

Reporting and financial management

Text of speech given by Kate Sayer to the ICAEW for their Trustee Week event Charity Trustee Update on 31 October 2011

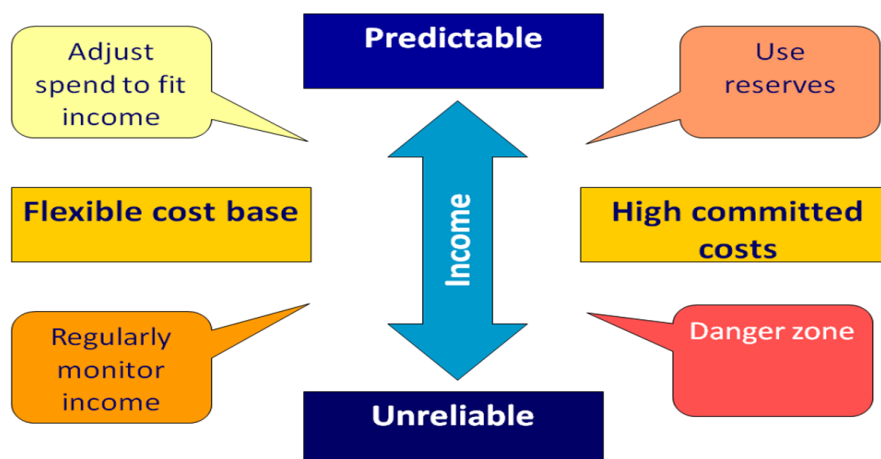
With so much change, I do not need to tell you that charities need to be ready to change and adapt to a new funding environment and new requirements. Even without the external funding changes, charities need to be able to respond to the changing needs of their beneficiaries.

What sort of charity are you?

The simple diagram below puts charities into four categories.

Firstly, income will be predictable if it is longer-term, but will include sources such as investment income, legacies and direct mail which may fluctuate, but the source remains. Whereas a charity with unreliable income is more likely to have sources such as one-year funding and fundraising is dependent on events or similar, where the risk of loss of funding is high.

Next, costs for many charities are fixed and unavoidable unless they close the service. For example, a care home has to operate with a certain number of staff. Whereas a grant-making foundation can make decisions about its distributions.



The most comfortable place to be in a time of change is in the top left of the diagram, where the charity needs to understand what its forecast income will be and flex expenditure to match.

Charities with unreliable income and a flexible cost base (bottom left) can do the same, but their task in forecasting income is more difficult. They remain vulnerable if they suffer a significant loss of funding and may have to consider other options such as collaborative working or merger to gain more secure income.

Charities with high committed costs and predictable income (top right), such as a care home, should use their reserves to maintain their service levels if income falls temporarily. Clearly if the reduction in income is more permanent, then using reserves is only delaying the inevitable decision and is not a good use of funds.

Charities in the bottom right corner are in the danger zone. If income falls, they may be able to use reserves, but may quickly exhaust them as they struggle to reduce costs. They are more likely to have to close services or seek a merger.

Get your financial shape right

In order to be fit in times of change, you need to have the right financial shape. This starts with the strategy, which needs to remain relevant. The risk assessment will both help to keep the strategy relevant and help you to develop your thinking about difficult scenarios in your external world. Your view on risk will inform your reserves policy, but equally you need to think about what sort of charity you are to understand what level of reserves you should have. Your financial plan should reflect your strategy, but also work through different scenarios to help your assessment of risk and reflect your actual reserves. Your management information should help you to monitor the plan, the risks and inform reviews of the strategy. The whole jigsaw has to fit together into a coherent whole.



Strategy

Is your strategy still relevant? Consider the external environment and how this is affecting your beneficiaries, funders, donors and volunteers. Is the need for your service still the same or are there changes in the demand pattern? Can funders still afford your service or have they been subject to funding cuts themselves? Some charities have found in the past that their service was much needed but the funders just could not afford to pay for it, with the result that the service had to close. You may need to think about alternative models to match changed expectations and ability to pay.

It may be difficult to predict change and actually it is not necessary. What is needed are two more important things:

- An ability to spot early warning signs of change
- An ability to respond to change quickly

Organisations are not always good at either of these, even if you have individuals within the team who are good at it.

You may also need to face some harsh truths – you may feel that a service is good and well-received, but if no-one is prepared to pay for it, it may have to close. Putting off such decisions will drain your resources. So face harsh truths head on.

As part of your strategic review, you need to check that you have the right *business* model for all activities. This means that the funding needs to match the risk you are taking, that you have the right cost structure and preferably that your costs are flexible if your income is flexible. An example where we have helped was an organisation that was set up to handle a major contract for an advice service. The funding for the service was performance related, with payment in arrears for the number of calls handled of different types within a framework of rates payable. Consequently, there was a high admin burden in recording calls within a rigid framework. So there was a risk of inaccurate recording, low demand for certain types of calls, fluctuating demand over all types of calls as well as lost time by staff undertaking tasks that did not fit into the payment framework. The organisation had not appreciated *all* the risks that they were taking on, and when they realised this, they understood that the funding was too low. They also realised that highly qualified staff on permanent contracts did not fit the model and their cost structure was too expensive.

