Triodos Bank

Balancing Risk

A GUIDE FOR TRUSTEES AND MANAGERS IN CHARITIES AND SOCIAL ENTERPRISES ON MAKING MAJOR DECISIONS INVOLVING RISK

Acknowledgements

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Introduction

We all make decisions about risk everyday. These may be very simple, like whether to park on a double yellow line or run across the road in front of a bus. Or they could be more complex, such as resigning from a job to return to studying with a future goal in mind. Life is full of decisions and many of them contain elements of uncertainty.

For an individual, decisions involving risks may be made based on past experiences or advice from friends and family. A decision about crossing the road could be instantaneous, based on what you see at that split second. But some decisions may involve taking time to gather information and attempting to balance the positives and negatives.

For organisations, risk decisions tend to be of the complex variety. The decision may affect current activities or future ones. Generally more than one person makes the decision and so different people's views must be sought, perhaps at different levels of the organisation. These views are then presented and discussed before a final decision is reached.

This publication is to help people make risk-based decisions within charities, social enterprises and voluntary and community groups. It suggests ways which may help provide a structure to the decision-making process, and for presenting this information in a way that makes decision-making easier. It also offers a range of tools to assess financial risk, illustrated by a case study.

Balancing risk

To make good decisions, you need to understand both the benefits and risks associated with a proposed course of action, either of which could have unforeseen consequences. A good decision-making model will help ensure you gather all relevant information before you make the decision, but also acknowledges that there are a range of possible outcomes. As it is impossible to predict exactly what might happen, the decision-making model may help equip your organisation to prepare for the range of possible outcomes.

A risk can be defined as any uncertainty which has the potential to prevent you reaching your goal, or which can enhance or inhibit performance. However, managing risk can also mean taking appropriate risks to achieve your objectives, and so should be about identifying opportunities as well as negative risks.

It's good to develop a method of ranking risks by likelihood and impact. For example, one person might score a risk as unlikely (such as a planned event being affected by rain), whereas another person may perceive this risk as highly likely. You can then rank risks by a further measure - attitude - drawing out people's perceptions about a particular risk (for example, how do they think the event's success will be affected if it does rain). This process can be very useful in showing the different perceptions of risk. Making this a collective exercise will focus the organisation's attention and help it come to a reasonable consensus about the level and types of risks it is prepared to accept - or what we call risk appetite.

Taking a structured approach is likely to improve the quality of decision-making. Most charities and social enterprises may have a consensus-based approach, and want to make decisions the whole organisation can accept. However, on occasions, this can conflict with the need for certain individuals to show leadership at crucial times.

The use of Edward de Bono's 'Thinking Hats' can be helpful here. Instead of trying to rush a decision, this allows the organisation to look at a possible course of action from many points of view before a decision is required. The method is simple – one hat at a time, everyone applies a particular 'hat' to the issue being discussed and thinks in the same direction. The six hats of different colours represent every basic type of thinking:

White	Used to identify available or missing information.
Red	Provides the opportunity to air feelings, intuition or emotion about a proposal.
Black	Focus on risks and why something may not work. A cautious approach, but needs to be balanced against the other colours.
Green	Positive, forward-thinking and requires everyone to be creative. You should be thinking about new ideas, alternatives or modifications and variations for the proposal.
Blue	Process of the decision itself, so it should be used at the beginning of a discussion to define what we need to think about, and in which order.
Yellow	Used to make a direct effort to identify the benefits of a proposal.

Decision-making by organisations is improved significantly when there are a range of possible solutions to choose from. The financial risk management tools described later in this guide are best used when comparing one proposed course of action to another. Decision-makers need to understand what they are saying no to, as well as the decision to go ahead, so all the options considered should be made explicit.

