Council, 24 May 2017

Reserves policy

Executive summary and recommendations

Introduction

Our reserves policy is part of HCPC's corporate governance framework. The policy was last reviewed by Council in May 2014[1], and at that time it was agreed that the policy would be reviewed at least every three years.

While other corporate governance documents are being reviewed by Council in September, the reserves policy and the investment policy are summarised in the annual report and accounts, so it is appropriate that those policies are updated prior to finalisation of the 2016-17 annual report and accounts.

The policy covers matters of judgements rather than objective facts, so it is expressed mostly in terms of guidance and targets rather than absolute rules. For example, the policy sets a target range of free reserves, which is intended to represent the range within which the objectives of sustainability and intergenerational equity are met.

If we were to find ourselves marginally outside the target range, we would not necessarily have *failed* to meet those objectives. We would assess the position and whether the target range was still appropriate, and if it was, we would continue to work towards achieving an outcome within the target range.

Decision

Council is asked to discuss and approve the attached reserves policy[2].

Resource implications

None

Financial implications

None directly

[1] See http://www.hcpc-uk.org/assets/documents/100045F2Enc02-ReservesPolicy.pdf

[2] This draft does not track the changes from the May 2014 paper, since the number of changes would make the document difficult to read, but Council members can refer to the previous paper linked in the previous footnote for comparison

Appendices

1. Proposed revised 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

15 May 2017

Appendix 1: Proposed updated reserves policy

1. Introduction

1.1. The reserves policy is part of HCPC's corporate governance framework, and is consistent with our legislation and our strategic intent. It is also consistent with HM Treasury's guidance for the financial management of public bodies[1]. The policy explains the relevance of reserves and cash for HCPC, and the purposes for which HCPC needs to hold reserves and cash, and establishes the process by which the minimum levels of reserves are calculated.

1.2. This policy will inform the annual budget setting process.

2. Responsibilities

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

3. Definitions and relevance of reserves and cash

3.1. In accounting terms, HCPC's reserves are the General Fund and the Revaluation Reserve shown in the bottom half of the balance sheet. The General Fund represents the net accumulated surplus or deficit since the organisation came into existence, and the Revaluation Reserve represents the extent to which fixed assets have been uplifted in value above their historical cost. At 31 March 2017, the General Fund was £4.1m, the Revaluation Reserve was £0.9m and total reserves were £5.0m.

3.2. The total value of reserves equals the value of the net assets in the top half of the balance sheet. At 31 March 2017, we had fixed assets with a book value of £6.8m, cash[2] of £19.5m, a deferred income liability of £20.7m (registrants' fees paid in advance), and other net current liabilities amounting to £0.6m.

3.3. We have a high cash balance, but it is important to distinguish between cash and reserves, and to recognise the relationship between our cash balance and our deferred income balance.

3.4. Reserves are not the same as cash. Reserves can be tied up in fixed assets such as buildings and equipment. Organisations can make surpluses and have positive reserves but still run out of cash (for example, if debts are not collected, or if capital expenditure is excessive). Conversely, organisations can make

[1] https://www.gov.uk/government/publications/managing-public-money
[2] In accordance with our investment policy, we place funds that are surplus to immediate requirements on deposit with qualifying banks for fixed terms of up to two years. In this policy, "cash" refers to the aggregate of cash and fixed term deposits.

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deficits and have negative reserves, but still be able to continue over the short or medium term (for example, if customers have paid them in advance, or if they have access to borrowings).

3.5. Cash or liquidity is essential for all organisations in the short and long term to provide working capital to pay salaries and suppliers, to fund the purchase of fixed assets, and to cover risks[3]. Reserves are a source of cash, in that operating surpluses are eventually realised in cash, but they are not the only source of cash. Other sources of cash and liquidity include receipts in advance from customers (or in our context, registrants), access to borrowings[4] and trade credit, or in the private sector, share capital.

3.6. Reserves are commonly applied by organisations to invest in fixed assets. Reserves that have been applied to purchase fixed assets still appear on the balance sheet as reserves, although they are no longer liquid. Depreciation reduces the value of the asset and the value of the reserves, but charging depreciation does not of itself guarantee that cash will be available to replace the asset at the end of its life.

3.7. In the charity sector, reserves that are not tied up in fixed assets are referred to as “free reserves”, and reserves policies are often expressed in terms of a target minimum level or a target range of free reserves. Free reserves, as the term implies, are reserves that the organisation can use as a source of working capital or to fund new investment. Positive free reserves will usually indicate liquidity.

