financehub

Introductory Pack on Funding and Finance

Guide to Financial Management

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Contents

About this guide

This guide describes what is meant by 'financial management' and how voluntary and community organisations can plan for, and move towards it. It outlines some sensible objectives, useful concepts and techniques for analysing situations, and guidance for actions and decision-making. It also highlights how all decision-making is dependent on sound judgement and outlines how financial management seeks to inform that judgement.

This is the second guide in the series that make up the Finance Hub *Introductory Pack on Funding and Finance*. Details of other guides are given below.

About the Introductory Pack on Funding and Finance

The *Introductory Pack on Funding and Finance* was commissioned by the Finance Hub, one of the centres of expertise created as part of ChangeUp[1]. The guides provide voluntary and community organisations and social enterprises with practical information, support and guidance on funding and finance options, and the skills needed to access these options.

The guides have been designed with new and small to medium-sized organisations in mind. They aim to be accessible, clearly written and to explain any specialist terms used. They provide case studies highlighting real life experiences that offer good practice tips and the lessons learned by organisations that have 'been there and done that', including the first steps of some smaller organisations. The guides also contain tools and signposts to resources to assist organisations in their search for long-term financial sustainability.

The guides that make up the *Introductory Pack* are:

1. Sustainable Funding
2. Financial Management
3. Fundraising
4. Trading
5. Procurement and Contracting
6. Loans and Other Forms of Finance

Copies of the guides are available from NCVO and the Finance Hub. They can be downloaded from the Finance Hub website at www.financehub.org.uk or NCVO's website at ncvo-vol.org.uk/sfp. Further details and information about the work of the Finance Hub and the support it provides is included in the Resources section at the end of this guide.

[1]ChangeUp is a programme of capacity building for the infrastructure of the voluntary and community sector.

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For more information on voluntary management programmes at Cass see: www.cass.city.ac.uk/charityeffectiveness

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Introductory Pack authors, contributors and advisory group

The *Introductory Pack* has been developed by experts in voluntary and community sector funding and finance with input on design and presentation from practitioners including an advisory group of front-line funding advisors.

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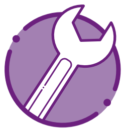
Guide to symbols and abbreviations

Each section uses the symbols shown below. These are designed to help readers navigate through the text and to highlight key points and signposts.

Good practice tip/key points to remember



Tool (e.g. template or checklist)

Signposts to further support and information

CVS = council for voluntary service
VCO = voluntary and community organisation
VCS = voluntary and community sector

Introduction – Why think about financial management?

Voluntary and community organisations (VCOs) operate in a challenging and uncertain funding environment. One of the ways organisations can prepare for and overcome these uncertainties is by successfully managing their income to ensure the best and most efficient use of their financial resources.

The need for improved financial management skills was clearly voiced in NCVO's 2005 strategic consultation where such skills were identified as an area needing significant development. Costing and financial planning are key areas where organisations can benefit from building skills and understanding. For example, to be financially sustainable organisations need to be able to understand and manage their cost base in order to seek appropriate and adequate income, and to be able to demonstrate effective use of resources, particularly to funders.

Two key needs for new and smaller organisations in particular are the need to understand the link between good financial management and sustainability, and the need to engage finance staff in the wider sustainability planning and strategic thinking of an organisation. This is especially the case for volunteers or part-time finance staff who often end up isolated from the day-to-day running and management of an organisation.

In addition to understanding the importance of good financial management, organisations can also benefit from understanding how their finance function is integral to them adopting a sustainable funding approach. This can stretch from ensuring an organisation is fully and properly paid for the work it does (achieving what is known as 'full cost recovery') to an appreciation of how integrating financial management with strategic planning can increase the effectiveness of both to the wider benefit of the organisation. It also involves ensuring all staff (not just those directly responsible for finance) understand the basics of sound financial management.

The financial management function for a VCO might comprise a volunteer honorary treasurer or treasurer together with part-time finance worker. Larger organisations may have a treasurer, a chief finance officer (possibly supported by other staff) and external auditors/accountants, investment advisors and bankers. No matter how large or small the finance function, those involved can do much to ensure that an organisation is managed efficiently, effectively, and as a result, sustainably.

Financial management is something every organisation needs to understand and practice effectively. The aim of this guide is to help organisations to understand how this can be achieved.

1 What is financial management?

Financial management is about ensuring funds are available when needed and that they are obtained and used in the most efficient and effective way to the benefit of an organisation. Used appropriately, financial management tools can help an organisation to deliver its mission better and to ensure the best and most beneficial use of resources.

Integrating financial with organisational planning

> At its most effective financial management is a core element of an organisation's wider strategic planning.

Time and again financial management ends up being divorced from wider organisational planning and management. This can lead to less effective use of resources. Worse still, failure to link financial management into wider organisational plans can lead to funding problems that, had they been planned for and effectively managed, could have been foreseen and avoided. This can often be the case in smaller or less well-resourced organisations where the finances are managed by a single, frequently part-time, staff member or volunteer. Pressures of time together with an organisational view of the finance worker as 'someone who comes in to do the books' can limit the potential effectiveness of an organisation's finance function to monitoring historical information rather than planning for the future.

For example, imagine that a VCO has been asked to expand an advice service to young people. The Local Authority agrees to fund the expanded service with a contract covering all the increased costs of £40,000. However, the contract says that payment will be quarterly in arrears and subject to a quarterly usage report.

Question – What are the implications for the organisation of this contract?

Answer – Although all costs are to be met, in reality there are very serious consequences implied in the condition of payment in arrears. In essence it is likely that the organisation will not receive payment until the end of each quarter. Worse still, it is most likely, given a report has to be completed, sent in, approved and then a payment order generated in the Local Authority, that it will be more like five months before the organisation is paid any money. This means that nearly half the costs (£20,000) will have been incurred by the organisation before it receives payment.

Has the organisation sufficient funds in its bank account to cover these costs before receiving the funds? If not, how will it cover these costs – with a bank overdraft? But this will mean interest and bank charges. Has the Local Authority agreed to pay these costs?

Even assuming there is sufficient cash in the bank account, this money may have been earning interest that will now be lost. This is a cost in itself. If the organisation is also a registered charity there are also potential implications relating to whether restricted funds meant for another purpose may now be being illegally used to fund the advice service until payment is received.

The final issue raised from this example is the report. Has the VCO the systems in place to capture this information? There will also be a cost to recording and supplying this information – have these costs been covered?

The consequences of bad financial management are therefore very serious. Good financial management requires sound organisational planning and the set-up and implementation of workable systems, policies and procedures which can respond to, accommodate and overcome the financial challenges a VCO may face.

Planning can be defined as the establishment of objectives and the formulation, evaluation and selection of the policies, strategies, tactics and action required to achieve these objectives. Planning comprises long-term strategic planning, and short-term operations planning. Financial planning, including budget setting, should form part of an organisation's ongoing planning process.

A detailed overview of the planning process and the stages involved is given in the *Introductory Pack Guide to Sustainable Funding*.

Developing a financial strategy

A financial strategy is a plan that sets out how an organisation will finance its development, identifies what funds are required, and from where they will be sourced.

As part of the planning process, organisations should also consider developing a 'financial strategy'. Financial strategies may seem to be the preserve of larger VCOs, yet even for smaller groups, considering future financial need is beneficial. These benefits include:

- Monitoring the viability of the organisation.
- Ensuring resource needs are correctly identified.
- Enabling the organisation to make informal decisions on new initiatives and opportunities.
- Being able to identify potential risks.
- Helping to identify contingency requirements.
- Enabling objectives to be met by outlining how funds will be made available, and when they will be needed.
- Allowing the organisation to approach funders, purchasers, or banks with confidence, knowing the exact amount of funding needed.

Knowing what funds are needed for an organisation to develop, alongside an awareness of what income streams are available to VCOs, can help an organisation to consider what might be the best ways of funding its work.

Further information on the range of income sources available to VCOs is included in the *Introductory Pack Guide to Sustainable Funding*.

Depending on the size of an organisation, developing a financial strategy will usually involve some or all of the Trustee Board, Chief Executive, finance officers, and senior managers.

A financial strategy will also highlight the need to develop new, or expand current, financial systems to accommodate future work or organisational growth (e.g. deciding to register for VAT based on a strategy to draw substantial future income from delivering services under contract). A Tool to help VCOs develop a financial strategy is included below.

Establishing financial polices, procedures and systems

Financial systems are the series of tasks and procedures by which a VCO's monetary transactions are processed and their financial records are created.

