

Financial governance

A gentle guide for the non-financial charity trustee

Dorothy Dalton



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About the author

Dorothy Dalton is a leading expert on governance who has written several books on the subject. She was editor of *Governance: essential information for effective trustees* from July 2005 to January 2016.

With a 'first' in mathematics, Dorothy, a former headteacher, was chief executive of the Association of Chief Executives of Voluntary Organisations (ACEVO), from 1992 to 2000. She is currently chair of governors of the Petchey Academy in Hackney. She has been a trustee of many charities including Marie Curie and has been chair of trustees of the Journey of a Lifetime Trust (JoLt) and chairman of governors of Orley Farm School Trust. From 2000 to 2003, she was a non-executive director of the Inland Revenue. She is a fellow of the Leadership Trust Foundation and International Students House and life fellow of the Royal Society of Arts. She founded JoLt, the Network of Women Chairs, and Groundbreakers: voluntary sector women leaders.

Dorothy was awarded the Leonard Cheshire Lifetime Achievement Award for enabling disabled people. She was nominated for the 1995 UK Woman of Europe Award for her work in the voluntary sector and is an Honorary Life Member of ACEVO.

Dorothy has a passion for travel. During her spare time, from 1983 to 2010, she organised and led month-long challenging expeditions for disabled and disadvantaged teenagers to remote corners of the world. She continues to participate in other expeditions (many of which she organises herself) including crossing the Bayuda Desert by camel, and canoeing, kayaking and white-water rafting the Zambezi, between Zimbabwe and Zambia.

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Foreword

Rathbones is delighted to have sponsored the production of this guide, which aims to help trustees understand – in a simple and practical manner – what is expected of them when it comes to the governance of their charity's finances. The vast majority of trustees ensure their organisations are effective and well-run, despite the many challenges they face. Trusteeship is a voluntary role. Yet the case for good governance in charities led by trustees that have a proper understanding of their role has never been clearer.

Exemplary governance has become an expectation rather than an aspiration, the rationale being that it is fundamental to effective charitable activity, alongside strong leadership. Mark Goyder (Director of Tomorrow's Company) highlighted the necessity of both aspects in organisations seeking to maximise their impact when he said: "Governance and leadership are the yin and the yang of successful organisations. If you have leadership without governance you risk tyranny, fraud and personal fiefdoms. If you have governance without leadership you risk atrophy, bureaucracy and indifference."

Governance is a subject close to our hearts at Rathbones. We are a member of the FTSE4Good

Index Series which only includes companies that demonstrate strong environmental, social and governance credentials. Separately, as a signatory to the United Nations-backed Principles for Responsible Investment, we are obliged to consider corporate governance in deciding whether or not we should invest in a company on behalf of our clients. In addition, around 3,000 trustees have participated in our dedicated trustee education programme over the past 10 years, our ultimate aim being to help them perform their roles more effectively.

It has been a great pleasure working with Dorothy Dalton in the production of this guide. There can be few better qualified practitioners in the field of governance and her detailed grasp of the subject shone through during drafting. I am sure that *Financial governance: a gentle guide for the non-financial charity trustee* will be much valued by experienced and inexperienced trustees alike.

Andrew Pitt
Head of Charities, London
Rathbone Investment Management
rathbones.com



How CEOs can use this guide

One of the key legal duties of a trustee board is to oversee the finances of the charity. As a CEO, you want your trustees to be able to provide oversight of the charity's operations in an effective and efficient way. To do this, you need them to be informed about financial governance and their role in planning, decision-making and monitoring your financial operations.

Trustees should feel able to challenge and ask questions of those responsible for the day-to-day work of the charity – its chief executive and executive team. Crucially, you need them to be asking the right questions of you: questions that enable them to fulfil their responsibilities while allowing you to deliver yours.

This guide is designed as a first and gentle introduction to charity finances, aimed at trustees who haven't had experience of this area before.

By giving it to new or less experienced trustees and even experienced trustees who lack confidence when it comes to financial governance, you can steer them towards the areas where they should have informed oversight, and give them the confidence to know they're asking the right questions to meet their duties.

Having well briefed and well informed trustees is not only good for you as the CEO, it's good for the whole charity. By including this guide in trustee inductions, circulating it before you begin to set a budget or encouraging trustees to read it before they discuss your annual accounts, you can help ensure they're doing their job as well as they can.

Vicky Browning
Chief Executive
ACEVO
acevo.org.uk



Introduction by the Charity Commission

The Charity Commission registers and regulates charities in England and Wales to ensure that the public can support charities with confidence. Our priorities are to develop:

- public confidence in the charity sector
- the sector's compliance and accountability
- the self-reliance of individual charities.

No charity can operate without the financial and other resources to meet its charitable aims, so the good management of a charity's finances and other assets is vital for its success. Many charities invest their funds in order to generate income for everyday spending and they may also invest to fund future plans and projects. What is appropriate will depend on the size and activities of any individual charity.

The key to good financial (and any other) governance depends on the trustees understanding their role and duties. The main points are that trustees are the people who serve on the governing body of a charity, they have the overall responsibility for managing and

directing the affairs of their charity and must ensure that their charity is financially viable. Their ultimate aim is to provide the best possible service to their charity's beneficiaries.

The Commission is keen to emphasise the importance of good financial governance and planning by trustees and has published a wide range of guidance on related issues. However, it also knows that in order to get the message across, it needs to be promoted in many different ways and by many different bodies.

We welcome this new piece of guidance as it sets out clearly the things trustees will need to know when looking at investing their charity's funds and is a useful addition to the resources available to the charitable sector.

Sarah Atkinson
Director, Policy and Communications
Charity Commission
[gov.uk/government/organisations/
charity-commission](https://gov.uk/government/organisations/charity-commission)



Preamble

When there are finance specialists on the board, a finance committee and a treasurer, why do all trustees have to engage in financial matters?

The short answer is that trustees are required to do so. *The essential trustee: what you need to know and what you need to do (CC3)*¹ sets out the six duties of trustees. The last three are particularly pertinent to trustees fulfilling their duties for the financial governance of their charity.

Duty four is to: manage your charity's resources responsibly

You must act responsibly, reasonably and honestly. This is sometimes called the duty of prudence. Prudence is about exercising sound judgement.

You and your co-trustees must:

- make sure the charity's assets are only used to support or carry out its purposes
- avoid exposing the charity's assets, beneficiaries or reputation to undue risk
- not over-commit the charity
- take special care when investing or borrowing
- comply with any restrictions on spending funds or selling land.

You and your co-trustees should put appropriate procedures and safeguards in place and take reasonable steps to ensure that these are followed. Otherwise you risk making the charity vulnerable to fraud or theft, or other kinds of abuse, and being in breach of your duty.

Duty five is to: act with reasonable care and skill

As someone responsible for governing a charity, you:

- must use reasonable care and skill, making use of your skills and experience and taking advice when necessary.

Duty six is to: ensure your charity is accountable

This includes being able to demonstrate that your charity is complying with the law, well run and effective.

To comply with these duties, every trustee has to play their part in the financial governance of the charity. Leaving finances to the more 'financial' members of the board or finance staff is not an option. It is important that all trustees play their part in financial planning, financial decisions and financial monitoring.

Many trustees feel that they do not know enough about finance generally, and charity finance in particular, to fulfil their responsibility for sound financial governance. For the trustee who is not strong on finance, I have set out what I believe are the minimum requirements for all trustees.

To help develop understanding in stages, I cover the financial basics in brief first, leaving readers to explore more detail on particular topics when they are ready to do so. This is very much my personal take on financial governance based on my own experiences of serving on boards and on subsequent study and research.

¹ [gov.uk/government/uploads/system/uploads/attachment_data/file/509664/cc3_lowink.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/509664/cc3_lowink.pdf)

1. The basics in brief



Image courtesy of Flickr/breadfortheworld

It is important for trustees to understand fully what the different fund types are and exactly what they mean. This should be part of their induction. Trustees should particularly understand what restricted funds are.

1.1 The different types of charity funds

More information on page 14

All trustees need to know about:

- restricted funds
- unrestricted funds
- designated funds.

If the charity has endowments, then trustees need to understand:

- permanent endowments
- expendable endowments.

1.2 The budget within a financial strategy

More information on page 15

Trustees should ask about and understand:

- how the budget ties in with strategic priorities, the business plan and the financial strategy
- the assumptions on which the budget is based
- the major risks relating to the budget and how they are to be managed.

1.3 Measuring financial performance

More information on page 18

Management accounts

Trustees need to understand why management accounts are a key financial tool (i.e. measure progress against budget) and what to expect by way of documentation, i.e.:

- columns for unrestricted, restricted and total funds
- column(s) to compare the year to date with the budget and last year's actuals
- column to show forecasts of what the end-of-year figures might look like
- explanations in the commentary for significant variations from budget and previous year's actuals.

Financial ratios and other key performance indicators (KPIs)

Trustees should be aware that each board has a responsibility to decide on the financial ratios or other financial KPIs that they would like to monitor and the importance of tracking these statistics over time.

Examples of ratios and figures that might be tracked:

- for each type of fundraising (e.g. voluntary donations, legacy, shops) the most common ratio monitored is cost of raising funds to funds raised
- charities delivering residential care (e.g. care homes, hospices, hotels) will almost certainly want to monitor and track occupancy rates at each residential base
- service delivery charities may wish to measure and track the cost of delivering one unit of care, e.g. one hour, one day or one week
- charities using temporary agency staff might want to monitor numbers and cost of agency staff and compare these with the cost of an employee doing the same job for the same period of time.

Use of graphs to illustrate trends or to compare ratios can also be helpful.

The SoFA, balance sheet and cash flows

Also trustees need to be introduced to *SORP* (*Statement of Recommended Practice – revised in 2015*) and its key requirements.

Trustees who are unfamiliar with charity finance need to be talked through the **Statement of Financial Activities (SoFA)** and have explained to them why charity accounts are different (i.e. the importance of columns showing restricted and unrestricted funds). They need to know that the SoFA is essentially the income and expenditure account but goes further by bringing in all financial transactions of the charity.

Most trustees need to have the **balance sheet** explained to them. It gives a picture (sometimes called a ‘snapshot’) of the charity’s assets, liabilities and reserves on the day that it was drawn up, usually the last day of the financial year. It is generally considered good practice to prepare balance sheets alongside income and expenditure accounts as part of regular financial reports to the board as they act as comfort that the income and expenditure account is correct and enable movements in assets to be tracked which might not feature in the income and expenditure account.

In regular financial reports to the board, **cash flow** projections can be very valuable. They give a picture of money coming in and out in each period and anticipated cash flow for the rest of the year by looking at receipts over payments and opening and closing balances. When looking at the closing balance for each period (usually every two months), I like to see the figure split into restricted and unrestricted funds.

1.4 Internal financial controls, fraud and whistleblowing

More information on page 26

Issues that all boards need to consider:

- How, and how often, does the board check the robustness of financial controls? The charity’s annual return² must confirm whether or not the charity has reviewed its financial controls during the reporting period. As a matter of good practice, the Commission recommends that a charity reviews its financial controls annually to ensure that they are up to date and effective.
- What are the charity’s anti-fraud policies and procedures and are they sufficiently robust and known throughout the charity?
- Is there a good whistleblowing policy and procedure which are known to all staff, volunteers, service users and contractors, etc.?

² The annual return now requires the following declaration:

The person submitting the annual return on behalf of the charity must certify that:

- they have understood all of the requirements associated with the submission of the annual return and all of the statements contained within it
- the information provided in the relevant parts of the annual return is correct and complete to the best of their knowledge and belief and has been brought to the attention of the charity trustees who have each individually verified this and given their informed express consent to this submission with full knowledge, understanding and acceptance of the contents of the privacy notice.

Charities with an income of over £25,000 must also confirm that there are no serious incidents or other matters that should have been brought to the attention of the Charity Commission that have not already been reported.

Increasingly, charities take out trustee indemnity insurance to help manage some aspects of the risk of trustee liability.

1.5 Understanding risks attached to different types of income

More information on page 30

For example, public service delivery contracts.

Issues that all boards need to consider:

- Does the board require all public service delivery contracts to be on the basis of full cost recovery? Will contracts covering more than one year also cover salary increases? If not full cost recovery, how is any shortfall to be funded?
- What is the board's risk appetite regarding public service delivery contracts? Who has delegated responsibility to check contracts prior to signing, to ensure the charity does not accept risks and liabilities that the board finds unacceptable?
- Is there any risk of clawback, i.e. the commissioning body demanding partial repayment because the charity has only delivered partially (e.g. only 79 per cent of unemployed people trained by the charity found employment so local authority demands refund of 21 per cent)?