3.8. Charities are required to have a reserves policy, and the policy should guide financial planning, ensuring sustainability and an appropriate balance between the interests of current and future beneficiaries of the charity. HCPC is not a charity but the concept of free reserves is still relevant to us.

3.9. Because the £5.0m value of our reserves is less than the £6.8m value of our fixed assets, we have *negative* free reserves of £1.8m. We have cash, but the source of our cash is the requirement for registrants to pay us in advance.

3.10. The £20.7m deferred income balance is the value of fees received by HCPC from registrants *before* 31 March 2017 that covers their registration for periods *after* 31 March 2017. Therefore our £19.5m cash balance is entirely the product of the requirement for registrants to pay their fees in advance: without that requirement, we would need to borrow in the form of an overdraft.

[3] For example, a legislative delay in implementation of a planned fee increase; the costs of major Fitness to Practise cases; or overruns on major projects.
[4] HCPC has the power to borrow, and it is likely that we could borrow at relatively low cost, because of the security of our fee income from registrants.

4. Comparison to other regulators

4.1. The reserves policies of the General Dental Council, the General Medical Council and the Nursing and Midwifery Council are reproduced in Appendix 4, together with a table comparing reserves and cash levels across all nine statutory regulators of health and social care in the UK. HCPC has the lowest levels of free reserves and cash of all nine regulators.

4.2. HCPC's negative free reserves represent negative 0.7 months of operating costs. The next lowest free reserves are held by the General Dental Council, with free reserves of negative 0.3 months of operating costs, and the highest free reserves are held by General Chiropractic Council, with free reserves of 16 months.

4.3. HCPC holds £56 of cash and investments per registrant. The other regulators' cash and investment balances per registrant range from £122 for the Nursing and Midwifery Council to £1952 for the General Chiropractic Council.

5. Principles

5.1. Our legislation requires us to meet our costs out of our income from registrants' fees[5]. This implies the principles of sustainability and inter-generational equity. That is, while meeting our objective of public protection, we should manage our operating costs and our capital expenditure within levels that can reasonably and sustainably be funded from registrant fees. Subject to no major changes in our Regulations, we should aim to keep fees relatively constant over the long term in real terms.

5.2. Our annual budgeting process, the five year plan process and periodic fee reviews are conducted with the aim of managing HCPC's finances on a sustainable basis.

5.3. We are a not for profit organisation and, in line with the principle of inter-generational equity, we should normally aim to break even over the long term, and not accumulate large surpluses or deficits. This will ensure that current registrants are not subsidised by future registrants or vice versa.

5.4. Unlike a local authority, we are not legally required to set an exactly balanced budget each year.

5.5. Over the short term, it may be appropriate to budget for a deficit or series of deficits provided that our finances remain sustainable in the long term. Equally, it may be appropriate to budget for a series of surpluses if we have a valid purpose in building our reserves.

[5] Health and Social Work Professions Order 2001, Article 45

6. Effect of the transfer of social workers in England to a new regulator

6.1. This revision of the policy needs to recognise the limitations imposed by the government's decision, to be implemented via the Children and Social Work Bill, to transfer the regulation of social workers to a new regulator.

6.2. The transfer of social workers will have a major financial impact on HCPC, with the loss of £9m in fee income, and the loss of contribution towards fixed costs. In these circumstances, we are unlikely to be able to increase our reserves over the next five years. It may be appropriate to plan financially for a decrease in reserves over the transitional period, subject to the principles of sustainability and intergenerational equity.

7. Appropriate levels of cash and free reserves

7.1. The previous reserves policy set a minimum level of cash equivalent to three months of budgeted operating expenses. On its own, that limit is not effective. In our 2017-18 budget for example, three months of operating expenses is £8.4m, but the lowest forecast cash balance during 2017-18 is £13.3m. That means that we could have proposed a budget deficit for 2017-18 of up to £5m without breaching the reserves policy cash limit.

7.2. A policy based only on a cash limit also lacks relevance because it is liquidity rather than cash that is essential. Because of the relative security of our income from registrants' fees, we could operate with a much smaller cash balance. This may be an appropriate solution in future, if for example we wanted to offer registrants other payment options which would reduce our cash balances. The previous policy effectively excluded our ability to offer other payment options.

7.3. As noted above, reserves policies in the charity sector are often expressed in terms of a target minimum level of free reserves, or a target range of free reserves. Targets are normally expressed in relation to annual operating costs, but other measures could be appropriate, for example if funds were needed for major planned capital expenditure. If the organisation's free reserves are below the minimum level or outside the target range, it will normally plan to operate at a surplus or deficit as applicable until free reserves are above the minimum/within the target range. These limits act to ensure sustainability and intergenerational equity.