To ensure the effective implementation of organisational plans, VCOs need to establish financial management systems. It is the responsibility of the Trustee Board to determine a VCO's financial policies (e.g. setting staff salaries, approach to using loans etc). These will usually be informed by reference to other VCOs, best practice, expert advice, or relate to a VCO's aims. The Board will also authorise the implementation of financial procedures. Again, these will usually be informed by financial expertise (e.g. from a finance officer and/or accountant or advisor) and standard financial procedures (some of which are outlined in this guide).

The important thing is to establish workable financial systems as early on as possible. These can evolve or change as an organisation grows, but getting systems in place early on means everyone understands how the organisation's finances should be managed and what their responsibilities are. Establishing systems also enables VCOs to see more clearly where issues may be arising and take action to mitigate any problems. They facilitate reporting to funders and transparent accountability to beneficiaries and wider stakeholders.

This guide aims to outline some sensible objectives, financial concepts and tools for analysing situations, and to provide useful guidance to ensure that problems, such as that given above, do not occur or are appropriately managed, and to ensure that good financial management for VCOs is in place.

Summary – What is financial management?

- Financial management is about ensuring that funds are made available at the right time; for the right length of time; at the lowest cost; and used in the most efficient, economic, and effective way.
- Financial planning should be integrated with core organisational planning.
- Developing a financial strategy helps VCOs consider how future work will be funded and plan for development.
- VCOs should aim to establish workable financial policies, procedures and systems as early on as possible.

Tool – Developing a financial strategy

Organisations need to have a financial strategy in place if they are to develop. How a strategy is written will depend on an organisation's stage in development, structure and levels of expertise. Essentially the document should contain information on:

- **Where the VCO is now** – What are the current financial commitments and objectives? (Whilst planning for the future it is still necessary to meet the current demands). How has development been financed to date and has this been successful, is it still appropriate?
- **What the VCO plans for the future** – What does the organisation want to achieve and what financial resources are necessary to meet these objectives?
- **How much it will cost** – How will the organisation finance its plans? How much is needed? Where will the finance come from and how? What allowances should be made for contingencies?
- **How the VCO will manage the process and minimise risks** – What are the risks within the finances and how will these be managed?
- **Integration of financial strategy with other organisational strategies** – Has the VCO been objective in the planning process? Are current organisational strategies working towards the achievement of stated aims? How will the financial strategy be implemented, communicated and support other plans and overall aims?

Use these headings to map out a financial strategy.

2 Budgets and cash-flow

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> A budget is a plan translated into money for a defined period of time.

A budget outlines measurable income and expenditure – based on assumptions and knowledge – against which actual performance can be measured. The purposes of a budget are:

- To coordinate different activities towards a single plan.
- To communicate and set targets.
- To maximize and allocate resources.
- To identify financial problems.
- To establish a system of control by having a plan against which actual results can be compared.
- To compel planning.

A good budget can mean the difference between an organisation's success and failure. Types of budget include:

- **Revenue budget** – An estimate of total incomes and expenditures for the forthcoming year.
- **Cash-flow budget** – Projections of the cash needs of the organisation over time (usually month-by-month).
- **Capital needs budget** – A longer-term assessment of financial need. Useful for planning organisational growth and development (such as acquiring a new building) as part of a financial strategy.

All organisations should aim to have at least revenue and cash-flow budgets. Managing budgets involves two processes: preparation and control.

Budget preparation

> Predicting potential expenditure and income is known as 'budget forecasting'.

A budget is prepared after an organisation has clarified its aims and objectives and produced a variety of action plans to achieve them – the budget translates the plans into pounds. The time period for a budget is usually one year.

A budget should list all expected expenditure and income. Parts of the budget can be calculated with precision (e.g. known annual rent) while other aspects are more a matter of estimation (e.g. potential postage or photocopying costs). In preparing a budget it is useful to keep clear notes of how figures have been arrived at. This can be particularly beneficial if budgets have to be revised or for facilitating the process in future years. Also, be aware that capital projects such as building works often have 'hidden' costs which may need planning for, even if unidentified at the start.

In preparing a budget a number of key questions have to be asked. These include:

1. **Does the budget have to balance?** i.e. should incoming and outgoing money cancel each other out at year-end (producing no surplus or loss). This is often the case with grants where VCOs are required to spend the exact amount. This decision has further implications for financial management in relation to the level of reserves the organisation holds. For example, if a deficit is planned will this affect the organisation's ability to meet costs such as paying salaries?

2. **What is the budget timescale?** Budgets must be completed to a deadline. This may include ensuring the timescale matches required monitoring for funders. Realistic dates need to be set to allow both those contributing to the budget, and those doing the calculations and coordination (the finance staff), sufficient time to complete their tasks.

3. **Will the budget allow for evolution?** During the year events can occur which require a radical change. Budgets can then become unrealistic or inaccurate. Budgets can and should be changed to reflect new circumstances. Without this, a budget could continue to signal a problem even though it has been resolved or, worse still, mask an emerging issue.

4. **Who is accountable for the budget?** It is important to allot responsibility for a budget. The planning process will have helped to clarify who has the power to affect various parts of the budget. Action plans are usually developed by those responsible for managing delivery of a service or product and the general rule is to delegate budget management down to that level.

5. **Will the budget be calculated on a 'zero' or 'incremental' basis?**
   - *Incremental budgeting* – Drawing up a yearly budget by applying a percentage increase to items originally identified (e.g. adding 10% to last year's postage costs). This method is criticised as it fails to consider whether activities and costs are still relevant and whether the amount allocated is still appropriate. It also does not recognise inefficiency, so mistakes in one year will continue to be repeated.
   - *Zero-based budgeting* – Assessing every budget item as if it was new (e.g. considering what postage costs will actually be incurred – for example, are any major one-off mailings planned?).

- The budgeting process is a facilitation tool to support the aims of the organisation.
- Budgeting is not an end in itself and must not stifle the creativity of the organisation.
- Participation by relevant staff is vital to a budget's success.

Structuring budgets

All budgets are split into lines (e.g. a line indicating amount available for catering, a line indicating funds for travel etc). Each line is effectively an authorisation to spend or a target to achieve. A simple budget for a year (the 'revenue budget') might list all potential income and expenditure lines against predicted amounts.

Tool – Example revenue budget

A simple balanced revenue budget for a VCO project might look like this:

Income		**£**
	Grants	50,000
	Earned income	4,000
	Total income (A)	**54,000**
Expenditure		**£**
	Salaries	35,000
	NI and pension	5,000
	Travel and subsistence	1,000
	Phone and fax	500
	Stationary	500
	Postage	1,000
	Photocopying	1,000
	Legal and professional	10,000
	Total expenditure (B)	**54,000**
Surplus/Deficit	**(A-B)**	**0**

As illustrated above, budgets also have columns. A cash-flow budget typically includes a column for each month, each column outlining the predicted amounts of incoming and outgoing funds for the respected month (see below).

Budget reports produced over time (e.g. monthly) have columns that enable the monitoring of income and expenditure against what was forecast during the planning process (in the revenue budget). Budget reporting is outlined at the end of this section.

Cash-flow

A cash-flow budget shows the total expected outflows (payments) and inflows (receipts) over the year, typically on a month-by-month basis.

Cash-flow budgets are vitally important because they ensure a VCO is aware of when there will be shortages and surpluses of funds during the year. A known cash shortage can be planned for and resolved by, for example, arranging an overdraft. Also, it would be wrong to assume that having a cash surplus is not a problem; idle cash can mean that an opportunity to earn interest is being lost.

It is important to note that a surplus in the cash-flow is not necessarily a surplus in the overall revenue budget – it might simply be that budgeted funds will be unused for several months and so could earn interest prior to use.

Tool – Example cash-flow budget

The following cash-flow budget is prepared for a VCO:

	April £	May £	June £	July £	August £	Sept £
Income						
Grant	50,000	-	-	50,000	-	-
Trading	1,250	1,250	1,250	1,250	1,250	1,250
Donations	416	416	416	416	10,416	416
Total Income (A)	**51,666**	**1,666**	**1,666**	**51,666**	**11,666**	**1,666**
Expenditure						
Revenue						
Salaries + N.I	15,833	15,833	15,833	15,833	15,833	15,833
Monthly Outgoings	833	833	833	833	833	833
Other Revenue Expenditure						
Project X	10,000	-	-	-	-	-
Project Y	5,000	-	-	5,000	-	-
Total Revenue (B) Expenditure	**31,666**	**16,666**	**16,666**	**21,666**	**16,666**	**16,666**
Capital						
Building **(C)**	0	3,000	7,050	0	0	0
Total Expenditure (D = B+C)	**31,666**	**19,666**	**23,716**	**21,666**	**16,666**	**16,666**
Net Inflow **(A-D)**	20,000	-18,000	-22,050	30,000	5,000	-15000
Opening Balance (b/forward)	12,220	32,220	14,220	-7,830	22,170	27,170
Closing Balance (c/forward)	**32,220**	**14,220**	**-7,830**	**22,170**	**27,170**	**12,170**

The letters A, B, C and D indicate how the various totals are calculated.