1.6 Understanding your charity's position with regard to taxes

More information on page 30

These should include:

- direct tax
- gift aid
- VAT
- business rates.

1.7 Insolvency

More information on page 32

Trustees need to be aware that:

- Under charity law, trustees put themselves at risk of personal liability² if they (in the case of unincorporated charities) commit the charity to debts which amount to more than its assets; or, in the case of charitable companies, continue to operate when they know or ought to know that they cannot avoid insolvent liquidation.



Insolvent liquidation

It is essential:

- For trustees to ensure that restricted funds are only used for the purposes for which they were given (remember you cannot without relevant consent – from donor or Charity Commission – borrow from restricted funds to pay for activities that fall within unrestricted funds).
- As soon as you think your charity might be insolvent or very near the point of insolvency, trustees must then act solely in the interests of the charity's creditors. Trustees need to speak immediately to professional advisers (e.g. insolvency practitioner and lawyer). The board must meet frequently and regularly. Careful minutes need to be kept of each meeting so that there is a record showing that the trustees were acting solely in the interests of creditors.

If insolvency is a possibility, trustees are advised to read *Managing a charity's finances: planning, managing difficulties and insolvency (CC12)*³.

1.8 Qualified accounts

More information on page 37

In your charity's annual return to the Charity Commission, the charity is asked whether your annual accounts are 'qualified'. Some tick this box thinking it means that the audit was carried out by a qualified auditor or independent examiner.

This is an easy mistake to make, but 'qualified' means something very different. It means that there are problems with your accounts – make sure that this box is not accidentally ticked.

1.9 Relationship with your auditors

More information on page 38

Listed below are issues that all boards need to consider proactively. Often this goes by default with trustees unaware of these requirements and the part that trustees should play in considering them.

- Will the board or a board committee (e.g. audit or finance) or both meet annually with the auditor to discuss their audit and the annual report and accounts? And will there be some time during this meeting for trustees to speak to the auditors without the executive present?
- Before the audit, will the board or a board committee consider the **audit planning letter**? If a committee, is there to be any input by the board?
- If a charitable company, each director is required to give certain undertakings to the auditor such as there is no relevant audit information of which the auditors are unaware. These declarations are made via a **letter of representation** which is drafted by the auditors. Trustees need to consider what assurances they need from the executive in order to give similar guarantees to the auditor. The chair of trustees normally signs the letter on behalf of every director.
- Will the board or one of its committees consider the **audit findings report** which is always addressed to the trustees and often called the 'management letter'? Management's response to the audit findings report should be considered alongside the report.

1.10 Investments

More information on page 39

All trustees of charities with money to invest are advised to refer to:

- *CC14 Charities and investment matters: a guide for trustees*⁴ (Charity Commission)
- *Writing your charity's investment policy: a guide*⁵ (Charity Finance Group/Charity Investors' Group).

³ gov.uk/government/uploads/system/uploads/attachment_data/file/496292/CC12.pdf

⁴ gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

⁵ cfg.org.uk/Policy/investment/-/media/Files/Policy/Investment/Writingyourcharitysinvestment%20policy%20guide.ashx

Some charities have relatively small amounts for investment, others might have significant funds including large endowments. All trustees need to be aware of the investment options (even if it is simply fixed interest deposits with a bank) and the risks and benefits of these different options.

The principles from a governance perspective are the same but governance must be proportionate. A small amount of cash to invest will mean a relatively simple investment policy that is reviewed on a regular basis by the board or its finance committee. Charities with substantial investments will have a more complex investment policy and often a separate investment committee whose members have relevant expertise.

The investment policy statement should include matters such as investment objectives, liquidity requirements, time horizon, risk appetite in relation to investment, ethical requirements and the method for reviewing the performance of investments.

Trustees should also be aware that the board should not ask its investment manager to write the charity's investment policy. The investment manager can advise but it is for the board to develop its own policy and to decide what is in the best interests of the charity.

There are different forms of investment:

- financial investment
- programme related investment (PRI)
- mixed motive investment.

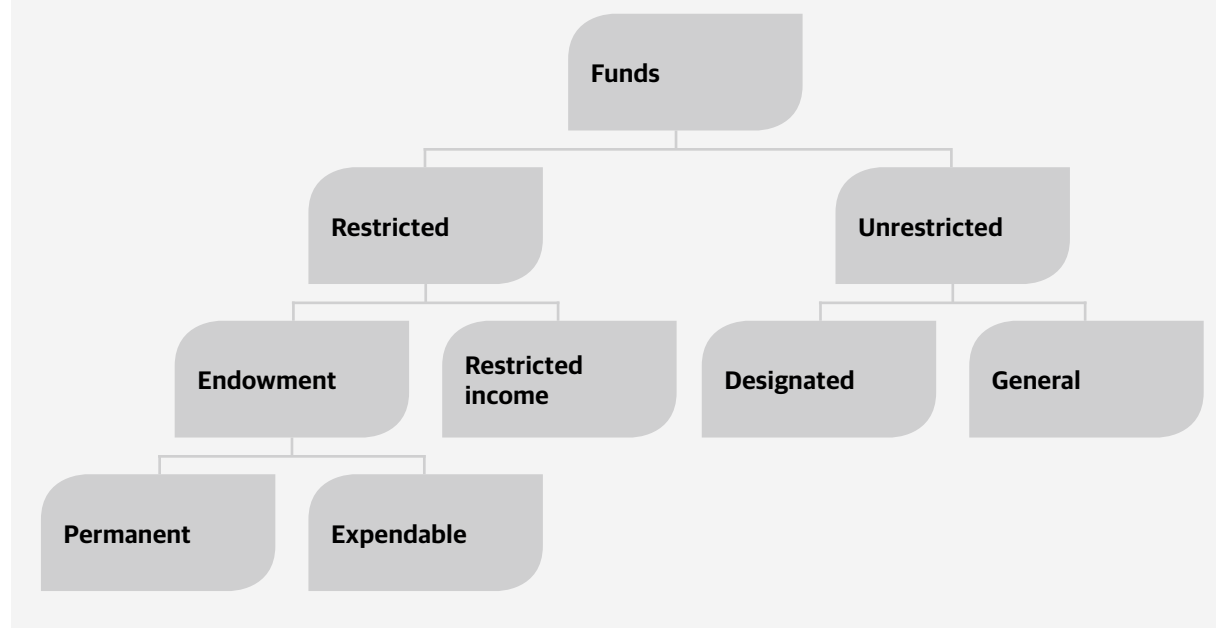
Even if not directly involved in investments, all trustees of charities with more substantial investments should have some understanding of basic concepts such as:

- commonly used investment asset classes
- programme related investments
- mixed motive investment
- ethical investment
- setting investment objectives
- relationship between risk and return
- income versus total return
- active versus passive
- pooled versus segregated
- discretionary versus advisory.



2. The basics in greater detail

2.1 The different types of charity funds:



Sayer Vincent in their guide *SORP 2015 made simple*⁶ describes the different types of funds as:

- **Restricted funds** are funds subject to special trusts specified by the donor. This might be because it was a public appeal for a specific purpose, grants or donations. It may also include land, buildings or other assets donated to a charity. The trustees will be in breach of trust if they use restricted income other than for the specified purpose. Unless specified, interest or other investment income on a restricted fund will be added to the fund. Significant restricted funds have to be separately disclosed in the notes to the accounts.

- **Permanent endowment funds**⁷ are donations that have been given to a charity to be held as capital with no power to convert the funds to income. Funds may be cash or other assets, but should be invested to maintain the value of the capital and to earn income. Only the income earned can be spent on the charity's aims. Trustees need to balance the needs of current and potential future beneficiaries when deciding how to invest the capital.

- **Expendable endowment funds** are donations that have been given to a charity to be held as capital, where the trustees do have a discretionary power to use the funds as income.

- **Unrestricted funds** are funds available for the purposes of the charity, to be spent as the trustees see fit.

- **Designated funds** are unrestricted funds that have been earmarked for a particular purpose by the trustees. The notes to the accounts should explain the purpose of designated funds.

⁶ sayervincent.co.uk/wp-content/uploads/2015/07/SORP2015MadeSimple-SayerVincent-July2015.pdf

⁷ CC12 "A charitable company cannot hold permanent endowment as part of company property. However, a charitable company can act as a corporate trustee of a permanently endowed charity. If the company is facing insolvency, these permanently endowed funds (and any other funds held on special trusts) would not normally be available as a company's corporate property to settle debts not relating to the permanent endowment or special trust."

- **General funds** are unrestricted funds which have not been earmarked and may be used generally to further the charity's objects.

2.2 The budget within a financial strategy

Before thinking about the budget, in an ideal world, all charities should have a financial strategy to help the charity maximise its impact and achieve its mission.

A good financial strategy is based on a number of factors including the charity's strategic goals, an assessment of the risks and opportunities facing the charity as well as the best possible use of reserves.

When you are new to a charity board, it is worth asking for a copy of the charity's financial strategy. If one does not exist, suggest to the board that the charity should develop one.

If a financial strategy does exist, check when it was developed. If more than three years ago, suggest it should be reconsidered to see if it is still relevant especially in these fast changing times.

It helps to have some idea of at least one process for developing a financial strategy. In an article for *Third Sector*, Kate Sayer gives the *Seven steps for a successful financial strategy*⁸ (descriptions of each are not necessarily Kate Sayer's):

1. Work out the purposes of your activities

What are the charity's strategic goals; how will the planned activities help to achieve these goals; what is the purpose of each activity financially – make a surplus, break even, subsidise?

2. Know your business model

Peter Drucker suggests a good business model answers questions such as, 'Who is the customer? And what does the customer value?' It also needs to answer the fundamental questions: How do we generate sufficient income? What is the underlying economic logic that explains how we can deliver value to customers at an appropriate cost?"⁹

3. Invest in new activities

All new activities require investment time and money. For each new activity, a clear business plan is needed to show when the activity is likely to become profitable and the impact on cash flow.

4. Plan a range of different income streams

Over reliance on one or two income streams carries high risks. It is important to diversify sources of revenue. As mentioned previously, each activity, including income generating commercial ventures, needs a business plan. Avoid introducing too many new activities at the same time as this can lead to overtrading and result in cash flow problems. Making sure each new activity is properly funded is important.

5. Take stock of your assets

You may have more assets than you think. Many charities under recognise their assets for example, intellectual property. Be clear about your charity's assets and, where necessary, take steps to protect them.

6. Test your new financial strategy

One way to test the robustness of plans and financial forecasts is to consider the level of uncertainty inherent in them. This also helps charities to identify potential trigger points and when action may be needed.

What is the relationship between income and expenditure? What are the key drivers? It is also worth considering the impact that changes in the external environment could have on both costs and income.

Different types of income will need slightly different techniques for forecasting, but it should be possible to group income into categories of confirmed, probable, possible and uncertain. Once the format for this is established, the degree of certainty can be varied to test the impact on income. This can help organisations establish critical points to watch for as early warning signs.

⁸ thirdsector.co.uk/kate-sayer-seven-steps-successful-financial-strategy/finance/article/1307528

⁹ Harvard Business Review 'What is a business model?' Andrea Ovens

Once a framework for preparing different versions of your financial plans is set up, it can be used to look at different scenarios and consider the consequences. For example, several versions of the budget can be prepared to show the impact of reduced levels of activity, reduced levels of income or ceasing certain activities.

7. Establish a strategy for reserves

If your charity has a reasonable level of reserves i.e. above that which is needed to meet liabilities, then spending of reserves should be a crucial part of both your strategic and financial planning.

*Beyond Reserves: how charities can make their reserves work harder*¹⁰ points out:

“It is important to take a strategic view.

Reserves are unspent income and strategic decisions need to be made around when and how this is best spent.

To do so, charities must balance the need to manage risks against the need to serve beneficiaries as quickly as possible. To achieve this balance, charities need to have a good understanding of the financial strategy and business model together with the risks inherent in the model.

“Reserves planning should form part of overall strategic planning.

When performing a high level strategic review, organisations need to look at where they want to be and how they are going to get there. This means having a clear financial strategy, but also understanding how reserves will be used to enable the organisation to reach their goals.

“Reserves are just one part of the complex financial management of a charity.

Well run organisations manage their long-term financial requirements, liquidity and cash flow to ensure that they get the most value out of their assets for the benefit of their beneficiaries. Reserves therefore need to be considered alongside things such as fundraising strategy, risk assessments and future business planning.”