7.4. Charities' reserves policies typically set a minimum level of free reserves equivalent to three months operating costs, but that is because charities' income is generally insecure. Our income is secure and our working capital is strong because of the requirement for registrants to pay their fees in advance, so we do not need free reserves equivalent to three months' operating costs. As at 31 March 2017, we have negative free reserves of £1.9m. We could continue to operate with negative free reserves. But in so doing, we are depending on registrants' fees in advance for our working capital, and we are precluding being able to offer other payment options.

7.5. Given the context of the expected transfer of social workers to a new regulator, this policy proposes a target range of free reserves for the next five years that recognises the reality that we are unlikely to be able to increase our reserves over that period. In the longer term, we would expect to set a target level for free reserves which would enable us to avoid dependency on registrants' fees in advance, and be able to offer other payment options, without alternatively requiring a large commercial borrowing facility.

7.6. The proposed upper limit of the range for the next five years is zero free reserves. From our current position, reaching the upper limit would require us to record £1.8m in aggregate net surpluses. The proposed lower limit is negative free reserves equivalent to three months operating costs. From our current position and based on likely expenditure levels after social workers are transferred, we could plan for up to £5m in aggregate net deficits before reaching the lower limit.

7.7. If we allow reserves to fall below the lower limit, we are likely to be failing to maintain the principles of sustainability and intergenerational equity. We would be accumulating deficits that would ultimately have to be recovered by premium charges on future registrants.

8. Policy

8.1. HCPC is required to meet its costs from the fees charged to registrants and so must manage its finances on a sustainable basis. We should not hold or accumulate excessive surpluses or deficits, as that would imply current registrants subsidising future registrants or vice versa.

8.2. In order to ensure financial sustainability and fairness between current and future registrants, HCPC has a target range of free reserves. Free reserves are reserves that are not tied up in fixed assets. They are available to use as a source of working capital or to fund new investment. The target range for the period to 31 March 2022 recognises the likely financial impact on HCPC of the government's plans to establish a new regulator for social workers in England. The target range also recognises that our liquidity is provided by the requirement for registrants to pay their fees in advance. Because of this requirement, HCPC is able to operate with negative free reserves.

8.3. The upper limit of our target range is zero free reserves, and the lower limit is negative free reserves equivalent to three months of budgeted operating expenses.

8.4. The target range of free reserves 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.

9. Reporting

9.1. The financial commentary section of the Annual Report will comment on the actual levels of free reserves relative to the target range, and (if applicable) how HCPC plans to address free reserve levels that are outside the target range.

10. Review of the policy

10.1. 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.

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Appendix 2: Draft disclosure of reserves policy in the 2016-17 Annual Report and Accounts

Our reserves policy was revised and approved at the Council meeting in May 2017 and will be reviewed every three years, or more frequently if there are significant changes in our operating or financial environment. 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 aim to hold or accumulate excessive surpluses or deficits, as that would imply current registrants subsidising future registrants or vice versa.

In order to ensure financial sustainability and fairness between current and future registrants, HCPC has a target range of free reserves. Free reserves are reserves that are not tied up in fixed assets. They are available to use as a source of working capital or to fund new investment. The target range for the period to 31 March 2022 recognises the likely financial impact on HCPC of the government's plans to establish a new regulator for social workers in England. The target range also recognises that our liquidity is provided by the requirement for registrants to pay their fees in advance. Because of this requirement, HCPC is able to operate with negative free reserves.

The upper limit of our target range is zero free reserves, and the lower limit is negative free reserves equivalent to three months of budgeted operating expenses. Our actual free reserves as at 31 March 2017 are negative £1.8m, which is equivalent to less than one month's expenditure in the 2017-18 budget. Each subsequent year's budget setting process will include and be informed by a recalculation of the target range of free reserves.

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Appendix 3: Current reserves policy, approved by Council in May 2014

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.

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Appendix 4: example reserves policies of other regulators, as disclosed in their annual reports and accounts, and comparison of reserves 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 2015 annual report and accounts, page 50

Reserves

The Reserves Policy was reviewed and agreed by the Council in 2015. It has regard for the:

a. objectives of the GDC in pursuit of our statutory and regulatory responsibilities
b. risks to the income and expenditure of the GDC
c. planned major capital spending programmes

In setting a target level, Council considered that reserves within a range of four to six months of annual operating expenditure would be appropriate. This range is subject to annual consideration by the Council's Finance and Performance Committee when it proposes the budget for the following year to the Council.