The cash-flow shows that the organisation will encounter problems in July. Having forecast this issue, the VCO can prevent it by adjusting expenditure plans, asking service purchasers or funders for payment in advance, or using surplus funds to earn interest that could be used to pay the charges for an overdraft facility if the former options fail. Because the VCO can balance its books and the budget demonstrates that they will be able to pay back an overdraft there should be no problem obtaining a short-term bank loan.

Budget control

In addition to helping VCOs plan, budgets are an essential tool for monitoring and controlling funding, and checking an organisation is on track. The focus of budgetary control is to answer these key questions:

- How are we doing?
- How much of the budget is left?
- What will it look like at the end of the year?

It is the responsibility of finance staff to provide timely reports that compare actual results against budget to enable those responsible for projects to see what is happening so they can either take corrective action or have reassurance that everything is going to plan. Every month or quarter an overall organisation report should also be provided to the Board and/or management committee.

It is good practice for finance staff to talk with budget holders to ensure the reports produced are understood and presented in a readily useable form.

Variations in budget expenditure

The most important aspect of budgetary control is checking the difference between actual and expected results. These differences are called 'variances'. 'Variance analysis' involves comparing actual results for a period (for staff usually a month and for trustees quarterly) with budgeted expectations. Small variances are obviously to be expected and do not require special comment – indeed to avoid overwhelming a management committee with unnecessary information it may be appropriate to provide exception reports, that is, reports, which show only large variances i.e. 5-10% or more. Variances need investigation to determine their cause and to decide what action might be taken to get the organisation back on track.

Budget holders may need to account for why variance has occurred, but it is not necessarily their actions that have caused it. The point of the control process is to facilitate appropriate action, not to find someone to blame.

One important distinction to make is whether the variance is:

- **Controllable** – due to factors within the VCO that can be rectified.
- **Non-controllable** – due to factors outside the control of the VCO. Large non-controllable variances may require a VCO to re-think its business plan.

For example, imagine a health centre's expenditure on drug supplies is £2,000 against a budget of £800. Possible reasons for this might include:

- Price increases by usual supplier – may be controllable, could try alternative suppliers.
- Unexpected world price rise for all aspirin-related drugs – non-controllable, medical budget may need revising for remainder of year.
- Spoilage of supplies due to inadequate storage conditions – controllable, storage problem needs resolving but may require expenditure.
- Use of expensive branded drugs instead of cheaper alternatives – may be controllable, the VCO needs to look at its purchasing policy.

Budget reporting

A typical monthly budget statement would have the following column headings:

Budget	Annual budget	Budget to date	Actual to date	Variance to date	Variance to date %	Budget unspent

The grid below explains what each column includes and why it is important.

Column	What is it?	Why is it important?
Budget	Description of the budget item (e.g. postage, travel).	Simply identifies the item that the figures refer to.
Annual Budget (A)	The annual budgeted amount for the year.	At the end of the year this will be compared with actual spend.
Budget to Date (B)	The amount expected to be earned or spent at this point in the year.	It is important that this is based on the expected cash-flow, not on an arbitrary 1/12 per month.
Actual to Date (C)	The amount that the accounting system records as having been received or spent to date.	Used to establish current position. It is important to know whether this figure includes commitments (i.e. income or expenditure expected but not yet actioned).
Variance to Date = B – C	The amount by which income or expenditure to date is under or overspent.	This is an important figure and if significant, should be investigated.
Variance to Date = (B-C)/B x 100%	Percentage calculated by dividing 'variance to date' by the 'budget to date' and multiplying figure by 100.	Indicates the relative extent to which actual figures differ from what was expected at this point in the year.
Budget Unspent = A – B	The amount of money left for the rest of the year.	It is important to know if this takes into account commitments.

Budget reports may be monthly or, sometimes for a Management Committee, quarterly. They are the primary tool by which a manager, Director or Trustee Board can assess if an organisation's finances are on track. The Tool below provides an illustration of how a budget might look and demonstrates the practical use of budget preparation and monitoring.

Tool – Example monthly budget report

Imagine that the following information relates to a VCO's service. The financial year runs from 1 April and the figures shown include expenditure up to and including month 7.

Budget	Annual budget	Budget to date	Actual to date	Variance to date	Variance to date	Budget unspent
	£	£	£	£	%	£
Rent	24,700.00	14,408.33	14,408.00	0.33	0.00	10,292.00
Postage	1,300.00	758.33	683.54	74.79	9.86	616.46
Telephone	3,000.00	1,500.00	1,924.56	-424.56	-28.30	1,075.44
Stationery	1,200.00	700.00	456.00	244.00	34.86	744.00
Equipment	4,500.00	4,000.00	4,235.76	-235.76	-5.89	264.24
	34,700.00	21,366.66	21,707.86	-341.20	-1.60	12,992.14

Which of the above budgets should be investigated and why? *(Answer: telephone, stationary, and equipment – although % variance for equipment is low, so may not be a problem).*

What factors might have contributed to the financial position on the selected budgets? *(Possible answers: greater user-need than anticipated, increase in utility charges, staff misuse of resources).*

Answering these questions will help the VCO to decide what actions, if any, should to be taken.

Summary – Budgets and cash-flow

- A budget is a plan translated into money for a defined period of time.
- A revenue budget is an estimate of total incomes and expenditures for the forthcoming year.
- A cash-flow budget shows the total expected outflows (payments) and inflows (receipts) over the year, typically on a month-by-month basis.
- Budget management involves two processes: preparation and control.
- Monthly budget reports compare actual results against budget from which the manager responsible can either take corrective action or have reassurance that everything is going to plan.
- The difference between actual financial income and expenditure results and expected results are called ‘variances’.
- Variances need investigation to determine their cause and to decide what action a VCO might take to get itself back on track.

3 Costing products and services

'Costs' are the financial value(s) of the resources used to develop a service.

'Price' is the amount of money that a product or service is sold for.

Organisations need to identify the full range of resources that go into a product or service and know their financial value. This is essential for developing robust funding applications, developing accurate budgets, and enabling management and trustee Boards to make informed decisions about future work continuation, development or cessation. For those organisations involved in, or planning to begin, earning income from their products and services (be this under contract or on the open market, even at a subsidised rate) identifying full costs is crucial for determining what price the organisation should charge for its work.

This section looks at how VCOs can effectively cost their work. Costing is essential whether seeking donations, applying for grants, bidding for contracts, or beginning to trade on the open market.

The associated considerations needed when developing products and services for trading activity are dealt with in the *Introductory Pack Guide to Trading*.

Types of costs

In developing their work, VCOs incur different types of costs. For example:

Question – If a playgroup considers extending its hours to include providing lunch, what factors would it have to take into account in preparing an estimate of the costs?

Answer – It would have to include items like food, wages if employing someone, electric and gas. But there might be additional costs to the organisation – for example is extra rent needed to pay for longer use of the building? These are not just costs, but different types of costs which can be broadly divided into:

- **Direct costs** – costs incurred as a direct result of carrying out a particular activity. In the example this would be food and any staff wages directly associated with preparing the food.
- **Indirect costs** – shared organisational costs. In the playgroup example this might include an overall manager, some of whose time should be allocated to the new food service, or some of the premises costs.

In costing a service it is vital that VCOs understand that costs are not all the same. They have different behaviour patterns and it is vital that organisations group costs both for budget projection and control into two different categories:

- **Fixed costs** – costs that do not change with outputs, for example the cost of telephone line rental which, no matter how much used, stays the same.
- **Variable costs** – which do vary with outputs, for example telephone calls, the longer you are on the telephone the more expensive the call.

A third category can also be used, known as **'semi-variable, mixed or step costs'**. This is where costs vary according to amount of use, for example the telephone becomes so busy that a second telephone line is rented, or a long-distance driver has to replace tyres every 25,000 miles. In reality it is more useful to think of such costs as fixed or variable since this encourages consideration of them as early as possible and ensures VCOs build the potential need for funds to cover them into their plans. The example below, demonstrating the different types of costs should illustrate why.

Tool – Example of fixed and variable costs

An organisation reviews the need for vehicles within its projects. Three different mileage uses are proposed ranging from 15,000 to 25,000 to 40,000 miles. What are the costs of vehicles at these different rates?

The following information is obtained per vehicle:

1. Vehicle leases are £3,000.
2. Petrol and oil cost 10p per mile.
3. Tyres cost £400 per set to replace. They require replacement at 25,000 miles.
4. Fixed maintenance costs are £175 per annum.
5. Tax and insurance are £300 per annum.