In addition, the decision to go ahead with something always means you may be closing the door to other opportunities. For example, you may decide to develop a new training course, which should generate revenue from fees. However, you will use some cash initially to develop the course. As you can't use this cash for anything else, it is known as the 'opportunity cost' of the activity, and you can compare this cost to the cost of alternative proposals or activities neglected. A proposal that requires a lot of money will prevent or delay other activities and so represents a greater risk to the organisation.

Tools for assessing financial risk

IF YOU ARE CONSIDERING A MAJOR NEW VENTURE OR EXPANSION OF YOUR CURRENT ACTIVITIES, FINANCIAL DATA WILL HELP YOU MAKE GOOD DECISIONS. HOWEVER, NONE OF US HAS A CRYSTAL BALL SO OUR PREDICTIONS ABOUT THE FUTURE MAY NOT BE RELIABLE. THE TOOLS DESCRIBED HERE WILL HELP YOU TO FOCUS ON THE RISKS ASSOCIATED WITH SOME OF YOUR FORECASTS AND QUANTIFY THE UNCERTAINTY INHERENT IN ANY FORECASTS.

UNDERSTANDING YOUR COST STRUCTURE

Looking at existing and planned activities, you need to identify the fixed costs. These will often be the costs of the premises and administration. The term fixed doesn't necessarily mean these costs will not go up, it refers to the fact they do not increase in proportion to the level of activity. So for example, if you operate a community centre, the number of different activities you run will not make a difference to the cost of rent and insurance.

It is difficult to reduce your fixed costs in the short-term so you need to ensure that you have covered these costs simply to break even.

The costs of activities are known as variable costs because you only incur them if you run the activity. You would immediately be able to cut costs if you ceased the activity. These are also called the direct costs of an activity.

The income for an activity, such as fees or grants, has to cover the direct costs of the activity as well as contribute towards the fixed costs of the organisation. So we call the surplus income after you have covered direct costs the contribution. This is a familiar concept to organisations that have studied full cost recovery. However, the full cost recovery model shows you how to recover your overhead costs in a stable environment. We will now go on to consider the right approach for organisations considering major change.

Because of issues around customer confidentiality, and to illustrate these issues fully, we have created the following hypothetical case study.

CASE STUDY

The Women's Health Collective (WHC) has existed for many years, providing advice and counselling to individual women. During that time, they have built up a significant amount of knowledge, but not very much in financial reserves.

They charge a small amount for individual and group counselling sessions, inviting donations, but never turning anyone away if they cannot afford to pay. Fundraising has always made up the balance, but their existence has always been rather precarious. For many years they have been occupying premises rent-free due to a generous benefactor.

WHC has low fixed costs because of the rent-free property, their only fixed costs being running the premises and the administrator's salary. All other staff work freelance so are part of the direct costs of activities.

BREAK EVEN ANALYSIS

We can use our understanding about our cost structure to help us understand the level of risk of a venture. Break even point is reached when the contribution is equal to the fixed costs (i.e. where total income equals total costs). We can use this concept for an activity or for a whole organisation. If we are considering a new venture, then it will help us to understand the point at which it will break even. And we can convert the financial information into the number of units that need to be sold, or the number of training places we need to fill. We use our judgement and experience to assess whether this point is likely to be difficult to achieve and so it informs us about the risk profile of a proposed activity.

CASE STUDY

WHC wants to publish a book on women's health issues. They think they can get a grant from a charitable trust to cover the design and print costs of about £12,000, but they will have to pay fees of £5,000 for a freelance writer and an editor. They plan to spend £1,000 on the book launch. The cover price will be £19.95 and they will print 5,000 initially. They will offer discounts to wholesalers and bookshops of 33% of cover price and they estimate that 50% will be sold through these channels.

All the costs are fixed costs for this activity as you have to commit to the expenditure early:

Writing and editing	£5,000
Design and print	£12,000
Publicity	£1,000
Total fixed costs	**£18,000**

For the sales to the trade, the sales price will be £13.37, so with half the books being sold at this price, we need to use an average sales price of £16.66. The break even point is calculated by dividing the total fixed costs by the average sales price (£18,000/£16.66). This number is 1,080.43. This means that (technically) WHC needs to sell 1,081 books to break even.

