A Practical Guide to

Managing in a Downturn

Staying Solvent and Surviving Well

Editor: Kate Sayer

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The law described in this book principally covers England and Wales, but insolvency law applies equally in Scotland. The law relating to insolvency is different in other parts of the British Isles and internationally. There are also small differences in charity law in other parts of the UK outside England and Wales.

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THINK Consulting Solutions is the leading international consultancy dedicated to not-for-profit sector marketing – strategy, management, fundraising, brand, communications and new media. As highly experienced senior practitioners with strong personal commitment to the sector, it offers a combination of intelligent thinking, creative problem-solving, and robust, workable advice and action plans. Its strategic and practical solutions are aimed at improving charities' efficiency, effectiveness and profitability. It works with major international charities, both at the centre and with national offices, and a wide range of large and small national organisations in the UK and Europe.

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Bates Wells & Braithwaite London LLP is recognised as one of the leading law firms in the charity and not-for-profit sector. It acts for more of the top 100 charities than any other firm and many more of the top 3,000 charities. It has developed this position by being involved not just as lawyers, but also on wider policy issues. It has contributed to the development of charity law in a number of ways, through pioneering cases such as the registration as charities of Charity Bank and the Fair Trade Foundation, the Environment Foundation and the Countryside Alliance Foundation, and also through its contributions to the Charity Commission's reform of CC9 (*Speaking Out – Guidance on Campaigning and Political Activity by Charities*) on campaigning and political activities and a variety of other topics.

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PricewaterhouseCoopers LLP has a long-term commitment to working with the not-for-profit sector. Its team of specialists provide assurance, tax and advisory services to more than 450 charity clients. It advises them on every stage of their life-cycle – from those starting up or reassessing their governance structure to more mature organisations perhaps expanding overseas. Whatever stage an organisation is at, whatever role it plays, the firm works with the team to find a working solution tailored to that organisation.

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Introduction

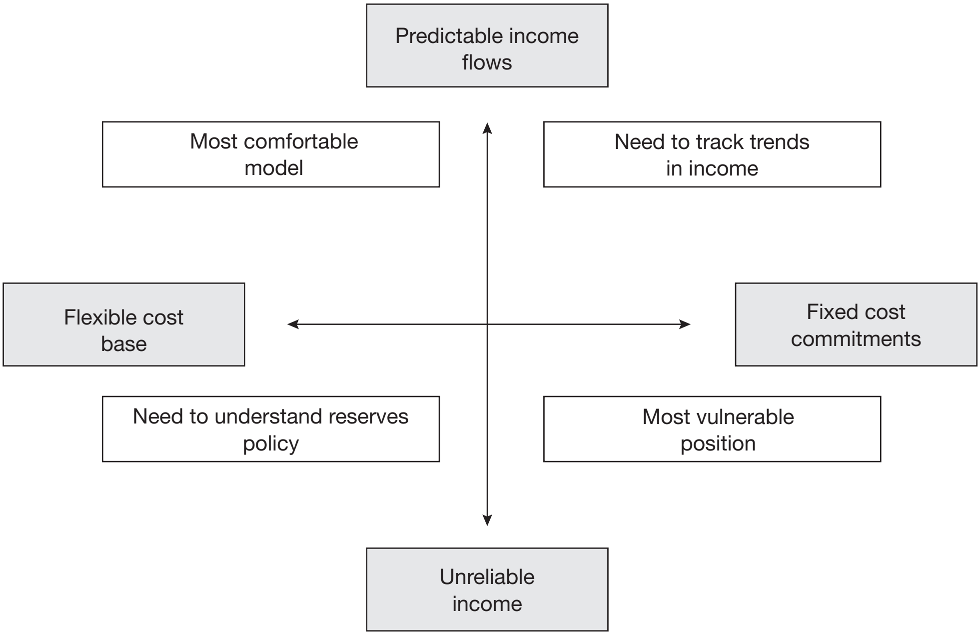
The turbulent economic conditions since the autumn of 2008 undoubtedly will have raised concerns among boards of trustees up and down the country about the ongoing viability of their charity. Charity managers and trustees will be well aware that most charities are far from immune to the possible consequences of the so-called 'credit crunch' and the consequent effect on economic activity. While the consequences will, of course, vary widely depending on the circumstances of each individual charity, trustees should be prepared to address the likelihood of both increased costs and falling income in the current environment. For some, this will mean a tightened belt, while for others the consequences may be more severe.

