FINANCIAL OVERSIGHT:
WHAT TRUSTEES NEED TO KNOW ABOUT FINANCES AND ACCOUNTS

NPC briefing, October 2014

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On 13 October 2014, NPC and the Clothworkers' Company held a seminar covering what trustees need to know about finance and accounts. This report highlights the main themes discussed during the seminar and summarises the advice given by the speakers.

The seminar was chaired by Iona Joy, Head of the Charity Team at NPC. The panellists shared their perspectives on what trustees need to know about finances and accounts, focusing on the following themes:

Kate Sayer (Partner, Sayer Vincent; Governor and Chair of Audit Committee, Cheltenham College) gave us an auditor's perspective on financial oversight and provided guidance on the minimum that trustees should know about their charity's finances and what they should expect to get from their organisation.

Ray Jones (Training Advisor, Charity Finance Group) discussed sector trends, SORP and pensions and the importance of transparency for charities.

Jonathan Taylor (Director of Finances and Resources, JDRF; Trustee and Chair Finance and Audit Committee, Local Trust) gave a personal account of his work as a finance director and explained why communication between senior management and trustees is crucial.

Fiona Thompson (Hon Treasurer, Fenton Arts Trust; Trustee and Vice-Chair of the Finance, Nominations and Remuneration Committees, CARE International UK; Audit Committee, Forum for the Future) defined the key issues as a treasurer and outlined the questions that all trustees should ask.

Introduction

Strong financial oversight from trustees is essential for charities, especially when many are experiencing pressures on their sources of funding. The board of trustees as a whole is responsible for the financial oversight of the charity and all trustees should be able to play an active role in this, although it is often the treasurer that guides the board on financial matters. However NPC has found that not all trustees feel well equipped to do this and many are concerned they are not asking the right questions. This briefing provides guidance to help trustees make confident decisions regarding the financial aspects of their organisation and stresses that when it comes to accounts and finances, there is no such thing as a stupid question.

The essentials of trusteeship

What is a trustee?

Trustees are voting members of the governing body of an organisation and are legally responsible for the running of that organisation. Trustees should make sure the charity is running well and is doing what it was set up to do.

What responsibilities do trustees have?

The Charity Commission's advice on responsibilities of trustees includes ensuring the charity:

- has the money it needs
- spends its money sensibly, on the activities it was raised for
- follows the law, including preparing reports and accounts to send to the Charity Commission
- doesn't break the rules in its governing document (its constitution, trust deed or articles)[1]

It follows therefore that trustees are responsible for the financial health of their organisation and have stewardship of the organisation's funds. All trustees must take responsibility for this and must put adequate safeguards and controls in place to avoid fraud and incompetence. Adequate reporting and monitoring processes are a minimum requirement for good governance. Trustees also need to identify and understand the major risks to their organisations so they can be managed or mitigated.

'Trustees always need to ask themselves who are our key beneficiaries and who are we accountable to.'

Fiona Thompson, Fenton Arts Trust

Other responsibilities of trustees include setting and maintaining an organisation's vision, mission and values; establishing and monitoring policies and promoting the organisation externally.

Understanding your responsibilities

All trustees have a responsibility for the financial stewardship of the charity, but in many organisations trustees often undertake specific roles relating to this—possibly sitting on an audit or finance sub-committee.

Fiona Thompson emphasised how important it is for trustees to understand the difference between audit and finances. Audit is an review of data, operations or performances (financial or otherwise) of an enterprise. An audit committee is involved in the audit planning and agreeing the scope of the auditors' work, for both internal and external auditors. The audit committee needs to have a good understanding of the charity's operations, so that it can understand the risks that the charity faces [2]. The remainder of the finance agenda is about the ongoing management accounts and looking forward—how secure is future income? Does future cash flow cover obligations? How should the charity spent its funds? What are the financial risks? In large charities the audit and finance functions are split and a trustee can only sit on one panel. In smaller charities splitting these functions can be impractical, but attention should be given to both aspects in meetings.

It can be reassuring and preferable to have financial expertise on the board—an accountant or someone with a financial background. Most treasurers have some financial expertise, but all trustees have a responsibility for finance and audit. Trustees are expected to read the annual accounts and make sure that they understand the

[1] https://www.gov.uk/charity-trustee-whats-involved

[2] http://www.sayervincent.co.uk/Asp/uploadedFiles/File/TrusteeForum/AuditCommittees.pdf

content. There is a lot of training available for trustees in this area[3]. Trustees should not just delegate financial stewardship to the treasurer.

