NPC

KEEPING ACCOUNT: A GUIDE TO CHARITY FINANCIAL ANALYSIS

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INTRODUCTION

Why financial analysis matters

New Philanthropy Capital (NPC) understands the challenges organisations face in getting the full costs of services, controlling cash flow, measuring performance, and managing and paying for staff and volunteers. But without proper allocation of resources, a charity's various activities will not operate well. Without visibility on income, it cannot plan existing activities or pilot new ones, and without money in the bank, it will soon struggle—though too much money in reserve might communicate that there is no need for new funding.

NPC is committed to helping charities become better at what they do based on our founding principle that more research into charities will enable the sector to improve.

Charities confront a hostile financial environment, with many facing increasing difficulty in bridging the gap between rising demand for their services and falling income levels. In addition, charity expenditure is perennially under the spotlight, with concern over administration costs and chief executive salaries adding to pressure. The growing social investment market potentially offers new sources of capital, but charities must be wary of the hype depicting social investment as a panacea for cuts in funding. Against this background, grasping the difference between different types of revenue, and understanding balance sheets and financial risk has never been more important.

In this report, we think about how charities should manage themselves and spend their resources, addressing issues such as:

- fluctuations in statutory income in a time of government cuts and changes in commissioning processes;
- difficulties of increasing voluntary donations generally and income from major donors in particular;
- the rise of new types of income: social investment and other forms of loan;
- whether levels of spending by charities on administration and fundraising matter;
- what level of reserves charities should ideally hold—especially in a period of slow growth;
- governance and the importance of constructive board involvement.

This report helps readers to understand a charity's financial position and the risks it encounters in the face of certain challenges.

The purpose of this report

NPC runs training courses for both funders and charities on how we analyse charities, using the methodology of *The little blue book*. This includes a section on financial analysis, which takes longer than the other sections and furrows the brows of participants. The variation in financial expertise is extreme: for some it is the first time they have seen a set of charity accounts. Other participants come with an accountancy qualification and ask forensically detailed questions about our analytical approach. And there are plenty in the middle who have seen accounts before but are unsure how to interrogate them.

This report is designed to give practical advice to all analysts, which makes the task necessarily unwieldy in places. Some readers will want to skip sections that are already familiar to them, such as how to read accounts.

Others will need to be taken through the accounts step by step so they feel confident they are looking at the right entry.

But regardless of level, this report articulates how NPC analyses the financial aspect of charities, and offers thoughts on where we think ratios and so forth should lie. It also aims to frame constructive debates within charities about what they need to do to maximise effectiveness, and highlight how funders should view the financial fitness of charities.

What the report covers

This report addresses in more detail the financial issues set out in NPC's *The little blue book* (see box below), which asks four key questions:

1. Is the charity financially sound?
2. Are there good processes for financial management?
3. Are financial resources used efficiently?
4. What are the unit costs of activities?

The report looks at each question in turn, including unit costs within the section on using resources efficiently. It explains how to look for answers in the accounts and calculate key ratios, and also consider risks.

Throughout the report we reference the current audited accounts of Place2Be to explain terms and calculations. Place2Be has been chosen because it is a charity that is focussed in one area—providing school-based mental health and emotional support services. As a result, the accounts are relatively straightforward for an analyst who is relying solely on published information.

The little blue book

The little blue book was published in 2010 as a guide to analysing charities. Its foreword begins, *'Doing analysis helps us to understand the world better. Applied to charities, analysis helps us understand what works and what does not, and how we can improve more people's lives.'*

The little blue book discusses six areas that NPC looks at when analysing charities: Activities, Results, Leadership, People and Resources, Finances, and Ambition. Each of these sections has four sub-sections, which are discussed by the analyst before he or she grades the overall area as Excellent, Good, Satisfactory or Below expectations. The guidelines for grading apply to all charities, from all sectors and of whatever size, and are set out in *The little blue book*'s grading grid.

The Finances section poses the four questions above, and a finance grading grid (on next page) is used to assess the charity. We remind analysts to consider the risks and whether management is managing them effectively:

- Has the organisation anticipated the main risks to its income?
- Does the organisation have good processes to manage its expenditure and control costs?
- Is the organisation's short-term cash flow secure, and does it have a means of meeting its liabilities?
- Are reserves adequate to protect against anticipated risks and take advantage of future opportunities?

GRADING GRID

Assessment criteria	Excellent	Good	Satisfactory	Below expectations
Financial security	Healthy and diverse financial base, getting stronger	Is well funded and stable, with fairly diverse income	Financially stable, but would benefit from additional funding or greater income diversity	Financial concerns
Quality of financial management	Uses voluntary or unrestricted income appropriately	Makes good use of voluntary income	Sometimes uses voluntary income to supplement statutory contracts	Uncertain about how voluntary donations used/poorly used
Efficiency and unit costs	Strong financial management demonstrated Boosts efficiency through detailed cost analysis/ efficiency targets Has excellent cost data	Internal cost controls and benchmarking processes Better than average cost data	Sound financial management, eg, internal cost controls but no efficiency improvement targets Has average comparative cost data	Weak financial management eg, few cost controls Unfavourable cost data
Risk analysis	Risk assessment takes place within each of the individual assessment criteria and is combined into an overall grade for the charity			

GETTING STARTED: INFORMATION YOU WILL NEED

Analysis relies on information: this is sometimes publicly available, such as charity accounts. Accounts provide a good overall view of the financial health of an organisation, and reveal any major risks, but only afford an historic and annual assessment. Depending on your relationship with the charity—if you are making a significant grant or are a trustee, for example—it may be reasonable to ask to see internal documents too. We ask to see a charity's budget for the current year and forecasts for the following year, as well as its management accounts. We examine these before meeting with the charity's finance director if it has one, or its chief executive if not, to try and get a handle on what drives the numbers and risks.

In this report, we identify the areas NPC looks at when analysing a charity's finances. This level of detail might not be appropriate for all, and you might want to prioritise certain areas above others. If you are planning a quick review of the charity's finances it is often sufficient to look only at publicly available documents. However, if you are planning a more detailed review—for a large grant, for example—you will probably need to dig deeper than this, and also have a conversation with the charity's finance director or chief executive.

The checklist below provides guidance on the documents required:

Availability	Documents	Quick review	Detailed analysis
Public documents	Charity report and accounts	✓	✓
Internal documents	Management accounts		✓
	Budget		✓
	Cash flow forecasts		✓
	Business plan or strategy documents		✓

We look at the charity's report and accounts for the past two years and, ideally, its most recent internal documents. These are not always available, especially for smaller charities, so it is important to keep a sense of proportion about what is required for the task at hand.

NPC had a conversation with Place2Be's Deputy Chief Executive, Catherine Roche, prior to writing this report. Place2Be also shared some internal reports with NPC.

Audited accounts

The report and accounts are the main statutory reporting mechanisms for charities and therefore an important component of the confidence that the public has in charities. The document comprises the trustees' annual report and the charity accounts. The charity's accounts include:

- the statement of financial activities ('SOFA') which shows income and spending;
- the balance sheet which shows assets and liabilities;
- the cash flow statement which shows the areas of the cash surplus or deficit for the year[1];
- notes to the accounts; and
- auditor's report or independent examiner's report.

NB: the SOFA includes all the resources available to the charity—even including capital such as new endowments and donated assets and services. This differs from commercial profit and loss accounts.[2]

Charity accounts alone cannot provide all the information required to understand a charity—its outputs, outcomes or impact, for example—so the trustee annual report provides additional information to explain these areas.[3]

The charity's audited report and accounts are available on the Charity Commission website, if based in England or Wales. The OSCR (Office of Scottish Charity Regulator) publishes basic financial information, but does not scan accounts onto a database. Instead, you are directed to ask the charity directly. In Northern Ireland, the regulator has not yet begun a registration of charities, so again you will need to ask the charity directly.

It is always worth checking the charity's own website as well in case a fuller version of the report and accounts is available, perhaps with an impact report or annual review accompanying it.

Although the most recent accounts will probably be at least six months old, these will have been audited and give an accurate picture of the charity at its most recent year end.[4] When analysing charities we primarily consider the effectiveness of their work. Their accounts tell a part of the story—how much this work costs, and whether the charity has the resources to do it properly. The SOFA (the statement of financial activities), balance sheet, and notes to the accounts show us what the charity's resources are, in terms of both income and people, and how it uses them—how many people are employed, at what cost, and for what activities. The accounts show the previous year as well as the year most recently audited, which gives an idea of the progression (or otherwise) of the charity over that period, and whether short-term needs are being balanced with longer-term strategy.

Audited accounts are, however, an imperfect tool for reviewing a charity's performance. A quirk to current accounting regulation means that grants are entered the year they are received, rather than the year the work is done, unless there is a performance-related condition attached to the grant. For instance, if NPC (year end 30 June) receives an upfront grant for six months of research on 1 June, it will appear in that year's accounts, when the bulk of the actual work will be undertaken the following year (ie, 1 July onwards). NPC assesses its own performance as work is done, not as income is received and this is reflected in the management accounts. Similarly, Place2Be receives a large amount of its annual income towards the end of the financial year for work

[1] Under current UK GAAP not all charities are required to produce cash flow statements.

[2] http://www.sayervincent.co.uk/Asp/uploadedFiles/File/Publications/MadeSimpleGuides/SORP_Made_Simple.pdf

[3] Charity accounting follows UK Generally Accepted Accounting Practice (GAAP) published by the Financial Reporting Council. There is a new UK GAAP, FRS (Financial Reporting Standard) 102, which comes into force in 2015.

The direction of travel in financial reporting is to reduce the reporting burden on smaller enterprises going forward. So under the new reporting framework organisations, including charities , below a threshold (income less than £6.5m, balance sheet less than £3.6m and fewer than 50 employees) are able to follow the FRSSE (Financial Reporting Standard for Smaller Entities). The FRSSE has a lot less onerous disclosure requirements than full UK GAAP and simplifies a lot of areas. A charity must choose under which standard – FRS 102 or FRSSE – it will be preparing accounts. Because financial reporting standards are written for companies as opposed to charities, best practice guidance has been produced on how to interpret these concepts and principles in a way that is suitable and meaningful for charities. This is the Charity Statement of Recommended Practice (SORP). Charities have to prepare accounts in accordance with the SORP. The SORP does not apply to charities preparing receipts and payment accounts, a choice available to those with annual income below £250,000. Currently there is a new SORP out for consultation which addresses the requirements under FRS102 and FRSSE separately.

[4] When an incorporated charity has annual income of less than £6,500,000, it can be exempt from an audit under the Companies Act 2006. Under the Charities Act 2006 the threshold is lower at £500,000. Incorporated charities must comply with both acts. Unincorporated charities only need comply with the Charities Act 2006. So charities with income above £500,000 must produce audited accounts and those with smaller income can have an independent examination.

which will be carried out in the following year. This is recorded as income on the SOFA although the work has not be done and offset by creating a creditor[5] on the balance sheet.

Internal documents

When a more detailed review of a charity's finances is required you will need to ask the charity for additional internal documents. These documents might include:

Management accounts

The management accounts show how the charity is progressing month by month, and will give a more accurate picture of real progress. For this reason, management accounts might differ from audited ones—a good finance manager will be able to explain the differences.

Budgets

Where possible, we ask to see the charity's budget for the next year (or more) to expand the financial picture further. It is helpful to compare the performance year to date against that budgeted. Again, the management should be able to explain any significant differences.

Cash flow forecasts

Cash flow forecasts may be useful for charities where reserves are tight or where income is received in arrears, instead of in advance. The latter has been a particular problem for smaller charities contracted to deliver services for the Work Programme. Due to the time lag in preparing annual accounts, the charity's internal forecasts offer a more reliable understanding of any cash flow issues the charity might face.

