## Framework for Management of Reserves and Use of Contingencies in Budgeting

### Purpose of paper
To propose a framework for the management of the General Dental Council’s (GDC’s) distributable general reserve and use of contingencies in budgeting.

### Action
For discussion and noting

### Status
Public session

### Corporate Strategy 2016 - 2019
**Performance Objective 2**: To improve our management of resources so that we become a more efficient regulator.

### Business Plan 2017
**Priority 1**: Continue to build a cost effective and efficient organisation.

### Decision Trail
The Finance and Performance Committee reviewed and discussed the proposed framework for the management of the GDC’s general distributable reserve and use of contingencies in budgeting at its meeting on 22 November 2017. The Committee confirmed it was content with the framework in principle. It was agreed the framework would be further developed and brought back to the Committee on 1 March 2018 for review with a view to recommend this to Council on 15 March 2018 for approval.

### Recommendations
The Council is asked to:
- review the framework for the management of the GDC’s general distributable reserve and use of contingencies in budgeting;
- note the Finance and Performance Committee’s proposal to develop the framework further with a view to recommend this to Council on 15 March 2018 for approval.

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### Appendices
Annex 1: 2017 Reserves Policy (Draft)
1. Executive Summary

1.1. This paper proposes a framework for the management of the GDC’s distributable general reserve, for discussion by the Committee, which will impact on how contingencies are used in budgeting.

1.2. The current reserves policy provides for a minimum of three months of operating spend, with an aspirational target to increase this to a range of 4 to 6 months of operating spend.

1.3. The 2018 budget approved by Council in September 2017, was drafted in, and will cover, a period when the organisation is undergoing significant change and when key aspects of the portfolio of projects which will implement Shifting the balance are still under development. Since the reserves position for 2018 is only projected at this stage, any proposal to draw down reserves would have been based on actual reserves of £3.2m as at 31 December 2016, which are below the levels stated in the reserves policy. It was considered prudent to present a budget that included contingent provisions for the cost of activity which is certain, but for which costs cannot be more accurately budgeted.

1.4. It was considered that no alternative mechanism existed in 2018, but that steps should be taken to develop one for future years. Such an alternative approach is proposed in this paper, which would establish an appropriate level of reserves by categorising amounts of reserves according to the estimated costs or loss of income they would cover as a result of the different types of risk that could materialise.

1.5. If any of the risks should materialise, a request would be made to Council to drawdown reserves at the level required, once the case had been made. Council’s authority to drawdown reserves would effectively be the approval of an increase in the GDC’s annual budget during the year, after the budget has already been approved.

1.6. Such a framework, whereby the Executive would seek Council’s approval to draw down reserves against crystallising risks after the annual budget has been approved, would ensure that budgets could have much more transparency as contingent provisions will be minimised.

1.7. The Finance and Performance Committee reviewed and discussed the proposed framework for the management of the GDC’s general distributable reserve and use of contingencies in budgeting at its meeting on 22 November 2017. The Committee confirmed it was content with the framework in principle. It was agreed the framework would be further developed and brought back to the Committee on 1 March 2018 for review with a view to recommend this to Council on 15 March 2018 for approval.

1.8. The Council is asked to:

- review the framework for the management of the GDC’s general distributable reserve and use of contingencies in budgeting;
- note the Finance and Performance Committee’s proposal to develop the framework further with a view to recommend this to Council on 15 March 2018 for approval.

2. Introduction and Background

2.1. The 2018 budget and the outlook for 2019 and 2020 were presented to the September Council meeting at which the budget was approved.

2.2. However, the Council noted the need for a clear narrative that explained how reserves and contingencies were to be used in the budgeting process.

2.3. Since the budget was drafted in, and will cover, a period when the organisation is undergoing significant change and when key aspects of the portfolio of projects which will implement Shifting the balance are still under development, the Executive made ‘enabling provisions’ in relation to headcount requirements which had not yet been finalised. It was therefore necessary to rely on the use of unusually high levels of ‘contingent provisions’ because of uncertainty in relation to the cost of a number of significant new activities for which budgeting has proved extremely difficult. This effectively inflated the overall budget.
Additionally, it reduced transparency and, it could be argued, budgetary discipline. Whilst the executive, including the Accounting Officer, viewed the approach as necessary for 2018, it agreed strongly with the Council that a formal process to allow structured use of reserves would be a preferable way of dealing with uncertainties.

2.4. Council were advised that as a result of annual surpluses projected, it is expected that the general reserve will increase to the equivalent of 6 months of budgeted operating expenditure by 31 December 2018, within the 4 to 6 months range identified in the current reserves policy (appendix 1), but the outlook for 2019 and 2020 indicated that the general reserve will be in excess of the levels stated in the policy.

2.5. The Executive agreed to develop this framework for approval to draw down reserves and for the use of contingency in the budgeting process for discussion at this Committee’s November meeting.