The costs can be divided into fixed, variable and mixed (step) costs:

Fixed costs are:	**£ per year**
Leasing charge	3,000
Maintenance	175
Tax, insurance	300
	3,475

Variable costs are:

Petrol and oil	10p per mile

Semi-variable/step costs are:

Tyre replacement at 25,000 miles. Therefore at:	15,000 miles	no cost
	25,000 miles	£400
	40,000 miles	£400

The estimated yearly costs then are:	15,000	25,000	40,000 miles
	£	**£**	**£**
Fixed costs	3,475	3,475	3,475
Variable costs (10p)	1,500	2,500	4,000
Step costs	0	400	400
Total	**4,975**	**6,375**	**7,875**

However, imagine the VCO chooses to limit its travel to 15,000 miles per year. In the first year costs would therefore be £4,975 as outlined. During the second year, however, the vehicles, while still only travelling 15,000 miles within that year, will actually pass 25,000 miles from when they began service and hence need new tyres. An extra £400 will be needed that year. In terms of budgeting for this and similar additional costs it may be more practical to include tyres as a variable cost of 'x' pence per mile. This would ensure the VCO was covering future tyre costs from the outset.

In most cases, it is possible to identify accurately the direct, fixed, variable and semi-variable costs of a project or service. What is less clear is how to identify indirect costs and (where VCOs have several products or services) the share of these costs that should be allocated to each product or service.

For those VCOs with several products or services, the process of sharing out indirect costs among them can seem a very arbitrary process: for example, how much of a manager's salary cost should be allocated to each service or product they oversee? It might seem easiest to divide the total salary cost by the number of projects served, but this may not reflect the true cost of serving a project. For example, a manager may devote more time to one project than to another. It is essential that funding for projects includes general overheads apportioned to those projects and that overheads are apportioned as accurately as possible. This allocation process is known as 'full cost analysis'. Ensuring all such identified costs are met by funding is known as 'full cost recovery'.

Full cost analysis and recovery

> Full cost recovery means funding, or 'recovering' the full costs of a project or service, where the full costs equal the direct costs of the project or service plus a relevant share of indirect overhead costs.

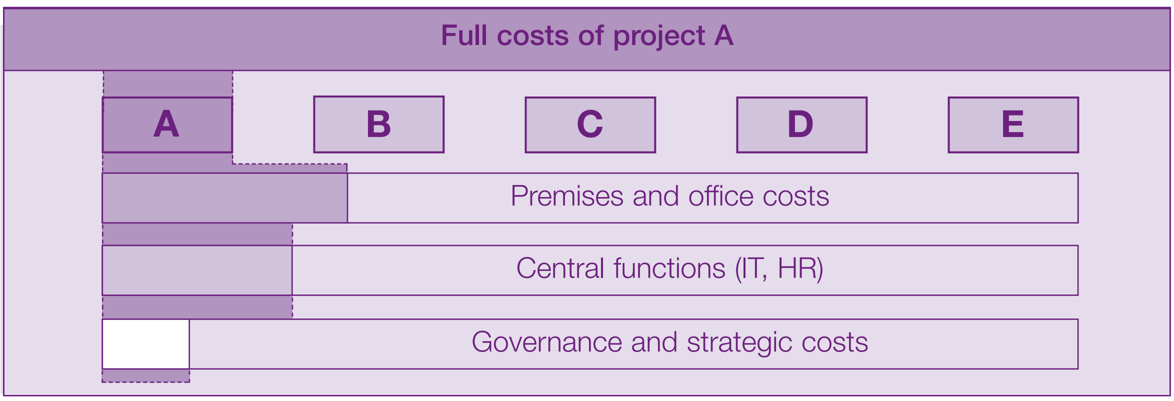
When preparing any budget it is important to consider all the costs likely to be associated with a project. Full cost analysis allows VCOs to do this.

As indicated above, all organisations, public, private and voluntary, incur organisational overhead costs, often referred to as 'indirect', 'core' or 'central' costs, in addition to direct project costs. Unless all these costs are recovered by an organisation – whether through a grant, contract or other income source – it can find itself effectively subsidising the work it does on behalf of a funder, or the delivery of a service provided under contract. This will erode a VCO's central funds and thus threaten its future viability.

Overhead costs include the cost of management and leadership, research, development and innovation, and support functions, such as premises, financial and personnel management. All of these functions are integral for a project, or service, to run effectively and efficiently. Therefore the true cost of a project, or service, includes an element of the cost of each function.

An example is illustrated by the diagram below.

Figure 1: Full cost analysis allocation of costs



If a VCO runs five projects (A-E) then the full cost of each will be the direct costs for that project together with a proportion of the organisation's overhead costs (premises and office, central functions, governance and strategic development). The proportion of each overhead will vary according to the extent to which each project draws upon it. For example, if project A is a telephone advice service, it might be that it draws more heavily upon 'Premise and office costs' because it is permanently located at a desk in-house using several telephones throughout the day. If projects B and C were outreach support services it might be that they would draw very little on office costs because these activities occur off-site.

Full cost of project or service	=	Direct costs of that project or service	+	Relevant share of overhead costs

A practical tool to help VCOs to understand and calculate their costs and allocate them appropriately has been developed by New Philanthropy Capital and ACEVO (Association of Chief Executives of Voluntary Organisations). The guide, *Full Cost Recovery: A guide and toolkit on cost allocation* (2005), includes a cost allocation template to help organisations calculate the full costs of their projects and services in an easy step-by-step process. **Details are provided in the Resources section.**

Understanding the full costs of a project can:

- Support grant or loan applications – VCOs will know the exact amount they need.
- Inform decisions about whether to apply to deliver a service for which there is a defined price – VCOs will be able to compare the funds available with the full cost of delivering that service.
- Where the funding available is below the true full cost, VCOs can take an informed decision on whether to run the activity anyway knowing the exact level of subsidy that will be required from their resources.

Many organisations that have adopted a full cost approach have found that the true cost of providing a service or activity is greater than the funding being offered. This information enables the organisation's managers to be more assertive when negotiating with funders or taking the strategic decision to subsidise and/or fundraise to cover the loss.

Although understanding the full cost of projects, or services, will not result in full cost recovery every time, calculating the full cost means VCOs know the exact level of funding they require. It gives them a clear picture of how a particular project draws on their central resources. Full cost recovery does not mean that projects cost more, just that all the relevant costs are taken into account and apportioned appropriately.

Summary – Costing products and services

- VCOs incur different types of costs: direct and indirect, fixed and variable.
- Understanding the full cost of a project enables VCOs to make informed decisions about future work and funding needs.
- Full cost analysis is essential for ensuring a VCO recuperates all costs incurred in the delivery of its work.

4 Simple book-keeping

Book-keeping is the recording of financial events and transactions.

Every VCO needs to keep track of all money coming in and going out of the organisation. For example, recording monthly pay or the instalment of a grant and noting it against actual or proposed expenditure. Such records, usually know as 'book-keeping' can also be used to produce regular (e.g. monthly or quarterly) summaries of financial activity, known as 'accounts'. The precise cut-off point between book-keeping and accountancy is a little vague. Many people use the term 'accountancy' to include book-keeping.

This section covers simple book-keeping processes. The following section outlines how this information feeds into more detailed accounting procedures.

Cash-book summaries

The simplest form of accountancy is based on receipts and payments. This type of accounting tends to be used by smaller organisations including registered charities with an income under £100,000.

At this level there are three things which require recording:

- Details of receipts (income).
- Details of payments.
- Balance of cash.

This recording is done in a book called the 'cash-book'. A cash-book should record all cash received on one side and all cash paid out on the other. In its simplest form, a cash-book layout should be:

Cash received			Cash payments		
Date	Details	£	Date	Details	£

An example is given in the Tool below.

Tool – Example cash-book summary

Imagine a VCO opens a shop selling fair trade goods during the month of August 2006. At the beginning of the month the organisation takes out a small bank loan to purchase stock. By the end of the month all stock has been sold. Those are the transactions. In practice, takings would be paid into the bank daily to safeguard the cash, but for the purpose of this example they have been entered weekly. Written in cash-book summary format, the transactions should look like this:

Cash received			**Cash payments**		
2006		**£**	**2006**		**£**
1 Aug	Loan	2,000	2 Aug	Purchases	1,000
5 Aug	Takings for week	800	5 Aug	Wages	120
12 Aug	Takings for week	950	5 Aug	Rent (4 weeks)	200
19 Aug	Takings for week	1,100	9 Aug	Purchases	900
26 Aug	Takings for week	2,150	12 Aug	Wages	150
			16 Aug	Purchases	1,000
			19 Aug	Wages	150
			19 Aug	Sundry exps	30
			23 Aug	Purchases	600
			26 Aug	Wages	160
			26 Aug	Sundry exps	40
			Previous balance carried down		2,660
		7,000			**7,000**
Balance brought down		**2,660**			

The cash-book illustrates:

- Cash received (left-hand side)
- Cash payments (right-hand side)
- Balance of cash in hand (cash received minus cash payments)

NOTICE the method by which the cash-book has been ‘ruled-off’ at the end of the period. The two sides are added up, and then the difference (in this case the balance at bank at the end of the period) is inserted on the ‘LIGHTER’ side of the book so that the two totals are identical at £7,000. This balance is then restated below the ruled-off totals to start the record of transactions for the next period.