The budget

Although the budget is likely to have gone through a finance committee of some kind and comes to the trustees with the committee's recommendation for approval, it is still important for trustees, especially those who are not on the finance committee, to ask questions and to make sure they have reasonable understanding of the financial position of the charity before they agree the budget.

Trustees should ask about:

1. How the budget ties in with strategic priorities, the business plan and the financial strategy.

Please refer to the discussion around this issue on page 15. It is advisable for budgets to make clear how the strategic priorities of the charity are to be resourced in the next financial year. It should also indicate how the proposed budget ties in with the agreed business plan. Were there significant variances between the proposed budget and the business plan or last year's budget? There should be explanations given in the budget commentary for all significant variances. If there aren't, then trustees should question that. Either way, trustees need to feel they can understand the reasons for any significant deviances.

2. For this year's budget, the assumptions on which the budget is based.

It is important to question the basis of the assumptions underpinning the budget. Some critical assumptions might turn out to be no longer true.

Take particular care with assumptions that in the current year, or previous years, are proving to be or have been off the mark. For example, assumptions such as the number of predicted beneficiaries or the number of different programmes or the cost of gas/electricity appear to be regularly inaccurate, then point this out to the executive and ask them to give the board their assessment of the accuracy of their current predictions/assumptions. Make sure their reply is minuted and refer the executive to what they said when the end of year accounts are available or when management accounts indicate some of these assumptions were weak.

¹⁰ sayervincent.co.uk/wp-content/uploads/2015/07/BeyondReserves.pdf

It might also be worth asking if some of the assumptions are based on trend analysis. For example if membership numbers have been falling steadily, is the assumption that membership numbers will grow based on resources (if there are any) being allocated in the budget in order to increase members? Are predicted numbers stretched but achievable?

3. The major risks relating to the current budget and how they are being managed.

All major proposals to the board, and a budget is a major proposal, should carry a risk assessment. This should be a genuine look at potential risks not a tick box exercise. If a trustee feels that a significant risk has not been recognised, it is important to share this with the board when the budget is being considered.

Cash flow can be a major risk to charities. Does the budget include a cash flow forecast split into restricted and unrestricted cash? Are these forecasts based on large but yet to be confirmed sources of funding? If a trustee feels that the cash flow forecast is based on unrealistic expectations, it is important to articulate this when the budget is being considered. If in some months, unrestricted cash might be unavailable to

meet liabilities, it is important to have plans in place to cope. For example, should the charity set up an overdraft facility in the short term with the bank, and what plans are there to increase unrestricted funds in the years to come?

Being dependent on a very few sources of income is often a significant risk. Check the main sources of income. Can the number of sources of income be grown to provide diversity of income and reduce risks to total income?

It might also be worth asking if the executive have carried out some scenario planning with regard to the budget. For example, if voluntary income drops by 25% or if there is significant claw back from the previous year's local authority or central government contracts.



2.3 Measuring financial performance

Financial reports to the board (sometimes called management accounts)

A good financial report will engage all trustees not just those with financial expertise.

It will focus on what is important and be succinct when providing explanations in the commentary. It will avoid jargon. It will draw out the good news, the bad news, the risks and the opportunities. The use of colour, e.g. red to highlight the figures causing concern helps. The financial report will avoid unnecessary detail especially detail that is only relevant to management or the budget holder.

Hilary Seaward, winner of the inaugural CFG Adrian Randall Prize in 2013, recommends that management accounts should be no longer than three pages and she suggests a very different and ingenious format to illustrate the financial picture. Readers are advised to read her paper entitled *More of the wood, less of the trees*¹¹. It should give finance teams ideas as to how financial information can be given in an easily understood format.

Trustees need to understand why management accounts are a key financial monitoring tool (i.e. measure progress against budget) and what to expect by way of documentation, i.e.:

- columns for 'unrestricted', 'restricted' and 'total'
- column(s) to compare the 'year to date' with the budget and last year's actuals
- column to show forecasts of what the end-of-year figures might look like
- explanations in the commentary for significant variations from budget and previous year's actuals.

Quite often regular financial reports to the board will also include a balance sheet (see page 22).

It should also include the cash flow position (split into restricted and unrestricted) and revised cash flow forecasts.

Financial ratios, benchmarks and other key performance indicators (KPIs)

Trustees should be aware that each board has a responsibility to decide on the financial ratios or other financial KPIs that they would like to monitor and the importance of tracking these statistics over time.

Financial ratios, benchmarks and other key performance indicators should:

- help the board to assess progress against stated strategies (don't have too many)
- be dependent on the nature of your 'business' (for example, providing residential care)
- be relevant to your charity not just what other charities in your sub-sector measure (i.e. your charity's area of work and its current strategy)
- link to key areas of the 'business' (for example, fundraising, income generation – such as charity shops, contracts)
- be reviewed regularly to ensure they remain relevant over time.

Trustees and management should keep an eye on both the absolute value of the chosen KPIs and, in many cases, trends over time.

Examples of ratios and figures that might be tracked:

- for each type of fundraising (e.g. voluntary donations, legacy, shops) the most common ratio monitored is cost of raising funds to funds raised
- charities delivering residential care (e.g. care homes, hospices, hotels) will almost certainly want to monitor and track occupancy rates at each residential base
- service delivery charities may wish to measure the cost of delivering one unit of care e.g. one hour, one day or one week
- charities using temporary agency staff might want to monitor numbers and cost of agency staff and compare these with the cost of an employee doing the same job for the same period of time.

¹¹ cfg.org.uk/about-us/adrian-randall-prize/-/media/Files/About%20Us/ARP2013_Publication.pdf

Some financial commentators recommend that all organisations, including charities, should monitor the following general ratios:

– **Profitability (not a term generally favoured in the charity world but nevertheless relevant).**
(net income/total income) x 100

This percentage can be calculated for each major activity/project/contract and/or it can be used for the charity as a whole.

If this figure (for the organisation as a whole) is positive, reserves will be boosted. If it is for a project/activity/contract, it will show you are generating a surplus on this particular project/activity/contract.

If this figure (for the organisation as a whole) is negative, then it is likely that you are eating into your reserves and the charity will not be financially sustainable. Negative percentage for a project/activity/contract indicates that you have not achieved full cost recovery and trustees need to consider where the additional funds for the project/activity/contract will be found if it is to continue. Is there an exit strategy if the project/activity/contract is actually not financially viable?

– **Liquidity**

This ratio shows how well the charity is able to pay its short-term bills. The most common and easiest ratio is called the current ratio, which is the ratio of current assets to current liabilities.

current assets/current liabilities

A ratio of greater than one is usually a minimum because anything less than one means the company has more liabilities than assets. If the ratio is less than 1.5, it would be wise to question the charity's ability to meet its payment commitments.

– **Debtor days**

Debtors days ratio measures how quickly cash is being collected from debtors (people or organisations that owe your charity money).

(amount for debtors¹² from the balance sheet/sales income from the SoFA) x 365 days

– **Creditor days**

Creditor days ratio measures how quickly the charity is paying its bills.

(amount for trade creditors – being unpaid supplier invoices – from the balance sheet/expenditure on purchases from the SoFA) x 365 days

Most invoices require payment within 30 days. If the figure is significantly above 30, ask questions. If the debtor days figure is significantly higher than the creditor days figure, the charity is better at paying its invoices than it is from getting in money owed to the charity.

Use of graphs to illustrate trends or to compare ratios can also be helpful.

The SoFA, balance sheet, statement of cashflows and SORP 2015

All boards are advised to have auditors who are charity specialists. The auditor should ensure that the trustees' annual report and accounts follow the *Charities SORP 2015*.

In order to ensure that every trustee knows roughly what to expect, brief descriptions are given (see pages 20-25). For those who are keen to learn more, further information can be found by reading:

1. *Financial disclosure reporting checklist: charities SORP FRS 102* (Crowe Clark Whitehill)¹³
2. *SORP 2015 Made Simple* (Sayer Vincent)¹⁴

¹² Debtors are unpaid sales invoices issued by the charity

¹³ croweclarkwhitehill.co.uk/wp-content/uploads/sites/2/2016/03/sorp-financial-disclosure-reporting-checklist-2016.pdf

¹⁴ sayervincent.co.uk/wp-content/uploads/2015/07/SORP2015MadeSimple-SayerVincent-July2015.pdf

The Statement of Financial Activities (SoFA)

Trustees who are unfamiliar with charity finance need to be talked through the **Statement of Financial Activities (SoFA)** and have explained to them why charity accounts are different (i.e. the importance of

columns showing restricted and unrestricted funds). The SoFA is essentially the income and expenditure account. It also includes all the resources available to the charity, including donated assets and services, and capital such as new endowments (see table below).

With the introduction of SORP 2015 (FRS 102), a SoFA has to follow a fixed structure which is given below:

	Unrestricted funds £	Restricted funds £	Endowment funds £	Total funds £	Previous year's totals £
Income and endowment:					
Donations and legacies					
Other trading activities					
Income from investments					
Income from charitable activities					
Other income					
Total income and endowments					
Expenditure:					
Raising funds					
Charitable activities					
Other					
Total expenditure					
Net gains/(losses) on investments					
Net income/(expenditure)					
Transfer between funds					
Other recognised gains/(losses)					
Fixed assets					
Actuarial gains/(losses) on defined benefit pension schemes					
Other gains/(losses)					
Net movement in funds					
Reconciliation of funds					
Total funds brought forward					
Total funds carried forward					

As with all financial reports, all material variances should be explained succinctly in the accompanying commentary without the use of jargon. If they aren't, trustees should ask for an explanation for each and require future reports to automatically include such explanations.

It is important for the finance team to be able to explain in a way that a lay person can understand.

The balance sheet

The balance sheet gives a picture of the charity's assets, liabilities and reserves on the day that it was drawn up (usually the last day of the financial year when looking at end of year figures or the last day of the relevant accounting period being reported to the board or finance committee). It is generally considered good practice to prepare balance sheets alongside income and expenditure accounts as part of regular financial reports to the board as they act as comfort that the income and expenditure account is correct and enable movements in assets to be tracked which might not feature in the income and expenditure account.

Fixed assets are typically things that the charity owns; for example land or property, computers, intellectual property. Long term investments are also shown in this section.

Current assets are typically cash or entities that can readily be turned into cash. These are sometimes called liquid assets. Debtors (money owed to you) belong under current assets.

A **liability** is any financial obligation where the charity owes money to another entity such as a landlord, a supplier, a bank or a pension fund. Like assets, these are usually split between **current liabilities**, i.e. liabilities due to be paid in the next twelve months (e.g. unpaid invoices for goods or services), and **long-term liabilities** (i.e. that are not payable within the next twelve months such as defined benefit pension liabilities, mortgage/lease).

Net assets are what's left when you subtract total liabilities from the total assets. If the net assets are negative then the charity is likely to be in financial difficulties and you should seek professional advice.



Image courtesy of Flickr/United Nations Photo

With the introduction of SORP 2015 (FRS 102),
a balance sheet has to follow a fixed structure which is given below:

	Total funds £	Previous year's totals £
Fixed assets:		
Intangible assets		
Tangible assets		
Heritage assets		
Investments		
Total fixed assets		
Current assets:		
Stocks		
Debtors		
Investments		
Cash at bank and in hand		
Total current assets		
Liabilities:		
Creditors: amounts falling due within one year		
Net current assets or liabilities		
Total assets less current liabilities		
Creditors: amounts falling due after more than one year		
Provisions for liabilities		
Net asset or liabilities excluding pension asset or liability		
Defined benefit pension scheme asset or liability		
Total net assets or liabilities		
The funds of the charity:		
Endowment funds		
Restricted income funds		
Unrestricted funds		
Revaluation reserve		
Pension reserve		
Total unrestricted funds		
Total charity funds		

Again, if there is anything in the previous table that a trustee does not understand sufficiently, it is important to have a session with the finance director (or chief finance officer) or the treasurer and ask for relevant terms to be explained, and to seek guidance on what are the key areas for your charity that trustees need to keep a watchful eye on.

Cash flow

In regular financial reports to the board, cash flow charts and projections can be very valuable. They give a picture of money coming in and out in each period and anticipate cash flow for the rest of the year by looking at receipts over payments and opening and closing balances. When looking at the closing balance for each period, I like to see the figure split into restricted and unrestricted funds.