3. Why are reserves required?

3.1. The current reserves policy is designed to ensure that the GDC has sufficient funds to maintain its statutory functions and processes for protecting the public and regulating the dental team, whilst recognising the risks that the GDC faces, ensuring that the GDC has adequate levels of working capital throughout the year.

3.2. As we set out in response to the consultation on the dentist and dental care professional annual retention fee levels for 2016, our reserves policy reflects good practice and an aim to maintain appropriate financial soundness. It is in line with reserves policies of comparable organisations. We hold reserves to ensure that we can continue to operate even when substantial risks materialise – for example, if another surge in complaints occurs – without resorting to ultimately more costly forms of finance such as bank loans.

3.3. The reserves policy was last fully considered by the Council in December 2016 when it was adjusted to reflect the financial realities at the time and was revised to a minimum of three months of operating spend, with an aspirational target to increase this to a range of 4 to 6 months of operating spend. It was suggested that the aspirational target should not be changed due to short term fluctuations in reserves outside of the range of 4 to 6 months of operating spend and that using the reserves policy in this way supports medium term planning considerations for both income required and total expenditure predictions.

3.4. An indication of significant unbudgeted risks that will need to be considered as part of any future policy review include:
   a. Unavoidable delays or cost overruns with the implementation of the estates strategy
   b. Increased costs in the Fitness to Practise process
   c. Unanticipated costs of legal challenges
   d. Any short fall over income for the cost of providing the ORE
   e. Uncertainty over constitutional changes following the referendum result to leave the EU
   f. Any short-term funding required for the defined benefit pension plan (lower risk, as it would be likely that if required, a medium to long term recovery plan would be put in place)

4. Reserves and cash

4.1. Reserves are measured on an annual basis at 31 December, but cash is measured on a daily basis and reported on monthly. Given different monthly profiles for income receipt and expenditure during the year, there are large fluctuations in the levels of cash held by the GDC. During 2017, cash balances plus investments realisable within seven days range from around £36m in January 2017 to an expected low of £16m in November, before increasing rapidly again in December. This trend is repeated annually and would only be
affected by large one-off costs. Cash balances are managed to ensure that minimum cash does not fall below £5m.

4.2. Key assumptions that affect reserves and cash are:

a. Annual retention fees from dentists are received in quarter 4 of each year, but credited to the income & expenditure account in the following January each year (approximately £36.0m collected in 2016 for the 2017 registration year).

b. Annual retention fees from dental care professionals are received in June and July of each year and credited to the income & expenditure account in August of that year (approximately £7.8m in 2017).

c. Expenditure is incurred monthly throughout the year at an average of around £3.4m per month in 2017, in cash terms, but with £3.5m charged to the income and expenditure account, including depreciation costs.

d. Capital expenditure is funded out of cash resources and charged to the income and expenditure as depreciation in future years, over the period in which the asset will be used.

4.3. Over recent years, reserves have been less than the range identified in the current policy of 4 to 6 months of operating spend, and have in fact been below an acceptable prudent minimum level of 3 months of operating spend. In addition, cash resources have also been significantly lower in recent years, due to both the investment in the redevelopment of Wimpole Street (£9.0m) and the £6.0m deficit incurred in 2014 (before depreciation):

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum cash November (including investments)</th>
<th>Year-end reserves</th>
<th>Year-end reserves (months of operating spend)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>£20.1m</td>
<td>£15.2m</td>
<td>5.6 Months</td>
</tr>
<tr>
<td>2014</td>
<td>£12.7m</td>
<td>£8.6m</td>
<td>2.7 Months</td>
</tr>
<tr>
<td>2015</td>
<td>£6.7m</td>
<td>£10.1m</td>
<td>2.6 Months</td>
</tr>
<tr>
<td>2016</td>
<td>£9.1m</td>
<td>£12.1m</td>
<td>3.2 Months</td>
</tr>
</tbody>
</table>

5. Use of contingencies in the 2018 budget

5.1. The 2018 budget utilised ‘enabling provisions’ in relation to headcount requirements which were not finalised. As a result, it incorporated unusually high levels of ‘contingent provisions’ because of uncertainty in relation to the cost of a number of significant new activities for which fully costed proposals had not yet been developed.

5.2. As remarked in section 2, whilst the reserves policy is now projected to be met in December 2017 and expected to be exceeded in 2019 and 2020 if the ARF remains unchanged, the projection could not be used as a robust basis for budgeting in 2018. Furthermore, the mechanisms for accessing the reserves were not sufficiently developed to allow their use in this context.

5.3. Contingent provisions are, at present, more practicable - once contingent provisions in the budget are approved by Council, the Chief Executive controls how budget is deployed on the activities which they relate to. Accountability is maintained by the Chief Executive regularly reporting to the Committee and Council on actual expenditure incurred compared with the approved budget.

6. An alternative approach to developing a reserves policy and a framework for the drawdown of reserves

6.1. Any framework for accessing reserves is intrinsically linked to the level at which we set the ARF. A drawdown of reserves would most commonly be required where budgeted expenditure exceeded budgeted income for the coming year and the ARF was not
increased to fund the shortfall. In such circumstances, a Council approval to the drawdown would be sought as part of the budget approval process.