Charities can go into administration and managing cash flow can be a serious challenge. The recent case of BeatBullying UK, which went into administration in October 2014[4], highlights the importance of the role of trustees and the responsibilities trustees have in ensuring sound financial management. Though it is too early to fully understand why BeatBullying had to shut down, cash flow does appear to have been a problem.

Where to look for financial expertise

It is very useful to have a trustee on the board of an organisation who has some financial expertise. Fiona Thompson highlighted some of the best sites for recruiting trustees with a financial background.

- BOND (international development) www.bond.org.uk/
- ACEVO www.acevo.org.uk/
- Institute of Chartered Accountants www.icaew.com/
- The Honorary Treasurers Forum www.honorarytreasurers.org.uk/
- Eastside Primetimers http://ep-uk.org/
- Business in the Community www.bitc.org.uk/

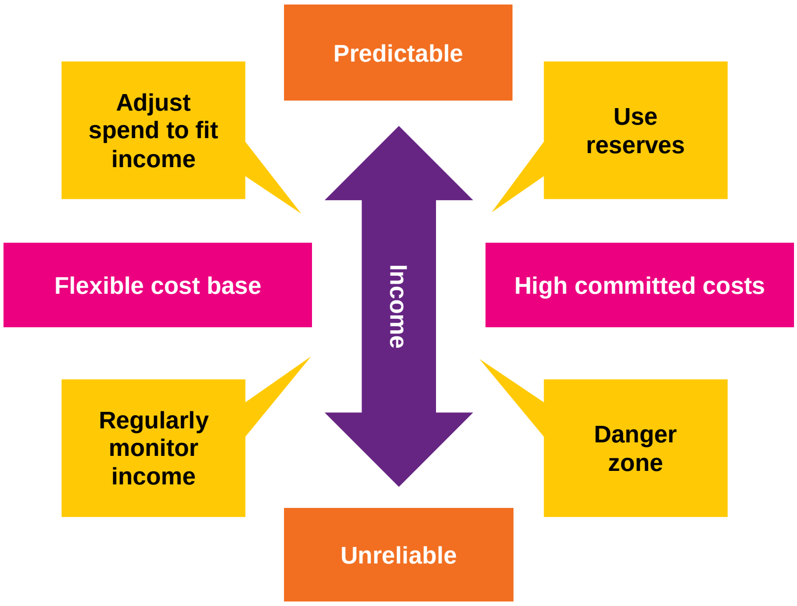
[3] http://www.sayervincent.co.uk/events_training

[4] http://www.independent.co.uk/news/uk/home-news/beatbullying-uk-and-mindfull-charities-suspend-services-as-administrators-called-in-9810142.html

Understanding your organisation

Kate Sayer and Fiona Thompson discussed the importance of understanding your organisation and how it is run before thinking about how to manage its finances. Kate Sayer outlined her process for assessing charities and provided a matrix for trustees to assess their own organisation, and determine what type of organisation it might be. The matrix in figure 1 plots income security against costs, along with some advice as to what to do with this information.

Figure 1. What sort of charity are you?



On the vertical axis predictable income includes income from long term contracts or grants, investment income, and income from supporters signed up with direct debits. Unreliable income for charities is more likely to come from sources such as one-off fundraising events, eg, the British Legion's poppy appeal, and BBC Children in Need's fundraising night. Grants that last for one year also fall into this category. It is a moot point, in NPC's view, as to whether legacies are predictable or unpredictable—some charities' patterns on legacy income are more predictable than others. Diversity of income is preferable to avoid dependence on one income stream, which can make charities vulnerable to external factors beyond their control.

On the horizontal axis, a flexible cost base will enable a charity to adjust its offer should its income prove unreliable. For example if a charity gives out grants to individuals and is facing a drop in income, it can consider the possibility of reducing the size of its grants. A high level of committed costs reduces a charity's ability to adjust services if income drops. Charities with high committed costs and predictable income, such as a care home, will be in the top right of the matrix, and should use their reserves to maintain their service levels if income falls temporarily. However if the reduction in income is more permanent, then using reserves is only delaying the inevitable decision of when to stop delivering the service.