A PricewaterhouseCoopers report published in December 2008 jointly with the Institute of Fundraising and the Charity Finance Directors' Group concluded that, in broad terms, a quarter of charities had already seen some negative impact on their income and expenditure, and some three-quarters expected to do so within the next 12 months. Furthermore, about three-quarters of all charities stated that they were taking action as a result. The Charity Commission survey published in March 2009 showed that '64% of charities with an annual income of over £1m are concerned that the downturn is going to affect future work'.

Charities run into financial difficulties for all sorts of reasons. This was the case even in the relatively benign environment in which charities have been operating for the past decade, and it is likely therefore that the number of charities facing financial problems will increase as the impact of the recession becomes felt more widely. Obviously, all charities will want to avoid the need to cease to operate, but sadly too many charities leave it too late and reach a crisis point such that the options for turnaround are limited. In some cases, a formal insolvency process is the only route available.

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



What makes charities vulnerable to failure?

attitude to risk and its reserves levels, will determine the extent to which it can absorb setbacks. The diagram above illustrates the balance between reliability of income and flexibility of cost base.

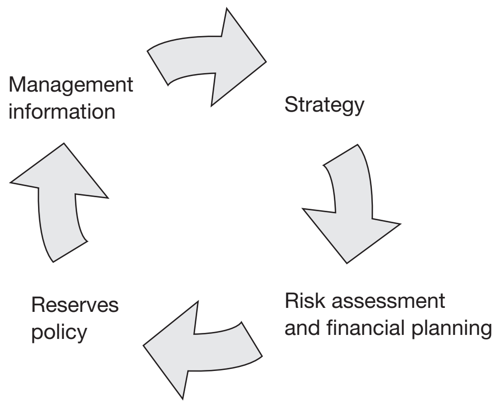
For example, a grant-making charity with limited overheads and controllable commitments is likely to find itself in the top left of the diagram. Such a charity will stand a good chance of remaining flexible in light of fluctuations in its income. On the other hand, a charity that is heavily reliant on restricted, project-based income, but 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.

Effective financial management

Effective financial management is important to minimise the chances of becoming insolvent in the first place, and should not be compromised. This is true at the best of times and vital in the current climate. When a charity operates in a benign environment when income and costs are easier to predict, it can often 'get away with' inadequate management, as funds are easier to come by. However, these inadequacies will be more exposed in a period when funds are limited and cost pressures significant.

The diagram below illustrates what we mean by effective financial management.



Strategy

Charities should have in place a long-term strategy to meet their charitable objects. This strategy should cover finance, operations and governance. During a downturn, it is imperative that the charity remains strategic in its focus. All options should be considered and trustees should not avoid difficult questions. Activities may need to be prioritised and even basic questions such as 'Can we survive as a stand-alone charity?' or 'Are we able to generate funds cost-effectively?' should be addressed.

Risk assessment and scenario planning

Once clear on the charity's basic strategy, budgets covering income and expenditure and cashflow, and balance sheet forecasts should be drawn up at a level of detail to allow trustees to understand the impact of the downturn and other risks on the strategy. Such detailed planning should take place for all realistic contingencies, for example 'What if our fundraised income declined by 20%?' This should enable the charity to understand – *really understand* – what it would do in the event of those contingencies materialising. This process of planning should not be underestimated: seeking agreement among the trustees on what may be very difficult decisions in the current climate will take time in itself, as not all trustees will necessarily have the same view.