GMC reserves policy as disclosed in GMC 2015 annual report and accounts, pages 56-57

Reserves policy and going concern

Our level of reserves and our reserves policy are reviewed annually, and any financial implications are addressed as part of the budget-setting process.

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 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 its taking full effect.

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.

We operate a defined benefit pension scheme. In line with the accounting standard FRS 102, 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.

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.

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. But 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 within a reasonable period.

Our free reserves at the end of 2014 stood at £36.3 million. As our costs in 2015 exceeded our income, our free reserves on 31 December 2015 reduced to £34.1 million. Total reserves at the end of the year were £69.4 million, made up of free reserves, plus £13.8 million of reserves represented by fixed assets, and a pension reserve of £21.5 million.

On 10 December 2015, we decided to embark on a major change programme to reduce our costs and increase our income over the medium term. This change programme involves additional costs in 2016 and 2017 to generate significant savings in future years. We also decided to increase the 2016–17 registration fees and annual retention fee in line with inflation, recognising the additional cost pressures we face. We estimate that our free reserves at the end of 2016 will reduce to around £30.9 million.

The majority of our income comes from registration fees paid by doctors. All doctors must be registered with us to practise medicine in the UK, and so our income is relatively certain. The trustees are therefore of the view that we are a going concern.

There are no material uncertainties related to events or conditions that cast significant doubt on our financial stability over the medium term.

NMC reserves policy as disclosed in NMC 2015-16 annual report and accounts, page 21

Reserves policy

The NMC operates a risk-based reserves policy which provides 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. Free reserves are that part of a charity's unrestricted funds that are freely available to spend, that is, excluding restricted funds, tangible fixed assets and amounts designated for essential future spending.

The reserves level is reviewed at least annually by the Council. In reviewing the level, the Council considers the latest assessment and quantification of major risks, and agrees an appropriate range in which the risk-based element of reserves (also known as 'available free reserves') should be maintained.

In March 2016 the Council reviewed the latest position in relation to risks underpinning the reserves policy and agreed that available free reserves should continue to be held in a target range of £10 million to £25 million.

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, while alternative funding is secured.

The unrestricted reserves were £41.113 million at 31 March 2016 (2014–2015: £27,468). Total free reserves were £17.913 million (£3.471 million at 31 March 2015) after deduction of the net book value of fixed assets of £23.200 million (2014–2015: £23.997 million).

Available free reserves at 31 March 2015 have been restated to £3.471 million, previously reported at £11.500 million, due to a change in the calculation of the defined benefit pension scheme deficit in line with changes to accounting policy implemented during 2015–2016. Further information can be found in note 27 to the accounts.

Reserves and cash of the nine UK statutory regulators of health and social care

	Number of registrants	Operating expenditure	Total reserves	Free reserves	Investments and cash	Free reserves per registrant	Investments and cash per registrant	Months of operating costs in free reserves
HCPC 31/3/17 (draft)	350,330	£31.4m	£5.0m	(£1.8m)	£19.5m	(£5)	£56	(0.7)
General Dental Council 31/12/15	108,209	£30.6m	£16.9m	(£0.8m)	£37.2m	(£7)	£344	(0.3)
Nursing & Midwifery Council 31/3/16	692,550	£76.3m	£41.1m	£17.9m	£84.7m	£26	£122	2.8
General Osteopathic Council 31/3/16	29,136	£2.7m	£2.5m	£0.7m	£1.3m	£137	£264	3.1
General Medical Council 31/12/15	276,761	£99.3m	£69.4m	£34.1m	£86m	£123	£311	4.1
General Pharm'cal Council 31/3/16	74,980	£22.0m	£13.3m	£7.6m	£25.6m	£101	£342	4.1
Pharm'cal Society of Northern Ireland 31/5/16	2,303	£1.1m	£0.9m	£0.9m	£1.5m	£376	£653	9.2
General Optical Council 31/3/16	29,136	£7.6m	£9.2m	£7.4m	£15.8m	£254	£543	11.7
General Chiropractic Council 31/12/15	3,109	£2.5m	£3.6m	£3.4m	£6.1m	£1,101	£1,952	16.5

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Notes

1. Free reserves are calculated as total reserves less book value of fixed assets, less any other reserves held for restricted purposes (eg pension reserves).
2. The number of months' operating costs held in free reserves is calculated based on operating costs in the latest accounts, since that is the information publically available. It will normally be more appropriate to use budgeted operating costs for the coming financial year when assessing whether free reserves are within their target range.
3. Numbers of registrants exclude regulated premises in the cases of the GPhC and the PSNI

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