Council, 15 May 2014

Reserves Policy

Executive summary and recommendations

Decision

The Council is asked to discuss and approve the attached Reserves Policy.

Background information

Since 2004, the HCPC's reserves policy has been that cash should represent a minimum of three months' operating expenditure. The actual minimum target level has been calculated each year and approved by the Council, most recently by the Council on 27 March.

It was agreed at the 27 March meeting that a revision of the policy would be proposed to the Council at their May meeting. The proposed revised policy uses the same formula, but provides an explanation of the relevance of reserves and cash in our context, and a rationale for the target of three months' operating expenditure.

Resource implications

None.

Financial implications

None. Our cash balance is forecast to remain above the minimum target level throughout 2014-15.

Appendices

1. Proposed new Reserves Policy
2. Proposed text to disclose Reserves Policy in the Annual Report and Accounts
3. Current Reserves Policy
4. Example reserves policies as disclosed by other regulators, and comparison of reserves levels

Date of paper

2 May 2014

Appendix 1: Proposed new Reserves Policy

Introduction

This policy explains the relevance of reserves and cash for HCPC, and the purposes for which HCPC needs to hold cash, and establishes the process by which the minimum level of cash is calculated.

This policy will inform the annual budget setting process.

Responsibilities

Council is responsible for approving the policy. The Executive is responsible for advising Council on the policy.

Definition and relevance of reserves in HCPC's context

Our legislation requires us to meet our costs out of our income from registrants' fees. Therefore we need to manage our operating costs within a level that can reasonably and sustainably be funded from registrant fees, and manage our capital assets and capital expenditure within a level that we can afford to maintain and replace.

In accounting terms, HCPC's reserves are the accumulated surplus or deficit shown in the bottom half of the balance sheet. HCPC is a not for profit organisation so making surpluses and accumulating reserves is not an end in itself. Unlike a local authority, we are not legally required to set an exactly balanced budget, and we do not aim for a particular level of budget surplus or deficit in any given year.

Reserves are not the same as cash. Reserves can be tied up in buildings and equipment. Companies can make surpluses and have positive reserves but still run out of cash (for example, if debtors are not collected, or if capital expenditure is excessive). Conversely, companies can make deficits and have negative reserves, but still have enough cash to continue over the short or medium term (for example, if customers have paid them in advance, or if they have access to borrowings).

Our annual budgeting and five year planning process, and periodic fee reviews, are conducted with the aim of managing HCPC's finances on a sustainable basis. We do not set specific policy targets for annual budget surpluses or deficits or minimum or maximum levels of reserves. We forecast our cash flow, and from time to time we may aim to build cash levels, for example to fund a large capital project. Like any organisation, we need to maintain an appropriate minimum level of liquidity or cash, to be able to pay our liabilities as they fall due, and to provide a buffer to absorb unexpected costs or risks.

A sufficient minimum level of cash, together with sustainable operating and capital budgets, should ensure that:

- we will have enough cash to be able to fund our operations throughout the registrant fee renewal cycle, including the low points in the cycle;
- we will have enough cash to fund our necessary capital expenditure; and
- we have enough cash to be able to cover our main financial risks.

The purpose of this policy is to set out the process by which the target minimum cash level is calculated each year. Each year's budget setting process will have regard to the policy and the current levels of cash in setting expenditure totals.

Factors affecting our cash level

The following are the main factors affecting our cash flow and cash balances as at the date of approval of the policy. These may change and new factors may emerge as circumstances change so this is not an exhaustive list.

1. ***Funding operational fixed assets***
   HCPC currently pays cash for its operational fixed assets, which are principally office buildings and IT systems, apart from leasing office space at Stannary Street. Renting or leasing options could be considered in future, but we aim to have enough cash to retain the option of buying assets outright, which will often be more cost effective in the long run. The five year planning process includes expected major capital projects, so that we can plan to have the cash available to fund them.

2. ***Registrant fee inflows***
   HCPC's registrants currently pay their renewal fees either bi-annually or 6 monthly in advance, so our cashflow is positive – that is, we receive cash in advance of the related expenditure. We forecast cash inflows from registrant fees annually in advance and (more approximately) 5 yearly in advance. A change in the payment methods or pattern for the renewal fee could have a significant impact on our cash flow and cash balances.

3. ***Other operating cash and working capital***
   Salaries and normal running costs are relatively stable and predictable in annual expenditure and monthly cash flow terms. We pay our suppliers in arrears (97% are paid within thirty days), so we normally generate positive working capital and cash flow in this area.

4. ***Contingencies and risks***
   HCPC needs to have sufficient cash to be able to absorb exceptional or unplanned costs without interruption to operations, or recourse to government or registrants for additional funds. Those contingencies and risks will be reflected in the risk register and would include for example a legislative delay in implementation of a planned fee increase; restructuring costs as a result of a change in the scope of our work; the costs of major Fitness to Practise cases; or overruns on major projects.