Most charities are required to use accrual accounting rather than cash accounting. Accrual accounting is

when adjustments are made for income (revenue) that has been earned but has not yet been received and expenditure (expenses) that has been incurred but not yet paid, e.g. gas and electricity bills. Therefore, a cash flow statement can be different to an income and expenditure account.

A statement of cash flows required in year-end financial statements is slightly different. Under SORP 2015 the cash flow statement which shows the areas of the cash surplus or deficit for the year must follow one of two formats (direct or indirect method). The indirect method is the one illustrated below, as it is the one that is most commonly used.

Cash flows have to be analysed under three headings: operating activities, investing activities and financing activities.

	Total funds £	Previous year's totals £
Cash generated from operating activities:		
Net cash provided by (used in) operating activities	X	(X)
Cash flows from investing activities:		
Dividends, interest and rents from investments	X	X
Proceeds from the sale of property, plant and equipment	X	X
Purchase of property, plant and equipment	(X)	(X)
Proceeds from sale of investments	X	-
Purchase of investments	(X)	(X)
Net cash provided by (used in) investment activities	X	X
Cash flows from financing activities:		
Repayment of borrowing	(X)	(X)
Cash inflows from new borrowings	X	-
Receipt of endowment	X	X
Net cash provided by (used in) financing activities	X	X
Change in cash and cash equivalents in the reporting period	X	X
Cash and cash equivalents at the beginning of the reporting period	X	X
Change in cash and cash equivalents due to exchange rate movements	X	(X)
Cash and cash equivalents at the end of the reporting period	X	X



Trustees' annual report (sometimes called the 'TAR' for obvious reasons)

As it says on the tin, it is the trustees' annual report – all trustees should read the report carefully and ensure that what it says is accurate.

The annual report as well as the annual accounts need to be approved by the board. The report should be both accurate and truthful. It should avoid exaggerating achievements or exaggerating what is actually happening at the charity, or underplaying the major risks it faces.

If your auditors are not charity specialists, you are advised to download and read pages 8-14 of *Financial disclosure reporting checklist Charities SORP (FRS 102)* written by Crowe Clark Whitehill¹⁵.

If the charity is using a charity specialist firm of auditors, the audit partner should ensure that the report complies with SORP and any other regulatory/legal requirements. Nevertheless, it is important for trustees not to be overreliant on the auditors and have their own checklist.

My recommended checklist is:

Structure, governance and management

- The methods used to recruit and appoint new charity trustees, including details of any constitutional provisions for election or appointment (unless the criteria for exemption from disclosure are satisfied).

If a larger charity:

- The policies and procedures for the induction and training of trustees.
- The arrangements for setting the pay and remuneration of the charity's key staff and any benchmarks or criteria used in setting their pay.

Public benefit disclosures

- Explain the main activities undertaken to further the charity's purposes for the public benefit.
- Confirm that the trustees have given due consideration to the Charity Commission's published guidance on the Public Benefit requirement under the Charities Act 2011.

Fundraising

If a larger charity:

- The performance of material fundraising activities against the charity's fundraising objectives set.
- If material expenditure was incurred to raise income in the future, the effect this has had, and is intended to have, on the net return from fundraising activities for both the reporting period and future periods.

It should be noted that the Charities (Protection and Social Investment Act) 2016 brings additional reporting requirements regarding fundraising, i.e:

- The charity's approach to fundraising, and in particular whether a professional fundraiser or commercial participator was used.
- The details of any voluntary fundraising schemes or standards which the charity or anyone fundraising on its behalf has agreed to, and any failure to comply.
- Whether and how the charity monitored fundraising activities carried out on its behalf.
- How many complaints the charity or anyone acting on its behalf has received about fundraising for the charity.
- What the charity has done to protect vulnerable people and others from unreasonable intrusion on a person's privacy, unreasonably persistent approaches or undue pressure to give, in connection with fundraising for the charity.

Investments

If a larger charity holding material financial investments:

- The investment policy and objectives set.
- The investment performance against the investment objectives.

Key risks and uncertainties disclosures

If a larger charity:

- The principal risks and uncertainties facing the charity and a summary of the trustees' "plans and strategies for managing those risks".
- Any factors that are likely to affect the financial performance or position going forward.

Pension liabilities

A larger charity should disclose the impact, if any, of a material pension liability arising from obligations to a defined benefit pension scheme or pension asset on the charity's financial position.

Reserves

- Policy for holding reserves, the amounts of those reserves and why they are held.
- If holding reserves is considered unnecessary, the report must disclose that fact and explain the trustees' reasoning for this view.

Funds in deficit

- Identify any fund or subsidiary that is materially in deficit, explaining the circumstances giving rise to the deficit and the steps being taken to eliminate it.

Going concern

- If, at the date of approving the report and accounts, there are uncertainties about the charity's ability to continue as a going concern¹⁶, the nature of these uncertainties should be explained.

¹⁵ [croweclarkwhitehill.co.uk/wp-content/uploads/sites/2/2016/03/sorp-financial-disclosure-reporting-checklist-2016.pdf](https://www.croweclarkwhitehill.co.uk/wp-content/uploads/sites/2/2016/03/sorp-financial-disclosure-reporting-checklist-2016.pdf)

¹⁶ Going concern is a basic underlying assumption in accounting. The assumption is that a company or other entity will be able to continue operating for a period of time that is sufficient to carry out its commitments, obligations, objectives, and so on. In other words, the company will not have to liquidate or be forced out of business in the foreseeable future.

2.4 Internal financial controls, fraud and whistleblowing

Issues that all boards need to consider:

- How and how often does the board check the robustness of financial controls? The charity’s annual return¹⁷ must confirm whether or not the charity has reviewed its financial controls during the reporting period. As a matter of good practice, the Charity Commission recommends that a charity reviews its financial controls annually to ensure that they are up to date and effective.
- Should the charity have an internal audit¹⁸ function and/or an audit committee? The answer to this question will depend on the size of the charity, its complexity and the range of risks it faces. Trustees should bear in mind the significantly changed environment in which charities now operate and the greater focus on trustees’ role in guarding the assets and funds of the charity within a framework of robust financial governance and management. As a result increasing number of charities have an audit (or audit and risk) committee.

- What are the charity’s anti-fraud policies and procedures and are they sufficiently robust and known throughout the charity? Cyber fraud is a particular and growing concern for all organisations, including charities.
- Is there a good whistleblowing policy and procedure which are known to all staff, volunteers, service users and contractors, etc.?

Financial delegations (or schedule of financial delegations)

The aim of financial delegations is to help run an efficient and effective charity with a strong internal financial control mechanism. Many trustees do not know what financial delegations should cover. To help, model financial delegations (written by Sam Coutinho, partner, haysmacintyre and reproduced here with her permission) are given in Appendix (page 46). These should be relevant to most charities.

A tabular format for financial delegation that indicates where responsibility lies, is often a more user friendly format. A sample is given below:

Area of responsibility	Level of responsibility			
	The board	Finance committee	CEO	Other staff member, e.g. FD/ CFO
Financial management Ensure the trustees’ fulfil their financial responsibilities and the charity is operating within the financial requirements and guidelines set out in law, regulation and the charity’s governing documents.	✓	Takes leading role in supporting board with this		
			✓	
	✓			
		✓		Named individual

17 The annual return now requires the following declaration:
The person submitting the annual return on behalf of the charity must certify that:

- they have understood all of the requirements associated with the submission of the annual return and all of the statements contained within it
- the information provided in the relevant parts of the annual return is correct and complete to the best of their knowledge and belief and has been brought to the attention of the charity trustees who have each individually verified this and given their informed express consent to this submission with full knowledge, understanding and acceptance of the contents of the privacy notice.

Charities with an income of over £25,000 must also confirm that there are no serious incidents or other matters that should have been brought to the attention of the Charity Commission that have not already been reported.

18 The Institute of Internal Auditors defines an internal audit as “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.” An internal audit function can also be a deterrent to people who might otherwise not comply with intended controls. Sometimes there is an in-house internal auditor. At other times, an external agency can be appointed as the internal auditor.

19 gov.uk/government/uploads/system/uploads/attachment_data/file/510581/CC8.pdf

20 gov.uk/government/uploads/system/uploads/attachment_data/file/510581/CC8.pdf

21 gov.uk/government/uploads/system/uploads/attachment_data/file/488887/cc8check.pdf

Internal financial controls

The introduction to *Internal financial controls for charities (CC8)* from the Charity Commission¹⁹ rightly points out:

“No system of controls, however elaborate, can guarantee that a charity will be totally protected against loss, waste, bribery, theft or fraud, or mistakes or mismanaged conflicts of interest. Having sufficiently rigorous controls does provide protection for the charity’s assets and is the best defence for the trustees against the charge of failing to protect the charity’s assets and funds.

“The ‘tone at the top’ – Executive management and the charity’s staff and volunteers are responsible for ensuring that the controls put in place by the trustees are implemented.

There should be a culture of control embedded in the operations of the organisation; this culture is created by the trustees and senior management, who should lead by example in adhering to the charity’s internal financial controls and good practice.

“Review of controls – The trustees should, at least annually, ensure a review is conducted of the effectiveness of the charity’s internal financial controls. This should include an assessment of whether the controls are relevant to, and appropriate for, the charity and not too onerous or disproportionate.

“Segregation of duties – A key feature of internal financial controls is to ensure that no single individual has sole responsibility for any single transaction from authorisation to completion and review. It is important where the trustees administer the charity personally, more likely in smaller charities, that there is sufficient segregation of duties amongst them, so that no one trustee is overburdened or exercises sole responsibility.

“There may be resource constraints which can make it difficult in smaller charities to achieve a full segregation of duties. However, trustees or management can take action to compensate for these difficulties. These actions include trustees or managers reviewing reports of transactions or carrying out checks on internal controls independently of the person who normally undertakes the work.”

Further guidance can be obtained by reading *Internal financial controls for charities (CC8)* from the Charity Commission²⁰ that comes with a separate checklist²¹.



Image courtesy of the World Bank

Charities working internationally²²

“Many charities are based in the UK and send money to projects, charities, not for profit organisations and direct to beneficiaries in other countries – these charities carry out invaluable work, in challenging circumstances, often helping the neediest in society. Trustees of such charities may need to take additional steps to ensure that charitable funds are properly used and reach intended beneficiaries. In some cases, the risks will be significantly higher. Sometimes these risks arise because the charity is not on the ground to check funds have been spent properly, requiring trustees to consider carefully what specific due diligence and monitoring steps they need to undertake. These steps may be more time-intensive than for other charities.

“When working internationally, charities often operate through local partners rather than establishing their own delivery infrastructure in their country or region of operation. Working through or with a local partner can be an effective way of delivering significant benefits direct to a local community. It does not, however, shift or alleviate responsibility for ensuring the proper application of the charity’s funds by the local partner.

“That responsibility always remains with the charity trustees, forming part of their duties and responsibilities under charity law. The need to implement risk strategies therefore remains critical.”

There may be possible tax consequences if the trustees have not taken steps “which HMRC consider are reasonable to ensure that the funds were used for charitable purposes”.

Bank accounts

It is important that trustees know exactly how many bank accounts the charity has and who the signatories are.

A charity can be more vulnerable to fraud if it has large numbers of bank accounts. So be very clear about why each account is needed.

The opening or closing of bank accounts should be authorised by the whole trustee body, but can be delegated where appropriate subject to reasonable limits but these need to be monitored carefully by the board or audit committee.

When closing a bank account it is essential to make sure that donors are not donating by standing order into the account that is about to be closed.

Arrangements will need to be made in good time before the account is closed to get donors to change the charity’s bank account details on their standing order mandate. Asking donors to do this will inevitably result in some donors not renewing their standing order.

Fraud and Whistleblowing

Fraud is on the increase. The *Annual Fraud Indicator Report 2016* estimates that fraud cost the sector £1.86bn in 2013/14, representing 2.5 per cent of the sector’s £74bn income. Many think that this figure might be the tip of an iceberg.

Fraudsters are becoming increasingly sophisticated and making the most of the advances in technology to defraud.

Just because you have not discovered any fraud, it doesn’t mean that fraud is not happening in your charity to a lesser or greater degree. It is possible that the charity just has not detected the fraud that is going on, because the systems and processes for preventing and detecting fraud are not strong in the charity.

Some charities perpetrate fraud themselves, such as Gift Aid fraud.

²² Charity Commission Inquiry Report Masoom Registered Charity Number 1124976 gov.uk/government/uploads/system/uploads/attachment_data/file/583333/masoom.pdf

²³ The Institute of Internal Auditors defines an internal audit as “Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.” An internal audit function can also be a deterrent to people who might otherwise not comply with intended controls. Sometimes there is an in-house internal auditor. At other times, an external agency can be appointed as the internal auditor.