Cash-books often have a few more columns to help organisations to analyse and group transactions as a step towards preparing an accounts statement. For example, the right-hand side payments column in the above example could also be represented as:

Total £	Purchases £	Wages £	Rent £	Sundry Exps £
1,000	1,000			
120		120		
200			200	
900	900			
140		140		
1,000	1,000			
150		150		
30				30
600	600			
160		160		
40				40
£4,340	**3,500**	**570**	**200**	**70**

Petty cash

The cash-book normally records the movements of the bank account. The inevitably small cash payments necessary for items like postage, minor travel expenses and similar are normally met from a float of cash held for the purpose and referred to as ‘petty cash’.

This float is replenished periodically by means of a cash cheque drawn on the organisation bank account. It is customary for the drawing to be the exact amount of the petty cash expenditure for the period, so as to exactly reinstate the amount of the float. This method is known as the ‘imprest system’ and is used to prevent the build up of an unnecessarily large petty cash balance.

Tool – Example petty cash summary

Date	Amount in £	Date	Details	Voucher No	Total out £	Travel £	Details Postage £	Stationery £
Aug-01	100	Aug-01	stamps	1	10		10	
		Aug-04	paper	2	3			3
		Aug-10	Kate Smith	3	14	14		
		Aug-29	John Jones	4	11	11		
		Aug-30	envelopes	5	3			3
					41	**25**	**10**	**6**
Aug-31	41							
			Balance		100			
	141				141			
Sep-01	100							

As each petty cash payment is made a voucher detailing the expenditure should be filled out (and its number recorded as above). This should have all relevant receipts attached for financial record keeping.

Bank reconciliation

The reconciliation of the cash-book and the bank statement is a check on the correctness of the cash-book.

The bank reconciliation statement is a powerful weapon against fraud. Therefore the person preparing the statement should not be the person who is responsible for the cash-book.

It is good practice to prepare a statement verifying agreement between cash-book and bank statement balances at the end of each month. This is called 'bank reconciliation'. There can be differences between the cash-book and the bank statement, and these fall into two groups:

- Differences caused by omission – for example bank charges on the statement but not in the cash book
- Differences caused by the differing timing at which the record of a transaction is made in the two records – e.g. a cheque drawn on the last day of the month and sent by post will not hit the bank account until later in the following month.

The first type of difference is corrected by means of checking the correctness of the charge listed and then entering it in the cash-book.

No correction is necessary for the second type of difference because with the passing of time the necessary entry will occur (e.g. when a cheque drawn and entered into the cash book eventually reaches the bank account). However, it is this second type of difference that is dealt with in the bank reconciliation statement. Details of the process are included in the Tool opposite.

Tool – How to do a Bank Reconciliation Statement

The following procedure should be followed:

1. Check each item in the cash-book for the month against the corresponding item in the bank statement, ticking in both places and correcting any errors found. When this is done there will be some unticked items.
2. Deal first with any unticked items in the bank statement for the month. These will require entering into the cash-book, unless the bank has made a mistake. Investigate each item in turn and make the necessary entries in the cash-book, ticking in both places.
3. Every item in the bank statement is now ticked, unless there is an error in the bank statement. The items unticked in the cash-book are going to be the items for the bank reconciliation statement. List and total the unticked payments. These will be cheques drawn and entered in the cash-book but not yet debited by the bank. Also list and total any unticked receipts (income). These will be items paid into the bank but not yet credited.

You can now prepare the bank reconciliation statement. An example is given below:

Bank Reconciliation Statement at 31.8.06

	£
Balance as per bank statement	6,666.66
Add: payments not yet credited	3,333.33
	9,999.99
Less: cheques not yet presented	3,666,66
Balance as per cash-book	**6,333.33**

If the cash-book balance does not agree with the calculated figure (£ 6,333.33), then the figures must be re-checked until the difference is found.

Good practice with internal financial controls

Good financial procedures and internal controls are just as vital in smaller organisations. In many cases these controls will be exercised by members of the management committee themselves. The principal underpinning good financial controls is that wherever possible there should be a proper segregation of duties so that one person does not process a complete transaction and proper references should be taken up for all staff and volunteers who handle money. The following internal controls should be in place:

- Two people should always open the post and count cash receipts.
- Cheque payments should require two signatures or equivalent authorisation controls if making automated payments.
- Goods and services should have an authorisation procedure.
- Petty cash should be managed on an 'imprest' system.
- Bank accounts should only be opened by the management committee.
- Personal records should be kept by someone other than the person who pays salaries.
- A fixed assets register should be maintained and (if applicable) a list of any investments.

Summary – Simple book-keeping

- Book-keeping is the recording of financial events and transactions.
- The simplest form of accountancy is a 'cash-book summary'. This lists receipts, payments and cash balance, usually on a monthly basis.
- Minor expenses should be managed using an 'imprest' petty cash system.
- Bank reconciliation should be used to check the correctness of the cash-book against the bank statement.
- Bank reconciliation is a powerful weapon against fraud. The person preparing the statement should not be the person who is responsible for the cash-book.

5 Financial accounting and audit

5

> Financial accounting is using the information recorded at the book-keeping stage to produce summary reports of groups of transactions to assist in the running of an organisation.

Accounting can be invaluable to VCOs. This is not just for reporting to funders. Accounts reports can inform planning, be used to ensure the organisation is on track, and help demonstrate how and where an organisation is doing well or under performing. As such, accounting should be carried out by small and large VCOs alike. Financial accounting is a valuable management tool.

Limitations of simple book-keeping

As previously outlined, a cash-book summary is a simple receipts and payments account summarising cash received and paid during a particular period. A simple cash-book summary for a VCO for a year might look like this:

The Very Small Voluntary Friends Organisation Receipts and Payments Account

Receipts/Income	£	Payments/Expenditure	£
Cash at Bank and in hand (01.01.0X – date of year start)	2,800	Fundraising dance costs	1,890
Membership fees	3,900	Office expenses	500
Sale of tickets for dance	1,930	Rent	1,250
		Secretary's fee	1,750
		Charity donation	40
		Cash at Bank and in hand (31.12.0X – date at year end)	3,200
	8,630		**8,630**

Because this is a cash-book summary, no account is taken of accrued expenditure (i.e. money still to be paid for something that occurred in this accounting period such as a catering bill for the dance which is expected but not yet received). Nor is account taken of pre-payments (i.e. money paid in advance for something that will occur in the next accounting period such as telephone rental paid in advance), increase or decrease in stocks, depreciation, or capital as opposed to revenue expenditure. All a cash-book summary can show is the excess of receipts over payments or payments over receipts. From these simple accounts, however, we can see that Cash at Bank has increased during the year from £2,800 to £3,200.

But does this format present the fundraising dance in a manner that allows management or trustees to gauge how profitable, and hence effective, it was?

The dance seems to have made a small profit of £40 (ticket sales of £1,930 less costs of £1,890) but has it? What is the rent for? And should some of the secretary's fee and the office expenses be allocated to the dance costs? Given that preparation time and management was certainly required for the dance then (as discussed in the full cost recovery section above) a proportion of these 'overhead' costs should certainly be included in the overall dance costs. Imagine it was decided that 10% of these costs should be apportioned to the dance, the management account for the dance alone would look like this:

Tool – Example Receipts and Payments Management Account

The Very Small Voluntary Friends Fundraising Dance Receipts and Payments Account

Income	**£**	**£**
Sales of Tickets		1,930
Expenditure		
Costs	1,890	
Office Expenses -10%	50	
Rent 10%	125	
Secretary's fee 10%	175	2,240
Balance (Loss on dance)		**(310)**

On this basis the dance has clearly lost money. It would be beneficial for management to be aware of this since they may then conclude that fundraising dances are not actually beneficial to the organisation. Another disadvantage of a receipts and payment account is that because it is based only on cash received it does not allow for people owing money, such as those attending the dance that have not yet paid.

A different form of accounting, known as 'accruals accounting', includes any money owed or owing. This would further improve the usefulness of this information to the organisation's management or trustees and enable them to make sound judgements and plans based upon it.