Risk assessment

The above example also demonstrates that you have to think about risk at all levels. Risk registers can often become dry and dusty – rarely looked at and not really seen as relevant to the day to day management of the organisation. However, risk assessment ought to be a continuous process and for many of you it probably is. It may not be formally documented, but organisations that are fit and ready for change are constantly looking outside their organisation to identify new uncertainties – which may be threats or opportunities depending on how you react to them.

What would be a killer blow to your organisation? A change in legislation maybe? A competitor moving onto your territory? It is worth brainstorming the unthinkable so that you are at least ready to respond. One charity had great success with a training programme for people with a chronic illness, teaching them practical ways to cope with their illness. PCTs and others commissioned them to run many courses and it became a valuable source of unrestricted income. But then the NHS decided they would run the course themselves, wiping out the charity in the process.

Challenge assumptions and deeply held beliefs to make sure that you are not taking anything for granted and can develop a response plan for various possible outcomes.

Reserves

Once you have done more thinking about the risks, you can re-examine your reserves policy and the actual level of reserves you hold. Reserves policies are often fragile – they tend to be a justification for those charities that hold high levels of reserves or feel like a fantasy for those charities reliant on restricted funding that does not allow the build up of actual reserves to match the policy.

The level of reserves you need depends on the type of charity you are, as already discussed. Some charities can flex their expenditure and so do not need to hold high levels of reserves. Ironically, the charities that most need reserves are usually those which find it most difficult to accumulate them.

But if you have reserves and it starts raining, then it is time to use them. Reserves are really there to buy time while you come up with a plan of action to respond to change. You need to use the money and the time well or you will have frittered it away and still not made the necessary changes.

Financial planning

When looking at re-assessing risks, we thought about challenging assumptions. In your financial planning, you should be looking at all the assumptions and areas of uncertainty. What happens to the financial plan if you change the assumptions? Really test the financial assumptions and make contingency plans. Talking these through with other people will make the organisation much more ready for change and able to adapt to change more quickly.

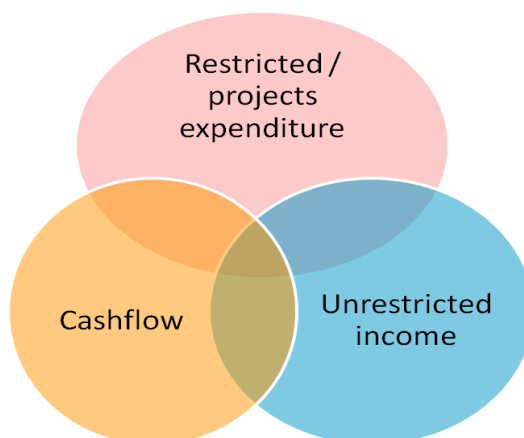
Cashflow is the most important aspect to planning and managing your finances. If a financial plan works from a cashflow perspective, then it will work from the perspective of income and expenditure. The timing of cash inflows and spending is crucial and ideally you want to match these. Regular re-forecasting of your cashflows is essential and the work involved can be reduced if you focus on key variables.

Management information

Good quality financial information should help managers and trustees to make decisions, so it needs to be forward-looking as well as reporting on the past.

Charities that have significant levels of restricted funds and low levels of unrestricted funds need to monitor their financial position particularly carefully. There is a danger that the charity will start dipping into restricted funds to pay for unrestricted expenditure. The trustees will then be in breach of trust as they will not have applied the restricted funds to the purposes for which they were given. In effect, this means that charities with low levels of unrestricted funds may find that they are no longer a going concern even though they have cash from restricted funds. Charities in this situation would be well advised to talk to their funders to see if there is greater flexibility about how the restricted funds may be used.

So how can you monitor the financial position quickly and regularly? Drawing up full accounts which allocate all costs to the individual restricted funds can take time. We use a simple approach called “the three-legged stool”.



For activities funded from restricted sources, the aim is to stay within the cost budget. Any overspend will have to be funded from unrestricted funds, so has to be avoided to preserve unrestricted funds. So the finance team should work closely with project managers to ensure that all costs are identified to the correct project, and that managers are looking ahead and planning activity and expenditure to stay within budget.

For unrestricted funds, it is the income which is most uncertain. You need to monitor actual and forecast income against the original targets and flag up shortfalls as early as possible.

Cashflow should be monitored overall. Usually it is easier to identify specific cash inflows as restricted or unrestricted, but much more difficult to split spending between these categories. As long as you are monitoring the restricted fund expenditure as well, then it is not necessary to undertake highly detailed cash spending allocations. The emphasis in the cashflow forecast is to track actual receipts and payments and predict likely patterns as accurately as possible.

You now have all the key components of information to enable careful monitoring of restricted and unrestricted funds. When you look at the actual and forecast balance at bank on the bottom of your cashflow forecast, you need to go a step further. How much should you have to reflect the balance of unspent restricted funds? This is not difficult to calculate if you have the opening balances on restricted funds, the new cash received for restricted funds and the information from the projects on their levels of spending. For reassurance, you can undertake the same calculation on unrestricted funds.

It is only by looking at all three aspects of the finances together that you can draw a picture regularly of the overall fund position. Hence it is a three-legged stool – take one leg away and it falls over.

Summary

Charities can operate all these aspects of good financial management all the time – you do not have to wait for a crisis! It is important to see how inter-connected they are and to see the links between the different elements. Bringing the pieces of the jigsaw together makes a picture you can read and interpret.