The most comfortable place to be in a time of change is in the top left of the matrix with a predictable income and a flexible cost base. From this position a charity will need to understand what its forecast income will be and flex expenditure to match. Charities in the bottom left hand corner, with an unreliable income and flexible cost base, are vulnerable if they suffer a significant loss of funding and may have to consider options such as collaboration or merger. High committed costs and an unreliable income puts a charity in the bottom right hand corner—the 'danger zone'. If income falls, a charity may be able to use reserves, but could quickly exhaust them as it struggles to reduce costs. It is more likely the charity will have to close services or seek a merger. The matrix shows that there is never a one size fits all approach for information that trustees need to know.

'Essentially you have to adjust your spend to fit your income and regularly monitoring your income will help keep an eye on this.'

Kate Sayer, Sayer Vincent

Thinking about money

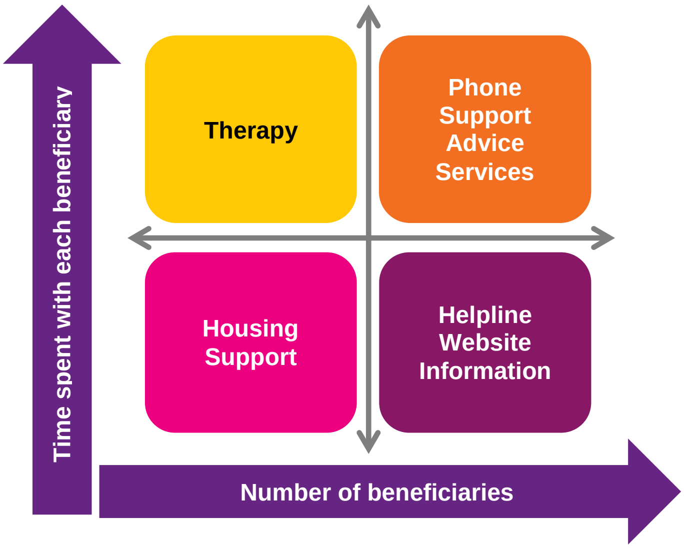
Once you understand your organisation better you can start thinking more about what to do with the money. Kate Sayer explained her framework to help charities think about how to manage their spending. However it is important to remember that if a charity's income depends on restricted funding, then there are limits on how spending can be managed. Restricted funds have to be used for the project they were designated for.

When considering where to focus spending, trustees need to think about the cost of delivery and the reach and intensity of the service, as shown in figure 2.

'Thinking about where to put your money is an organic process. You should be reviewing it as a team by looking at the external environment and responding to feedback.'

Kate Sayer, Sayer Vincent

Figure 2. Where to focus spending



Ray Jones highlighted the importance of considering the external environment when allocating resources, especially for charities involved in service delivery. These charities need to take into account if the demand for services is growing and if is likely to continue growing[5]. They will have to think carefully about whether they can meet this demand before they commit[6].

[5] From the ACEVO Social Sector Tracker (2014). 88% of charities surveyed experienced a rise in demand for their services in the last year and 89% envisaged that demand rising again next year.

[6] From the ACEVO Social Sector Tracker (2014). Only 32% felt confident that they would be able to meet this demand.

To spend or save

During the seminar, questions were raised about whether to spend or save reserves and whether there is a correct level of reserves for a charity. Both Kate Sayer and Fiona Thompson addressed this issue and stressed that there is no single answer and no precise formula for calculating an appropriate level of reserves. It is different for every charity.

Trustees are generally cautious about spending reserves. Ray Jones mentioned that a survey of trustees by Sayer Vincent and Charity Finance Group in 2012 showed that trustees would rather make staff redundant then spend reserves. Trustees often see reserves as a safety net, but not spending reserves can be counterproductive. Those charities with large reserves should ensure that they are maximising their impact and think about how to make the reserves work harder.

When thinking about reserves, trustees need to address the questions highlighted in this paper—how steady and secure is the charity's income and how committed are the charity's costs? Trustees also need to consider future cash flows and what projects may be coming up. A charity that gets paid six months, or more, after delivering work will need more reserves. A charity holding a one-off event to fundraise for a new project will have their reserves temporarily inflated. Answering these questions will help assess a charity's current financial position, which helps set an appropriate level of reserves.

'It is not helpful to be anxious as trustees and sit on a big fat pillow of reserves.'

Kate Sayer, Sayer Vincent

Further resources

For more information on reserves and how to calculate them, download NPC's guide to charity financial analysis *Keeping account*.

Trends in the sector

All our speakers highlighted the importance of understanding the wider context in which your organisation operates. Ray Jones took us through some of the recent trends in the sector that trustees need to be aware of, and also highlighted some of the changes in regulation which could impact the finances of charities.