Accruals accounting

Larger organisations keep accounts on what is known as an 'accruals' basis. Registered charities with an income greater than £100,000 and all VCOs and charities irrespective of size that are incorporated (e.g. registered as a company limited by guarantee) are required to keep accrual accounts.

Accruals accounting unlike receipts and payments is based on the principal that income and expenditure should be reflected on the basis of **relating** to the period rather than actually **paid** in the period. This can be a very useful management tool, particularly for budgeting and planning future expenditure.

The benefit of accruals accounting is that although the amounts listed under 'expenditure' may be the same as with receipts and payments, awareness of money owing (a liability) or paid in advance (an asset) can inform future planning and enable better management decisions.

Assets and liabilities

> A liability is a financial obligation or debt to another party entered in a balance sheet.
>
> An asset is a financial benefit entered on a balance sheet. Assets include all properties, both tangible and intangible, and any claims for money owed by others. Assets can include cash, stock, inventories, property rights etc.

Accruals accounting also includes what are termed 'assets' and 'liabilities'. Beyond any cash an organisation may have in the bank, it may also owe money to others, have paid for something in advance, or possess items of value (e.g. property). For example, office expenses may imply that there is a desk or a computer which is owned and which has a value. This is an asset.

VCOs which are registered charities with an income under £100,000 are required to not only submit a receipts and payments account but also a Trustees' Annual Report (see section 7) and a Statement of Assets and Liabilities which outlines the charities main assets and liabilities at the end of the year and also includes the cash balances in the receipts and payments account.

Assets and liabilities together with the principles of accruals accounting are demonstrated in the Tool below.

Tool – Example of how accrual accounting works

Consider this example:

Agreed Rent on Office for the Year:	£4,000 payable quarterly in arrears
Rent actually paid in the year:	£3,000

Q. What is the rent figure to be put in the expenditure account?

A. £4,000

This is because this is the amount for rent relating to the period under review (the year). At year end the balance sheet would show £3,000 paid and a liability of £1,000 for rent due but not yet paid. This is what is known as a 'creditor' (a liability the organisation has to pay) that will now appear in the Balance Sheet under the heading 'Liabilities'.

Q. If rent was paid in advance, so that by year end £5,000 had been paid, what then would be the respective figures in the accounts?

A. £4,000 would still appear in the expenditure.

The difference is that because the organisation has paid in advance, it now has an asset of £1,000, because if it left the premises the organisation would be repaid the £1,000. This is shown as a prepayment (usually under 'debtors' in the Balance Sheet) under the heading 'Current Assets'.

Restricted funds

Unlike commercial organisations which can spend funds as they wish, a charity holds funds in trust to spend on, and only on, its charitable purposes. Resources given to charities often have restrictions as to how they can be spent. Restricted funding can be defined as funds which have donor-imposed restrictions like a grant and some contracts, or where the charity raises funds for a specific appeal. A charity must therefore ensure that it records what the purpose of the income is and demonstrate that the funds which have been spent have been spent only on that purpose.

Templates showing how to account for funds in both receipts and payments and accruals formats are available to download from the Charity Commission website. These templates are for the three reports required to be submitted annually to the Commission for Charities under £100,000 (in the receipts and payments format) and for larger charities over £100,000 but under £250,000 (in the accruals format), but are also useful guidance for VCOs not registered as charities. **See www.charity-commission.gov.uk for further information.**

Independent Examination and Audit

To meet the requirements of the Charities Act 1993, all charities with an income in excess of £250,000 will require an audit. Smaller unincorporated charities and other VCOs may require an audit if their governing document or a donor requires it. Incorporated organisations fall under the auspices of the Companies Act 1985 in respect of a requirement to audit and prepare an accountants report. Audits must always be undertaken by registered auditors. If none of these conditions apply the charity can elect to have an independent examination. This may more frequently be the case with very small VCOs.

What is an independent examination?

Independent examination is less onerous than audit. It is primarily based on a review of the accounts and consideration of any unusual items or disclosures identified. It indicates whether certain matters have been brought to the reviewer's attention. The examiner is not required to form an opinion as to whether the accounts give a true and fair view. If the accounts are prepared on an accruals basis, then the independent examiner must check them for compliance with the Charity Commission regulations in terms of format and content, review accounting policies, and enquire about post balance sheet events. The examiner must also compare the accounts with the trustees' report to make sure the two are consistent with each other.

Who can do an independent examination?

An independent examiner is defined as 'an independent person who is reasonably believed by trustees to have the requisite ability and practical experience to carry out competent examination of the accounts'. Independence is defined as having 'no connection with a charity's trustees which might inhibit the impartial conduct of the examination'.

An independent examiner should be someone who has good analytical and communication skills in order to be able to raise questions and to interpret and challenge responses. Although the independent examiner should be familiar with accountancy methods, they need not be a practising accountant. Ideally they should have practical experience, perhaps gained by being involved with the financial administration of another charity or other independent examinations.

Report content and concerns

Charity Commission regulations determine the content of the independent examiner's report which should avoid making positive statements of opinion or belief that can only be substantiated by carrying out an audit. The examiner should report clearly and unambiguously where the charity's accounts appear to be in order. An independent examiner is required to report certain matters to the Charity Commission if there are significant failings in the management of a charity's affairs. However, this is very rare.

Summary – Financial accounting and audit

- Accounting is using information recorded at the book-keeping stage to produce summaries of groups of transactions to assist in the managerial running of an organisation.
- Accruals accounting can be more effective than simple payment and receipts accounting because it can inform future planning and enable better management decisions.
- Charities over £250,000, incorporated organisations and VCOs whose funders or constitution require it need to have their accounts audited annually.
- Audits must always be undertaken by registered auditors.

6

6 Tax and voluntary and community organisations

> All areas of taxation are extremely complex, and the financial cost of a bad decision could far outweigh any savings on professional fees.

One of the great myths is the belief that VCOs do not pay tax. Tax law does not recognise voluntary organisations; it only recognises charities, as defined by case tax law. Nevertheless, it is important for VCOs to be aware of tax issues, particularly those just taking on paid staff, beginning to deliver work under contract or starting trading activities where new tax implications may arise.

As with other legal areas, it is generally recommended that VCOs seek expert advice on tax. Many decisions and contracts cannot be restructured once set in train. It is therefore essential to get competent advice to ensure that a VCO gets it right the first time.

Most tax problems occur for VCOs when circumstances change. For example they grow and turnover increases, they take on paid staff for the first time, or move from delivering activities funded by grants to activities purchased with a contract. At such times specialist advice can be invaluable. Most large firms of accountants have specialist charity tax departments. Some also provide pro bono services, details of which can be obtained from agencies such as Business in the Community's ProHelp scheme. Tax and accountancy specialists should be consulted whenever a VCO thinks it may have a problem.

This section is therefore intended as a brief overview only of the various taxes that VCOs can be subject to. Further support is provided in a number of publications listed in the Resources section, including NCVO's *Good Financial Management Guide*. However here too, the topic is dealt with via an overview for information rather than direct advice due to the specialist nature of taxation.

Direct taxes

Charities benefit from a very favourable tax regime in relation to income and corporation tax, as long as they are careful about how they arrange their affairs. Both regimes are very similar; charitable trusts are subject to income tax rules whereas charities limited by guarantee and unincorporated associations are subject to those for corporation tax.

> The general rule is that as long as the charity income in question is applicable for charitable purposes only, and actually applied for charitable purposes, then much of it is exempt from income tax.

Areas likely to be exempt from tax include:

- Rent or other receipts from rights over land.
- Bank interest received by charities.
- Tax-effective donations.
- Company donations.
- Dividends.

Further information on tax-effective giving can be found in the *Introductory Pack Guide to Fundraising*.

Further information on tax as it applies to trading activity can be found in the Charity Commission publication *CC35 Charities and Trading* available on the Charity Commission website www.charity-commission.gov.uk

VAT

VAT is a tax on transactions, not on profits, which is borne by the ultimate consumer.

VAT is based on the level of taxable output activity an organisation does. It is levied on turnover, calculated on the value, actual or deemed, of the supply of certain goods and services known as 'taxable supplies'. These supplies have to be made 'in the course or furtherance of business'. The term 'business' can apply to activities other than those of a commercial nature.

It is not just a matter of knowing whether an activity is regarded as business, but also whether its outputs are classified as standard-rated, zero-rated or exempt. The growing use of contracts within the VCS has extended the VAT variety within the sector. Contracted services tend to be classified as business and standard-rated (VAT at 17.5%). By contrast, a grant made without the requirement of service provision would fall outside VAT as a form of donation.

Tax planning is important for VCOs, and particularly for those registered as charities. Organisations are not legally required to register for VAT until a certain level of turnover is achieved (details from the Charity Commission). However VCOs not required to register may still consider doing so because this may allow for a partial recovery of VAT incurred from others.