Business plan and/or strategy documents

Access to a business plan or strategy documents is particularly important if the charity plans to make significant changes that require additional resources. However, it is not always possible to see supplementary documents. Some charities do not have them because they are too small, new or lack the skills to produce them. Others may not want to share their plans, although this is unlikely if a funder requests them.

We often have to glean additional information from the accounts, which also reveal any risks to the charity: is it dependent on one income stream? Do its donors restrict their grants, or does the charity have unrestricted income? Does it have cash in the bank?

Financial accounts also give us clues about the abilities of management and trustees—do they balance income and spending, and maintain adequate reserves? Does this stimulate questions regarding the charity's leadership? For example, deficits running over a number of years leading to dwindling reserves might suggest poor cost control. Alternatively, it might reflect a conscious strategy to reduce reserves so that money accumulated in the past is not left idling in a bank account.

Talking to management

Where possible, we try to speak to the charity's management or trustees. This can be instructive: if the chief executive or finance officer cannot explain the finances clearly, then there might be a weakness in the organisation. At NPC, we always ask where challenges to the charity's finances lie and if they pose a risk to achieving its goals. We always ask for explanations of entries we do not understand: research analysts are not

[5] Creditors or liabilities are what the charity owes to others.

accountants, and even an experienced analyst will be baffled by badly-presented financial statements. We take particular care when accounts have not been audited[6], although most will be—and it goes without saying that the audit should not have been modified (previously termed 'qualified') by the auditor. Modified accounts indicate that the auditors doubt the picture presented of the charity's activities is true, complete and fair.

[6] See previous footnote

FINANCIAL SECURITY

Summary from *The little blue book*

Financial security refers to how predictable a charity's income and expenditure are, how strong its balance sheet is, and what its outlook for the future is. These factors affect its ability to continue its activities and plan for the medium and long term.

To determine the financial security of a charity, we need to look at its financial history, its current cash flow and its future projections. A key consideration is the charity's ability to manage fluctuations in income. Analysts should look at the following aspects:

- Recent track record: Has the charity been balancing income with expenditure? Does its track record match its ambitions?
- Diversity of income: Is the charity over-reliant on a small number of income sources?
- Risks to major income streams: How reliable is the charity's income? Which sources of income are most at risk and how does the charity plan to deal with this?
- Composition of income (restricted or unrestricted): Is all of the charity's income tied up in projects? How much room does it have to manoeuvre?
- Reserves: Does the charity have an appropriate level of cash to meet immediate financial commitments and provide some flexibility in case of unexpected events? Does the charity have a clear reserves policy that justifies the level of reserves?
- Short-term cash flow: Is the charity's income sufficient to meet its monthly obligations, such as rent and payroll? Will delays cause problems?
- Future liabilities and commitments: Can the charity meet its financial commitments? What debts does it have? Has the charity had any pension liabilities valued properly and taken proper advice?
- Investment policy: Does the charity have a sensible approach to managing its assets? Is risk managed by spreading investments?

Is the charity financially sound?

The reason we want to look at the charity's financial health is less to judge the charity than to understand the risks of making a donation, grant or social investment. It also helps to identify what management should focus on.

In the current financial climate, many good charities are struggling to remain on a solid financial footing. In some cases, supporting the charity might give it the necessary breathing space to recover its finances. However, a clear understanding of the risks surrounding its finances is essential to any decision on whether or not to fund. Some funders embrace risk, and would willingly take on a high-risk challenge; others are more risk-averse and prefer low-risk options.

A small charity we know well which was running a significant deficit, with no reserves, was able to persuade funders to continue their funding by sharing a robust and credible recovery plan. Almost all of the funders continued their commitments and some high risk new funders came in to support the charity, which did recover.

Past audited accounts often reveal trends that give an indication of the charity's future, by describing whether the charity has been prudently or recklessly managed, and whether it is growing steadily, stagnating or fluctuating wildly.

If available, access to the charity's budget or projections enables valuable insight into its future ambitions. If the current budget looks very different to the most recent accounts, it is right to question how an upwards step change is likely to be achieved, or why a significant down-sizing is expected.

To determine a charity's financial soundness, we ask four main questions:

1. Is income covering expenditure?
2. Where does the money come from: are income sources diverse? Are they at risk? Are they restricted or unrestricted?
3. Where does the money go?
4. Is there enough for a rainy day? How strong is the balance sheet?

1. Is income covering expenditure?

The charity's Statement of Financial Activities (SOFA) tells us whether the charity is in surplus or deficit at its most recent year end and in the previous year, which allows us to compare the two years and observe progress. If annual income covers annual expenditure the charity will produce a surplus. Looking even further back (ie, three years ago) will extend the analysis of the trend.

Surplus funds are usually a sign of a healthy charity. However, an enormous surplus can raise questions; for example, whether the charity's service provision can keep up with a successful fundraising team, or if income is stable but charitable activity has slowed over the year. Place2Be's SOFA in Figure 1 shows that income covers expenditure in 3/2012 but not in 3/2013 (1, 2). However, the deficit was only £291,000, about 4% income. Since Place2Be has significant reserves (3,4), shown as balances carried forward, this is not a current concern.

Figure 1: Place2Be statement of financial activities

STATEMENT OF FINANCIAL ACTIVITIES INCORPORATING AN INCOME & EXPENDITURE ACCOUNT - for the year ended 31 March 2013

	Note	Unrestricted Funds £'000	Restricted Funds £'000	Total Funds 31 March 2013 £'000	Total Funds 31 March 2012 £'000
INCOMING RESOURCES					
Incoming Resources from Generated Funds:					
Voluntary Income: Donations & Grants		1,328	1,125	**2,453**	*2,929*
Investment Income		75		**75**	*61*
Activities in Furtherance of Charity Objectives:					
School Services		96	4,760	**4,856**	*4,413*
TOTAL INCOMING RESOURCES	**13**	**1,499**	**5,885**	**7,384**	*7,403*
RESOURCES EXPENDED					
Charitable Activities:					
School Services	**15**	(986)	(6,186)	**(7,172)**	*(6,518)*
Cost of Generating Funds	**16**	(390)		**(390)**	*(348)*
Governance	**18**	(113)		**(113)**	*(89)*
TOTAL RESOURCES EXPENDED		**(1,489)**	**(6,186)**	**(7,675)** 2	*(6,955)* 1
NET INCOME / EXPENDITURE		**10**	**(301)**	**(291)**	*448*
Other recognised gains/losses					
Unrealised gain/(loss) on revaluation of investments		17		17	*1*
NET MOVEMENT IN FUNDS		**27**	**(301)**	**(274)**	*449*
Fund Balances Brought Forward at 1 April 2012		3,936	440	**4,376**	*3,927*
				4	3
FUND BALANCES CARRIED FORWARD at 31 MARCH 2013	**12**	**3,963**	**139**	**4,102**	*4,376*

A charity in deficit may not necessarily be 'bad'; but understanding the reasons for it, and, as far as possible, ascertaining the degree to which management is on top of the situation, will help to assess the real risk. A one-off deficit—a deliberate draw down of reserves or an unavoidable and unplanned reduction in income, for example—are both good reasons why a deficit may have occurred. A continuous deficit should raise questions as to financial management ability.

A recent example is Platform 51, a charity providing support to girls and women, where income has exceeded expenditure for the past five years. [7] The charity has intentionally used its reserves, which were generated from the sales of hostels, to fund the deficit and as of 3/2012 still had endowments valued at £19m. Despite this, the trustee board has decided that an annual deficit is not sustainable going forward and is undertaking a significant reorganisation. It is likely that the business model of the charity will change materially.[8]

As well as looking back, we also try to project forward by asking to see charities' management accounts (where available) and budgets for the current year, and discussing their expectations further out. We look for steadiness, predictability, and awareness of the risks to various income streams: growth, yes, but growth that is—as far as possible—managed.

Sudden growth—where a charity has received an unexpected legacy or a big grant for a new service, for example—can be difficult to manage. We saw a large legacy left to a small charity anonymously—£100,000, almost equal to the entire income for the previous year. Surely not a problem, then, but a piece of good fortune? In practice, the legacy was difficult to digest, distorting the charity's income for the year and swelling its reserves. This is something that can be off-putting to donors and particularly dangerous in a small charity if such one-offs mask a decline in regular income. In the end, the charity managed its fortunes wisely.

2 . Where does the money come from?

Charities receive money from a variety of sources which include public donations, grants and government contracts. NPC looks at a charity's income from several perspectives:

- How is the charity's income made up and how reliable are those income streams?
  - Is there a good mix of different types of income, or is the income dominated by one particular source?
  - How reliable is each different stream of income?
  - What are the trends in the income streams?
  - How important is statutory funding (found generally under 'income from charitable services')? How might policy changes affect this, eg, government cuts?
  - How much is 'generated' (eg, by the fundraising department in the form of grants, donations and events, or from investment in an endowment)?
  - How important are legacies?
- How much of the organisation's funding is restricted versus unrestricted?
- What contribution do gifts in kind make?
- Does the charity have a profitable income stream? What does it do (eg, runs a shop chain)? Could a profitable income stream be grown through social investment?

How is the charity's income made up and how reliable are those income stream?

There is no ideal combination of income—though in general terms, the broader the mix is, the less reliant the charity is on any one source of funding, and the less risk there is that it will not be able to carry out its work. However, fewer low-risk sources of income may be preferable to many high-risk sources of income, remembering that superficial analysis can be deceptive.

[7] http://platform51.org/

[8] http://www.civilsociety.co.uk/finance/news/content/11910/lack_of_funding_forces_closure_of_former_ywca_branches?topic=&print=1

For instance, a charity such as Place2Be receives much of its income from a number of different schools, and might therefore appear to have a nicely diversified mix of income. However, a change in government policy on school budgets may affect all schools, leading to a simultaneous funding cut across all customers. This risk is difficult to mitigate against, but for the time being Place2Be is benefiting from a change in policy as schools become more autonomous in their budgets and contract directly with the charity rather than through local authorities. This has the effect of reducing the charity's exposure to large single contracts and the risks associated with these.

Where charities have been very dominated by one source, such as a few local authority contracts, we have seen them suffer during the recent government cuts, Drops in statutory income of, say, 20% in a single year, as experienced by Family Action during 2011/21012, can be difficult to manage. Donations have also been under pressure in the current climate.

In explaining how to read accounts, you will see that income streams on the SOFA fall into three main constituent parts:[9]

- Incoming resources from generated funds
- Incoming resources from charitable activities
- Other income

These titles don't always seem particularly meaningful. So when analysing sources of income, the notes to the accounts can be more informative than the SOFA. The SOFA briefly identifies the type of funding in broad categories, rather than the source. These can be confusing, with grants (sometimes from government) mixed up with voluntary income, and with earned income (eg, from contracts) mainly falling under 'incoming resources from charitable activities', which seems a bit of a misnomer given that charities generally ask donors to give to fund charitable activities. Confused? We are, even after all these years, but the new SORP currently under consultation has suggested a reduced number of activity headings in an attempt to simplify the situation. So if the notes to the accounts are more helpful by splitting items out by funder or activity, then stick with those!

However, it's still useful to understand what the titles in the SOFA refer to. The incoming resources for Place2Be's SOFA are shown in Figure 2.

[9] The new SORP's suggested classification is donations; earned from charitable activities; earned from other activities; investment and other income.