6.2. As an example, in 2014, in only one year, the GDC general reserves reduced by £6.6m from £15.2m (5.4 months of operating spend) to £8.6m (2.6 months of operating spend). This was primarily caused by an increase in Fitness to Practise expenditure relating to the increase in complaints received in recent years. In this instance, the ARF was not increased and Council were asked to approve a deficit budget requiring a drawdown of reserves.

6.3. It is important to note that agreement to drawdown reserves in this context implies that current income levels cannot support proposed expenditure levels if they persist into the future. In those circumstances the ARF would need to increase. Moreover, if reserves are below the levels set out in the policy, the only means by which activity can be funded is out of ARF income.

6.4. The current reserves policy has been established to protect the GDC from a significant event or events which would have the effect of a major loss of income or a sudden major increase in expenditure. As the GDC’s revenue comes mainly from statutory fees, any major permanent loss of income would only be due to a reduction in the number of registrants or a revision to the statutory position. Risks to expenditure largely relate to variable volumes (including significant external legal costs), adverse reputational issues and unforeseen legal challenges.

6.5. As an alternative approach to the current reserves policy, an appropriate level of reserves could be established by categorising amounts of reserves according to the estimated costs or loss of income they would cover as a result of the different types of risk that could materialise:

a. **Allocated reserves** - reserves allocated to cover management of specific risks identified on the corporate risk register that could not be fully mitigated by management actions and are therefore not provided for in the annual operating budget.

b. **Unallocated reserves** – these set out to cover management of risks that are unforeseen and costs that cannot be quantified and are not addressed in the corporate risk register e.g. unforeseen legal challenges, pension funding deficits in the current uncertain market conditions that need to be met,

c. **Capital reserves** - to cover future capital projects such as office refurbishment or expansion while avoiding an extraordinary rise in the ARF

d. **Operating reserves** - to cover corporate risks identified that relate to inaccurate forecasting of capacity required by the GDC, either in the form of new work or the expansion of existing work e.g. if Fitness to Practise volumes are higher than we anticipate for the year.

6.6. If any of the risks as described above should materialise, a request, with supporting rationale, would be made to Council to drawdown reserves at the level required. The quarterly forecast process is an existing framework within which the case for a drawdown of reserves could be made to Council. Council’s authority to drawdown reserves would effectively be the approval of an increase in the GDC’s annual budget during the year, after the budget has already been approved.

6.7. It is proposed that the Head of Finance and Procurement and the Head of Risk should work with the Executive to allocate GDC risks to the different reserves categories described, and estimate the potential costs/loss of income that could arise from those risks materializing.

6.8. This will allow us to estimate the total level of funding that would be required to cover any remaining exposure to risk after putting control measures in place, resulting in a target level for reserves that is equivalent to the total impact of risk exposure on the GDC.

6.9. As a precedent, the 2010 budget was set by the Council in September 2009. The approach to the budget was ‘business case driven’. A number of new developments had been planned where the general policy approach had been approved by Council, but neither detailed implementation plans nor fully costed proposals had been developed sufficiently to
enable Council to commit to funding them. The view at the time was that the level of reserves was sufficient to enable the Council to approve funding at a later point and, on this basis, the ARF was held without an increase for the second year running.

6.10. In March 2010, the Executive presented a range of proposals that would refocus the GDC’s regulatory functions and address a range of capacity issues at a cost of £5.3m – a 22% increase in the expenditure budget – and recommended Council approve the drawdown of £5.3m from reserves, representing 38% of the 2009 reserves position (£13.9m).

6.11. While it is envisaged that there will always be provision for a small ‘general contingency’ under the control of the Chief Executive, putting a framework in place whereby the Executive can seek Council’s approval to draw down reserves after the annual budget has been approved will ensure that budgets can have much more transparency as contingent provisions will be minimised. As such, it should not be seen as a failure in forecasting if the need to draw down reserves arises.

7. **Recommendation**

7.1. The Council is asked to:

- review the framework for the management of the GDC’s general distributable reserve and use of contingencies in budgeting;

- note the Finance and Performance Committee’s proposal to develop the framework further with a view to recommend this to Council on 15 March 2018 for approval.
Annex 1: Reserves Policy (Draft)

1. The Council establishes a policy to maintain an appropriate level of financial reserves to protect the General Dental Council from a significant event or events which would have a substantial affect, such as a major loss of revenues or a sudden major increase in expenditure.

2. Reserves are defined as the general reserves as stated in the Annual Report & Accounts of the Council.

3. However, as our revenue comes mainly from statutory fees, we set the reserves level having regard to the:
   a. objectives of Council in pursuit of our statutory and regulatory responsibilities
   b. risks to the income and expenditure of the Council
   c. planned major capital spending programmes

4. The GDC aims to maintain reserves at a minimum of three months of operating spend, with an aspirational target to increase this to a range of 4 to 6 months of operating spend.

5. The Council will review this Reserves Policy not less than annually.