How to plan a strategy for financial sustainability

The tough financial environment is unlikely to ease any time soon. A robust financial strategy is essential, says Fleur Holden.

"HARD COMMERCIAL THINKING IS VERY RELEVANT TO UNDERSTANDING A CHARITY'S FINANCIAL STRUCTURE"

Fleur Holden
is a director at Sayer Vincent

ALTHOUGH THERE were reports this summer that the economy may be picking up after a sluggish start to the year, the harsh reality for charities is that they continue to be under significant financial pressure. On top of this, damaging media reports such as those we have seen this year about international development organisations clearly show that a non-financial reputational incident can have very real financial implications.

One of the risks of financial insecurity is that it often results in costly reactive and short-term thinking. Taking a broader, longer-term view of the situation can provide much needed stability and even present new opportunities. But developing a financial strategy that will ensure sustainability can take time and will involve many different aspects for an organisation to work through.

What are the key considerations for charities and not-for-profit organisations when creating a financial strategy to help them face these challenges and secure their longer-term sustainability?

UNDERSTANDING YOUR BUSINESS MODEL

The term "business model" may be perceived as commercial. However, hard commercial thinking is also very relevant to understanding a charity's underlying financial structure. Stepping back and thinking about the key factors that determine how the organisation operates is the vital first step for a charity to take to ensure that everyone is starting from the same place.

Business models within the charity sector vary widely. For example, you may have a grant-making trust receiving regular investment income and making grant payments. The amount of the grants awarded can vary according to the performance of the investments. At the other end of the spectrum, you could have a care home running an expensive staff team and building, with high fixed costs. Income may fluctuate with the risk of vacant bed spaces damaging sensitive margins.

> "Needs differ widely so there is no one-size-fits-all answer"

To understand your own business model, some key questions that can support this process are:

- What are the organisation's key activities?
- How are these activities funded?
- How flexible is the cost base?
- What is the working capital requirement?
- How are the charity's capital commitments financed?
- What is the relationship between its income and expenditure?

The last question is arguably the most important and yet it is often overlooked. The link between income and expenditure should be considered in terms of the organisation's short and medium-term plans. For charities, there is often little or no relationship between the two, which makes this planning a difficult exercise to undertake, and this is a primary cause of financial instability.

The spending of funds to preserve the generation of income is also a dilemma. The cost of fundraising, together with the cost of implementing strong compliance measures to ensure safeguarding and combat fraud for example, form part of the administration costs of an organisation – spend that does not go directly to beneficiaries. This expenditure may not be desirable from a funder's perspective, but it is essential for sustainability, as well as good risk management and assurance.

WHAT RESERVE POLICY IS NEEDED?

Once the business model is understood and the risks are identified, the next step is to consider the type of reserves policy needed. As illustrated above in the context of business models, needs can differ widely between charities which means there is no one-size-fits-all answer. The goal is for organisations to ensure they consider why the reserves are needed rather than coming up with a figure.

Looking again at the business models explained above, a grant-making trust would not need to hold a significant amount in reserves. Its business model can be flexible and reactive as it can adjust its spend to match its income. Conversely, the care home cannot react quickly as its cost base is high and fixed. Any short-term decreases in funding will have to be funded out of reserves and therefore

its need to hold onto reserves will be higher.

Other questions to ask when drafting your reserves policy are:

- Do we need finance for capital work or fixed asset purchases?
- Are we anticipating any restructuring costs?
- Do we need to advance-fund the expansion of activities or new projects?
- Are there any significant known liabilities to settle, for example pension deficit payments?
- Are we expecting any fluctuation in our charitable activity income and what does our mapped out income pipeline tell us about any potential shortfalls in funding?
- What do we need for general working-capital management?

When considering all of the above, charities need to understand the likely probability of the spend occurring, the planned timing and the amount needed. Forecasting is not an exact science but it is important to be able to support any assumptions used within your calculations.

Overall, the aim of your reserves policy must be to spend money to help the beneficiaries as quickly and as efficiently as possible. In more recent times, charities have been criticised for not having enough in reserves to continue operating, however it is just as likely that charities will be challenged for holding too much and not maximising their immediate impact. To get the balance right, it is important to be able to justify the reserves needed at hand in order to manage the financial and operational risks of the charity.

CREATING A FINANCIAL STRATEGY

Having an understanding of the key financial drivers within any business model is the making of a financial strategy. However, it needs to be placed clearly in the context of the organisational strategy and look at how to take the charity from where it is currently to where it wants to be. The financial strategy should be an enabler rather than the driver for organisational strategy, and any risks identified as part of this process should be managed and not avoided.

The charity may already be where it wants to be, so the strategy might conclude that it is best to remain operating in the same way, and this isn't a bad thing. The grant-making trust considered above may feel that it is maximising the return on its investment portfolio, and therefore also maximising its charitable impact by paying this out in full to grantees. If the business model is simple, straightforward and well managed, there could be nothing to change.

> “Charities need to be aware of external factors outside of their control”

However, where an organisation such as the care home is reliant on its reserves to fund short-term drops in income levels, it needs to consider how to maintain its reserves levels in the longer term. Therefore, it will need a different strategy to diversify the charity's income streams and make it less reliant on key charitable activity income. This option usually requires high levels of upfront investment and effort, which may also include a longer lead time before results come to fruition.

Some organisations may consider changing their model completely by altering the focus of activities or collaborating or merging with other charities. However, changing the business model entirely may have other strategic implications that need to be considered.

Lastly, charities also need to be aware of any external factors that may be outside its control that would force a change in strategy. The move from grants to contracts and payment-by-results arrangements is a prime example. Charities have needed to adapt their financial and business models to facilitate these changes or decided they cannot provide the services in the way they wish to under the new arrangements and have walked away from them.

While every charity is different, they all need a good financial strategy in place as a starting point. Only then will they be reassured they can plan ahead with confidence. ●