Figure 2: Place2Be incoming resources

STATEMENT OF FINANCIAL ACTIVITIES INCORPORATING AN INCOME & EXPENDITURE ACCOUNT - for the year ended 31 March 2013

	Note	Unrestricted Funds	Restricted Funds	**Total Funds 31 March 2013**	*Total Funds 31 March 2012*
		£'000	£'000	**£'000**	*£'000*
INCOMING RESOURCES					
Incoming Resources from Generated Funds:				6	5
Voluntary Income: Donations & Grants		1,328	1,125	**2,453**	*2,929*
Investment Income		75		**75**	*61*
Activities in Furtherance of Charity Objectives:				8	7
School Services		96	4,760	**4,856**	*4,413*
TOTAL INCOMING RESOURCES	**13**	**1,499**	**5,885**	**7,384**	*7,403*

- **Incoming resources from generated funds (5, 6).** This generally includes voluntary income, consisting of donations and grants, and investment income, although this is identified separately. It may also include grants from government and government bodies. Place2Be's voluntary income has fallen from the previous year, a subject for discussion with the charity. Where restricted funding makes up the majority of voluntary income, charity income fluctuations may be more a result of the phasing of project expenditure. Where this is the case, it might be useful to ask the charity for longer-term forecasts and understand the financial position beyond the end of financial year.
- **Incoming resources from charitable activities or Activities in Furtherance of Charity Objectives (7, 8)**. This generally includes an organisation's statutory income, essentially, income from government contracts to provide statutory services. It may include other types of earned income that relate to goods and services sold in pursuit of charitable objectives. Statutory income is income that government is contracted to pay. So a grant from government might not show up in statutory income, as it won't be deemed 'statutory'. Instead it will show up in voluntary income. For Place2Be, the income from charitable activities comes from providing school services, which principally comes from schools and local authorities.
- **Other income.** This covers sundry items that cannot be classified elsewhere and will comprise the minority of incoming resources, the categorisation of which may vary.

Incoming resources from generated funds

Voluntary income is often the dominant stream within 'generated funds'; it accounted for just over a third of the sector's income in 2009/2010.[10] However, it is subject to the economic cycle—for example, Oxfam recently reported a drop in voluntary income of 16% for the year ending March 2013.

The voluntary income part of a charity's SOFA can cover a variety of different types of income: voluntary donations, including major donations and direct giving; capital appeals; legacies; grants; and community fundraising. The latter is a feature of larger charities, which have teams of volunteers grouped locally around the country, arranging local fundraisers and national events, such as Macmillan's Coffee Morning.

[10] Bass, P, Clark, J., Kane, D. and Wilding, K. (2012) The UK Civil Society Almanac 2012. NCVO.

Most voluntary income comes from the general public, and is unrestricted (ie, it can be spent on anything within the objects of the charity) and therefore very useful. **But direct giving** which represents almost a third of the overall amount given[11] in 2011/12 has fallen for UK charities. The annual survey, UK Giving, found in 2012 [12] that the total amount given to charity had dropped by 20% in real terms in the past year. Direct debit mandates are one of the easiest things to cut back on—and without the embarrassment of having to say no to a fundraiser or event organiser.

Many of the charities we see are looking to offset such fluctuations by the pursuit of major donors—philanthropists thought likely to donate large sums. Major donors do indeed exist, but are limited in number and even more limited in the time they have available, so that their pursuit and conversion can be a frustrating and time-consuming process. Larger charities have specialist fundraising teams for this purpose.

Capital appeals are another area to watch in times of difficulty: a new building that may have appealed to donors a few years ago might not appear so essential today. Analysts should also check whether such appeals are cannibalising the charity's ordinary fundraising activities by keeping a close eye on other income areas.

Another possible cause of 'lumpiness' in voluntary income from year to year is **income from legacies**. Many charities are not lucky enough to attract legacy income, and do not attempt to fundraise for it, but for those that do, this is a wonderful, albeit unpredictable source of unrestricted income. However, there are risks attached here too: even charities as big and as long-standing as Sue Ryder see major fluctuations in legacy income (in 2009/10 legacy income stood at £5.5m; in 2010/11, it rose to £7m only to fall again in 2011/12 to £5.3m). Such 'lumpiness' will be more problematic for smaller charities.

Grant income is another type of voluntary income.[13] For most charities, grant-makers are a mix of corporates, trusts and foundations, and individual grant-givers. Grant income, however supportive the funder, does carry risks, of which analysts must be aware. Some grants will be dependent upon achieving performance targets before disbursements are made. And recipients can become overly-dependent on grants—so pleased to be awarded one that they fail to anticipate its ending. A well-run charity will plan for the end of a grant at the start, and in the meantime, apply to other grant-makers for new funding.

The notes to the accounts will often break down the major grants that a charity has received, which is useful for working out how dependent it might be on one funder. However, the notes do not disclose how long the grant has been given; it is therefore impossible to work out from the accounts if this funding will continue at the same level the following year.

Activities for generating funds usually relate to events and trading, including shops. Trading can often see fluctuations in income, even where, in larger charities, there is a separate trading subsidiary gift-aiding its profits back each year to the parent charity. Analysts need to be cautious if charities are overly dependent on such income, and be ready to question charity's projections of revenues and the costs associated with attracting those revenues. Charity shops are an important source of income for larger charities and are discussed later.

Events, both conventional fundraisers and 'challenge events' abroad, carry clear risks—especially in a downturn and when the costs of putting them on are relatively high (NPC wrote a paper on this—*Just the ticket*—several years ago). [14] Analysts need to look carefully at the profit margin on events, and what else they might achieve (eg, awareness raising).

[11] UK Giving 2012 Summary of findings. November 2012. NCVO, CAF.

[12] UK Giving 2012 Summary of findings. November 2012. NCVO, CAF

[13] NPC analyses grants from the Big Lottery Fund separately. BLF grants are often significant in their size and term for recipients and managing the end of such a grant can be a challenge.

[14] Webber, D (2003) Just the ticket. NPC

Although not a large part of most charities' income, investment **income** is important to some long-established organisations either set up with endowments or with many years' accumulated reserves invested in externally-managed portfolios. Income from this source can go down as well as up and, with currently low returns on cash, some charities have had to make cuts to reflect the falling income from these portfolios.

Analysts should always be aware of this possibility, and should look to see how reliant a charity is on this source of income. An analyst can make a quick, back-of-the-envelope calculation to see the rough return (rough because the analyst will not be aware of the timing of investments and disinvestments over the year) achieved on the charity's cash and investments by its advisers.

Incoming resources from charitable activities

This mainly relates to **statutory funding** and is highly topical. Cuts in statutory funding are probably the biggest risks to charities' overall income at the moment. Around one third of UK voluntary sector income comes from the state: central government departments, local authorities, and health service commissioners. Although levels of statutory income vary greatly between charities, income from government contracts and grants is more important for organisations with income over £100,000.[15]

This information is disclosed in more detail in the notes to the accounts as shown below in note 13 for Place2Be (Figure 3). The charity receives over half its funding from government, local government (9) and schools (10).

Figure 3: Place2Be note 13: incoming resources by source

13 TOTAL INCOMING RESOURCES, BY SOURCE

	31 March 2013 £'000		*31 March 2012* £'000
Government and local government	1,648	9	1,688
Schools	3,223	10	2,850
Training excluding government grants	329		390
Companies and corporate trusts	827		987
Other trusts and charities	755		945
Corporate gifts in kind	114	11	50
Private donations and events sponsorship	413		432
Investment income	75		61
	7,384		7,403

The stability of statutory funding will be crucial to a charity's success if this is its main source of income. It is important to ask the questions: How secure are the service level agreements between the charity and the local authority or NHS? How onerous are the terms? Are there multiple commissioners, resulting in complex negotiation and monitoring? [16] Is the commissioning body itself stable (the transition from Primary Care Trusts to GP Clinical Commissioning Groups, for example, is causing plenty of headaches as service providers wonder who they should be talking to)? Is the funding on a payment by results basis, meaning that if the charity's service fails to succeed, some of the funding for it will be withheld? Does any of this income come from a central government pot which might be terminated? What would happen were the statutory funding to be cut, or to end? Would the service simply cease? Might it be transferred to another provider, or would the charity spend time and money trying to replace the funding from another source?

[15] Bass, P, Clark, J., Kane, D. and Wilding, K. (2012) The UK Civil Society Almanac 2012. NCVO.

[16] 'Commissioners' are constantly referred to in the public sector. Commissioners – eg, in health, social services, are responsible for buying services either from within the public sector or externally, from the private sector or charities.

All of these are key questions for a charity's management, and the greater the proportion of statutory income to the whole, the more key the questions.

Since we wrote *The little blue book*, we have a different perspective on the cost of contracts. Changes in commissioning practice have resulted in increasing burdens for charities funded in this way. Bilaterally negotiated Service Level Agreements are being replaced by competitively tendered contracts. Bids can be time-consuming to put together, with no guarantee of success. However, these costs are rarely identified in the accounts.

Sue Ryder is typical of a large charity contracted to carry out government functions—in this case, care of neurologically-impaired and palliative care patients—with 31% of its income coming from statutory sources (the NHS and local authorities) in 2012/2013. Sue Ryder has adapted to changes in statutory commissioning. It has been quick to react to a fast-changing environment: to cuts in local authority budgets; to the 'Personalisation Agenda' in social care (giving care users increasing control of their individual care budgets); and to the contracting out of some health services to private providers. The charity has been adapting on all fronts. For instance in 2010/2011 it successfully tendered for and won the bid to provide palliative care for an entire PCT: Berkshire West.

Some charities earn income from **non-statutory sources**—for example, fees for the provision of training, courses or consultancy. Income that is generated by consumer choice is attractive; it is less likely to be subject to the caprice of government policy. But it does require organisations to satisfy customers and provide a service that they want and is competitive. The increase in personal budgets for health and social care is an interesting opportunity here.

What contribution do gifts in kind make?

Gifts in kind are assets that are received rather than cash. This can take the form of goods donated to charity shops or goods for distribution—such as disaster relief supplies distributed by overseas aid charities. The value of the gifts in kind is included on the SOFA as the value to the charity of the gift received—usually the market price. This has no impact on cash flow and is offset by a similar amount in the expenditure line.

Donated services are also included in a similar way—but not volunteer time—for example, the time given by trainee counsellors for a mental health charity. Solace Woman's Aid records £69,120 of gifts in kind in the 2011/12 accounts for services provided by counselling students. Place2Be discloses corporate gifts in kind in note 13 (11) shown in Figure 3 on the previous page.

Although these are not cash, gifts can be a significant asset for a charity and important to consider when looking at the incoming resources for a charity. For example, a charity may be receiving free office space which if withdrawn will have a significant impact on its cost base.

How much of the funding is restricted versus unrestricted?

The mix of restricted and unrestricted funding is key to a charity's ability to manage itself. Many funders restrict grants to a specific project, activity or post—a restriction which is legally binding.

The extract from the SOFA for Place2Be in Figure 4 below shows that the majority of Place2Be's funding is restricted (12) compared to unrestricted (13). Place2Be manages this by taking care to price contracts to include some recovery of central costs and still has a healthy £1.5m of unrestricted income to contribute to core costs.

Figure 4: Place2Be incoming resources

	Note	Unrestricted Funds £'000	Restricted Funds £'000	**Total Funds 31 March 2013 £'000**	*Total Funds 31 March 2012 £'000*
INCOMING RESOURCES					
Incoming Resources from Generated Funds:					
				23	
Voluntary Income: Donations & Grants		1,328	1,125	2,453	*2,929*
Investment Income		75		75	*61*
Activities in Furtherance of Charity Objectives:					
School Services		96	4,760	4,856	*4,413*
			13	12	
TOTAL INCOMING RESOURCES	13	1,499	5,885	7,384	*7,403*

Unrestricted funding from funders and donors can be used for any purpose the charity chooses within its objects. Many charities use this to fund activities which donors might not find attractive. Others use it to fund pilot projects to provide evidence for funders. The charity might additionally designate such unrestricted funding to a particular activity, but the designation is not legally binding—and if necessary the charity can use the funds for other purposes.

