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Talking to Charity Trustees – Risks and Reserves

By Kris Taylor

Following the demise of Kids company and Olive Cooke, charities in England and Wales have been heavily scrutinised in the public domain. In light of this, charity specialist Kris Taylor looks at guidance on managing risks and reserves and how advisers can assist with this.

The public accounts committee on Keeping Kids Company reported that the Kids Company operating model – based on the concept that no child should ever be turned away – carried the constant risk that the charity would not be able to ensure that its' commitments would be matched by its' resources. The charity's trustees failed to address this risk. 'Instead the Chief Executive and the Trustees relied upon wishful thinking and false optimism and became inured to the precariousness of the charity's financial situation'.

Earlier this year the Charity Commission reissued two pieces of guidance: **Charity Reserves: building resilience**, and **Managing a charity's finances: planning, managing difficulties and insolvency**, emphasising the central importance of the prudent arrangement of charity finances, enabling trustees to identify financial risks and plan for their management at an early stage. If a charity runs out of resources, it doesn't matter how laudable its' objectives are!

The two pieces of guidance work side by side, the risk policy identifying and updating the financial risks to which the charity is exposed and the reserves policy setting out what the reserves are for and how they can be used. When SORP FRS102 was initially published it required all charities subject to statutory audit (over £1m income in England and Wales, £500,000 in Scotland) to describe the principal risks and uncertainties the charity faces and outline its plans and strategies to manage those risks. For accounting periods beginning on or after 1 January 2016, the threshold for these disclosures will be for charities where income is over £500,000.

Risk management may not be restricted to financial considerations, but it is certainly key. In a recent survey carried out for the publication The Third Sector, the biggest concern identified by trustees was financial, with the termination of funding from other bodies ranking as the most important risk, followed closely by the loss of contracts which enabled them to deliver benefit and the fear of a decline in fundraising from the general public. At the same time many feared a rise in demand for their services which may or may not have been anticipated. These fears are likely to be at the heart of the financial risk assessment that any Board of Trustees should be carrying out in assessing the level of reserves needed to maintain its position.

There are some warning signs that the advisor may well spot, which those involved in the day to day management of the charity may be slow to pick up on:

- Economic climate - the availability of funds is limited at the moment. It can be easy for a charity to drift into activities which are over and above their key charitable aims (mission creep), and trustees need to keep a clear eye on both the funds available to them and those they are trying to support. Regular financial information, comparisons with budgets cash flows and consideration of outcomes may be a section of the regular trustee meetings that some trustees drift off in, but are crucial to the exercise of their responsibilities.

- Limited numbers of funders. Just as a single income stream is dangerous for a commercial organisation, the reliance on one or two grants can be disastrous for a charity, particularly in the current climate where competition for limited funding is fierce. It can also be dangerous to assume that public generosity will continue from period to period at the same level. Charitable objects go in and out of fashion, and a scandal in a charity totally unrelated to the one under review can affect donations.
- Timing - the first issue can be exacerbated if a number of grants or contracts are due to expire simultaneously.
- Related costs. New contracts may look attractive, but are they fully self-financing? Is there sufficient capacity to service them and if expansion is needed to meet the terms of the contract what will happen when it ends? Will the charity be left with overhead costs that cannot be borne once the initial contract has been completed?
- Allocation of income. There needs to be care in ensuring that income is used to fund the projects it was raised for. This is not usually a problem in a climate where projects are growing and funding is generous, but once the cycle comes to an end if money for new projects has been used to service existing ventures a credibility gap will appear. (Think of lottery grants where charities are required to raise matching funding, what will happen if existing funds have been used?)
- Overambitious acceptance of clients. Kids Company never turned a child away. This meant that eventually it failed all of its clients.

These risks are the dangers which reserves are meant to provide a cushion against.

The public accounts committee reported that the auditors of Kids Company felt that a level of around six months spending (around £12m) would have been an appropriate level for its' size and demand led model. The charity's free reserves were a fraction of this – generally in deficit and peaking at £434k in 2013 against expenditure of £15.6 million (which would have predicted £7.8 million in reserves). The annual report contained an acknowledgement by the trustees that its' principal risk was financial, including the need to have sufficient reserves. The charity, however, made little commitment to building these reserves, stating only that 'we aspire to build up our reserves when circumstances allow'. Of the charity's ten priorities for 2014, its final year, working 'with Government to identify sustainable and long term funding for Kids Company' was only ranked at number seven.