As with direct taxes there are some VAT concessions for charities (e.g. on sales of donated goods, fundraising events). However, it is important to be aware that VAT may be applicable regardless of whether an activity is for charitable purposes or not.

Because VCOs have a mixture of supplies that are taxable, exempt and outside-the-scope, there are issues as to how much of their costs can be recovered and what exactly they should be paying. Professional advice from a specialist charity VAT expert may be required. Although this will require paying a fee, many larger accountancy firms with specialist charity departments will often base their fee as a percentage of the amount of VAT they can recover or cap their fee to an agreed amount.

Further information on VAT is available in NCVO's *VAT for Voluntary Organisations: A step-by-step guide*. See Resources section for details.

The importance of seeking specialist VAT advice

This short overview should not be used as a replacement for specialist advice. All areas of taxation are extremely complex, and the financial cost of a bad decision far outweighs any savings on professional fees. Many decisions and contracts cannot be restructured for tax purposes once set in train, and so it is essential to get it right first time.

Summary – Tax and voluntary and community organisations

- Most tax problems occur for VCOs when circumstances change (e.g. turnover increases, taking on paid staff for the first time, beginning delivery of services under contract).
- As long as charity income is applicable for charitable purposes only, and actually applied for charitable purposes, then much of it is exempt from income tax.
- VAT is based on the level of taxable output activity an organisation does. It is levied on turnover, calculated on the value, actual or deemed, of the supply of certain goods and services known as ‘taxable supplies’.
- VAT may apply whether an activity is for charitable purposes or not.
- All areas of taxation are extremely complex, and the financial cost of a bad decision far outweighs any savings on professional fees.

7

7 Financial management and governance

VCOs are increasingly seeing a need to provide information about their performance. This is not just for public relations; for VCOs registered as charities it is also a statutory requirement for the Charity Commission through the Statement of Recommended Practice (SORP) and the Standard Information Return.

As well as providing timely and relevant financial management information within an organisation, the finance officer, team or department is also required to produce information for a variety of external stakeholders. This includes producing end of year accounts and any associated reports, particularly if the VCO is a registered charity. The production of end of year accounts is not the final stage in the financial management process, in some respects it is the beginning. For example, end of year accounts are a crucial tool for helping trustees to gauge the extent to which an organisation is on track, and should inform long-term strategy.

The role of the finance department in producing this information is crucial, both in ensuring the organisation produces accurate quantifiable data and in helping it to convert such data into meaningful analysis and information. For smaller organisations this may simply amount to compiling end of year accounts, an annual review, and ensuring management and trustees understand their findings. For larger organisations, this extends to complying with Charity Commission requirements. It may also include using formal performance monitoring and improvement techniques such as benchmarking, where actual performance is compared against predetermined targets or budgets.

Reporting performance

A simple method of reporting performance is to look back at the end of the year and write a basic review. Ideally, this should link performance to the planning process discussed earlier. This way the organisation can report how successfully they achieved their objectives and where not can critically evaluate what went wrong or needs altering.

The important point to note is that, like budgetary control, this should not be a ‘blame process’. Instead it should be looked at as a step on the VCO’s journey towards achieving its mission. Where needed, reassessment, change, or new focus is important. No organisation gets it right first time and all the time and VCOs should not be afraid to report both success and failure – unlike commercial organisations there is no share price to fall! – and an honest, trying VCO is more likely to be supported than one that pretends all is well when it is not.

Tool – Example contents of an annual report

A simple reporting process template would including the following:

- The organisation's aims.
- Achievements this year.
- Objectives for the year ahead.
- Strategies and activities.
- Success indicators.
- Measurement methods.
- End of year accounts (figures may be referenced in above outlines).

For example, this template applied to A Young Women's Accommodation Project might include full details of:

Organisation aims
- The provision of short-term accommodation for women aged 16-21 who have problems at home.
- To counsel and provide services to enable a return to home or refer to alternative longer-term accommodation.

Achievements this year
- X Number of women housed and re-established at home.
- X Percentage growth in membership, income, supporters.

Objectives for the year ahead
- To meet the needs of young women in the xxx area who need emergency accommodation.

Strategies and activities
- To make contact with Schools, Social Services and other VCOs to raise awareness of the service for referrals.
- To raise the profile of the organisation with coverage in local media.

Success indicators
- Increased number of referrals.
- Occupancy levels and future destinations.
- Coverage in local media.

Measurement methods
- Application statistics.
- Occupancy levels and length of stay.
- Destination statistics.
- Number of mentions in local media.

End of year accounts
- Summary management accounts, including assets, liabilities etc for the year (as discussed in sections 4 and 5).

Statement of Recommended Practice (SORP)

'SORP' stands for 'Statement of Recommended Practice'. It requires organisations to demonstrate a greater transparency in their affairs, and to ensure that the charity's trustees are managing their charity effectively.

Charity accounting changed in the 1990s with the official recognition that charity operations are very different to commercial companies. In recognition of these differences the Charity Commission set up a working party to help improve the quality of financial reporting by charities. As a result, an agreed Statement of Recommended Practice (SORP) for charity accounts was developed. This is subject to annual review, so organisations should consult the Charity Commission website to ensure they are up to date. SORP forms the basis of the accounting regulations prescribed in the 1993 Charities Act. Even for charities formed as companies, or indeed for VCOs not registered as charities, its application is best practice for performance reporting.

Charities having to comply with the SORP are required to provide not just financial data but also information about the achievements of the organisation. SORP 2005 and the Standard Information Return for larger registered charities are at the forefront of making charities explain not just their aims and objectives but also the strategies and activities they are following to achieve them. In essence if the charity does not have a strategy with measurable targets how can the charity know if it is achieving its objectives?

The Standard Information Return

Larger charities (£1million plus) also have to complete for the Charity Commission an expanded Standard Information Return. This, like the SORP, has a similar focus on objectives, activities and outcomes. Details are available from the Charity Commission.

Performance improvement

Performance reporting is still in its infancy in the voluntary sector. Various management consultancies and auditing firms have and are producing tools for their clients to assist with their reporting.

Organisations interested in finding out more about performance improvement systems, many of which relate to financial management, should consult the Performance Hub website. Details are available in the Resources section.

Tool – SORP information required in the annual report

Administrative details
Names of trustees, chief executive and other relevant persons and principal advisors, banks, accountant, solicitor etc.

Structure, governance and management
To enable the reader to understand how the charity is constituted, its organisational structure and to explain how charity trustees are recruited and new ones inducted.

Objectives and activities
Requires the charity to explain both what the aims and objectives are and what strategies it has in place to achieve the stated objectives. Significant activities during the year should also be reported relating to the type of charity activities, for example a grant making charity detailing its grant making policies.

Achievements and performance
Links to objectives and achievements. What the charity has achieved during the year should be reported and how it compared against the objectives that have been set. This section also asks for disclosure on fundraising or investment performance and to also comment on factors within and outside its control and which are relevant to the achievement of those objectives.

Financial review
As well as describing the charity's principal financial management policies this section should also include the reserves policy, principal funding sources and if investments are held whether any social, environmental or ethical considerations have been taken into account.

Plans for the future
This section links back to the aims and achievements section but for future periods and should set out key objectives for the future and what plans exist to achieve them. Note the link with on-going reporting – future plans become the following year report on what was achieved.

Summary – Financial management and governance

- End of year accounts or an annual report is a crucial tool for helping trustees to gauge the extent to which an organisation is on track.
- Annual reports allow VCOs to show how successfully they have achieved their objectives and critically evaluate what could be improved.
- 'SORP' stands for Statement of Recommended Practice.
- Charities having to comply with the SORP are required to provide not just financial data but also information about the structure and achievements of the organisation.

8

8 Where next?

The Tools contained within this guide are intended as a starting point to help organisations thinking about financial management. Further Tools will be available in the *Finance Hub Toolkit for Funding Advisors* due for publication early in 2007. The *Toolkit* will complement the information contained in the *Introductory Pack* guides to provide a working support pack of resources to enable VCOs and their advisors to work together in thinking through funding options.

For organisations in need of support a first point of call should be local agencies such as Councils for Voluntary Service (CVS); see Resources section for details, or, in the case of more complicated financial procedures, a qualified accountant. Advisors can assist groups by alerting them to training opportunities, whilst qualified accountants can help with setting up robust systems. Some accountancy offices may offer pro-bono support. Details of these can be obtained from Business in the Community as detailed in the Resources section. Advisors should also be able to signpost to specific support agencies and professional specialists. In addition, a number of useful resources including support agencies, publications and websites are included at the end of this guide.

