funds relate to the balance sheet?
- Is the policy written in plain English, and does it avoid excessive use of terminology?

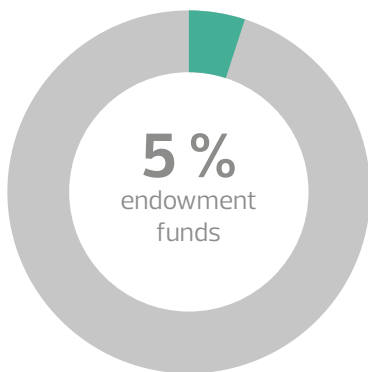
Part 5: Crunching the numbers

In Appendix 2 the financial reserves of the 60 schools reviewed have been summarised based on total levels of funds.

As would be expected, the schools with the largest levels of funds overall have the highest proportion of endowment funds.



Schools with £100m + total funds



Schools with <£15m total funds

Schools with over £100m total funds have the lowest level of unrestricted reserves (36 per cent) but have designated almost one third of these funds (11 per cent).

Schools with funds of £16m–£20m have the highest proportion (86 per cent) of 'general unrestricted funds' i.e. unrestricted funds not formally designated and the lowest overall level of designated funds at just 1 per cent. Therefore, schools at this fund level have the most to do in terms of clearly allocating their unrestricted funds to school buildings, specific projects and objectives.

Schools with £21–40m total funds have the joint highest proportion of total unrestricted funds (88 per cent) as well as the highest level of designated funds (18 per cent). This still leaves 70 per cent of their unrestricted funds without a specific designation.

Schools with total funds of under £15m also have 88 per cent unrestricted funds but have designated just 10 per cent of these funds.

Percentage of unrestricted funds formally designated

£100m+ total funds	31%
£71m - £100m	20%
£41m-£70m	19%
£21m - £40m	20%
£16m - £20m	1%
<£15m	10%



Appendix 1 – Reserves Assessment

Question	Yes (score)	Not applicable (score)	No (score)
Is there a clearly defined section for reserves within the Independent School's governors' report including a sub-heading, where appropriate?	3	0	0
Does the reserves section clearly explain the total funds of the Independent School?	2	0	0
Do the disclosed total funds agree to the balance sheet?	1	0	0
Is the amount of restricted funds disclosed?	1	1	0
Does the amount of restricted funds reconcile to the balance sheet?	1	1	0
Is there an explanation of why restricted funds do not form part of general reserves?	1	1	0
Is there an explanation of designated reserves and the purpose?	1	1	0
Is the amount of designated reserves disclosed?	1	1	0
Is there either a designation of reserves for tangible fixed assets or alternatively an explanation that these funds can only be realised on disposal?	1	1	0
Does the designation of reserves agree to the balance sheet?	1	1	0
Does the designation of any tangible fixed assets reconcile to the corresponding asset or, if not, is there an explanation?	1	1	0
After the above, is the actual balance of funds, ie general reserves disclosed?	1	0	0
Does the report sufficiently explain the reserves policy determined by the governors?	3	0	0

Question	Yes (score)	Not applicable (score)	No (score)
Is it evident that the governors have updated or re-confirmed the reserves policy since the last annual report?	2	1	0
Does the policy refer to current and future strategy?	1	0	0
Does the policy cover risks particularly those associated with the changing funding and financial climate?	2	0	0
If an endowment fund is present is account taken of whether it is permanent or expendable in developing the policy?	1	1	0
Is a target level for reserves specified?	2	0	0
Is there an explanation as to how the target level of reserves differs to actual levels held at the end of the financial year?	1	0	0
If a 'zero level' reserves policy has been adopted then is this explained in the annual report and is the financial risk stated?	1	1	0
If actual reserves are below the target level of reserves then are steps to be taken by governors explained including, but not limited to: <ul style="list-style-type: none"> · raise the necessary funds · diversify the funding base · mitigate the risks that might arise if the independent school has to close suddenly? 	2	2	0
If actual reserves are above the target level of reserves then are steps to be taken by governors explained including, but not limited to: <ul style="list-style-type: none"> · considering whether they could be effectively spent on the school's purposes? If an independent school has more resources than it needs to fulfil all of its purposes then the governors must consider whether the purposes of the school should be amended to enable the school to operate more effectively. 	2	2	0
If a charitable group, then does the reserves policy explain and quantify the impact of subsidiaries' funds?	3	0	0
Award a score for plain English, avoiding excessive use of terminology and providing definitions, where appropriate.	3	0	0
Maximum total score	37		

Scores

0 – 18	Significant improvement required and ensure the policy and resultant disclosure is included on the agenda for the next governors' meeting
19 – 28	Some improvement required and consider as part of the next financial year end process
29 – 32	Nearly there – review low scoring answers and improve in certain areas
33 – 37	Best in class!

Appendix 2 – Reserve levels

Number of schools	Total funds	Endowment	Restricted	Unrestricted Designated	Unrestricted Other	Total unrestricted
8	£100m +	34%	31%	11%	24%	35%
4	£71m – £100m	32%	12%	11%	45%	56%
18	£41m–£70m	24%	7%	13%	56%	69%
18	£21m – £40m	8%	4%	18%	70%	88%
6	£16m – £20m	6%	7%	1%	86%	87%
6	<£15m	5%	7%	9%	79%	88%

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Nick is the National Head of Charities and Independent Schools at RSM and is a client partner responsible for a portfolio of RSM's largest Not for Profit clients including a number of Top 250 charities and large independent schools and groups.

Presently, from 2013 to 2017, Nick submitted responses to the Charity Commission and OSCR on various Charities SORP consultations and the Financial Reporting Council on the Practice Note 11 Consultations: The Audit of Charities in the UK. As a result, Nick has worked with a number of boards to improve their financial reporting over the past decade.

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Kerry leads RSM's Charity and Independent School team in the South and has over 15 years' experience in the sector. Kerry's client portfolio includes a broad range of independent schools, from some of the largest boarding schools in the south, to small prep schools. She also works with educational and other charities. Kerry is the editor of RSM's End of Term Report for Independent Schools and has been a regular speaker at the ISBA finance conference. Kerry is also a Governor and Chair of the Finance Committee of a boys' prep school.

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