Recently the media have been more critical of charities, putting the spotlight on topics such as chief executive salaries, staff expenses and the administration costs of charities. Charities have also come under fire for their campaigning and lobbying, and 'aggressive' fundraising tactics. Issues around charity finances are also in the media. Charities investment policies are being scrutinised and the public are taking a more critical and questioning view over how the charity sector is spending money. Financial issues, transparency and accountability are in ever sharper focus so this meant that all trustees need to think about how the charity responds to these pressures.

Many of the trends highlighted above are reflected in the recently revised charity Statement of Recommended Practice (SORP)[7]. Because financial reporting standards are written for companies as opposed to charities, the best practice guidance, the SORP, has been produced to help charities interpret these concepts and principles in a way that is suitable and meaningful. Charities have to prepare accounts in accordance with the SORP for accounting periods starting on or after 1 January 2015.

The new SORP

- A charity must choose under which standard—FRS 102 or FRSSE—it will be preparing accounts.
- There is a nudge towards reporting outcome and impact and a nudge towards disclosing CEO and senior staff pay and benefits, as well as explaining how executive pay is set.
- There is more disclosure required on total pay and benefits received by 'key management personnel'; redundancy / termination payments and the total amount of benefits received by staff.
- More focus on explaining risk and uncertainty.
- More focus on looking forward and a charities ability to continue in the future.

[7] http://www.charitysorp.org/download-a-full-sorp/

Pensions

Pensions can pose a significant challenge for charities. Many charities operating defined benefit pension schemes[8] continue to report large pension deficits in their accounts caused by the falling stock market[9]. This presents challenges both in terms of funding the increased contributions required and in managing the increased public and media interest in how charities spend their money. For charities participating in multi-employer defined benefit pension schemes, changes in accounting rules will mean that deficit funding agreements will need to be recognised as a liability in their accounts and this may have a very significant impact on their balance sheets.

Moreover, charities also face changes in how their contribution to the Pension Protection Fund levy[10] will be calculated. The methodology for the scoring risk will change in the future and charities that move to a higher risk banding may see their levy payments increase significantly.

Even if a charity does not operate a defined benefit pension scheme there is auto-enrolment[11] to consider. Pension legislation obliges employers, including charities, to automatically enrol 'eligible' employees into a workplace pension scheme. The largest charities have already complied and many others will reach their 'staging-date' in 2015—by 2107 even 'micro' charities will be required to comply with the new auto-enrolment rules.

It's therefore vital that trustees understand the nature of the pension scheme operated by their charity, the financial impact of this and how pension risks are managed. As pension costs increase, we can expect to see continued media interest in how charities manage this difficult issue.

For further information see CFG's *Navigating the Charity Pension Maze*.

[8] https://www.moneyadviceservice.org.uk/en/articles/defined-benefit-schemes

[9] http://www.cfg.org.uk/Policy/pensions/pension-deficits.aspx

[10] http://www.pensionprotectionfund.org.uk/levy/Pages/PensionProtectionLevy.aspx

[11] http://www.thepensionsregulator.gov.uk/automatic-enrolment.aspx

Getting controls in place for finances

An effective controls framework is essential if trustees are to have a good grip on the financial management of a charity. Staff, such as the finance director, are responsible for operating the controls of a framework—but trustees need assurances that this is working.

Figure 3. Example controls framework

Reporting and communication

Ray Jones spoke about the importance of transparency in charity communications. Transparency is not just about openness and honesty, it is also about being easy to understand. Lengthy and technical explanations of finances that are not understood by the audience are not transparent.

Trustees with specific responsibilities for finances and accounts need to be able to present and summarise key financial issues to other trustees. All trustees have a responsibility to make sure important financial information is accessible to, and can be understood by, a range of audiences.

Ray Jones and Jonathan Taylor both explained that this communicating a charity's financial position goes beyond purely financial reporting. Trustees need to think more about how to communicate the information to stakeholders, rather than producing more data for the annual report. Grant Thornton reported in 2014[12] that the average length of the Trustees' Annual Report was 58 pages long—9 pages more than the previous year—yet its unlikely that annual reports have become more useful to the reader.

'It shouldn't be a race for length—focus on what is important to your stakeholders.'

Ray Jones, Charity Finance Group

Trustees should use their reports as an opportunity to communicate their key messages and address essential questions such as:

- Is the charity is achieving its mission?
- Is it doing so in a reasonably efficient way?
- What are the risks that need reporting?