Reserves policy

The charity's reserves policy will need to be reviewed in light of the scenario planning. If a charity has a risk-based policy already, then this should make life easier. If not, then now is the time to put one in place. The extent to which reserves are used to 'smooth' the effect of the downturn will be a key decision, as will the extent to which activities should be reduced further if reserves are insufficient to build up a reserve.

Management information

More than ever, detailed and appropriate management information will be vital to a charity's understanding of the extent to which the downturn is affecting its performance. The better the information, the earlier the charity will be aware of any issues and the longer it will have to implement a response. This is about optimising your charity's chances of surviving and prospering in this downturn.

Fundraising in an unpredictable market

During a recession the only certainty is that you will be fundraising in an unpredictable market. In such conditions, it is important to monitor the market, perhaps through the press, economists and emerging research, so that you understand what is happening. But don't forget that media hype is often not the reality of your donors' lives. After an initial period of concern, donors generally settle down until reality bites them directly, for example in the form of reduced income, employment uncertainty or rising household expenditure. And the point at which the media lose interest and move on to more interesting stories may be the precise point at which the recession is affecting your donors badly. Your priority is to see behind the media hype to understand the reality of what is happening in your supporters' lives.

Embrace change

At the start of a downturn, the focus is inevitably on worsening conditions, downward trends, and the need to protect the organisation from damage and loss. A defensive strategy may seem logical, and indeed by cutting back your investment you may avoid short-term losses and minimise your risks. However, if you maintain this defensive stance in the medium and longer term it will be counterproductive, leading you to miss opportunities and be poorly placed to take advantage of the market upswing when it eventually occurs.

The faster you accept that you are in an unpredictable market, the faster you can start driving towards it, as opposed to reversing away. Difficult times call for confident action. You will be able to assess and respond to the marketplace faster than the competition – competition that may be busy reversing.

Nurture your fundraising expertise

In a recession, you will need to call on your fundraising expertise as never before. Every day your 'rapid response' fundraising team will need to respond, decide and innovate. Every fundraising programme will need to be made to work harder. Every donor will need to be communicated with more intensely, more persuasively.

Your fundraising team is the driver of your fundraising, and if you reduce your investment in expertise you reduce your capacity to drive your fundraising forwards. In a recession, you need to drive as hard as you can just to stand still. To reduce your fundraising expertise in a recession is, therefore, a deliberate decision to reduce your income.

Focus on your core business

In an unpredictable market, the highest risks are related to areas of your business that are furthest away from your 'heartland'. For example, the donors for whom you are fifth choice, the donors who have been with you the shortest time, the fundraising techniques in which you have the least expertise. The last recession taught us that it is our 'core' business that is most likely to weather the recession, and that this is where we should be focusing our investment. Your portfolio should be diverse, but within the context of core business.

General fund

Make sure you understand your general fund needs. It is often the case that committed giving and general fund go hand in hand, but not always. General fund is crucial for the stability of the organisation, for paying your overheads and often for enabling you to accept major grants which do not cover their overheads. General fund gives you flexibility, fuels investment and enables you to be fleet of foot. Ultimately, general fund allows you to maintain your organisation even if you have to reduce your direct expenditure for a period of time.

Prioritise profit over growth

Big is not always beautiful. 'Doubling gross income in five years' is not the only fundraising strategy. Indeed, gross income should never be the focus of your fundraising strategy. The investment required to drive gross income growth – especially where recruitment is initially loss-making – will usually reduce your net income in the short to medium term.

Net income is the amount that is available to the rest of the organisation to spend on the mission and organisational overheads; maintaining net income should be the goal during a recession.

Put your greatest effort into keeping the supporters you already have. Develop the relationships you have with them, and aim to increase their giving. From the commercial world of marketing we know that it costs five times as much to recruit a new customer as it does to keep one you already have, and existing customers will spend up to ten times as much with you as new customers. This equally applies to donors.

Relationships with companies and trusts

Charities with a strong corporate portfolio or a track record need to hold firm and implement a new strategy to get through the next two years successfully. They need to prepare to emerge stronger and in a new shape for the future. Charities new to this area should look much harder at their cause and brand, and ask themselves whether they should revise expectations and scrutinise resource commitments in a very unpredictable market.