²⁴ kingstonsmith.co.uk/wp-content/uploads/2016/09/Charties_fraud_toolkit.pdf

²⁵ cfg.org.uk/resources/Publications/-/media/Files/Resources/CFDG%20Publications/charity_fraud_guide_full.ashx

There are lots of different ways in which a charity can fall foul of fraud. Fraud can be:

- internal (e.g. abuse of a position of trust, misuse of credit/debit cards, false invoices created by staff/volunteers, expenses fraud, payroll fraud, hiring out charity vehicles for private gain)
- external (e.g. bogus fundraiser, external false invoices, credit card scams, cyber fraud).

What can trustees do to prevent fraud?

1. Get the culture of the charity right. Create a culture of honesty and integrity where all those associated with the charity are protective of the charity and its beneficiaries.
2. Develop an anti-fraud policy (make sure this includes cyber fraud) and a whistleblowing policy. Ensure they are known throughout the charity. Make sure that they are part of the induction and ongoing training of trustees, staff, and volunteers. Ensure that beneficiaries, their families, suppliers and other stakeholders know what to do if they suspect something untoward going on.
3. Put together a robust fraud response plan as part of your anti-fraud policy.
4. Have good systems for looking at risk strategically

and systematically. Understand your fraud risks and general risks particularly with regard to financial and other assets.

5. Is there a case for the charity having an in-house internal auditor²³ reporting directly to trustees or for an external agency to be appointed as internal auditor?
6. Implement robust financial controls and review them regularly. Evaluate the adequacies of internal control systems.
7. Record suspected, attempted and confirmed fraud to see if there are any patterns and to ensure the charity learns from experience.

For a **fraud recording template** put forms. charitycommission.gov.uk/media/90880/tkch3_gathering_evidence.xls in your web browser. This template requires updating but nevertheless its format is helpful.

Trustees might find *Charities Toolkit: a toolkit for managing fraud risks*²⁴ by Kingston Smith useful.

The flow chart on 'Where to report Fraud' on page 29 of *Charity Fraud: a guide for trustees and managers of charities*²⁵ is very helpful.



2.5 Understanding risks attached to different types of income

Every board should endeavour to ensure that their charity has a range of sources of income and is not overdependent on one or two income streams. Each stream of income carries its own risks that need to be understood by trustees.

Sources of income include:

- public service delivery contracts
- charity shops
- raffles and lotteries
- trading companies
- other forms of trading (e.g. consultancy)
- events
- donations and gifts
- legacies
- membership subscriptions
- corporate donations and gifts in kind
- corporate sponsorship
- grants from trusts, foundations, government
- investment income
- crowdfunding.

Each will carry risks and have their own governance issues. For example: public service delivery contracts issues that trustees should consider include:

- Does the board require all public service delivery contracts to be on the basis of full cost recovery? Will contracts covering more than one year also cover salary increases? If not full cost recovery, how is any shortfall to be funded?
- What is the board's risk appetite regarding public service delivery contracts? Who has delegated responsibility to check contracts prior to signing, to ensure the charity does not accept risks and liabilities that the board finds unacceptable?
- What are the consequences of not fulfilling a contract?
- Is there any risk of clawback i.e. the commissioning body demanding partial repayment because the charity has only delivered partially (e.g. only 79 per cent of unemployed people trained by the charity found employment so local authority demands refund of 21 per cent)?
- Is there an exit strategy?

It is important to understand the risks and opportunities for each income stream and to have considered how the charity will cope if a key income stream dries up.

Finance can also be raised through:

- loan financing
- social impact bonds.

2.6 Understanding your charity's position with regard to taxes²⁶

It is a commonly held misconception that charities do not have to pay tax.

However, as a charity, you get certain tax reliefs. To benefit from these reliefs a charity must be recognised as such by HM Revenue and Customs (HMRC).

Charities don't pay tax on most types of income as long as they use the money for charitable purposes. This includes tax that might otherwise be payable:

- on donations
- on profits from primary purpose or ancillary trading
- on rental or investment income, e.g. bank interest
- on profits when the charity sells or disposes of an asset, like property or shares
- when the charity buys property.

A charity can claim back tax that's been deducted, e.g. on donations (this is known as Gift Aid).

When the charity needs to pay tax

Your charity may need to pay tax if it:

- received income that doesn't qualify for tax relief
- spent any of its income on non-charitable purposes. This is known as 'non-charitable expenditure'.

Charities also pay tax on:

- profits from developing land or property
- purchases, but there are special VAT rules for charities.

²⁶ Parts of the content in section 2.6 have been drawn directly from gov.uk/charities-and-tax/overview

VAT

- A charity must register for VAT if the charity's VAT taxable turnover (the total value of everything the charity sells that isn't exempt from VAT) is more than £85,000.
- A charity can choose to register if it's below this, e.g. if it wants to reclaim VAT on its purchases relating to taxable turnover.

Gift Aid

There are special rules for claiming Gift Aid on:

- funds from sponsored challenges, e.g. overseas treks or marathons
- charity membership fees
- church collections
- selling goods on behalf of an individual, e.g. through a charity shop
- charity events or admissions to view charity property
- charity auctions
- volunteer expenses donated back to your charity
- funds raised through charities involved in running schools.

A charity can't claim Gift Aid on donations:

- from limited companies
- made through Payroll Giving
- that are a payment for goods or services or made because your charity bought goods and services
- that started as loans, but no longer need to be repaid
- where the donor gets a 'benefit' over a certain limit of shares
- from charity cards or of vouchers, e.g. Charities Aid Foundation (CAF) vouchers
- the charity got before it became a recognised charity.

Business rates

Charities pay business rates on non-domestic buildings, but they get an 80% discount if the property is used for charitable purposes.

Life can get complicated if for example part of the property is used by the charity's non-primary purpose trading company. Full business rate relief normally applies if the building is mainly occupied for charitable purposes. Otherwise, full business rates normally apply for the relevant fraction of the property being used by the charity's non-primary purpose trading company.

Finally

If you want to know more about charities and tax, go to gov.uk/charities-and-tax

If you want to know more about charities and VAT, go to gov.uk/vat-charities

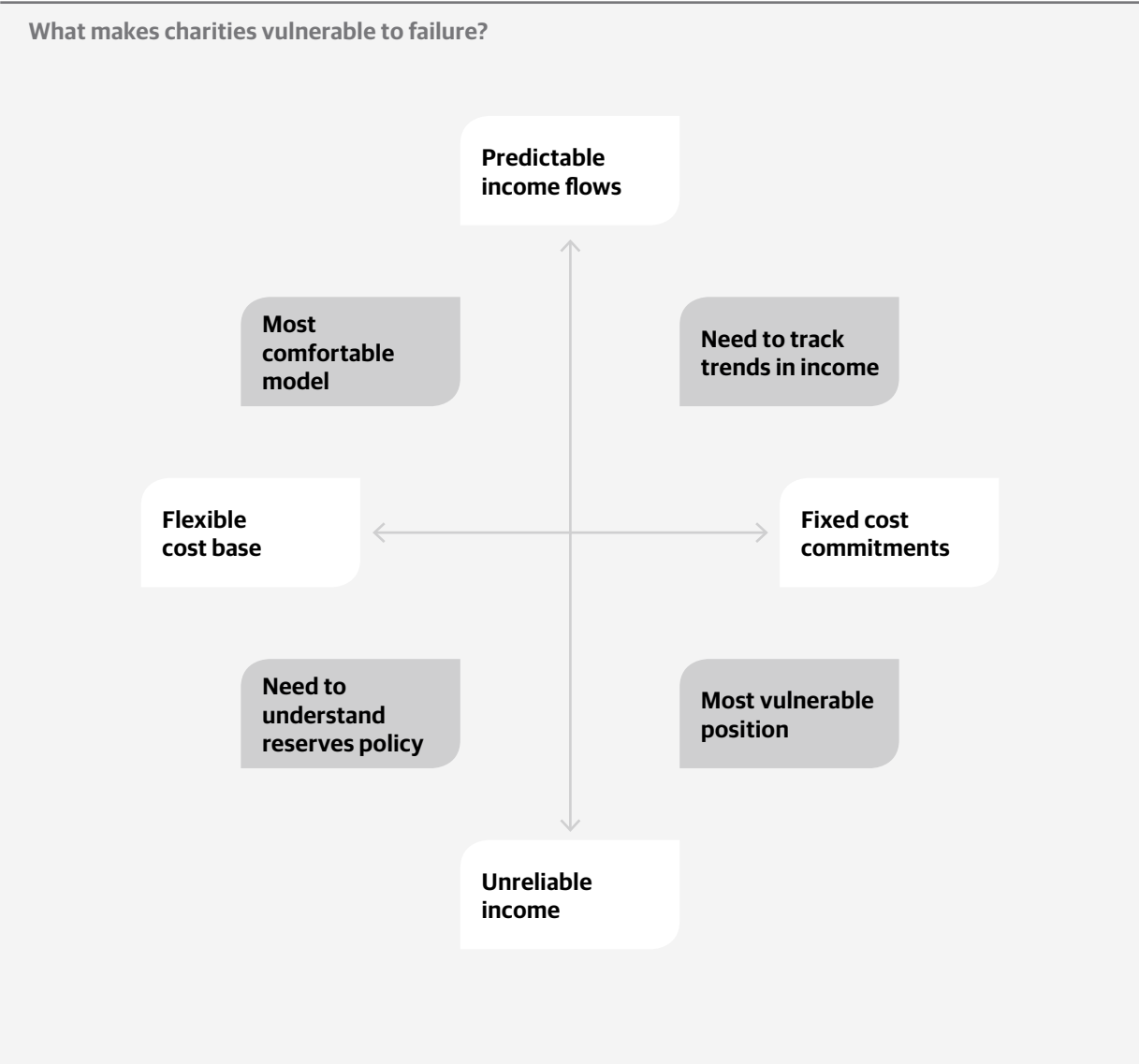
The rules regarding charities and tax are complex. It is important that trustees receive professional written advice from charity tax experts when necessary. If your charity hasn't recently had an **independent tax audit** to ensure that it is paying the right taxes and claiming back all relevant taxes (e.g. Gift Aid), you should suggest that such an audit is carried out.

2.7 Insolvency

The following extract is taken from *Managing in a Downturn: Staying Solvent and Surviving Well*²⁷ and is reproduced here with the kind permission of its publisher, DSC, and its author, **Ian Oakley-Smith**, director and head of charities, PWC.

“Why do charities fail?

The external environment has the potential to affect all charities, but some charities will survive where others will fail. A charity’s operating model, coupled with its attitude to risk and its reserves levels will determine the extent to which it can absorb setbacks. The chart below illustrates the balance between reliability of income and flexibility of cost base.



27 dsc.org.uk/wp-content/uploads/2015/07/Look-Inside-Managing-in-a-Downturn.pdf

“For example, a grant-making charity, with limited overheads and controllable commitments, is likely to find itself in the top left of the chart. Such a charity will stand a good chance of remaining flexible in the light of fluctuations in its income. On the other hand, a charity which is heavily reliant on restricted, project-based income, but which has a significant fixed cost base (employees, premises, etc) may well be in the bottom right hand corner and may be less able to absorb setbacks.

“However, while it remains true that a charity’s operating model will render it more or less likely to fail, in practice, there is one common theme running through all failing charities – inadequate financial management. Put simply, poorly managed charities will be more vulnerable to failure.”

Trustees need to be aware that:

- Under charity law, trustees put themselves at risk of personal liability if they (in the case of unincorporated charities) commit the charity to debts which amount to more than its assets; or, in the case of charitable companies, continue to operate when they know or ought to know that they cannot avoid insolvent liquidation.

Some common signs of impending insolvency:

- repeated failure to produce accurate and timely financial information for the board and finance committee
- liquidity ratio less than 1 (see page 19)
- overdue or missed tax payments (such as PAYE, National Insurance, VAT) or special arrangements agreed with HMRC
- overdue or missed pensions contributions
- bank overdraft approaching its limit
- delays in paying invoices for services or goods
- suppliers demanding cash in hand or stricter credit terms

- creditors starting or threatening to start legal proceedings
- payment to creditors in rounded sums which cannot be reconciled to a specific invoice
- late filing of accounts
- high turnover of trustees/directors on the board
- high turnover of staff particularly senior staff.