Prior to meeting with an advisor or accountant, it may be useful for organisations to use some of the Tools included here and to have considered their current financial procedures. This will provide a starting point an advisor can build upon to ensure organisations get the most out of any advice session.

Key words and phrases

Accounting/book-keeping systems – the series of tasks and records of an organisation by which the transactions are processed as a means of maintaining financial records.

Annual report and accounts – a set of statements which may comprise the director's/trustees' report and the financial statements of the organisation.

Audit threshold – this is the threshold (which may include income, expenditure and asset limits) above which a charity will be required to have a statutory audit.

Budget – a quantitative statement, for a defined period of time, which may include planned income, expenses, assets, liabilities and cash flows. A budget provides a focus for the organisation and helps the coordination of activities and facilitates control.

Budget forecast – a prediction of future income and expenditure or receipts and payments for the purpose of preparing a budget.

Budget variances – the difference, for each expense or income element in a budget between the budgeted amount and the actual expense or income.

Controllable costs – a cost that can be influenced by the budget holder.

Current liabilities – liabilities that fall due for payment within one year.

Direct cost – expenditure that can be identified and specifically measured in respect of a relevant activity.

Financial procedures manual – a document outlining the key responsibilities of trustees, management and staff, and the controls in place to regulate financial activity.

Full cost recovery – funding, or 'recovering' the full costs of a project or service, where the full costs of a project or service equal the direct costs of the project or service plus a relevant share of overheads.

Governance – a function of trustee boards, concerned with the fulfilment of a VCO's strategic objectives.

Incremental budgeting – a method of budgeting that uses the previous period's results and inflates these by a fixed amount to account for increase in retail prices, for example.

Indirect costs – expenditure on labour, materials or services that cannot be identified with a specific activity.

Internal audit – an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The object of internal auditing is to help members of the organisation to discharge their responsibilities effectively.

Reserves – income available to be spent at the trustees' discretion in furtherance of the charity's objects but which is not yet spent, committed or designated; in other words, 'free' reserves.

Restricted fund – a fund subject to specific trusts within the objects of the charity (for example, by a letter from the donor at the time of the gift or by the terms of a public appeal). It may be a capital fund which cannot be spent but must be retained for the benefit of the charity; or it may be an income fund which must be spent on the specified purpose within a reasonable time.

Standard rate of VAT – the main rate of VAT (currently 17.5%) on the cost of goods or services.

Value Added Tax (VAT) – a tax collected by HM Customs & Excise (not the Inland Revenue) charged on supplies of goods and services.

Zero-based budgeting – a method of budgeting which requires each cost element to be specifically justified as though the activities to which the budget relates were being undertaken for the first time. Without approval, the budget allowance is zero.

Further support and resources

Financial management specific advice and support

Association of Charity Independent Examiners – website includes directory of independent examiners by region. See www.acie.org.uk

Business in the Community ProHelp – largest national provider of pro-bono (free) specialist support. See www.bitc.org.uk

Centre for Charity Effectiveness – runs various courses and consultancy, including courses in financial management. See www.centreforcharityeffectiveness.org

Charities Aid Foundation – provides specialist financial services, information and news for charities. See www.cafonline.org

Charity Commission – provides free guidance on all matters relating to improving charity financial management. See www.charity-commission.gov.uk

Charity Finance Directors Group – runs introductory courses and holds monthly meetings throughout the country on charity finance issues. See www.cfdg.org.uk

Community Accountancy Self Help (CASH) – excellent online service providing financial advice and training for small charities and VCOs. Includes useful factsheets covering key financial procedures. See www.cash-online.org.uk

Community Accounting Plus – offers a variety of training and support in all aspects of managing VCO finances. See www.communityaccounting.co.uk

Directory of Social Change – provides inexpensive short courses in charity finance. See www.dsc.org.uk

Institute of Chartered Accountants in England and Wales – can sometimes assist by providing members on a 'pro-bono' basis. Further details at www.icaew.co.uk

NCVO Financial Management Network – network and website providing support and information for finance staff and treasurers. See www.ncvo-vol.org.uk/fm

Publications

Copeman, C et al (2004) *Tools for Tomorrow – A practical guide to strategic planning for voluntary organisations*. NCVO. London.

Elliot, G (2005) *VAT for Voluntary Organisations: A step-by-step guide*. NCVO. London.

Full Cost Recovery: A guide and toolkit on cost allocation (2005). New Philanthropy Capital and ACEVO. London. Includes a cost allocation template to help VCOs calculate the full costs of their projects and services in an easy step-by-step process. Available in hard-copy or as an interactive CD-Rom from www.acevo.org.uk

Palmer, P with F. Young and N. Finlayson *(2005) The Good Financial Management Guide.* NCVO. London.

Charity Finance Magazine and *Charity Governance* – two monthly journals that contain informative articles on charity finance. Further details at www.charityfinance.co.uk and www.charitygovernance.co.uk

General voluntary and community sector support

www.ncvo-vol.org.uk	NCVO (National Council for Voluntary Organisations)
www.bteg.co.uk	Black Training and Enterprise Group
www.acre.org.uk	Action for Communities in Rural England
www.navca.org.uk	NAVCA (National Association of Voluntary and Community Action)
www.guidestar.org.uk	Guidestar
www.charityfacts.org	Charity Facts
www.charity-commission.gov.uk	Charity Commission

ChangeUp Hubs of expertise

Finance Hub

The Finance Hub is delivering to the Government's ChangeUp programme to create VCOs which are effective and independent because they are financially sustainable. Further details and resources available at www.financehub.org.uk

Governance Hub

The Governance Hub aims to improve the quality of governance of VCOs in England at national, regional and local level. It offers a wide range of services and resources to chairs, trustees and boards that are inspirational and useful to help them in effectively leading and developing their organisations. Further details and resources available at www.governancehub.org.uk

ICT Hub

The ICT Hub aims to improve VCS information and communications technology infrastructure so that VCOs are enabled to achieve their missions more efficiently and effectively through the better use of ICT. It provides ICT guidance, good practice, advice and support accessible at a local level. Further details and resources available at www.icthub.org.uk

Performance Hub

The Performance Hub aims to bring together in one place the wealth of experience and expertise in performance improvement that already exists, and make this expertise far more accessible to VCOs. It also helps local, sub-regional, regional, and national infrastructure improve the quality and quantity of the support they can offer to VCOs and works with funders and policy-makers to improve the environment within which VCOs operate. Further details and resources available at www.performancehub.org.uk

Volunteering Hub

The Volunteering Hub works to achieve a leaner, effectively marketed and high-quality volunteering infrastructure reaching, recruiting and placing a greater number and diversity of individuals coupled with improved volunteer management. Further details and resources available at www.volunteering.org.uk/aboutus/volunteeringhub

Workforce Hub

The UK Workforce Hub helps VCOs recruit, retain and develop the staff, volunteers and trustees they need. It works in four main areas: learning and skills, human resources and good employment practice, leadership and working and volunteering in the voluntary sector. Further details and resources available at www.ukworkforcehub.org.uk

Additional support

Councils for voluntary service and other support agencies

The NAVCA website can help with locating local CVS. Available at www.navca.org.uk

CIB/fit4funding

fit4funding (The Charities Information Bureau) provides training, information and consultancy on every aspect of the funding process – from giving grants, accessing and managing funds, to giving funding advice. A Finance Hub commissioned programme of training designed for funding advisors and delivered by partners (fit4funding, SYFAB, CA Hants, FINE, Engage East Midlands and NAVCA) throughout the country will be launched in 2006. Further details available at www.fit4funding.org.uk

Strategic planning

NCVO's Third Sector Foresight project helps VCOs to plan effectively for the future by providing information on trends affecting the sector and planning guidance to deal with these. The project's annual publication, The Voluntary Sector Strategic Analysis, is a useful tool for future planning and decision-making. For more information, visit www.ncvo-vol.org.uk/3sf

Sustainable Funding

NCVO's Sustainable Funding Project works to encourage and enable VCOs to explore and exploit a range of funding and financing options. Further case studies illustrating how VCOs have pursued income diversification and other resources providing ideas, information and inspiration available at the Sustainable Funding Project website www.ncvo-vol.org.uk/sfp

To register for the Sustainable Funding e-newsletter – delivered free via email each month – email sfp@ncvo-vol.org.uk and ask to join the mailing list.

NCVO's Sustainable Funding Project encourages and enables voluntary and community organisations to explore and exploit a full range of funding and financing options to develop a sustainable funding mix.

The Sustainable Funding Project
funding in the round
Website: www.ncvo-vol.org.uk/sfp
Tel: 020 7520 2519
Email: sfp@ncvo-vol.org.uk

The Finance Hub is delivering to the Government's ChangeUp programme to create voluntary and community organisations which are effective and independent because they are financially sustainable.

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