The report also made the point that the form in which reserves are held can be crucial – cash flow is as important to a charity as it is to a business and the ownership of a large property, funded by the grant it received from a major financial institution, did not improve its ability to continue as a going concern. The requirement for positive net current assets is something that all accountants would feel immediate affinity with.

Developing a risk policy

Once the charity has accepted that it needs to develop a risks policy and describe its plans to manage the principal risks and uncertainties it that faces in its annual report, there are areas where the accountant can help. We are used to thinking in terms of systems and controls, mostly financial, it's true, but the concept of establishing controls and gathering evidence that they are working can be translated into other areas. Also as auditors we're used to assessing what is important (material) in any situation and concentrating on that.

In developing a risk policy it is easy to get bogged down in long lists of all the things that could possibly go wrong and miss the main concern staring you in the face. I recently lead a discussion at a group of charities working with children in the area of the performing arts. They each had lists of all those things that could possibly go wrong and were inclined to spend as much time on the (hopefully) remote risk of a terrorist attack on their small events and less time on the (unfortunately) more immediate risk of injury or inappropriate approaches to the children in their care. Yes, all of these are risks the events could face but not all are within the control of the charities running them.

What the board needs to do, and what accountants can perhaps help with, is in identifying those risks which they can mitigate and put procedures in place to ensure they are indeed mitigated. If other risks are really major and cannot be mitigated then trustees need to consider what else can be done. Some risks may be so critical that a service cannot continue to be provided or an event cannot take place. In other circumstances the board may need to accept that the risk is unavoidable and accept it, but they should have a good (and clearly recorded) reason for doing so. So, for each of the major risks identified on my group's list, we assigned levels of impact and likelihood and eventually managed to come up with a much smaller list that reflected the issues that affected each of us.

The next job was to consider any additional action that should be taken to mitigate the risk, either by lessening the likelihood of the risk-event occurring, or lessening its impact if it does, for example the board could:

- avoid risk by avoiding the activity (e.g., not running an event, stopping work in a particular country, cease providing the service)
- transfer risk to a third party (e.g. using the fire and health and safety provision of the halls being hired, using a trading subsidiary, outsourcing the activity)
- share risk with others (e.g. establishing a joint venture project or adopting a standard approach sponsored by an umbrella group)
- limit the charity's exposure to the risk (e.g. establishing reserves against loss of income, taking out foreign exchange forward contracts, phasing in commitments to projects);
- insure against risk (e.g. event cover, employers liability, third party liability, theft, fire)
- reduce or eliminate the risk by establishing or improving control procedures (e.g. child protection policies / D&B checks on staff, internal financial controls, controls on recruitment & volunteers, personnel policies) or simply
- the risk may be accepted as unlikely to occur and/or of low impact and therefore will just be reviewed annually (e.g. earthquake damage or loss of a single cash donation of £10 a year).

Once each risk has been evaluated, trustees can draw up a plan for any action that needs to be taken. This action plan and the implementation of appropriate systems or procedures allows the trustees to make the required risk mitigation statement in the annual report.

Of course there are other issues to bear in mind. The costs of mitigation or control must be considered in the context of the potential impact or likely cost of the control when seen against the risk. The cost of mitigating a risk needs to be proportional to the potential impact, with a balance struck between the cost of any further action in mitigation of the risk and the potential impact of any residual risk. Good risk management is not just about preventing disasters it should also be about enabling organisations to take opportunities and meet emerging needs. For example, a charity may not be able to take advantage of technological change if their reserves policy does not provide it with sufficient resources or mount an emergency relief programme without adequately trained staff and organisational structures.

The charities I am involved with could not continue to run events if the supply of willing volunteers dried up or they are faced by a child protection scandal. On the other hand the unseasonal snow that caused one to cancel part of an event one year was minor in comparison – and depending on the strength of the charity's reserves, not even worth insuring against!

In a number of the above areas accountants have expertise that can help, not just with the detail of financial controls, but in the overall approach of deciding just what is material and what can be done to develop a coherent approach that will enable the board to make its risk statement in its annual report confidently.

Mercia can help you assist your charity clients in a number of ways:

Charities Specialist Assignment Manual

Current and permanent file programmes needed to undertake an audit or independent examination for a charity in England and Wales, Scotland or Northern Ireland.

Specialist Courses

Face to face and Online

Charities - Current Issues

Charities- Life After the FRSSE SORP

Charities Conference 2017

'Save the Date'

London - 7 March

Midlands - 14 March

Scotland - 23 March

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