To ensure transparency in communications, trustees should focus on what is important and relevant to their stakeholders. The annual report should explain the difference between outcomes and impact and the difference made to beneficiaries. Trustees should be willing to experiment and be innovative in drafting the annual report and present narrative information in a way that enables the charity to best 'tell its story', while remaining within the regulatory framework. It was suggested that finance icons and infographics could be used to make information more accessible. Numbers need to be made interesting so that others are persuaded to take a look at them. It can be very hard to capture the complexity of an organisation and what it does in figures alone, which is why the story telling element is important too. Trustees should ensure the accounts are available on the website—transparency in the digital age means that accounts need to be easily accessible.

Jonathan Taylor highlighted some of the communication issues that can arise during financial management and reporting:

- The relationship trustees have with the executive team, particularly the finance director and chief executive, can sometimes be problematic if a CEO merely sees compliance as a nuisance. This is why communication and dialogue between trustees and senior staff is crucial.
- Dialogue can be opened up between staff and trustees through board meetings, the finance and audit committee meetings, and through one-to-one meetings for individual trustees and staff. However it is important to remember that different issues need to be addressed in different ways.
- Finance directors generally welcome a constructive process of questioning from their trustees as it offers them feedback about the areas of uncertainty for trustees and can help them in the development of even better ways of reporting.

[12] http://www.grant-thornton.co.uk/Global/FINAL-Charity-Governance-Review-2014.pdf

Tips for trustees

Throughout our seminar, all speakers emphasised that when it comes to charity finance, there is no such thing as a stupid question. Fiona Thompson listed some questions that all trustees should ask and topics they need to know about.

What all trustees should know

- **Income:** what is the turnover for your organisation?
- **Break-even, bottom line and key sensitivities.**
- **Cash:** when is your income coming in? You need to know your cash flow.
- **What is the budget and** are you going to make it?
- **Big movements:** if they are there you need to ask why.
- **Finance trends:** what are they?
- **Funding streams:** know the big issues.
- **Timing issues:** are people paying you on time?
- **Beneficiary changes:** are you still targeting and reaching the right people?
- **How much expenditure is 'fixed'; charitable and overheads?** Understand your cost base.
- **What commitments do you have?** Can you pull out of something quickly if you needed to?
- **Read the accounts:** do they make sense of the charity? If they don't why not?
- **What does the business case look like for projects?** What are the benefits, risks? Undertake a sensitivity analysis.
- **What is the exit strategy for big and/or new projects?** If it goes wrong what will we do? Draw up some 'what if' scenarios to understand the downside and identify potential pitfalls.

Key Performance Indicators (KPIs)—some basics

- **What financial numbers are critical for your organisation?**
- **Restricted vs unrestricted income.**
- **Acquisition cost per donor vs long term income per donor.**
- **Cost ratios:** what are your unit costs, fundraising ratios and how do you calculate reserves?
- **Are you measuring what your strategy says?**

Further resources

Joy, I., McKenzie, D., and Rotheroe, A. (2013) *Keeping account: A guide to charity financial analysis*. New Philanthropy Capital.

Vernon, B., and Copps, J., (2010) *The little blue book*. New Philanthropy Capital

Bull, D., (2014) *Back to basics: A seminar for charity trustees.* New Philanthropy Capital

CFG (2014) *Navigating the Charity Pension Maze*.

TRANSFORMING THE CHARITY SECTOR

NPC is a charity think tank and consultancy which occupies a unique position at the nexus between charities and funders, helping them achieve the greatest impact. We are driven by the values and mission of the charity sector, to which we bring the rigour, clarity and analysis needed to better achieve the outcomes we all seek. We also share the motivations and passion of funders, to which we bring our expertise, experience and track record of success.

Increasing the impact of charities: NPC exists to make charities and social enterprises more successful in achieving their missions. Through rigorous analysis, practical advice and innovative thinking, we make charities' money and energy go further, and help them to achieve the greatest impact.

Increasing the impact of funders: NPC's role is to make funders more successful too. We share the passion funders have for helping charities and changing people's lives. We understand their motivations and their objectives, and we know that giving is more rewarding if it achieves the greatest impact it can.

Strengthening the partnership between charities and funders: NPC's mission is also to bring the two sides of the funding equation together, improving understanding and enhancing their combined impact. We can help funders and those they fund to connect and transform the way they work together to achieve their vision.

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