If much of its income is restricted, the charity has less flexibility in allocating resources between projects and overheads. Many charities fail to recover the full cost of providing a service from the restricted funding stream allocated to it for a variety of reasons, and have to find extra unrestricted funding to contribute to these costs. NPC's report on *Full cost recovery*, published in 2004, discusses this issue in detail.[17]

We spoke to a charity that was unable to fund a chief executive's post because all of the projects were subject to restricted funding and did not cover the full cost of running the organisation (which should include a contribution to the chief executive's salary). Consequently, there were insufficient unrestricted funds to cover the running costs of the charity and it could not achieve its full potential.

Most recently a shortage of unrestricted income affected Merlin, the UK charity that sends medical experts to the frontline of global emergencies. The charity announced in July 2013 that it had been taken over by Save the Children which:

'…brought to light Merlin's growing struggle in recent years to generate enough unrestricted income to compete for funding from governments and international institutions.

International aid contracts nowadays increasingly require significant up-front funding to finance the bidding process and set up or maintain programmes in the period between signing an agreement and the arrival of funds. Such pre-financing has to come from unrestricted income, which is not tied to particular projects and can be used for any purpose.

Only about 10% of Merlin's income of £69m in 2011 and £61m last year was unrestricted.'[18]

The Third Sector, 30 July 2013

[17] Full cost recovery - can your organisation survive without it? (2004) NPC. ACEVO.

[18] http://www.thirdsector.co.uk/Governance/article/1193125/analysis-merlin-save-children/

Does the charity have a profitable income stream?

A profitable income stream is another valuable source of unrestricted funding. Charity shops are the obvious example, but charities might also run training programmes, cafés or even MOT centres, with mixed profitability. Sometimes such outlets provide employment for the charity's service users.

Several of the UK's larger charities have retail chains, which take in donated goods from the public and sell them on. Although most shops are run by paid managers, the rest of the staff are usually volunteers and this, plus the fact that the stock is often unpredictable, means that charity shops can be a tricky thing to manage. However, figures for the UK *Charity Shops Survey 2013* show that charity shop chains posted an overall rise in profits of 4% year on year.[19]

Well-run shops can contribute a good deal to a charity's income. Recent figures show that profit per shop per week was £909 for British Heart Foundation and £762 for Cancer Research UK.[20] At Sue Ryder, for example, shops are contributing a net £5.5m to the charity in 2012/2013, having enjoyed sales growth of 14% in the last year, but no improvement in the 13% margin. Shop income is unrestricted—just what charities want, plus shops can help with awareness-raising of the charity's work. Demos recently found that charities with a high street presence received a boost in support beyond retail sales.[21]

Analysts should check that shops are actually making a net contribution to the charity and what the trend in the margin is, not forgetting that the sales and costs of shops are shown gross on the SOFA—meaning that, as at Sue Ryder, a charity's income can look bigger than it actually is. The offsetting costs of the shops are shown under resources expended. By subtracting one figure from the other the profitability of the shops can be calculated.

Scope has taken the step of issuing a bond to expand its shop chain. It forecasts that the return it makes from shops will exceed the 2% cost of borrowing, and the move will secure an independent income stream in the long term. This is a good example of charities starting to use social investment to expand their operations. Social investment is the provision of loans to charities and other social enterprises with the aim of creating social impact, and sometimes generating a financial return. NPC has written about social investment from the charities' perspective in *Best to borrow*?[22]

[19] Charity Shops Survey 2013. Charity Finance.

[20]. Charity Shops Survey 2013. Charity Finance.

[21]http://www.demos.co.uk/press_releases/charityshopsencouraginganationofgiverssaysthinktank

[22] Rickey, B, Joy, I and Hedley, S (2011) Best to borrow? A charity guide to social investment. NPC

3. Where does the money go?

How much do charities spend on their core activities, and how is that spending progressing from year to year? This is shown under resources expended on the SOFA.

At Place2Be expenditure is rising year on year (14, 15) shown in Figure 5 below, consistent with the charity's growth strategy.

Figure 5: Place2Be resources expended

	Note	Unrestricted Funds £'000	Restricted Funds £'000	**Total Funds 31 March 2013 £'000**	*Total Funds 31 March 2012 £'000*	
RESOURCES EXPENDED						
Charitable Activities:						
School Services	**15**	(986)	(6,186)	**(7,172)**	*(6,518)*	
Cost of Generating Funds	**16**	(390)		**(390)**	*(348)*	
Governance	**18**	(113)		**(113** 15	*(89)*	14
TOTAL RESOURCES EXPENDED		**(1,489)**	**(6,186)**	**(7,675)**	*(6,955)*	

SORP 2005 requires charities to break out their expenditure into different activities between the cost of generating funds, charitable activities, governance and other costs. [23] The **costs of generating funds are** the costs associated with generating income from all sources except undertaking charitable activities. The **cost of charitable activities** is the expenditure related to the objects of the charity. **Governance costs** are related to running the charity, such as audit fees and trustee costs.

Being able to compare figures with those from previous years, helps analysts to understand what is happening at a charity, and where its priorities lie. Staff numbers, detailed in the notes to the accounts, should also be split between activities, enabling us to see where resources are allocated, and how that changes from year to year.

The reason we look at allocations is to see whether the charity's spending chimes with its strategy. For instance, is it continuing to fund activities that are less effective? Sue Ryder shows a sharp drop in home care spending, down from £11.6m in 2011 to £3.3m in 2013, in line with its strategy to cease bidding on home care contracts where the prices are too low to add value. Place2Be shows a 10% increase in spending on school services.

NPC pays close attention to how a charity uses its unrestricted income. Is it using it to subsidise a service that should be financed sustainably? Or is it using it to achieve social change through, say, service expansion or a public campaign?

Marie Curie Cancer Care's nursing and hospice service is only 50% funded by the NHS, but the annual report states that Marie Curie *'depends upon charitable donations to fund these with balance of funding received from the NHS'*—an important distinction consistent with the charity's mission suggesting that full cost recovery is not necessarily sought or required. [24]

[23] The new SORP under consultation also requires this but the number of headings has been reduced to cost of raising funds; expenditure on charitable activities; other expenditure.

[24] http://www.mariecurie.org.uk/Documents/WHO-WE-ARE/Reports/annual-report-accounts-2011-2012.pdf

Finally, what does the charity's track record over the past three years imply for its future? Is it likely that it can fulfil its ambitions? Should a charity wish to expand an area of activity significantly or to set up a new service, has it done so before? And if so, how successfully?

4. Is there enough for a rainy day?

Charity balance sheets

Underpinning a charity's financial security are the assets of the charity, and how these compare to its liabilities. To understand whether the charity has enough for a rainy day, the analyst must get to grips with the charity's balance sheet, and its constituent parts. The balance sheet underpins the day to day 'getting and spending' of a charity's operations. Understanding the cash flow is also a significant part in this process.

We look at the following:

a) Reserves: does the charity have enough in the bank for a rainy day? Are these sums restricted or unrestricted?

b) Assets: does the charity have other assets it can use?

c) Liabilities: what does the charity owe to creditors?

d) Cash flow: is there sufficient cash flow to meet obligations?

a) Reserves

Reserves are the funds held by the charity that can be spent on the charity's purpose. They are primarily held to protect the continuity of the charity's work if income falls. They are also held to provide capital for expansion or asset purchase. The trustee's annual report should include a reserves policy stating the level of reserves and why they are held.

There is no hard and fast rule on the level of reserves that a charity should have—it depends on the risks in the charity's business model and the potential use of the reserves. Having said this, many charities have a specific number in mind, either in absolute terms or relative to their monthly expenses.

Since publishing *The little blue book* in 2010, we have re-thought our position on reserves. We used to say that three to six months of monthly expenses were sufficient to have in reserve for the efficient running of an organisation. Anything more was inefficient. We now believe that in a period of low growth, and depending on the charity's activities and vulnerability of beneficiaries, a case can be made for more generous reserve-holding policies. However, charities should have a clear reserves policy that takes into account the future plans of the charity and the risks attached to the business model.

Calculating reserves

There are several ways to calculate reserves. NPC looks at the ratio of net current assets plus investments to the costs of running the organisation. This can be expressed as the number of months' worth of expenditure kept in reserve. Calculating reserves in this way gives a sense of how the organisation would manage in the event of an unexpected drop in income.

Basic reserves calculation

Current assets include cash, stock and debtors (including trade debtors).

Realisable investments are those not already included in current assets, such as shares in listed companies, bonds, or funds that can be quickly converted into cash. These are listed in fixed assets under investments.

Current liabilities include trade creditors, overdrafts and loans due within a year.

Average monthly expenditure is the total annual expenditure divided by 12. This includes operating costs, such as salaries, rent and utilities. Other deferrable costs, such as capital expenditure, should be considered separately.

To calculate reserves, NPC uses the following formula, taking figures from the charity's annual accounts:

$$\frac{\text{(current assets + realisable investments – current liabilities)}}{\text{average monthly expenditure}}$$

Using the above equation for Place2Be and the numbers in Figure 6 below the reserves cover is:

$$\frac{\text{current assets (16) 5390- current liabilities (17) 2124}}{\text{average monthly expenditure (15) 7675/12}} = 5.1 \text{ months}$$

Figure 6: Place2Be balance sheet

BALANCE SHEET AT 31 MARCH 2013

	Note	31 March 2013 £'000		*31 March 2012 £'000*
FIXED ASSETS				
Tangible Fixed Assets	5	2,077		*2,146*
CURRENT ASSETS				
Debtors	7	607		*271*
Current Asset Investments	8	196	22	179
Cash at Bank & in Hand	9	4,587		*4,248*
		5,390	16	*4,698*
Creditors - Amounts falling due within one year	10	(2,124)	17	*(1,154)*
NET CURRENT ASSETS		**3,266**		*3,544*
CREDITORS: Amounts falling due after more than one year	11	(1,241)		*(1,314)*
NET ASSETS		**4,102**		*4,376*

Free reserves calculation

An alternative, but related, way to calculate the reserves adequacy of a charity is to look at the break down of funds on the balance sheet and work out its 'free reserves' (as defined in the SORP). Free reserves are the unrestricted and undesignated funds available to a charity.

Free reserves normally exclude endowments and restricted funds specified by a donor, and any part of unrestricted funds that are not available for spending—ie, assets that are tied up, such as property. Designated funds should be included when calculating the charity's reserves unless they are earmarked for essential future spending, according to the Charity Commission's guidance in CC19.[1] The Charity Commission is wary of charities that designate funds in order to make their overall level of reserves seem lower.

The SORP requires a charity's reserves policy to explain the reason for the designation of material funds and the timing of when these might be spent. Remember: charities should use the funds they receive unless they have a good reason not to.

The starting point is to look at the total level of funds on the balance sheet and to take away any restricted funds, endowments or fixed assets. Designated funds are open for debate—depending on their use as mentioned above.

N.B. When the fixed assets have associated borrowings, the free reserves calculation removes the substantial asset but includes the borrowing, which can turn free reserves negative even though the working capital position of the charity remains unchanged. The reserves policy should draw attention to this but it serves as a reminder to always look at the form the reserves are in. If reserves are all tied up in debtors, or restricted to future projects, then this may affect the charity's ability to meet its short-term liabilities. It is prudent for charities to hold some unrestricted cash that can be used in an emergency.

NPC warns against looking at the reserves position in isolation. A charity should explain in its reserves policy the rationale for holding or targeting a particular level of reserves. This will differ from one charity to another. The analyst can use this information to check if the position is consistent with the policy and whether the policy makes sense from a business perspective. For example, a charity that receives a large amount of restricted income might have a large amount of restricted reserves—this should not be an issue. But a charity that relies on unrestricted income but has restricted reserves might find itself in breach of trust if it spends the restricted reserves on projects outside their restriction in the event of a shortfall in cash.