However, the grant to fund the design and print reduces fixed costs to just £6,000 and so the breakeven point is 361 books (£6,000/£16.66).

BREAK POINT

There is an inherent assumption in break even analysis that additional activity can be taken on within the same level of fixed costs. But obviously you will only be able to expand so far on this basis, as you will run out of space in your premises, or admin staff will be over-stretched. So you may need to move to new premises or hire more staff. Usually this means a significant and sharp increase in costs – a step increase. The point where this step increase is needed is called break point.

Using break even analysis, we can also see that an increase in an organisation's fixed costs means it needs to have a matching increase in contribution from activities. This is where you may face a mis-match – the fixed costs are usually a step increase, whereas contribution from activities is a gradual increase over a period of time. So an organisation faces significant risks at this point and needs to consider these carefully before making a decision to go past break point.

CASE STUDY

WHC now faces major change. The benefactor who provided the rent-free premises has recently died and the property will be sold. WHC has to either buy the property or rent somewhere else. This will be a step increase in fixed costs and the income they currently receive will not generate enough contribution to cover the new fixed costs.

WHC will have to consider new activities and new ways of generating income in order to survive. However, in doing so they must remember that they need to generate contribution, so the new activities need to be profitable.

PAYBACK PERIOD

There is also a cash flow aspect to breaking even – this is best understood by looking at the payback period for a project or activity. All activities require some time invested at the outset, and sometimes cash is required as well. We focus here on the cash invested, but you would include staff time and effort if it required additional staffing or effort diverted away from another activity which would generate funds.

The payback period is the time needed to repay the initial investment. You can work it out by preparing a cash flow forecast for the activity, based on your understanding of the timing of events.

A new activity will have a higher risk profile if it takes longer to pay back. A long payback period means that there is more time for other changes to occur and disrupt your plans. For example, a competitor may launch a similar product, the legislation may change making your activity irrelevant, or technology may develop to make achieving the same outcome easier.

CASE STUDY

WHC would like to run a small café so there is an informal space for women to meet. Also, they think it should be possible to make profits from the café if they find the right location. Talking to another group, they found that fitting out and equipping a café and kitchen amounts to approximately £30,000. They would need to employ an experienced manager and two assistants, which they estimate would amount to approximately £1,350 per week, including national insurance.

They would need to buy initial stock costing approximately £8,000 and thereafter re-stock regularly in line with sales. The mark up on food and beverages is usually about 100% for food you prepare rather than buy in.

They estimate that takings will start slowly at only £1,000 a week, but then increase by about 20% a week until they settle at about £6,000 a week.

If we assume that the £30,000 fitting out cost can be treated as part of the investment in the premises, then the payback period is 16 weeks.

However, we should really consider the fitting out costs as part of the initial costs and so then the pre-trading costs are £38,000 and the payback period is longer at 35 weeks (the added time it takes for takings less costs to bring the balance to a positive figure).

	Takings £	Costs £	Staff costs £	Balance £
Pre-trading		8,000	1,350	-9,350
Week 1	1,000	500	1,350	-10,200
Week 2	1,200	600	1,350	-10,950
Week 3	1,440	720	1,350	-11,580
Week 4	1,728	864	1,350	-12,066
Week 5	2,074	1,037	1,350	-12,379
Week 6	2,488	1,244	1,350	-12,485
Week 7	2,986	1,493	1,350	-12,342
Week 8	3,583	1,792	1,350	-11,900
Week 9	4,300	2,150	1,350	-11,101
Week 10	5,160	2,580	1,350	-9,871
Week 11	6,192	3,096	1,350	-8,125
Week 12	6,000	3,000	1,350	-6,475
Week 13	6,000	3,000	1,350	-4,825
Week 14	6,000	3,000	1,350	-3,175
Week 15	6,000	3,000	1,350	-1,525
Week 16	6,000	3,000	1,350	125

SENSITIVITY ANALYSIS

You undertake this after you have prepared your draft financial plans, to test the validity of the assumptions you have made and to highlight the key risks. Its main focus is the financial impact of risks.