Insolvent liquidation

It is essential:

- For trustees to ensure that restricted funds are only used for the purposes for which they were given (remember you cannot without relevant consent from donor or Charity Commission ‘borrow’ from restricted funds to pay for activities that fall within unrestricted funds).
- As soon as you think your charity might be insolvent or very near the point of insolvency, trustees must then act solely in the interests of the charity’s creditors. Trustees need to speak immediately to professional advisers (e.g. auditor/independent examiner and insolvency practitioner). The board must meet frequently and regularly. Careful minutes need to be kept of each meeting so that there is a record showing that the trustees were acting solely in the interests of creditors.

A company is considered to be insolvent if it is unable to pay its debts.

There are two tests for corporate insolvency:

- **The cash flow test:** is the charitable company currently, or will it in the future, be unable to pay its debts as and when they fall due for payment?
- **The balance sheet test:** is the value of the charitable company’s assets less than the amount of its liabilities, taking into account contingent (current, provisional) and prospective (future) liabilities?



Image courtesy of the World Bank

In recent cases the courts have ruled that, where the balance sheet test applies, consideration needs to be given to whether or not, on the balance of probabilities, each contingent or prospective liability is ever likely to fall due and, if so, when.

If insolvency is a possibility, trustees are advised to read *Managing a charity's finances: planning, managing difficulties and insolvency (CC12)*²⁸

The options

Trustees should consider carefully whether they have a business plan that has a reasonable prospect of returning the charity to financial good health.

If there isn't (the following extracts are taken from *Managing a charity's finances: planning, managing difficulties and insolvency (CC12)*²⁹), the options are:

²⁸ gov.uk/government/uploads/system/uploads/attachment_data/file/496292/CC12.pdf

²⁹ gov.uk/government/publications/managing-financial-difficulties-insolvency-in-charities-cc12

³⁰ A company is eligible for a moratorium where it can satisfy 2 or more of the following criteria:

- a turnover of less than £6.5 million
- a balance sheet total of less than £3.26 million
- less than 50 employees

"1. Administration (a charitable company)

Administration is a court procedure that gives a company some breathing space from any action by creditors – in effect it is a rescue process.

A court can grant an administration order to enable a company to:

- survive, in whole or in part, as an ongoing business
- organise a voluntary arrangement or compromise with its creditors
- get a better realisation of assets than would be possible if the company went into liquidation.

"The procedure is managed by an administrator, who must be an authorised insolvency practitioner.

"When a company goes into administration, an administrator is appointed to act in the interests of all the creditors of the company and attempt to rescue it as a going concern.

"2. Arrangement with creditors

When facing potential insolvency, charities can consider entering into an arrangement with their creditors as a rescue mechanism to avoid compulsory liquidation or winding up. The nature of the arrangement will depend on whether it is incorporated or not.

“Charitable companies

Under the Insolvency Act, a charitable company may enter into a **Company Voluntary Arrangement (CVA)** with its creditors. The creditors may agree, as part of the arrangement, to accept a reduction in their debt and/or a delay in payment. The directors would need to apply to the court with the help of an authorised insolvency practitioner, who would supervise the arrangement and pay the creditors in line with the accepted proposals. A CVA can be implemented during an administration.

“The Insolvency Act 2000 introduced a new procedure to enable a small company³⁰ to obtain a moratorium where a CVA is proposed. A moratorium provides a breathing space to give a company's directors time to put a rescue plan to its creditors. It prevents the company's creditors from proceeding against the company during the relevant period, whilst allowing the directors to remain largely in control of the company.

“Unincorporated charities

It is possible for the trustees of an unincorporated charity facing insolvency to enter into an informal arrangement with their creditors. The creditors under such an arrangement might agree to defer payment of the debts and liabilities that the trustees have incurred on behalf of their charity, and/or agree to reduce the size of their claims. Such an arrangement falls outside the provisions of the Insolvency Act. If the arrangement is legally binding, it will only bind those creditors who are party to the agreement. Trustees should take appropriate professional advice before entering into such an agreement.

“3. Liquidation or winding up the charity

This is the last resort.

Trustees should note the following:

- Payments to creditors are the trustees' primary responsibility and should be scheduled in accordance with their priority.
- A charity could contravene the provisions of the Insolvency Act if it paid grants to beneficiaries or made a transfer to another charity in anticipation of insolvency so that other creditors do not get a fair settlement – this means that trustees should not apply the charity's funds for its purposes if it could be construed that the application could be seen to have this effect (a 'preferential transaction').
- The charity's assets should not be removed – however, in a winding up cash is important and if buyers are found for the charity's non-cash assets, they can be sold – in doing this the trustees must always keep in mind the need to maximise the funds available to pay the charity's creditors.
- If the charity is small or its operations are simple and straightforward and it has been unable to appoint a professional liquidator, the trustees may have to decide to agree to enter into a voluntary arrangement with its creditors – it is essential that the charity trustees keep a full written record of all decisions and actions taken through any closing down period and the reasoning behind them – the process of taking full detailed minutes can encourage a structured thought process and will help to protect those taking the decisions.

“The differences that apply to various charity structures are:

“Charitable companies

When the directors of a charitable company know, or ought to know, that there is no reasonable prospect of avoiding insolvent liquidation they must from that time take every step necessary to minimise the potential loss to the company's creditors. This may involve cutting down or stopping some or all of the charity's activities. Paying professional fees for advice obtained is justifiable if incurred with a view to ensuring the best outcome for the charity's creditors.

“The court will not normally order the compulsory liquidation of a charitable company on the ground of inability to pay debts until after a creditor has either:

- Issued a formal legal notice called a 'statutory demand', and the demand has not been met (this applies to sums greater than £750 which then remain unpaid for 21 days).
- Obtained a court judgment against the charity, in relation to a claim against it, and that claim has not been satisfied. In these circumstances the creditor can petition the court to wind up the company. Once a charitable company is being wound up, whether voluntarily or compulsorily, it is placed under the management of an insolvency practitioner as liquidator. It is then too late for the directors to take action of their own to bring the charity out of insolvency.



Image courtesy of Flickr/United Nations Photo

“The role of company members

Members of charitable companies can voluntarily place the company into liquidation. Where the members of a company pass a resolution to liquidate the charity, this will be a creditors' voluntary liquidation if the company is insolvent. It will be a members' voluntary liquidation if the company is solvent. The main difference between the two is that in a creditors' voluntary liquidation, the creditors rather than the members control the choice of insolvency practitioner.

“Unincorporated charities

The decision to wind up an unincorporated charity will normally be one taken voluntarily in accordance with the provisions of the charity's governing document.

Although unincorporated charities cannot be compulsorily wound up, their trustees may face legal demands from creditors in relation to liabilities that they have incurred on behalf of the charity.

“Where the trustees of an unincorporated charity see that there is no reasonable prospect of avoiding insolvency, their duty to act prudently may involve cutting down or stopping some or all of the charity's activities. This means that there is more likelihood that sufficient property will remain in the charity to cover the costs of meeting the debts and liabilities they have incurred in the administration of the charity.”

2.8 Qualified accounts

In your charity's annual return to the Charity Commission, the charity is asked whether the annual accounts are 'qualified'. Some tick this box thinking it means that the audit was carried out by a qualified auditor or independent examiner. This is an easy mistake to make but 'qualified' means that there are problems with your accounts so make sure that this box is not accidentally ticked.

Unqualified report (also known as a 'clean report')

If you have an unqualified report, it means that your auditors are of the view that the financial statements in your accounts present justly the charity's financial affairs in all material aspects. 'Material' is a key auditing word³¹.

Unqualified report or opinion means that your auditors obtained sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the charity's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the trustees and the overall presentation of the financial statements.

An unqualified opinion does not endorse a view that your charity is in good economic health (some trustees think it does). It just states that your financial report is transparent, thorough and does not hide critical facts.

Qualified report (or modified report)

A qualified report is usually given when the auditor determines that most matters have been dealt with adequately, except for a few issues. An auditor's report might be qualified if there was a constraint on the scope of the auditor's work, or when there is a disagreement with management regarding application, acceptability or adequacy of accounting policies.

These issues must be material or financially worth consideration to qualify a report. The issue should not be pervasive, that is, the issue should not misrepresent the factual financial position. If issues are material and pervasive, the auditor will issue a disclaimer or adverse opinion³².

A qualified (modified) audit report does not mean that your business is failing, and it doesn't mean that your financial statements aren't transparent. It may, however, reflect problems with your systems or the basis on which you have made judgements and estimates for the financial statements. In most cases, a qualification (modification) will be seen as a serious issue by funders so you will need to be prepared to answer further questions.

³¹ Information is said to be material if omitting it or misstating it could influence decisions that users make on the basis of an entity's financial statements. Put differently, "materiality is an entity-specific aspect of relevance, based on the size, or magnitude, or both," of the items to which financial information relates. [en.wikipedia.org/wiki/Materiality_\(auditing\)](https://en.wikipedia.org/wiki/Materiality_(auditing))

³² International standard on auditing (UK and Ireland) 705

frs.org.uk/Our-Work/Publications/APB/ISA-705-Modifications-to-opinions-in-the-independe.pdf

Adverse Opinion. The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion. The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to ISA (UK and Ireland) 705 4 the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

2.9 Relationship with your auditors

It cannot be overemphasised that if you are a professionally managed charity, it is best to ensure that your chosen auditor is a specialist in charities. It is tempting, especially as their fees can be considerably lower, to use a local firm of accountants with a handful of charity clients but no real specialism. Having a charity specialist is particularly important if you trade or have a trading company, claim Gift Aid on membership fees, etc.

Issues that all boards need to consider proactively (often this goes by default with trustees unaware of these crucial requirements and the part trustees should play).

- Will it be the board or a board committee (e.g. audit or finance) or both that meet **annually with the auditor** to discuss their audit and the annual report and accounts? And will there be some time during this meeting for trustees to speak to the auditors without the executive present? The latter should be routine.
- Will it be the board or one of its committees that considers the audit findings report which is always addressed to the trustees and often called the 'management letter'? Management's response to the audit findings report should be considered alongside the report.
- If a charitable company, each director is required to give certain undertakings to the auditor such as there is no relevant audit information of which the auditors are unaware. These declarations are made via a letter of representation which is drafted by the auditors. How do trustees know that nothing of material interest has been kept from the auditors? Trustees need to consider what assurances they need in order to give similar assurances to the auditor. The chair of trustees normally signs the letter on behalf of each director.
- Before the next audit, will it be the board or a board committee that will consider the audit planning letter? If a committee, is there to be any input by the board?

Questions to ask the auditor regarding the annual report and accounts

Sam Coutinho, partner, haysmacintyre suggests the following questions:

1. Were you able to perform your work as planned? If not, why not?
2. Was the audit completed within the expected timetable? If not, why not?
3. What were the areas of judgement and how did you obtain audit assurance? Common areas to consider are depreciation rates, recoverability of debts, value of stock, recognition of income.
4. Do you think the trustees are addressing the issue of the pension deficit effectively?
5. What was the level of materiality? Auditors will make a decision whether the errors identified are significant enough to adjust the accounts.
6. Were there errors/adjustments not reflected in the final accounts?
7. How have you addressed fraud as part of your audit?
8. Are there any unresolved matters raised in previous years?
9. How did you decide on the areas to test this year? What work has been performed on the income, expenditure, the assets and the liabilities?
10. Do you have any recommendations on how the systems can be improved including efficiency, authorisation limits and internal controls?
11. How have you audited the trading activity in the charity and the trading subsidiary?
12. What work have you performed on going concern?
13. Have management agreed your control weaknesses recommendation and provided a timeframe for addressing the points raised?
14. What were the issues discussed and resolved with management in arriving at these final accounts?
15. Explain your audit opinion.

In line with good governance practice, trustees should look to changing their auditors or their audit partner about every five years. Otherwise the relationship might become too cosy.

2.10 Investments

There are various reasons for investing spare cash including:

- ensuring that the money is safe and keeping its value particularly in line with or above inflation
- generating an income for the day-to-day running of the charity.

Circumstances vary considerably. Some charities have relatively small amounts for investment, others might have significant funds including large endowments. All trustees need to be aware of the investment options (even if it is simply fixed interest deposits with a bank) and the risks and benefits of these different options.

The principles from a governance perspective are the same, but governance must be proportionate. A small amount of cash to invest will mean a relatively simple investment policy that is reviewed on a regular basis by the board or its finance committee. Charities with substantial investments will have a more complex investment policy and often a separate investment committee whose members have relevant expertise.