Figure 7 below shows the reserves split between restricted funds (18), unrestricted designated funds (19) and unrestricted charitable funds (20). Place2Be takes two pages in the notes to the accounts to explain the approach to reserves so the reader of the accounts receives a comprehensive picture of the reserves policy for the charity and its consistency with strategic objectives. The strategic plan includes the impact on the reserves under the different scenarios modelled in the charity's three year business plan.

Figure7: Place2Be accumulated funds

BALANCE SHEET AT 31 MARCH 2013

	Note	31 March 2013		31 March 2012
		£'000		£'000
NET ASSETS		4,102		4,376
Represented By:				
		£	18	£
Restricted Funds		139		440
Unrestricted Funds - Designated			19	
Property fund		1,061		1,061
Development & Strategic Priorities fund		589		589
Base fund		2,200	20	2,200
Unrestricted Charitable funds		113		86
TOTAL ACCUMULATED FUNDS		4,102		4,376

Marie Curie Cancer Care has put an actual figure on the level of free reserves that it is comfortable with in the 2011/12 report and accounts:

'In assessing the amount of reserves required to be held, the risk of a shortfall in income or an increase in cost is estimated and a sum held to cover the potential shortfall for each element of a charity's income and expenditure. The risk weightings range from 5% to 25% depending upon the nature of the activities.

Based on these calculations, the Council estimates that a total of £47.3million of free reserves is required. This represents four months of the charity's operating expenditure for 2012/2013. At £47.1million this is just below the target level.'[25]

NPC also looks at the committed income at the year end to assess the adequacy of reserves. A high level of committed income indicates that a lower level of reserves might be required[26]. As ever, it is important to understand the nature of the charity you are analysing in order to make a sensible judgement on the suitable level of reserves.

It is also important to understand the difference between cash and reserves. Reserves may be tied up in debtors and therefore not available to spend. So an analyst should look closely at the breakdown of assets on the balance sheet and check for hidden overdrafts and long-term deposits in the debtors and creditors notes (see later).

Charities with reserves representing less than three months' worth of spending are usually more risky than those with over a year's worth of reserves: should funding fall, it takes little time for the money to run out and the charity to fail. If a good proportion of those reserves are restricted, the situation is even riskier—as mentioned earlier; restricted donations can only be spent on the projects to which they were restricted. However, rough rules of thumb do not always apply. A very big, well-supported charity with three months' worth of reserves would not

[25]http://www.mariecurie.org.uk/Documents/WHO-WE-ARE/Reports/annual-report-accounts-2011-2012.pdf

[26] However committed income will only be available from management accounts.

concern us as much: funding flows can be more predictable than elsewhere in the sector, so that three months' worth represents sufficient security, and keeping more than that on the balance sheet could be seen as hoarding.

A year's worth of reserves is about the most we would want to see on a charity's balance sheet. There are exceptions to this rule: a capital appeal over several years to be spent on a large building; a one-off donation or legacy; or an historic endowment. The trustee's annual report should explain the reason for any significant build-up in reserves in the reserves policy. When reserves are well over the level of a year's spending, NPC and many funders we talk to want to know why.

Other than exceptional cases mentioned above, a heavy reserve position can denote a cautious management or trustee board, perhaps one that had a difficult experience in the past. Or it could mean the charity hoards cash because its activities are already well-funded and has no wish to expand them—sounds unlikely, but we have seen this in the past. Either way, giving to such a charity is less attractive to a donor than other possibilities: would you give £5 to a collector outside the station if you thought it would take a year or more to reach the beneficiary?

With a smaller charity we worry if reserves are at three months or below. One charity analysis client showing these levels in 2010 went into administration in 2011, despite good backing from some well-known foundations. Where reserves are this low, we begin to focus more attention on the charity's cash flow—literally, when money is coming in and when it is due to go out—to gauge its viability.

Where a charity has a pension fund deficit we may decide to subtract the whole of the deficit from the numerator of the reserves calculation. Pension liabilities are an issue for some charities in much the same way as they are for companies. In March 2013, merger talks between NAVCA and Community Matters collapsed over pension debts.

b) Assets

Assets are things that the charity owns and they are listed on the balance sheet. The balance sheet is only a snap shot at the year end and it is important to remember this when analysing accounts. On the balance sheet assets are split between current and fixed assets.

Current assets comprise stocks and work in progress, debtors, investment and cash in the bank. Those that are not cash are expected to turn into cash in the course of one year. It is important to monitor any significant change in these year on year.

Fixed assets are assets not consumed or sold within the normal course of business. They principally consist of intangible assets, fixed assets and investments. Intangible assets do not often occur on charity balance sheets, but fixed assets do and they are a valuable resource for a charity.

Charities may own **heritage assets** which are *'tangible assets with historical, artistic, scientific, technological, geophysical or environmental qualities that are held and maintained principally for their contribution to knowledge and culture.'*[27] Accounting for heritage assets differs from fixed assets and is outside the scope of this report. We would refer the interested reader to FRS 30.[28]

Fixed assets are often the property from which the charity operates and delivers its service, but they also include vehicles, fixtures and fittings. Most tangible fixed assets depreciate– ie, they wear out and require maintenance so it is important that the assets provide value for money. [29] A big building, such as a community centre, can provide additional income generating opportunities from renting out rooms, to running a community café or training

[27] http://www.frc.org.uk/getattachment/11989f89-363e-474e-abab-d54917239e28/FRS-30-Heritage-Assets-(June-2009).aspx

[28] http://www.frc.org.uk/getattachment/11989f89-363e-474e-abab-d54917239e28/FRS-30-Heritage-Assets-(June-2009).aspx

[29] A word on depreciation: like companies, charities must depreciate the value of their fixed assets over a period of time, to reflect the fact that they deteriorate. Whilst this applies to fixed assets, thus affecting that line of the balance sheet, the depreciation charge appears on the SOFA although it is not a cash charge.

programme. A conversation with management is the most effective way of judging their approach to asset utilisation. Place2Be's major asset is its office building. Catherine Roche, Deputy Chief Executive, explains the rationale behind its purchase:

'The trustees took the view, on advice, that a purchase was a better long term strategy for the organisation, than other options such as rental. Prior to this office space had been provided pro bono by BT and we'd simply outgrown this space. As a growing organisation, Place2Be required sufficient space to conduct its central activities, including interviewing of volunteers and the running of training courses for both staff as well as the public.'

Increasingly we find that charities are looking to maximise the use of their assets and also use them as collateral for borrowing against. However, the charity must ensure there is an income stream able to repay any borrowings if it considers doing this.

Place2Be's tangible fixed assets are in the form of property which cost £2.4m, against which there is a Futurebuilders loan outstanding of £1.24m. The loan is shown within creditors of more than one year (21) in note 19 in Figure 8 below.

Figure 8: Place2Be note 19: analysis of net assets between funds

ANALYSIS OF NET ASSETS BETWEEN FUNDS at 31 March 2013

	Unrestricted Funds £'000	Property Funds £'000	Restricted Funds £'000	**Total** £'000
Tangible Fixed Assets		2,077		**2,077**
Debtors	222		385	**607**
Current Asset Investments & Cash	3,073	347	1,363	**4,783**
Creditors Due Within 1 Year	(393)	(122)	(1,609)	**(2,124)**
Creditors Due After 1 Year		(1,241)		**(1,241)**
TOTAL FUNDS	2,902	1,061	139	**4,102**

21

24

Most charities have some cash on the balance sheet (accounted for in current assets); some also have **investments** (in fixed assets); a few also have endowments[30] (also in fixed assets). When these monies are significant sums, we always ask how they are managed—less to pass comment on the manager or the instrument, more to know that the management of this cash is properly considered, its risks spread, and that it is actively monitored.

Place2Be has £4.6m cash (22 in Figure 6) on the year end balance sheet; this reflects the annual billing cycle of the charity. The charity invoices annually in March, for services to be delivered through the following year. Therefore, the cash is drawn down throughout the year.

It can be instructive to check the return the charity's advisers are making on any investments. A rough and ready (there will be timing issues of which we are not aware) guide to doing this is to add cash and investments on the balance sheet together, and divide into the investment income shown on the SOFA. If the result is more than the

Jenkins, R. and Rogers, K. (2013) in For good and not for keeps. How long term charity investors approach spending on their charitable aims. Association of Charitable Foundations .classifies endowments into four types:1.permanent endowments, which are required by law to operate in perpetuity;2.expendable endowments, which are not technically obliged to exist in perpetuity but which may aim to preserve the value of the endowment for future generations;3.endowments that are spending out within a specific time frame; and4.foundations that take an open-ended approach to longevity, spending what seems appropriate in terms of mission without making preservation of the endowment a goal. [30]

current bank rate, then the advisers are doing fine (though we would hope without too much risk); much less and we would need to ask further questions.

The calculation for Place2Be uses the information from note 19 in Figure 8 and the investment income figure from the SOFA in Figure 4.

investment income (23) 75/ cash and investments (24) 4783 = 1.6%, which seems about right.

c) Liabilities

Simply put, liabilities or creditors shown on the balance sheet are what the charity owes to others. There are both short-term liabilities, which include creditors due within one year, and long-term liabilities. Figure 9 below shows that Place2Be has short-term liabilities (25) of £2,124 and long-term liabilities (26) of £1,241 as of 3/12.

Figure 9: Place2Be balance sheet

BALANCE SHEET AT 31 MARCH 2013

	Note	31 March 2013 £'000		31 March 2012 £'000
FIXED ASSETS				
Tangible Fixed Assets	5	2,077		2,146
CURRENT ASSETS				
Debtors	7	607		271
Current Asset Investments	8	196		179
Cash at Bank & in Hand	9	4,587		4,248
		5,390		4,698
Creditors - Amounts falling due within one year	10	(2,124)	25	(1,154)
NET CURRENT ASSETS		**3,266**		3,544
CREDITORS: Amounts falling due after more than one year	11	(1,241)	26	(1,314)
NET ASSETS		**4,102**		4,376

Short term liabilities are those settled in cash within one year. They tend to include loan repayments, tax and social security costs and advance income for services not yet delivered.

When present, the larger proportion of liabilities tends to be long-term. However, many charities do not have them at all, especially smaller charities.

Long-term liabilities include long-term loans or mortgages, pension commitments or, for some medical charities, grants awarded but not yet due for payment. [31] Look out especially for pension liabilities: these are an increasing headache for charities.

We expect to see long-term liabilities for charities of all sizes more often in the future. The current recognition of loan financing as a source of capital means that increasing numbers of charities will have long-term liabilities on their balance sheets. **Social investment** is increasing in popularity, with recent high profile deals including:

- Scope's £20m social investment programme, developed in partnership with Investing for Good; the initial tranche was invested in charity shops.
- Golden Lane Housing's (an affiliate of Mencap) bond to invest in better housing for its residents.
- The involvement of charities such as St Giles and St Mungo's in Social Impact Bonds.

Social investments that charities have accessed are most likely to appear as liabilities on the balance sheet because the principle behind social investment is that the investment is repaid. creating a future liability which is recorded on the balance sheet. Most often this will be a fixed term loan, possibly on preferential terms, or it may be a bond such as those listed above which also have a fixed term.

Funders making social investments will record the investment differently, guided by *CC14 Charities and Investment Matters: A guide for trustees,* which splits social investments between mixed motive and programme related investment. [32]

NPC has written on social investment from both a charity and funder perspective in *Best to borrow?* a guide for charities[33], and *Best to invest?,* a guide for funders.[34]

The business plan of the charity will show future commitments, including long-term liabilities and should explain how these commitments will be funded. This is also where a cash flow forecast comes into its own, especially if any liabilities require lump sum repayments which will require a significant build up in cash to enable timely repayment.

d) Cash flow

We probably look at charities' published cash flow statements less thoroughly than we should. This is partly because not all charities are obliged to produce them.[35]

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[31] The issue of pensions deficits only applies to charities supporting a final salary (or defined benefit, DB) scheme. In these schemes, the liability of charities is not capped because the charity is on the hook for paying retired employees a proportion of their salary until they die. (In defined contribution schemes, the liability of the charity is restricted to specific contributions made in each financial year.)