Cash flow forecasting and minimum level of cash

The annual budget and the five year forecast will include a cash flow forecast including the first three factors in the above list. The budgeting process should ensure that the forecast minimum level of cash for the coming year is at least 3 months of budgeted operating expenditure. Given that we do not have access to commercial lenders, this is the minimum level which gives us reasonable assurance of maintaining liquidity throughout the year, including in the event of the crystalisation of risks or other exceptional or unplanned costs. Because registrants pay their fees in advance, we will often hold significantly more cash than that minimum level.

Policy

HCPC is required to meet its costs from the fees charged to registrants and so must manage its finances on a sustainable basis. In order to ensure financial sustainability, HCPC will hold a minimum level of cash. The target minimum level of cash will represent 3 months of budgeted operating expenses.

The minimum level of cash will inform the annual budget setting process, helping to ensure that budgets are sustainable, and will be reported to Council as part of the proposed budget for each financial year.

Reporting

The actual levels of cash will be disclosed in the Annual Report and Accounts. The financial commentary section of the Annual Report will comment on the actual levels relative to the minimum level, and (if applicable) how HCPC plans to address cash levels that are significantly below target.

Review of the policy

This policy will be reviewed in outline by the Council annually as part of the approval of the Annual Report and Accounts, and will be reviewed in detail every three years to coincide with the review of the Financial Regulations, or more frequently if appropriate due to changes in circumstances.

Appendix 2: Draft disclosure of Reserves Policy in the 2013-14 Annual Report and Accounts

Our reserves policy was revised and approved at the Council meeting in May 2014 and will be reviewed at least every three years. Our legislation requires us to meet our costs out of our income from registrants' fees. Our annual budgeting and five year planning process, and periodic fee reviews, are conducted with the aim of managing our finances on a sustainable basis. We do not set specific policy targets for annual budget surpluses or deficits or minimum or maximum levels of reserves. We forecast our cash flow, and from time to time we may aim to build cash levels, for example to fund a large capital project. Like any organisation, we need to maintain an appropriate minimum level of liquidity or cash, to be able to pay our liabilities as they fall due, and to provide a buffer to absorb unexpected costs or risks. Therefore our policy is to hold a minimum level of cash equivalent to three months of operating expenditure. The minimum cash balance based on our 2014-15 budget is £6,340,000. Each subsequent year's budget setting process will include and be informed by a recalculation of the minimum cash balance.

Appendix 3: Current reserves policy, originally approved by Council in 2004 and last reviewed by the Finance & Resources Committee in June 2013

Introduction

A private meeting of the Council in October 2004 ratified the September 2004 proposed policy that sufficient Reserves should be held to cover three months overheads. The Reserves policy was last approved by the Finance and Resources Committee in March 2012.

1.0 **Reserves definitions**

HCPC defines reserves as working capital which is trade and other receivables plus cash less trade and other payables.

2.0 **Reserves Policy**

That HCPC maintain a reserves level that is a MINIMUM of three average months budgeted operating expenses.

Appendix 4: example reserves policies of other regulators, as disclosed in their annual report and accounts, and comparison of reserve levels

The General Dental Council is, like HCPC, a public body but not a registered charity. The General Medical Council and the Nursing and Midwifery Council are public bodies and also registered charities, so they must comply with the accounting and reporting requirements for charities, in which reserves have a particular significance and sensitivity.

GDC reserves policy as disclosed in GDC 2012 annual report and accounts, page 39

Reserves

The Reserves Policy was reviewed and agreed by the Council in 2012. It has regard to the:

• objectives of the GDC in pursuit of our statutory and regulatory responsibilities

• risks to the income and expenditure of the GDC, and

• planned major capital spending programmes.

In setting a target level for the Reserves, the Council considered that reserves within a range of four to six months of annual operating expenditure were appropriate. This range is subject to annual consideration by the Council's Financial and Business Planning Advisory Committee when it proposes the budget for the following year to the Council.

GMC reserves policy as disclosed in GMC 2012 annual report and accounts, pages 26-27

Reserves policy

108 Our level of reserves and our reserves policy are reviewed annually, and any financial implications are addressed as part of the budget-setting process. In 2012, the Resources Committee was responsible for determining the reserves policy, and the current policy was approved on 15 November 2012. From 1 January 2013, our governance arrangements changed and the reserves policy will, in future, be considered by the Performance and Resources Board and then approved by Council.

109 We hold reserves:

- to fund working capital and manage the normal day-to-day cash flow of the business because our expenditure is broadly linear whereas income is concentrated in summer and winter peaks to provide funds to address the risks we have identified that may result in an unexpected increase in expenditure and/or a reduction in income
- to provide funds to respond to new initiatives and opportunities that come up during the year
- to fund the period between a decision to increase income and it taking full effect.

110 There is no standard formula that can be used to calculate the ideal level of reserves. We follow the Charity Commission's guidance and set a target range of reserves based on our cash flow requirements and an assessment of the risks facing the organisation. We aim to hold reserves at a level that is not excessive, but does not put our solvency at risk.

111 We operate a defined benefit pension scheme. In line with the accounting standard *FRS 17: Retirement Benefits*, the value of the pension scheme assets and liabilities is recognised on the balance sheet. While the operation of the defined benefit pension scheme does create a financial risk for the organisation, any deficit or surplus in the scheme can be managed over the medium term, and so has no immediate impact on our cash flow requirements. Any risks associated with changes in the level of pension scheme assets and liabilities are therefore disregarded for reserves policy purposes.