To do it you ask the most uncertain areas of your financial plan a series of "what if...?" questions. For example, it can be very difficult to estimate how many users you will have for a new service or how long it may take it to become established. You must have made assumptions about these areas of uncertainty when you prepared the financial plans. Now you revisit those plans, varying the assumption. For example, what if the number of users for our new service are 10% less, or 20% less?

As a result of this exercise, you may decide to revise elements of the plan, but you will also have mapped some of the most important areas of risk and uncertainty. These will be the areas that you monitor most closely once the activity is up and running.

CASE STUDY

With their accumulated knowledge and skills, WHC think they should run training courses for professionals working in health and social service areas in the public sector as well as individuals in other charities and some private sector organisations. They have undertaken some market research and discovered that there are very few specialist courses of this type – most of their competitors run general courses that do not specifically address women's issues.

They plan ten one-day courses initially, two a month – each one has capacity for 20 people. They plan to charge £300 a place on each course. They would use their existing or new premises for the courses, so there are no additional costs for the room. They would need to make an initial investment in furniture and equipment, likely to amount to £3,000. They would provide refreshments and lunch within the price, and have received a quote to supply this at approximately £20 a head.

They will publicise the courses through their network, on their website and through free events listings in the relevant press. However, to gain initial interest, they think they need to post a brochure to all their contacts about three months before the first course. This is likely to cost £1,500. After this, they will use e-mail to remind contacts of the forthcoming events. They will use their own staff to lead the training, hence they are only planning to run ten courses. Any more than this and they would have to get in external trainers costing approximately £500 a day including travel expenses. They anticipate that they will receive a first wave of bookings for courses immediately after the brochure is mailed out – maybe 30 bookings for various courses, then 30 bookings a month.

Based on this WHC have prepared the outline financial plan.

Total income from 10 courses each with 20 people	£60,000
Variable costs – 200 @ £20	£4,000
Fixed costs – publicity	£1,500
Furniture and equipment	£3,000
Total costs	**£8,500**
Profit	**£51,500**

Some of the key questions to ask:

- What if they do not fill all the places on the courses?
- What if the organisations booking places do not pay at the time of booking, but wish to be invoiced and pay later?
- What if their premises are no longer available or the new premises do not have a training room?
- What if staff are unable to deliver the training and they do have to get in outside trainers?
- What about the opportunity costs of staff time taken up with devising and delivering courses?

Someone has suggested that they might be able to get a charitable trust to provide funds for a bursary scheme which could then be targeted at potential participants from smaller charities. This would be a way to manage some of the risk related to the number of places on the courses.

ON-GOING MONITORING

Having made changes to your fixed costs, these should then remain fairly stable. There is also often little change to many of the staff costs. There will be a number of areas of expenditure where monitoring will be less important because the level of expenditure is predictable and stable.

However, you should have a good understanding of the level of contribution your organisation needs to achieve to cover those fixed costs. And you will be able to convert that information into units in some way rather than a monetary target. So you will be able to set a target for the month or week and then monitor whether the organisation achieves that target.

Similarly, your work on the payback period will have highlighted when you should be able to expect income, so you would monitor progress against that plan.

The sensitivity analysis will have provided some good indications of the key areas to monitor - you need to focus your attention on the points where there is significant uncertainty. These will be the points where you should gather information about how well the organisation is performing. It will be much more helpful if you can do this at the earliest point by tracking 'lead' indicators. These are early signs in the life-cycle of an activity and you will be able to work out what these are if you track back through the phases of an activity and use your experience.