Increase the amount of communication you have with existing grant supporters; try to understand the challenges and circumstances they are facing; share with them how your charity is progressing. Strengthen your research to track and understand what is happening in the grant-giving market, as things will change quickly, with the potential for short-term opportunities to arise.

Legal aspects to managing in a downturn

The first thing to consider is the legal status of your charity, as the law relating to insolvency affects charities differently depending on how a charity is constituted. Charities operate under a great variety of constitutional forms, including companies limited by guarantee or by shares, societies incorporated by royal charter, industrial and provident societies, unincorporated associations or trusts, and soon the charitable incorporated organisation.

The tests for insolvency

There are two tests for insolvency under the Insolvency Act – the going concern test and the balance sheet test. The basis of the going concern test is whether the company can pay its debts as they fall due.

Under the balance sheet test, a company is technically insolvent if the value of the company's assets is less than the amount of its liabilities, including its contingent and prospective liabilities.

The effect of insolvency on different forms of charity

Charitable companies are normally limited by guarantee, which means the members will only be liable for the amount of their guarantee, usually a nominal sum of £1. The trustees do not have personal liability.

In contrast, the trustees of a charitable trust or the management committee of an unincorporated association are personally liable for the debts of the charity if it becomes insolvent. So if it has more liabilities than assets, the trustees (and possibly members) are liable to make up the shortfall.

Wrongful trading

Charitable companies still need to exercise care, however. Wrongful trading occurs when a company continues to trade even though the directors or trustees *knew or ought to have concluded* that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Note that the fact that a company is trading while insolvent does not necessarily mean that the trading is wrongful, as long as there is a reasonable prospect of it not going into insolvent liquidation.

Practical implications of possible insolvency

The trustees must ensure that they have taken appropriate written legal and financial advice to show that they have acted responsibly. The trustees should hold prompt and regular meetings to show that they took matters seriously and acted with the interests of the creditors in mind. The trustees should also ensure that proper and detailed minutes are kept of all meetings so that there is an adequate paper trail to show how and why decisions were reached.

Treatment of restricted funds

How restricted funds held by a charity are treated in an insolvency is a difficult question. Charity trustees face the risk that they may be liable to make good restricted funds used for unrestricted purposes, as it could be a breach of trust. However, with little case law, it is not clear whether unused balances on restricted funds would be available to discharge the liabilities of the charity in an insolvency.

Managing difficulties

A charity may find itself unable to respond promptly to external factors, which could lead to insolvency. However, in the case of insolvency it may be possible to turn things round. First, the charity needs to know how severe the problem is. In particular, it needs to know how long it has before the charity runs out of money. The important issue here is remaining in control: if it runs out of money, then control may be taken from the charity by creditors or other stakeholders seeking to protect their position. This process may require a combination of deferring amounts due to creditors and obtaining short-term funding, either by selling assets or borrowing from stakeholders or funders. Cash is critical in this period, so every effort needs to be made to realise and conserve money.

A turnaround plan

Once the extent of the breathing space is known, trustees will need to agree a detailed turnaround plan. This will involve making an assessment of the various potential options and acting decisively to rule out those that cannot be funded and concentrate only on what is achievable. Time will be of the essence here. Almost by definition, a charity will have less time than is ideal to find a workable solution that is acceptable to all parties. Obtaining a consensus among the trustees may be a challenge, such that strong leadership will be required to ensure that inaction does not result.

Working closely with stakeholders and funders will be vital in this period. The charity will need to conduct its affairs with openness and transparency to ensure that stakeholders understand the full extent of the commitment they are likely to be asked to make and can contribute to what is possible.

In addition, keeping staff informed and motivated is very important. Ensuring key staff are retained in a period of uncertainty may be challenging.