As a result of a number of factors (poor investment returns, increased longevity), many charities operating DB schemes have a shortfall between the assets held in the pension fund and the sum of their future liabilities. Charities with deficits need to have a plan in place to fund any deficit, or face sanctions from the pension's regulator. When analysing a charity operating a final salary scheme, consideration needs to be given to the plan to deal with any deficit. If there is a pension deficit, it does not absolutely mean the charity is in trouble—pension liabilities only crystallise as employees retire, and some charities have other reserves larger than the potential liability, which gives comfort. But an analyst should always ask whether there is a Funding Plan agreed between the charity and the trustees of the pension plan—there should be—and what it is (more than 10% a year is quite onerous). Furthermore the new accounting standards brought in this year mean that charities participating in certain defined benefit schemes will have to disclose the payment plans set up to pay off an overall deficit as a liability. This may make the charity appear insolvent on the balance sheet.

[32] http://www.charitycommission.gov.uk/publications/cc14.aspx

[33] Rickey, B, Joy, I and Hedley, S (2011) *Best to borrow?* A charity guide to social investment. NPC

[34] Rotheroe, A, Hedley, S., Lomax, P and Joy, I (2013) *Best to invest?* A funder's guide to social investment. NPC.

[35] Under FRS102 there is no exemption for small charities from preparing a cash flow statement, as is permitted under current UK GAAP. Therefore unless small charities follow the FRSSE they will have to prepare a cash flow statement.

The cash flow statement in Figure 10 on the following page for Place2Be shows that cash flow from operating activities rose year on year (27)—largely a result of an increase in creditors—which is not uncommon for a growing organisation. This is principally the advance income from schools and grant funders—ie, grants paid but where expenditure has not yet occurred. At year end 3/2013, Place2Be's advance income is £1,609,000 against £720,000 the previous year.

However, annual cash flow statements are of less interest than monthly cash flows included in charities' management accounts. This is where access to management accounts is most crucial. It is interesting, of course, to see the charity's forward budgeted income and expenditure, and how that impacts on its current balance sheet—but, in difficult times, management accounts are the only way to tell how a charity fares month to month.

The SOFA shows income and spending for the past year; the budget forecasts both for the current year; and the balance sheet records the charity's net worth. The management accounts show the reality of the current situation, for instance, how the charity is progressing against the budget; where the differences are and why; what cash is coming in month by month, and what the monthly obligations are—payroll, rent, and bills. They are the only place we can really see, for example, that even though a charity is due a grant in the current financial year, this might not arrive in time to meet shorter-term obligations.

In the absence of management accounts, NPC looks to trends in the creditor and debtor position on the balance sheet. A significant increase in either warrants further discussion. The debtor position (28) at Place2Be has doubled year on year despite a 10% increase in expenditure. The notes indicate that it is the trade debtor position that has doubled—so how is the charity handling this situation, is this a cause for concern?Place2Be explained that this is simply a consequence of the amount of business that concluded towards the end of the year. As the invoices were raised late in the year, settlement spanned the financial year end, indicating the shortcomings of the balance sheet as just a snapshot at a particular moment.

The frequency of charities having to actively manage short-term cash flows is increasing: as mentioned earlier, a charity analysis client of ours, although promised decent grants from well known grant-makers, simply lacked cash short-term and was closed by its trustees. The trend towards payment by results contracts places further strain on charities that often cannot afford to deliver a service and be paid in arrears. Charities that have pulled out of the Work Programme cite cash flow predictability as a major issue. Whilst NPC does agree that charities should measure their impact and make a difference in their work, financially, they are often less able than the prime contractor to bear the financial risk and manage differences in timing.

Figure 10: Place2Be cash flow statement

CASH FLOW STATEMENT
For the Year Ended 31 March 2013

	31 March 2013		*31 March 2012*
	£'000		*£'000*
	£		*£*
Net Incoming Resources for the Year	(274)		449
Interest Received	(75)		*(61)*
Depreciation Charges	69	28	*69*
(Increase) / Decrease in Debtors	(353)		*(118)*
Increase / (Decrease) in Creditors	970		*(377)*
Net Cash Inflow /(Outflow) from Operating Activities	**337**	27	***(38)***
Return on Investment and Servicing of Finance:			
Interest Received	75		*61*
Capital Expenditure and Financial Investment:			
Loan Capital Repayments	(73)		(71)
Net Cash Inflows / (Outflows) after Financing, and Increase / (Decrease) in Cash	**339**		***(48)***

FINANCIAL MANAGEMENT

Summary from *The little blue book*

Financial management refers to the ability of organisations to understand and control their income and expenditure, and balance day-to-day needs with long-term objectives.

Although all organisations need good financial management to underpin their activities, the quality does vary, partly depending on the size of the organisation. Small charities often lack the resources to pay someone with the expertise to manage them. In this case, the chief executive or someone senior in the management team should be familiar with the finances and be able to answer questions competently. A financially literate trustee can help, but it can be risky to rely on a trustee. In large charities, we expect a high standard of financial management.

To judge how well managed finances are, analysts can look at the following aspects:

- Published financial information (annual report and accounts): Are the accounts well presented, transparent, accurate, and not modified by auditors?
- Internal financial information: Does the charity have good internal financial information, produced in a timely manner, which can help management make rapid decisions and plan ahead? Management accounts should be well presented and show progress against the budget, so that the organisation can analyse differences and adapt if circumstances change.
- Procedures: Does the charity have clear and sensible procedures for approving expenditure and making payments, to safeguard from fraud or excess? Does it have a process for chasing invoices and managing debtors? Procedures should be clear but not over-bureaucratic, so as not to hold back innovation.
- Budgets, forecasts and cash flow: Is the charity able to look into the short to medium-term future? Do its projections for future income look realistic?

Are there good processes for financial management?

It is one thing to look at numbers on a page, quite another to weigh up the people who put them there and the processes those people use.

Assessing the financial management of a charity is more of an art than a science. It does become easier over time, as experience of discussions about finances builds, but there are early clues to look for even before meeting a finance director, chief executive or treasurer. These can be found in the charity's published accounts and internal financial information (such as management accounts, budget for the year and forecasts further out, often included in the business plan).

Published financial information

The trustees' annual report and audited accounts is the key to analysis of a charity's finances—this is the only objective, independently validated financial information available to the public.[36] Accounts are useful to an analyst more generally too: a well-presented trustees annual report gives us not only the financial picture of a charity, but also sets out its mission, provides an overview of the year's activities and what it has achieved, and a preview of its work and aims for the next year.

English and Welsh accounts can be found on the Charity Commission website from around six months after the charity's year end. Accounts filed close to or after the 10-month deadline might raise a red flag; however, some very large charities consistently file towards the end of the period. The quality of the information in the published accounts is more important than its presentation; the accounts should not be modified by their auditors and the trustees' report should link to the financial statements (SOFA and balance sheet). Here, check that both tell the same story. We assume the numbers are accurate, but the division of activities into different categories on the SOFA and in the trustees' report can be confusing.

Internal financial information: management accounts, budget

Gauging the quality of a charity's internal financial information is harder because it is not independently verified.

Unfortunately it is often difficult to access internal information: **management accounts** are most likely to be available, and these usually have the current year's budget attached, but forecasts further out and business plans are less common.

A charity without up to date management accounts will not be able to make timely or good decisions. Despite this obvious truth, NPC has come across many charities where timely and accurate information has not been prioritised. Monthly management accounts should track monthly and cumulative performance so that at the end of the year the management and board can assess whether targets have been met and if next year's budget has any relevance. One board we have spoken to did not have this information for over three months after year end and was unable to make informed decisions on resourcing for the next year. A clear understanding of current finances is essential for decision making.

Given the availability of useful accounting and book keeping packages, we expect most charities to be able to produce timely management information. Excuses as to why it's not possible to do this usually mask problems.

Cash flow, particularly in times of recession, is crucial to any business—charity or otherwise—and there have been several cases already of charities closing or merging due to cash flow difficulties. As explained in the previous chapter, cash flow is the first thing we look at in the management accounts.

The second thing we look at is the year's budget, and the charity's progress against it, both on income and spending, and how that affects its balance sheet (we often have to calculate the latter ourselves—very few management accounts look at the balance sheet position except at year end).

Budgets are notoriously difficult to make, and can never be more than a best guess, with variables in both income and spending swinging about—particularly in tough economic times. We do ask to see them, though, not to second-guess, but to get an idea of how the charity hopes to progress. If possible, we also like to see forecasts further out, although these are rare, and, where they do exist, are usually part of a business plan.

[36] Where an incorporated charity has annual income of less than £6,500,000, it can be exempt from an audit under the Companies Act 2006. Under the Charities Act 2006 the threshold is lower at £500,000. Incorporated charities must comply with both acts. Unincorporated charities only need comply with the Charities Act 2006. So charities with income above £500,000 must produce audited accounts and those with smaller income can have an independent examination.

We always add the budget—adjusted if we think that likely, but only after discussion with the charity—as the final column of the summarised financial statements in our analyses. Where possible, we add more columns for **forecasts for the years to come**—one of the drawbacks of published accounts is that they often only appear six months or more after year end, and will therefore always be slightly out of date.

Procedures

We can only discuss working practices with the staff involved. As in any business, efficiency and accuracy come from the top, so warning bells should sound if a finance director dismisses questions about procedure as mere detail.

Regular and simple financial procedures help guard against fraud: it is much less easy to be dishonest when there are clear, transparent procedures in place, and financial information is distributed to management and trustees alike. A charity may be able to refer you to its financial procedures manual as a starting point.

When Jodi Manning joined **Just for Kids Law** as Operations Director in 2010, her first move was to introduce simple procedures, such as buying in the SAGE accounting package and beginning to input financial data monthly and monitoring monies in and out. This enabled the timely production of management accounts. Jodi also instituted budgeting where before there was little.

The charity says that putting sound financial procedures in place has assisted the board and directors in making informed strategic decisions about the charity's finances. They are able to use the information in operational planning and review budgets on a regular basis. Ultimately, it has led to stronger governance of the charity and has increased its ability to successfully fundraise. Between May 2010 and May 2012 the charity's income has grown from £65,988 to £309,639.

An organisation that talks about internal cost controls and benchmarking processes is more likely to be on top of its spending than one that never mentions either. This includes reviewing contracts to procure services, thinking about assets and whether they are costing more than they benefit the charity and coming up with ways to avoid costs.

NPC covers efficiency in more detail in Section 3.

Governance

At NPC we have written on governance in our report, *Board Matters*, and with the support of The Clothworkers' Company have supported many trustee events. [37] Risk, financial issues, how to fundraise, social investment—all these topics are popular with trustees who rightly desire effective financial management.

The trustee's annual report includes the names of trustees and also the various governance committees that a charity has.

Over the years, we have noticed treasurers making a growing contribution. The difference a concerned and knowledgeable treasurer can make is marked, particularly if he or she is able to spend time with the charity; a token presence on the trustee board is not good enough.

Small charities may not employ a full-time finance director and others outsource to external service providers. In either situation, it is essential for the chief executive to have a good understanding of the finances and receive support from the trustee body. It is unwise to devolve this responsibility to one person, since the trustees are collectively responsible for any decisions made. Ideally, the treasurer leads discussions on finance and is the point of contact for the charity, but does not have sole responsibility for financial decisions. An understanding of

[37] Vernon, B and Stringer, E (2009) Board Matters. NPC.

the composition of the board, the financial knowledge and the input of the board is essential to form an opinion on governance.