For example, if you run training courses, then you can track the bookings onto courses as your lead indicator. Waiting to see the management accounts that show the final outcome of income and expenditure on the course will only show you after the event how the organisation has performed. This is known as a 'lag' indicator. Lead indicators for your activities are more useful as you can use them to highlight potential problems and take action to improve the situation. So it may be worth spending a little more time and money on advertising the courses to increase the number of bookings.

CASE STUDY

WHC decided to move to new premises for which they were able to obtain a loan. They have much higher fixed costs as they have to pay interest on the loan in the first year, and then start repaying some of the capital as well in year two. They have taken on all three projects to generate more income, so they are running a café on the premises, running training courses and publishing a book.

An initial risk on the café project is that the fitting out costs will be higher than planned, so these will need to be monitored carefully and regularly during the building works. They should try to fix prices for the majority of works in advance to give them more certainty. Once the café is open, they need to manage the profitability. Key areas to monitor include:

- takings – actual cash taken in the till each week to see if they are breaking even
- cost of food and drink and the mark up being used
- level of stock held and wastage

The risk on the training courses is that they will not get enough people to attend, so the key indicator to monitor is the level of bookings. However, they can track back a little further to improve on this. Bookings will suffer if they do not get the information out to people on time, so the key activity to monitor is the marketing of the courses. They could create a plan to show when they should be e-mailing about certain courses, get courses listed and sending out brochures.

The risk on publishing the book is low once they secure the grant and establish the costs in advance. The biggest risk is that there will be a delay in the project, so they need to monitor the progress on the project to ensure that they do produce the book on time in order to satisfy the funder and have the book available for sale. Once produced, they will need to monitor the level of sales and where the sales are made, so that they can see the progress towards the breakeven target.

Presenting a business case for a decision

When an organisation faces a major decision, it is important that all the relevant information to enable the decision to be made is gathered together into a coherent business case. The format of a document setting out a business case can vary, but if the following components are present, it will form a good basis for a collective decision.

The findings of proper consultation or research will be valuable in supporting a decision that involves a long-term commitment or a significant change in direction for the organisation. You cannot expect decision-makers to simply back a hunch – they will need evidence to support your case. A good test is to consider the questions a sceptical friend might ask and try to answer these as you develop your business case. For example:

- What evidence do you have to suggest that there is a problem?
- How will what you propose address the problem?
- Have you tested your suggestion in a small way to see if your theory is valid?
- What will you do if beneficiaries or funders do not like your proposal?
- Have you checked whether they consider this to be an appropriate course of action?
- Do people support your idea?

Decision	What is the proposal?
Reason for decision	What change is needed? What is the problem you are trying to solve?
Benefits	Describe the main benefits anticipated from the change or decision. How will it contribute to the achievement of the strategic objectives?
Options	Set out the main options including the recommended solution – what are the pros and cons of each option?
Consultation	Who will this decision affect? What will be the impact on beneficiaries, staff, donors and others? Have you asked them about this decision or researched the effects on them?
Financial impact	How much initial funding will be required? What is the financial impact of this decision? How will it affect the longer-term finances of the organisation? Include summary financial forecasts, explaining the key assumptions you have made. You may include more detailed financial forecasts in the appendices.
Risk assessment	What are the risks involved? What are the consequences of them materialising? Do you have contingency plans to help you deal with these risks?
Plan	What is the timetable for any decisions and the major stages of this plan?

Conclusion

We all make decisions about risk everyday. But for organisations, how these decisions are made can be critical to long-term survival. They must ensure they have considered all risks that relate to a particular decision, including financial risks.

While risks can be a threat to an organisation, an appropriate level of risk may also create opportunities.

A structured approach to discussing and categorising risk, together with the appropriate tools to assess financial risk, will enable decision-makers to take an informed decision based on a coherent business case.

We hope that in this publication we have been able to suggest some tools and structures which will help with your decision-making.

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www.charity-commission.gov.uk

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