112 A significant proportion of our total reserves is represented by fixed assets, which cannot easily be converted into cash at short notice without adversely affecting our ability to fulfil our charitable aims. The value of fixed assets is therefore disregarded for reserves policy purposes.

113 Based on our analysis of cash flows and the risks facing the organisation, our policy is to maintain free reserves in the range of £25 million–£45 million. However, we recognise that the level of reserves will inevitably fluctuate year on year, reflecting variations in actual levels of income and expenditure compared with the budget. Our policy is to maintain actual free reserves in line with the target level over the medium term. If our actual reserves vary significantly from the target range set out in the reserves policy, we will address the variation as part of the annual budget-setting process to bring actual reserves back into line.

114 Our free reserves on 31 December 2012 were £45.5 million, which is marginally above the target range set by the Resources Committee. Our total reserves at the end of the year were £61.6 million, made up of free reserves, plus £11.9 million of reserves represented by fixed assets, and a pension reserve of £4.2 million valued in accordance with *FRS 17: Retirement Benefits*.

115 On 5 December 2012, we decided to freeze the 2013–14 annual retention fee at the current level, and to reduce registration fees for new doctors joining the register. Also, a proportion of doctors facing revalidation – for example, those not in clinical practice – might choose to relinquish their licence to practise or seek voluntary erasure from the register, so we expect our reserves to move back in line with the target range over the medium term.

NMC reserves policy as disclosed in NMC 2012-13 annual report and accounts, page 17

Reserves policy

40 The NMC's reserves policy until September 2012 required that free reserves should equate to at least three months' worth of budgeted operating expenditure, plus an amount to cover our estimated share of the pension deficit based on the latest pension scheme valuation.

41 Free reserves are that part of a charity's unrestricted funds that is freely available to spend, that is, excluding restricted funds, tangible fixed assets and amounts designated for essential future spending.

42 In September 2012 Council agreed to change our reserves policy to adopt a risk based approach. The revised policy states that our free reserves level should be based on an assessment of the financial impact of the risks faced by the NMC, plus an amount to cover our estimated share of the pension deficit. Having approved the assessment and quantification of the major risks, Council agreed that the risk-based element of reserves (also known as 'available free reserves') should be maintained in a range of £10 million to £20 million.

43 The reserves policy is reviewed annually by Council as part of the business planning process and as a core component of the NMC's financial strategy. In March 2013 Council reviewed the risks underpinning the reserves policy and amended the target range of available free reserves to be held in a range of £10 million to £25 million.

44 This level of reserves is considered sufficient to meet the NMC's operating priorities and working capital requirements in the event of a significant unplanned circumstance, whilst alternative funding is secured.

45 In deciding to accept the Department of Health grant of £20 million, the Council has committed to restoring available free reserves to a minimum level of £10 million by January 2016. The financial projections on which this is based include an increase to the annual

registration fee to £120 from April 2015. The need for this will be considered as part of the next annual fee review process in March 2014. Any increase in the annual registration fee would be subject to consultation.

46 The total free reserves of the NMC were £15.276 million at 31 March 2013 (£23.133 million at 31 March 2012), and the available free reserves at 31 March 2013 (excluding the NMC's estimated share of the pension deficit), were £7.4 million (£14.1 million at 31 March 2012). This level of available free reserves is not in accordance with our reserves policy of maintaining available free reserves in the range of £10 million to £25 million. Charity Commission guidance is that free reserves may be reduced in the short term from the level required by the policy, but only in circumstances where there is a clear and robust plan for building them back up to the required level. The financial strategy agreed by Council in 2012, the increased fee level and the Department of Health grant will build reserves back up to the required level. Progress towards meeting our reserves target is reviewed by Council on a monthly basis.

HCPC's reserves compared to the other main regulators

	HCPC 31 Mar 2014 (draft)	**GDC 31 Dec 2012**	**GMC 31 Dec 2012**	**NMC 31 Mar 2013**
Registrants	322,037	101,594	252,538	673,567
Operating expenditure	£23.1m	£30.6m	£88.4m	£63.3m
Reserves	£3.0m	£16.8m[1]	£57.4m[1]	£35.7m[3]
Investments and cash	£16.0m	£38.8m[2]	£90.5m[2]	£56.6m[3]
Reserves per registrant	£9	£165	£227	£53
Cash and investments per registrant	£50	£382	£358	£84

1. Pension reserves held by GDC and GMC for defined benefit (final salary) pension schemes are excluded from the reserves totals.
2. GMC held £60m of cash deposits within fixed asset investments at 31 December 2012, so those have been added to their cash balance in the table above. GDC held £13m of investments in equities and bonds at 31 December 2012, which has been added to their cash total in the table.
3. In 2012 accounts, NMC had an unspent balance carried forward of £18.9m on their £20m DoH grant, so that £18.9m has been excluded from NMC's reserves and their cash balances in the table above