The absence of any trustees with financial experience on the board can create problems. A charity's head of finance needs an effective opposite number among the trustees as a challenger, sounding board and provider of knowledgeable support. In one particular case, a head of finance had no financial support when questioning some of the wilder ideas of the chief executive. NPC does not have a treasurer, but it does have several trustees with strong financial backgrounds who are prepared to engage with financial issues.

The role of board committees

Some charities choose to set up committees to look at issues concerning finance. The trustee's annual report lists all the committees. Place2Be has five sub-committees, two of which relate to finance—finance and risk. Non-trustees may be co-opted onto the committees to provide additional expertise. These committees may have titles relating to their purpose:

- Audit committee: this is responsible for appointing auditors, overseeing the audit process, and reviewing the comments back from auditors.
- Investment committee: if a charity, such as an endowed foundation, holds large sums, an investment committee is responsible for managing the investments. It might appoint investment managers and review performance. It sets risk and return criteria when appointing managers, and makes recommendations on what level of programme expenditure is advisable.
- Financial management committee: a board may choose to have close oversight of the financial management of an organisation, and appoint a committee accordingly. A well-resourced management team may not need this, but they may seek it anyway.

EFFICIENCY AND UNIT COSTS

Summary from *The little blue book*

Efficiency refers to the ability to control costs and ensure that waste is kept to a minimum. Organisations must have a good understanding of their costs, their sources of expenditure, and how these are likely to fluctuate. Management should be able to justify its expenditure and point to efforts to improve efficiency, such as cost-reduction targets.

The culture of the organisation and attitude of the chief executive are key to efficiency. This is not about spending as little as possible on administration, fundraising or the salary of top management—charities have to invest in these functions to be effective. Analysts should look for evidence that they spend wisely and that waste is kept to a minimum, but be wary that underinvestment does not hold the charity back.

Administrative and fundraising costs

When analysing charities, it is tempting to look for simple measures of administrative efficiency, such as the proportion of income spent on overheads. But when it comes to judging how effective a charity is, such a measure can be misleading on its own.

Administrative cost is not a predictor of what a charity achieves. In fact, spending more on back-office staff can lead to improved results. For example, by employing more secretaries, the Disability Law Service, a charity that employs solicitors to give advice to disabled people, was able to relieve the burden of administration on the solicitors and serve more clients at a lower cost.

As well as being potentially misleading, administrative spend is not straightforward to interpret. Despite guidelines, charities use a variety of methods to report on administrative costs. For example, one charity might report the salary of an office manager as an administrative cost, while another might report it as a cost within its charitable activities. Without a detailed knowledge of a charity's expenditure, simple comparisons of costs can be misleading.

Fundraising costs raise similar issues. Some causes are inherently more popular with funders, and it is easier to raise money in some geographical areas than others. The costs of raising money tell us little about results achieved for beneficiaries, and we must be careful about making comparisons between charities.

It is therefore dangerous to use reported administrative or fundraising costs as the basis of any judgement of effectiveness. Analysts should ask themselves whether the charity is spending wisely on fundraising and administration, and if the ratio of spending to income is reasonable. Comparing the cost ratios of similar organisations may give a clue as to whether a charity is using its resources efficiently. However, simple financial indicators of a charity's operational efficiency should always be considered within the broader context of the charity's results.

NPC analysed a charity working overseas. We found that because the organisation managed its work from a very small head office in the UK, it was in fact under-resourced centrally, and struggled to oversee activities on the ground. This created inefficiencies, especially around planning and reporting, and NPC felt that increasing the capacity of the central team would have been a good investment.

Are financial resources used efficiently?

The first two sections of *The little blue book's* chapter on finances, financial security and financial management, flow through to the third—efficiency. This section includes resource allocation and unit costs.

Resource allocation

Looking at accounts and internal financial information, and talking to staff, should give us an idea of how efficiently finances are managed. Do the relevant people have a handle on likely income, likely expenditure, monthly cash flow, levels of reserves, and the risks to each of these? At the same time, do these people manage the bigger picture and allocate resources efficiently?

Resource allocation is one of the first things NPC analysts look at within a charity's expenditure. Of course, charity leaderships have always had to decide where best to allocate resources—something we spoke of in the section on expenditure on the SOFA. But in straitened times, these decisions become harder, and we can now see the beginnings of a trend, which will surely grow, of closing down activities rather than stretching resources to bursting point. Whilst this can sometimes be a tragedy for the charity, and for the people it serves, it can sometimes create the opportunity for a strategic re-think.

One such example is the strategic disinvestment by **Sue Ryder** of its home-care activity. Home-care contracts—where Sue Ryder care workers visit people with long-term conditions in their homes, providing basic, practical care—are awarded by local authorities. Local authorities want both value for money and cheap provision of services. Spending cuts have forced service providers to lower their prices, to the point where Sue Ryder told us that competitors were bidding for contracts at prices that the charity could not match while providing decent care.

In addition to these pressures, Sue Ryder had for some time considered the make-up of its range of activities with a view to refocusing on specialist care for those at the end of life and with long-term conditions, especially neurological ones. So, the decision to divest its low-margin home-care work, when the opportunity arose, was consistent with its long-term strategy, even though some of the short-term ramifications were difficult.

Sue Ryder is also continually reviewing its property portfolio. The current management inherited many listed buildings attracting too much attention from bodies such as English Heritage, resulting in large bills for the maintenance of architecturally important roofs and guttering. This is an unwelcome distraction for a charity in the business of providing palliative and neurological care. So the intention is for costlier buildings to be sold off over time and the proceeds reinvested in modern, fit-for-purpose buildings that are less expensive to maintain using the savings to spend on care. Sue Ryder appointed an experienced Property Director several years ago which, according to the chief executive, saved the charity *'a lot of money'*.

Efficiency is not about cutting costs where doing so might compromise the charity's outcomes. This is obvious to most charities and observers alike as far as charitable expenditure is concerned. Where people differ is on non-charitable spending, specifically on management and administration, and on fundraising costs.

Management and administration costs

For a line of spending that attracts so much comment, management/administration/support costs are sometimes hard to determine. Since the implementation of the 2005 SORP, and the growing emphasis on full cost recovery, management/administration/support costs are mostly allocated between the charity's different charitable activities (and shown in the notes to the accounts). However, just how much is allocated, and where to, varies from charity to charity and there is no clear convention on how this should be presented.

This lack of consistency makes the popular trend for judging charities according to the proportion of income spent on overheads useless. So dispiriting is the public focus on items such as support costs, we know charities that

have legitimately stopped reporting on these, and now simply highlight the minimum of governance costs (to comply with SORP) in the notes to the accounts.

The implications are clear: overhead cost is not a predictor of what a charity can achieve. Management and administration costs are a necessary part of running a charity effectively. Analysis on charities from the United States comes to the clear conclusion that low administration costs do not signal that a charity is good: they signal the opposite.[38] Charities that trim these functions to the bone—often for the sake of a fundraising story—might struggle to run their operations smoothly, analyse their data, or plan for the future.

NPC came across a charity working in overseas development whose scrimping on central logistics, in our analysis, probably cost an additional £200,000 of waste in the field—simply because it couldn't track its equipment efficiently so had to double upon expensive vehicles etc. Its motivation was to avoid accusations of unnecessary administration cost.

As *The little blue book* says: *'…efficiency. This is not about spending as little as possible on administration, fundraising, or the salary of top management. Charities have to invest in these functions to be effective. Analysts should look for evidence that charities spend wisely and that waste is kept to a minimum, but be wary that underinvestment does not hold the charity back.'*

This is one of NPC's most enduring mantras and a topic we frequently write about.[39] Some charities perpetuate the myth by promoting in their marketing literature the proportion of a donation reaching the beneficiary compared to the amount spent on overheads. Although we welcome transparency, we are about measuring efficiency and impact as a focus for donations. Charities that slavishly follow a particular ratio are more likely to rely on poor systems, under-invest in people and facilities, and distort their true overheads.

Comparisons are misleading, then—dangerous, even. At NPC, we use other calculations to help us determine whether a charity is effective or not: cost per user or the fundraising multiplier, for example (see below).

Executive pay

Executive pay has hit the headlines recently, the criticism being that some charity chief executives are paid too much. Naturally a charity's supporters want as much money as possible to go towards the front line as efficiently as possible, but NPC thinks that the focus should not be on paying as little as possible to staff but rather to focus on value and impact. Is the individual worth it in terms of helping deliver for beneficiaries? Is the individual driving the organisation to improve its effectiveness?[40]

This debate also seems to have lost sight of the complexity of today's larger charities, which often deliver vital public services in diverse locations and need to attract talented managers. Charities require high quality staff and should be able to pay reasonable salaries to attract them.

'The CEO of Oxfam is paid £120,000, and is responsible for a £360m budget, 700 shops in the UK, and 5,000 employees and 20,000 volunteers who work in over 90 countries across the world—some of them very risky places to be. £120,000 doesn't feel like a lot in the context of that job description. The CEO of Next also runs 700 shops (but no humanitarian aid) and gets nearly £1.5m.'[41]

[38] http://giving-evidence.com/2013/05/02/admin-data/

[39] http://www.thinknpc.org/blog/how-can-we-move-the-conversation-about-overheads-on/

[40] http://www.thinknpc.org/blog/should-we-be-shocked-by-charity-chief-executive-pay/

[41] http://www.spearswms.com/spears-world/salon/gift-aid/48917/why-high-charity-ceo-pay-is-not-always-a-bad-thing.thtml

Having said this, salary should be proportionate to the income of the charity and increases should be dependent upon the chief executive meeting targets agreed with the board. Of course, some boards may feel more comfortable setting executive pay than others. For those with little experience, the proposed guidance from the Charity Commission and NCVO will help in this matter.[42]

Fundraising costs

Fundraising is also under the spotlight as face to face fundraising methods—such as chugging—are receive more and more criticism. But fundraising has never been harder for charities as they struggle to plug drops in statutory income and falling private donations. NPC has written about the habits, attitudes and motivations of donors in *Money for good UK*.[43]

Against this backdrop, NPC understands that charities will need to become more innovative in their fundraising practices and, rather than compare the absolute spending levels of fundraising departments, it is more important to see what fundraising departments achieve with the spending.

One of the ways to begin to assess how successful a charity's fundraising activities are relative to their cost is to look at its fundraising multiplier. This calculates the efficiency of the fundraising function ie, how much money it took to fundraise the voluntary income of the charity. The fundraising multiplier is shown below.

$$\frac{\text{all voluntary donations and grants, plus income from events}}{\text{cost of generating voluntary income}}$$

Voluntary income includes donations, legacies, grants and income from fundraising events. It does not include investment income, any earned income from activities, and trading income where it involves shops. The cost of generating these funds should include the proportion of staff and costs that are engaged in fundraising. Ideally, it should include the proportion of time the chief executive (and/or that of other senior managers) spends on fundraising. In our experience, this can be anything up to 50%, especially at smaller charities where there is rarely enough money to employ fundraisers. But this is difficult to estimate and brings us onto our next point.

Not all charities calculate their fundraising costs in the same way and although we do compare the fundraising multiple of several charities in Table 1—the results are only a starting point for discussion and no definite conclusions should be drawn from it.