The investment policy statement should include matters such as investment objectives, liquidity requirements, time horizon, risk appetite in relation to investment, ethical requirements and the method for reviewing the performance of investments³³.

Trustees should also be aware that the board should not ask its investment manager to write the charity's investment policy. The investment manager can advise but it is for the board to develop its own policy and to decide what is in the best interests of the charity.

³³ Writing your charity's investment policy: a guide (Charity Finance Group/Charity Investors' Group)
cfg.org.uk/Policy/investment/-/media/Files/Policy/Investment/Writingyourcharitysinvestment%20policya%20guide.ashx



Image courtesy of Flickr/United Nations Photo

Setting investment objectives

It helps to start with reviewing the charity's financial position and answering a series of questions such as:

- What are the charity's short and long term financial commitments (past patterns of expenditure may be relevant for predicting future expenditure)?
- What is the charity's anticipated income excluding investment returns?
- What are the charity's longer term organisational objectives?

After having considered the charity's financial position but before framing the investment objectives, questions trustees need to ask themselves include:

- Of the reserves in hand, how much needs to be available on instant access?
- What can the charity afford to tie up for longer? Over what time periods?
- How much might be needed to deal with unplanned events?
- Do trustees have a preference between capital and income returns?
- Do trustees have an income target?
- Can trustees adopt a total return approach?

Examples of investment objectives can be found in *Writing your charity's investment policy: a guide*³⁴ (Charity Finance Group/Charity Investors' Group).

Relationship between risk and return

When it comes to investments, the definition of risk is the chance that an investment's actual return will be different (lower) than expected and the possibility of losing some, or even all, of the original investment. Low levels of risk or uncertainty are associated with low potential returns. High levels of uncertainty or risk are associated with high potential returns. Higher risk does not necessarily equate to greater return though. The higher risk gives the possibility of higher returns. Just as risk means higher potential returns, it also means higher potential losses. There are no guarantees.

³⁴ cf.org.uk/Policy/investment/-/media/Files/Policy/Investment/Writingyourcharitysinvestment%20policya%20guide.ashx

³⁵ CC14 Charity Commission gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

Financial investment

Charity Commission Guidance *Charities and investment matters: a guide for trustees (CC14)*³⁵ is a very good starting point for all trustees. It includes the following general advice:

The purpose of financial investment is to yield the best financial return within the level of risk considered to be acceptable – this return can then be spent on the charity's aims.

"In order to act within the law, trustees must:

- know, and act within, their charity's powers to invest (legal requirement)
- exercise care and skill when making investment decisions (legal requirement)
- select investments that are right for their charity; this means taking account of:
 - how suitable any investment is for the charity
 - the need to diversify investments (legal requirement)
- take advice from someone experienced in investment matters unless they have good reason for not doing so (legal requirement)
- follow certain legal requirements if they are going to use someone to manage investments on their behalf (legal requirement)
- review investments from time to time (legal requirement)."

The Charity Commission also recommends that trustees should:

- “decide on the overall investment policy and objectives for the charity
- agree the balance between risk and return that is right for their charity; this may include a wide range of factors that will impact on return including environmental, social and governance factors
- have regard to other factors that will influence the level of return, such as the environmental and social impact of the companies invested in and the quality of their governance
- be aware that some investments may have tax implications for the charity
- invest any permanently endowed funds in a way that helps them to meet their short and long-term aims
- decide whether to adopt an ethical, socially responsible or mission related approach to investment and ensure that it can be justified³⁶.”

Traditionally, there have been four main asset classes of investment:

1. cash
2. fixed-interest securities (also called bonds)
3. property (building or land)
4. shares (also known as equities).

Newer asset classes available to charities include:

- infrastructure (e.g. social housing, bridges, hospitals)
- hedge funds
- commodities
- derivatives.

All of these asset classes have different risk and return profiles and therefore play different roles in a charity's investment portfolio.

1. Cash (low risk, low returns)

Charities using cash deposits

Trustees need to have a short written policy covering:

- how long cash may be deposited for
- the maximum amount to be placed in one institution (splitting large deposits between banking institutions reduces the risk of large losses due to institutional failure)
- policy for short, medium and long term deposits.

Trustees should only invest with reputable institutions, such as those authorised by the Financial Conduct Authority (FCA) in the UK.

Other matters to consider include:

- the timing of interest payments (e.g. monthly or annual)
- any charges or penalties arising from access at short notice or early termination
- whether interest is paid gross or net of tax (UK banks ceased deducting tax from charities' and individuals' bank account interest with effect from April 2016)
- the charity's ethical stance
- the regulatory protection of the deposit³⁷.

Cash as investment

Advantages of cash in portfolios:

- provides stability and readily available funds to meet known liabilities, such as regular fixed drawdowns as it avoids the need to sell investments at inopportune times
- helps reduce overall risk within a portfolio
- acts as 'dry powder' for opportunistic investments that might arise.

Trustees are reminded that the opening or closing of bank accounts should be authorised by the whole trustee body, but can be delegated where appropriate subject to reasonable limits. The Charity Commission recommends that all subsequent deposits of funds should be authorised by at least two authorised individuals. For most charities, these individuals should be trustees.

³⁶ Charity Commission Guidance CC14 Charities and investment matters: a guide for trustees

gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

³⁷ On 21 November 2016, the Prudential Regulation Authority (PRA) opened a consultation to reset the deposit protection limit at £85,000 as a result of requirements in the European Deposit Guarantee Schemes Directive (DGSD). The new limit of £85,000, subject to eligibility, took effect on 30 January 2017. www.cfg.org.uk/resources/Publications/-/media/Files/Resources/Briefings/Understanding%20FSCS%20compensation%20Dec2013.ashx?campaignkw=Understanding-FSCS-Compensation

2. **Fixed interest securities – bonds (generally low risk, low returns)**

When a company wants to raise money to fund new projects or expand, it can launch a fixed-interest or fixed income security which is called a bond or a corporate bond. If a country does the same it is called a government bond (or gilt if the UK government is the issuer).

How do bonds work? Suppose a bond is issued for a period of 5 years offering a fixed rate of 2.5% per annum. A charity decides to invest £100,000 into this bond. Every year for five years the charity gets £2,500 and at the end of the five years the charity gets its £100,000 back.

However, if the charity wants its money back before the end of the five year term, it can sell the bond to a third party who wishes to buy – normally on a stock exchange – but will not necessarily get £100,000 back. The market price might have risen and it might get more. Equally, the market price (a reflection of the market’s perception of the value of the future cash flows) may have fallen and it might get less. Bonds which have a longer time to maturity tend to be more volatile (have greater price variability) than those with shorter time to maturity, all other things being equal.

Bonds have credit ratings associated with them. There are three main credit rating agencies:

Moody’s, Standard & Poor’s and Fitch. Bonds with lower credit ratings (e.g. those issued by small companies) tend to be more volatile than those with higher credit ratings (e.g. those issued by governments) all other things being equal.

3. **Property (moderate risk, moderate return)**

Property investments can include buildings and land. They can be residential or commercial (including office buildings, shopping centres, hotels, industrial units and even farms).

Property investments earn income from rent and the capital appreciation of the land and property. Property should be viewed as a long-term investment (five+ years).

Organisations can make property investment either directly or via property funds.

Investing directly is when a residential or commercial property is purchased to rent out thereby generating regular income, though there is a risk of low occupancy rates. Charities with smaller amounts to invest will rarely, if ever, invest directly in property in this way as property tends to come in fairly large unit sizes. Some charities do invest directly in property that they intend to occupy thereby saving on paying rent to others, possibly leasing or renting out unused space and thereby generating some income, and hoping for growth

Credit ratings for bonds:

	Moody's	Standard & Poor's	Fitch
Highest quality	Aaa	AAA	AAA
	Aa1	AA+	AA+
High quality	Aa2	AA	AA
	Aa3	AA-	AA-
Upper medium	A1	A+	A+
	A2	A	A
	A3	A-	A-
Medium	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
Speculative	Baa3 and lower	BBB- and lower	BBB- and lower



Image courtesy of Flickr/United Nations Photo

in the long-term in the value of the building and land. Charities considering going down the route of having tenants or lessees should take appropriate charity specialist professional advice (legal, financial, tax) including whether this would constitute trading rather than an investment.

With a property fund, an investor can purchase units in a fund that purchases properties on behalf of investors. This allows investors to invest in a wide range of property investments without restrictive minimum investment amounts.

Property funds may borrow money to purchase properties. The distributions and returns to investors are made after borrowing costs have been deducted. The level of debt used in the fund affects the riskiness of the investment.

4. **Shares or equities (high risk, high returns expected in the long-term)** Shares, also known as **equities**, represent a part ownership of a company. A charity can invest in the UK and international shares. Share prices constantly fluctuate both up and down – sometimes sharply. Shares are considered a long-term investment and a growth asset in the long-term (five+ years).

The returns available from shares come in two forms: **dividends** and **capital gains**. Dividends are payments made by companies to their shareholders, and are normally paid twice a year or quarterly. Companies have no obligation to pay a dividend, and may instead decide to reinvest their profits in the company.

Capital gains occur when the price of a share or asset rises above the purchase price. The share price is influenced by many factors.

Some common considerations in respect of investment portfolios

Income versus total return

An **income-only** approach is where the investor simply takes the income (interest and dividends) generated from the investments.

A **total return** approach is where the investor draws from both the income (interest and dividends) and a portion of the capital appreciation, i.e. the rise in the value of the portfolio. In other words any increase in the capital value can be used as income. Trustees can allocate whatever portion of the capital gain they consider appropriate as income. The balance remaining is carried forward as unapplied total return and invested as capital. A total return approach can give charities greater flexibility in achieving their investment objectives. This is because the focus is on investments that are expected to give the best overall performance rather than those that just happen to produce a certain level of income.

Charities that do not have permanent endowment can adopt a total return approach without the Charity Commission's consent.

The Charities Act 2011 allows trustees of permanently endowed charities to adopt a total return approach to investment by means of a resolution, and the Charity Commission has made regulations and issued guidance setting out how this power can be exercised and operated³⁸.

Active versus passive

Actively managed funds depend on the skill and expertise of the investment manager. These have the potential to perform above market benchmarks and achieve higher rates of return, although nothing is guaranteed. When fees are taken into consideration, many managed funds underperform the market.

Passively managed funds track the performance of an index, e.g. the FTSE 100 or FTSE 250 and are generally low cost. Passive investing allows trustees to gain exposure to an asset class without the need to worry about the expertise of an investment manager (although logically they should underperform the index they are tracking, once fees are taken into consideration).

Pooled versus segregated

Pooled funds (Collective Investment Schemes) are funds that are owned jointly with other investors who 'pool' their funds together. Investors in pooled fund investments potentially benefit from economies of scale (lower fees), greater diversification within the portfolio and simplified administration.

Segregated funds are where the charity's assets are held completely separate from the assets of other charities and are managed alongside – but separately from – other investments under the control of a particular fund manager. This arrangement is likely to be more expensive than a pooled fund but will often be the only route available if the charity has bespoke requirements (e.g. income, ethical) not met by the pooled fund.

'Discretionary' versus 'advisory' investment management services

With **discretionary** investment management services the charity's investment manager, having gained a deep understanding of the charity's investment objectives and risk appetite, will take charge of all investment decisions and will not require consent for individual purchases and sales (the charity having signed over permission for this). Revising the charity's investment strategy regularly as its needs evolve will form a core part of the investment manager's service.

Discretionary investment management services are quite popular as they free the charity from involvement in day-to-day investment management decisions.

Advisory investment management is reliant on express consent being granted by a charity to any recommendation offered by the investment manager. This is labour-intensive and requires high levels of investment expertise. It also increases the potential liability for trustees if something were to go wrong.

Ethical investments

Trustees must ensure that any decision that they take about adopting an ethical investment approach can be justified and in particular, there must be clarity about why certain companies or sectors are excluded, i.e:

- a particular investment conflicts with the aims of the charity
- the charity might lose supporters or beneficiaries if it does not invest ethically
- there is no significant financial detriment.

³⁸ [gov.uk/government/uploads/system/uploads/attachment_data/file/353957/Total_return_investment_for_permanently_endowed_charities.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/353957/Total_return_investment_for_permanently_endowed_charities.pdf)

Programme Related Investment (PRI)

This is where the aim is to use the charity's assets to further the charity's mission in a way that also potentially produces some financial return, e.g. a charity that works to relieve poverty may lend cash to another charity that helps unemployed people back to work.