Leadership and accountability are key

It is a fact that many successful turnarounds involve changes in management. There is a strong likelihood that the management team that allowed the problems to remain unaddressed for too long may not be the right one to achieve a successful turnaround, either in reality or at least in the perception of key funders and stakeholders. Most importantly, ownership of the turnaround plan often will itself be a full-time job. Consideration most certainly should be given to an additional, specialist interim resource, with the necessary experience and authority to lead the process

Trustees' responsibilities

Clearly, if a charity is seeking to turn itself around while it remains under threat of failure and insolvency, the trustees will need the comfort of knowing that they are not falling foul of their responsibilities and obligations. They may consider it wise to seek independent legal advice to confirm this.

Conclusion

There will be winners and losers during this downturn as with any other. Winners will have considered their environment, implemented good management, had strong cash resources and used reserves appropriately. It will be more difficult for charities to find solutions to problems in the current climate and the importance of avoiding problems in the first place therefore cannot be overestimated.

1 Effective financial management

Introduction

One of the characteristics of 'super-fit' companies is that they are able to take decisions relatively quickly and so respond effectively to external market conditions. Even if you do not aspire to being 'super-fit', you may find it helpful to consider ways in which you can improve your decision-making processes, as this will be a significant factor in your charity's survival.

Most decisions depend on the availability of information as a basis for the decision. The information needs to be appropriate – that is, relevant to the particular decision being made. It also needs to be recent information. Most decisions are looking forward and we are trying to use past information to help us make a decision for the future, so the more recent it is, the more likely it is that it will be helpful. We also need information of the right type, so for example, estimates about the future cash likely to come into the organisation may be more helpful than a schedule showing how much we have invested in the project in the past.

This chapter focuses on the financial management tools available to the charity trustees and the management team to help them have good-quality information readily available to support decision making.

Making sure your strategy is relevant

Many charities will develop their strategy for a medium-term period – say three or five years. As part of the process of developing the strategy, many charities will consult with their stakeholder groups, consider the external environment, and review their own strengths and weaknesses. The drawback to this process is that the review reflects the position only at the time that the review takes place. Many aspects of the external environment may have changed since the initial review to generate the strategy. Therefore, you need to have mechanisms to revisit the strategy in light of a changing external environment.

Scenario planning

Developing different possible scenarios will help the organisation to prepare for change in the external environment. Having talked about different possibilities, the trustees and managers will be more attuned to the early warning signs of change in the external environment, thus equipping them to respond more quickly.

Step 1

The first step in scenario planning is to consider whether your strategic plan relies on a certain view of the world.

Case study

Women's Health Centre (WHC) provides counselling and therapy for women. WHC has developed a strategy that assumes the following.

- Society will continue to see some women's health issues as different from the general health requirements of the population as a whole.
- Health issues specific to women will not be provided for adequately through the general health service.
- Women will prefer to seek help in a specifically women-oriented environment.
- Therapy is seen as an appropriate approach to deal with problems.

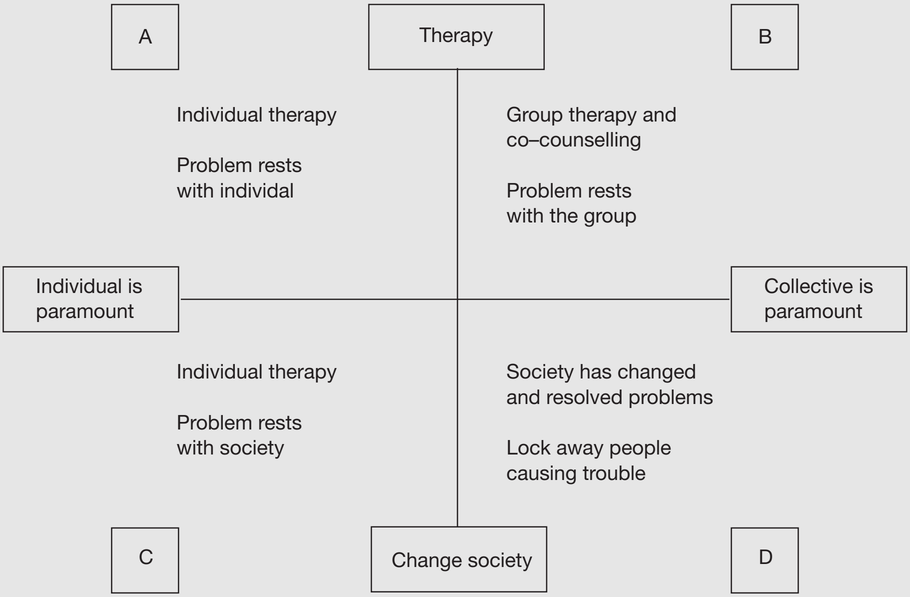
From this we can extract two different world views that underpin the overall existence of WHC:

- an approach that focuses on individuals as opposed to a view that it is the collective good that is paramount
- an approach that values therapy rather than changing the basis on which society operates.

Step 2

Each of these approaches is an axis that we can use to build four different scenarios, allowing us to develop pictures of how things might look if we change the assumptions.

Case study – WHC



From this, WHC can see that it may have a role to play where the individual is seen as paramount (scenarios A and C), but that it may have no role where this approach is not valued. It may have some role in helping with group therapy (scenario B), but the collective view may also 'de-professionalise' therapy and see it more as a shared responsibility of the group. WHC would have no role in a society that does not recognise the value of therapy and treats anyone who cannot adapt to the new society as a troublemaker or even a criminal (scenario D).

Step three

Now overlay these different views with a changing economic environment and consider which approach is more likely. You can then start to develop responses to the changed environment and consider how your organisation will be perceived, how it would need to change its position and the services that it offers.

Case study

Scenario A – WHC would be able to offer individual therapy as now, but fees would have to be paid by individuals and it would be difficult to raise funds from other sources other than philanthropic individuals interested in supporting their work.

Scenario B – WHC could increase its group therapy offer and adapt this to an appropriate style to fit the demands. Also, it may have to consider how it changes its position. Currently, its core offer is based on the assumption that it treats only women – this assumption may no longer be appropriate. This approach may be seen as irrelevant if the view is that the group or collective is responsible for dealing with its problems. So WHC may have to consider a radical change to include men and children, or it may consider merging with another organisation.

Scenario C – WHC would be able to develop its individual therapy even further and should be able to obtain funding for its work from the health service or Social Services. The current work of WHC would be valued and seen as relevant.

Scenario D – WHC would be seen as irrelevant and would cease to exist.

You can consider other fundamental assumptions about your organisation, its services and activities, and consider how these might fit into different scenarios in similar ways. The purpose of this form of planning is to stimulate thought and open discussion about situations when your organisation may face serious risk of becoming irrelevant. If nobody wants the services that you offer, or your model of service is no longer perceived as appropriate, then you will find it difficult to find funding. Also, you can think about how your stakeholders' priorities may change in a changing economic environment. If your service is seen as 'icing on the cake' then it may be dropped from the menu, as funding will be prioritised for essential services. An obvious choice for an axis on a scenario-planning grid is the length of the recession: at one extreme you assume that the recession will be short, and at the other extreme you assume that it will be long. You may wish to combine this with another axis that looks at the level of demand for your services: in other words, the needs of your beneficiaries.

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A Practical Guide to

Managing in a Downturn

This new addition to the Practical Guide series contains valuable advice for non-profit making organisations on how to manage finances and fundraising during an economic downturn.

Providing guidance on the legal and management issues that can arise in an uncertain financial climate and a case study on the practical financial management aspects, it covers:

- using risk assessment effectively
- reassessing reserves levels
- obtaining and interpreting management information
- cash flow management and credit control
- fundraising in an unpredictable environment
- legal issues relating to insolvency
- how to manage through financial difficulties

Written by an authoritative group of experts, this guide is essential reading for trustees, chief executives, finance directors, general managers and all those with the responsibility for the running of charities.

sayer vincent
consultants and auditors

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