[42] http://www.thirdsector.co.uk/Management/article/1194733/ncvo-charity-commission-draw-guidelines-executive-pay/

[43] Bagwell, S., de Las Casas ,L., Van Poortvliet, M and Abercrombie, R. (2013) Money for Good UK. NPC

Table 1: Fundraising multiples

Charity	Sector	Year end	Voluntary income (inc legacies) thousands	Fundraising cost thousands	Fundraising multiple (including legacies)	Fundraising multiple (excluding legacies)
Children's Society	Children	2012	22,128	5,929	3.7	2.6
NSPCC	Children	2012	114,423	24,311	4.7	3.9
Marie Curie	Cancer	2012	76,186	29,558	2.6	1.8
Alzheimer's Society	Dementia	2012	41,122	11,967	3.4	2.4
Mencap	Learning disability	2012	19,081	6,667	2.9	2.0
Place2Be	Young people	2013	2,453	390	6.3	6.3

From Table 1 we can see that the multiple for the group ranges from 2-6 times. In this instance, the higher the multiple the more efficient the charity is at raising voluntary income. It is important to note that there is no 'right' fundraising multiple but we would hope most multiples to be at least two—meaning that for every pound spent on fundraising, two pounds are raised. The table shows the multiple with and without legacies. Some sectors attract more legacies than others and this can have a significant impact on their multiple.

The size of the charity will also influence its multiple: a large organisation attracting multiple streams of income from different places and audiences will spend more than a smaller organisation that can survive successfully off grants from trusts and foundations. Some fund raising methods have a higher multiple than others - unrestricted funding raised via individuals is generally more costly than restricted- and it is important to take this into account when looking at the overall ratio. For example community fundraising and direct mail are usually lower than fundraising from trusts and foundations. This difference can be seen from the higher multiple for Place2Be compared to Mencap. Place2Be does not have the same level of fundraising resources that larger charities have and its multiplier therefore looks better. But if the charity wanted to raise significantly more funds it might have to invest more in this function and the multiplier would look less strong. The multiple can often be dictated by the sector the charity works in—fundraising in unpopular sectors (such as prisoners or refugees) is harder than others and requires more resources.

Hence relatively high fundraising costs can reflect more how the organisation funds its work rather than its efficiency in doing so. Another point to bear in mind is that a charity may invest substantial sums within one year to develop a new income stream. The charity may not amortise this over several years, so the multiple in the year of the investment will look low. For an accurate picture, it is ideal to look at the trend in the fundraising multiple, especially if a new method of fundraising has been introduced. For example, a charity reported to us that it required an investment of £400,000 (as one of the official charities for the London Marathon) but from this it expected to raise £1m in the first year—a relatively low multiplier for that event of 2.5x. However, the charity expected the multiple to rise in later years as the associated costs would be lower. Events are particularly

expensive to run but may achieve other objectives such as promoting awareness of an issue or courting supporters. NPC's report, *Just the ticket*, talks about events and their costs.[44]

Fundraised income is extremely valuable to charities become it is unrestricted income which is difficult to raise from elsewhere. NPC has written about the unwillingness of donors to give unrestricted funds and how restrictions affect charities in *Granting Success.*[45] Bearing this in mind, charities are prepared to spend considerable resources to attract unrestricted funds. Anecdotally, a chief executive told us he would prefer to receive £600,000 in unrestricted funds than £1m in restricted grants.

What are the unit costs of activities?

A unit cost is the financial cost to a charity of working with one beneficiary. Analysts can calculate a unit cost per user of a service or, where a charity has information on the outcomes it achieves, a cost per successful user.

Unit costs give a sense of the efficiency of an organisation, and whether it provides value for money. They are needed when identifying economies of scale, and are the basis for any cost-benefit analysis. Where comparisons are available, unit costs can also help to benchmark the organisation's work.

Unit costs can be calculated using a 'top down' method—by dividing the total costs incurred by an organisation by the number of people it helps. Or they can be calculated using a 'bottom up' method—by adding together elements of known costs.

The first method is appropriate for charities that have distinctive activities or only one activity. It has the advantage of capturing all costs, although it is sensible to exclude one-off costs incurred that year. This is NPC's preferred method, as it includes overhead costs, such as management time, fundraising costs, and depreciation of facilities. The second method can be applied to organisations with more complicated activities, but it is more problematic in allocating overhead costs, and risks underestimating the true cost.

When making comparisons between the unit costs of different organisations, analysts must be careful to compare on the same basis. For example, the total cost of providing services funded by voluntary donations will be higher than for those funded by contracts, as they include the costs of fundraising. Analysts must be aware of this, as it means that charities may look much more expensive than other providers.

Another way of looking at the efficiency of a charity is to look at its unit costs, comparing them to the charity's own history and to the unit costs of other charities doing similar work. The unit cost is not only interesting in itself but is, as *The little blue book* says, the basis of any cost-benefit analysis. Again, the caveat is to ensure that like is compared to like as much as is possible. The fuller the notes to the accounts the easier the job is.

In the main, we calculate unit costs (or cost per user) by dividing the total number of people using the charity's services into its total spending for that year—see box above. This method is simple and also ensures that all costs involved in helping each person are captured—from the salary of the key-worker who may be allocated to a beneficiary, through the depreciation on the charity's minibus, to the bill from the accountants for auditing its accounts. Although we exclude one-off costs and the cost of charity shops, we include all others to get an accurate picture of the full cost of helping one person. If we are calculating the 'cost per successful user', we simply divide this cost by the number of beneficiaries successfully helped by the charity.

[44] Webber, D (2003) Just the ticket. NPC [44]

[45] Brick, P., Kail ,A., Jarvinen, J & Fiennes, T. (2009) *Granting success. Lessons from funders and charities* .NPC.

When analysing Sue Ryder in 2010, we felt a unit cost for the whole organisation—which provides three distinct services in the UK, and makes grants overseas—would be meaningless. [46] Instead, we took each of its three UK services, worked out their proportional cost to the total charitable expenditure, and allocated a proportion of central costs to each of the three areas. At that time, this gave us a total cost for the charity's neurological services, for example, of almost £30m or £14 per user hour. This number, though a guesstimate, was much more useful to our analysis, enabling us to attempt a comparison with another charitable provider, the Royal Hospital for Neuro-disability in South London—whose cost per user hour, according to our calculations, also came out at £14. This could have been more complex had we factored in the different means of funding the three services.

A single activity charity such as Beanstalk—formerly Volunteer Reading Help which provides help for children falling behind with their reading skills—is easier to analyse. In 2012, it helped 6,400 children to read and cost £1.9m to run. So the cost per child helped equates to £300. A more nuanced calculation would be about how many of the children helped moved to functional literacy. However, the impact published in the accounts describes the average improvement of two reading sub-levels over three terms (ie, one year) of support, rather than what percentage of pupils improve more markedly.

Where we are trying to determine the cost per user of a specific activity within the charity, we work out the proportion of spending on that particular activity to the total charitable expenditure, apply it to the charity's non-charitable expenditure, and then add the two together to get a rough idea of the full costs of delivering the particular activity. It is important for a charity to understand its unit cost of delivery too, since this will help it correctly price services to achieve full cost recovery. Full cost recovery means being able to recover all the costs of delivering a service which will include the direct and overhead costs. Full cost recovery has been written about by NPC in the past and the principles have been accepted by many funders, but are not always put into practice. [47]

Interpretation is everything. A lower unit cost than in previous years could mean that the charity is more efficient in its cost control, or that clients receive a lower quality service. A higher cost per user than the years before could mean that costs have spiralled or that there are fewer users. Or, it could mean that the charity has been broadening and deepening the activities it offers. Most analysts should be comfortable with this, but take care to check that the unit costs stabilise as the charity's activities reach a steady state.

However this method may not always produce meaningful results and analysis of Place2Be highlights some of the complexities, showing that the calculation to just use school services costs divided by number of children is not as straightforward. Within the school, the Place2Be service is multi-faceted—so it's more than just the 1:1 counselling unit cost—and in terms of 'business lines', the charity also works with parents and is growing this, along with training activities. In addition, the timing of school entry/exit can skew the numbers. Taking a different approach, Place2Be commissioned research in 2010 to calculate the economic benefit of the work and whether it provides value for money. The report found that the initial costs of the intervention were paid back within the first five years, and if the short-term benefits continued into the longer term, the financial and human cost savings continue.

By the time we get to unit costs we should have a good idea what these yearly fluctuations in unit cost mean. At the very least, we will have an intelligent set of questions to ask at our interview with the charity.

[46] http://www.thinknpc.org/publications/charity-analysis-sue-ryder/

[47] NPC and ACEVO (2004) Full cost recovery – can your organisations survive without it

CONCLUSIONS

We return to our opening thought: numbers on a page are a key part of the analysis—often all we have to work with—but for a full understanding of a charity's finances discussion with its leaders is crucial.

Over the years, NPC analysts have met with hundreds of charity chief executives, and often with finance directors and occasionally treasurers too. In that time we have seen many different styles of financial management, and many different levels of ability—from the top-flight, ex-FTSE standards of Lynne Robb who was at Cancer Research UK, to the manager of a small charity who failed to grasp the importance of cash flow and the charity became insolvent.

Grading a charity's finances can help to articulate the risk of donating to the charity. It can also highlight actions that a charity might need to take to improve its financial management or increase its sustainability. Aspects of financial performance will be more or less in a charity's control. NPC has plenty of sympathy for charities battling with financial uncertainties associated with government policy over which it has no say. NPC has less sympathy for a charity with adequate resources but poor financial systems. Below we highlight some key elements of the grading grid:

- **Excellent** covers those charities with healthy accounts, strong financial management and a good handle on cost data.
- **Good charities** are well-funded, make good use of voluntary incomes, and have good internal cost controls and processes.
- **Satisfactory** charities would benefit from an improvement in their funding structures and processes.
- **Below expectations** is rarely seen in the charities we've analysed. This is shorthand for high-risk stemming from poor management, funding concerns and with little grasp of costs.

However good the grades are in other areas—Results, People and so on—a 'Below expectations' on Finances is a red flag, particularly during difficult times with uncertainties regarding all types of funding.

NPC believes that a charity is unlikely to reach full effectiveness without efficiency—to the standard of at least 'Good'—in its financial management. This is difficult in tough economic times, but many charities are adapting sensibly.

NPC GRADING GRID: PLACE2BE

Assessment criteria	Assessment	Rationale
Financial security	Good	• Is well funded and stable with increasing number of individual schools contributing • New £2m partnership with Impetus—The Private Equity Foundation for secondary schools • Sufficient unrestricted income although proportion of restricted increasing • Not excellent because voluntary income ie, donations and grants have fallen year on year • High fundraising multiplier • Some concern over year on year increase in debtors • Prudent and clear reserves management. Sufficient reserves
Quality of financial management	Good	• Has shared internal documents with NPC indicating good and timely financial procedures • Strong financial expertise on board and on audit and risk committees • Are currently recruiting to increase the finance function
Efficiency and unit costs	Good	• Focussed in primary and secondary schools • Scalable model • Good fundraising ratio • Focus on measuring impact • Economic benefit work undertaken
Risk analysis	Satisfactory	• Vulnerable to reduction in local authority budgets • Vulnerable to changes in education policy • Reduction in private sector funding • Increasing budget autonomy of schools positive • Good cost control and procedures • Adequate reserves

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TRANSFORMING THE CHARITY SECTOR

NPC (New Philanthropy Capital) occupies a unique position at the nexus between charities and funders, helping them achieve the greatest impact. We are driven by the values and mission of the charity sector, to which we bring the rigour, clarity and analysis needed to better achieve the outcomes we all seek. We also share the motivations and passion of funders, to which we bring our expertise, experience and track record of success.

Increasing the impact of charities: NPC exists to make charities and social enterprises more successful in achieving their missions. Through rigorous analysis, practical advice and innovative thinking, we make charities' money and energy go further, and help them to achieve the greatest impact.

Increasing the impact of funders: We share the passion funders have for helping charities and changing people's lives. We understand their motivations and their objectives, and we know that giving is more rewarding if it achieves the greatest impact it can.

Strengthening the partnership between charities and funders: Our mission is also to bring the two sides of the funding equation together, improving understanding and enhancing their combined impact.

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