"In order to fulfil their duties and act within the law, trustees:

- Must be able to show that the PRI is wholly in furtherance of the charity's aims (legal requirement).
- Should make sure that any benefit to private individuals is necessary, reasonable and in the interests of the charity.
- Should consider reasonable and practical ways to exit from a PRI if it is no longer furthering the charity's aims³⁹."

Mixed Motive Investment⁴⁰

"Where an investment cannot be wholly justified as either a financial investment or a PRI, it may be possible to justify it as a mixed motive investment. Considerations for trustees should include:

- The justification for making the mixed motive investment that will need to be established before making the investment.
- The suitability of a mixed motive investment for the charity.
- Whether there is a need to take professional advice before making the investment.
- Whether any private benefit arising from the investment will be acceptable⁴¹."

Financial investment in a subsidiary trading company

Trustees can invest in the charity's non-primary purpose subsidiary trading company as long as they treat the investment in exactly the same way they treat all other investments. Trustees must:

- "Consider whether it is in the charity's interests to make an investment in a subsidiary trading company after making a fair comparison of this form of investment with other forms of investment available; this should involve an objective assessment of the company's business prospects (the suitability of the investment type or class).
- Be satisfied that the particular company is financially viable based on its business plan, cash

flow forecasts, profit projections, risk analysis and other available information (the suitability of the investment within that asset type or class).

- Take appropriate advice on the investment and the financial viability of the subsidiary trading company; what is 'appropriate' will depend on the circumstances – the cost of taking the advice is a relevant factor, and should be proportionate to the size of the proposed investment (considering and taking advice if appropriate).
- Decide the nature of the investment in the subsidiary trading company, taking professional advice as needed (the trustees' duty of care).
- Consider from time to time whether the investment in the subsidiary trading company should be retained (the review and diversification of investments).

Trustees should also:

- Take account of the length of time over which funds may be tied up in an investment in a subsidiary trading company, since funds invested in this way may not be easily realised if they are needed in the short to medium term.
- Consider, and take suitable advice on, the possibility of obtaining funding from another source as an alternative to funding by the charity⁴²."

Trustees cannot 'bail out' the subsidiary trading company by paying the debts of the company before it goes into liquidation, solely to prevent it having to be treated as an insolvent company.

Sometimes a subsidiary trading company can be set up to further both the charity's aims and to generate a financial return. It is important that trustees are able to justify the investment either on the basis of the financial return or the extent to which it furthers its aims. Where the company is doing both, it is a mixed motive investment and the criteria set out in section 11 of *CC14* apply.

39 CC14 Charity Commission gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

40 Increasingly referred to as 'Social Investment'

41 CC14 Charity Commission gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

42 CC14 Charity Commission gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

Appendix – Model financial delegations

(Written by Sam Coutinho, partner, haysmacintyre, and reproduced here with her permission)

Financial delegations

All model documents need to be tailored to the needs of the charity.

The [finance] committee is given delegated responsibility on behalf of the board of trustees for oversight of all financial operations and for ensuring the charity's short and long term viability.

Financial responsibilities of the [finance] committee

Financial management responsibilities of the [finance] committee

- To ensure the trustees fulfil their financial responsibilities and the charity is operating within the financial requirements and guidelines set out in law, regulation and the charity's governing documents.
- To ensure there are appropriate and sufficiently robust financial controls which are regularly reviewed, monitored and tested.
- To ensure there is an appropriate budgetary process.
- To ensure there are adequate controls on financial and physical assets.

Financial management tasks of the [finance] committee

- To define the financial strategy of the charity for the trustees to approve.
- To ensure that the trustee deliberations and decisions are made taking into consideration financial implications and operational risks.
- To create the budgetary process for the trustees to approve and then each year to advise, scrutinise and evaluate draft annual budgets for the approval of the trustees.
- To work with the management team to ensure that financial information is both accurate and useful for decision making.

- To ensure management accounts are reviewed regularly, and performance measured against the budget approved by the trustees. All significant variances should be explained and reported to the trustees.
- To formulate for the trustees the investment objectives, risk appetite and policy for approval by the trustees, and then to regularly review and to monitor the performance of the portfolio and the investment managers.
- To formulate a cash and treasury management policy for approval by the trustees.
- To ensure that the charity has anti-fraud and whistleblowing policies and procedures that are regularly reviewed and known throughout the charity.
- To ensure that the charity has a financial procedures manual.

Financial audit responsibilities of the [finance] committee

- To determine the frequency of tendering for external auditing services.
- To review the independence and performance of the auditors, and advise the trustees on any issues arising.
- To manage the external audit process.
- To carry out an annual review to determine the need for internal audit and report back to the trustees. The purpose of which is to check that the financial procedures are being observed, the systems are operating as intended and that the financial controls remain effective.
- The chief executive (CEO) must notify the trustees of any matter that may involve irregularities concerning the charity.

Other financial delegations

Financial accounting procedures

- The financial procedures manual should be reviewed each year by [the finance director (FD)] and it should be approved by the [finance] committee.
- The [FD] is responsible for ensuring there are systems and controls within the finance function which are monitored, controlled and audited on a regular basis.
- The [CEO and FD] are responsible for ensuring there are sufficient resources in terms of head count and skills to ensure the finance department is able to operate adequately and safeguard the assets of the charity.
- The [FD] is responsible to the CEO and ultimately the board for ensuring compliance with legal and regulatory matters as they apply to finance.
- The CEO is responsible to the board for ensuring compliance with all legal and regulatory matters affecting the charity including finance.
- The [FD] is responsible for maintenance of the accounts and accounting records.
- It is the responsibility of the [FD] to effect and maintain proper insurance cover and negotiate all claims, in consultation with the CEO.

Controls on physical and financial assets

Property

- The charity's property solicitors have custody of all title deeds and a record is kept by the [FD].
- A register of fixed assets, including their location and condition, is held and updated regularly by the [FD].
- All IT assets are security tagged.

Income

- Collection of money due to the charity shall be by the systems approved by the trustees as advised by the CEO and FD.
- No deduction may be made from any money received by any member of staff for expenses or for any other reason.
- The charity's money laundering procedures must always be followed.
- The charity's Bribery Act procedures must always be adhered to.

Banking arrangements

- Bank accounts may be opened or closed only by resolution of the trustees.
- Other banking arrangements are made only with the prior approval of the trustees.
- Cheques and similar instruments may only be ordered by the [FD] who shall make proper arrangements for their safe custody. There must not be pre-signed cheques or more than 1 cheque book in use at any time.
- All cheques, cash and other receipts coming into the charity must be banked at the earliest opportunity, normally the day of receipt. They must be held in the safe if not banked.

Bank mandates

- The signatories for all bank accounts held by the charity are [].
- The following limits apply:
 - Payments up to £[] need one signature.
 - Payments between £[] to £[] need two signatures.
 - Payments over £[] need three signatures.
- Where payments are for payroll or Bacs runs, the amounts of individual items will be the determining factor, not the value of the whole run. Three signatures are required to sign off a single payment to a creditor for more than £[].
- The combinations of signatories apply:
 - Single signature – usually the [FD] but any of the listed individuals may sign in [FD]'s absence.
 - Two signatures – any one of [FD or CEO] plus any one of the listed individuals.
 - Three signatures – the [FD] and [CEO] plus any one of the listed trustee signatories.

Debtors

The CEO may, on the recommendation of the [FD] and with the agreement of the Chair of the [finance] committee, write off individual trading debts which do not exceed £[], provided the debt is no longer recoverable or the cost to recover is prohibitive.

Controls on expenditure

Contracts and tenders

- Staff can only proceed with contracts or tenders if they have prior budgetary approval.
- Where the estimated value of goods or services is more than £[], staff must obtain [] written quotations or tenders unless [] authorises otherwise.
- In exceptional circumstances the CEO or [FD] may authorise emergency works, goods or services in excess of £[] without obtaining written quotations or tenders when delay would cause either loss to the charity or endanger health and safety.
- The relevant member of staff must ensure, in liaison with the [FD], that the contractor has appropriate insurance before the commencement of any works.
- Staff must at all times take reasonable steps to ensure they are getting value for money.
- All contracts must be in writing and kept securely in the custody of [].

Orders for goods and services

- All purchases within budget in excess of £[] require written authorisation from [].
- Orders for goods and services, within budget, may be placed by phone, email or letter and may only be placed by budget holders or on their instruction. The member of staff placing the order should keep a written record of the transaction to compare against the delivery.
- In the case of contracts with consultants or contractors, the charity's standard form of contract for consultants should be issued.
- Any order of less than £[] that is outside the annual budget requires email or other written authorisation from the [FD].
- Any order in excess of £[] and less than £[] that is outside the annual budget requires written authorisation from the [finance] committee.
- Any order in excess of £[] that is outside the annual budget requires written authorisation from the board.
- Goods delivered should whenever possible be signed for by the person who placed the order. The delivery note should be matched to the invoice before it is authorised for payment.

Bacs payments

- For reasons of security and efficiency, Bacs is the preferred method of paying creditors.
- The [purchase ledger clerk] is responsible for identifying creditors due for payment each week and for preparing the payment batches.
- The [FD] is responsible for authorising (by signing) and processing the batch payments and transmitting the data to Bacs.
- Where a Bacs batch contains an item that exceeds the single signatory limit the batch must be signed off by one or more of the additional signatories authorised by the bank mandate.

Payment of accounts

- Expenses claims for incidental expenses up to £[] will be met from petty cash when possible. All other reimbursements will be by Bacs.
- A cheque payable to a bank account signatory for reimbursement of expenses must not be signed by that person.
- When authorising a supplier's invoice for payment, the member of staff responsible for the expenditure must first be satisfied that the goods and services have been received at the right price.
- The member of staff responsible must sign the invoice to indicate it is authorised for payment, apply the appropriate budget expenditure code and pass the invoice to the finance department.
- Payment will only be made against an original invoice.

Salaries, wages and pensions

- The payment of all salaries, wages, pensions, PAYE and compensations is made by arrangement of the [FD]. All require two signatories.
- The CEO will notify the [FD] in writing of any matters affecting the payroll.

Travel and subsistence claims

- Claims for travel, subsistence and minor expenses up to the value of £[] may be met from petty cash within five days of the claim being presented. Each claim must be presented on an official claim form with details of the expenditure supported by receipts and coded, signed and dated by the claimant and authorised by their line or team manager.
- Expense claims for trustees and committee members will be authorised by [] who will make any checks deemed necessary.
- Expense claims by the CEO will be authorised by the chair of the [finance] committee.
- All expense claims will be processed within ten days of receipt of the claim at the charity's offices.

Petty cash account**(sometimes called imprest account)**

- The petty cash imprest may not exceed £[].
- Money received on behalf of the charity must not be paid into petty cash; it must be banked intact.
- Payment from petty cash is limited to minor items except with the prior approval of the FD.
- Expenses claims for incidental expenses up to £[] will be met from petty cash. All other reimbursements will be by Bacs or cheque.

Credit cards

- Credit cards will only be issued to [] with credit limits agreed by the trustees.
- The credit cards are authorised to be used only for charity business expenditure. Cash is not to be drawn on credit cards.
- Credit card payments must be signed off ideally by the line manager of the person authorised to use it (e.g. The Chair for the CEO).
- Monthly statements must be checked promptly, coded and VAT invoices attached.
- Any query regarding items on the card statement must be pursued promptly.

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⁴³ As at 31 December 2016. Includes funds managed by Rathbone Unit Trust Management.

⁴⁴ As at 31 December 2016.

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Financial Guidance from Charity Commission

*CC3 The essential trustee: what you need to know and what you need to do*⁴⁵

*CC8 Internal financial controls for charities*⁴⁶

*CC12 Managing a charity's finances: planning, managing difficulties and insolvency*⁴⁷

*CC14 Charities and investment matters: a guide for trustees*⁴⁸

*CC19 Charity reserves: building resilience*⁴⁹

*CC25 Charity finances: trustee essentials*⁵⁰

⁴⁵ gov.uk/government/uploads/system/uploads/attachment_data/file/509664/cc3_lowink.pdf

⁴⁶ gov.uk/government/uploads/system/uploads/attachment_data/file/510581/CC8.pdf

⁴⁷ gov.uk/government/uploads/system/uploads/attachment_data/file/496292/CC12.pdf




⁴⁸ gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14

⁴⁹ gov.uk/government/publications/charities-and-reserves-cc19

⁵⁰ gov.uk/government/publications/managing-charity-assets-and-resources-cc25

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