CFDG
PROMOTING BEST PRACTICE
IN CHARITY FINANCE

Know Your Cost Base
Know Your Charity

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FOREWORD

Charities make a vital contribution to the fabric of society in Britain. They are diverse and innovative in their make up and do an extraordinary amount of work to help a wide range of beneficiaries. As the workload for charities increases they need to ensure they make best use of limited resources in order to carry out their charitable objects efficiently and effectively. A key aspect of this is good financial management.

Good financial management allows charities to be more transparent and accountable in their activities and is key to good governance. Trustees are responsible for the financial control of a charity and without accurate and reliable financial information cannot make informed strategic decisions about the financial viability of the charity.

The more a charity understands its cost base and can properly allocate costs, the better it is able to negotiate effectively with a funder about having an appropriate proportion of overheads funded. I very much welcome this report from the Charity Finance Directors' Group which aims to raise awareness of the importance of understanding a charity's cost base and its implications for broader financial management, I look forward to the Commission for the Compact working with Charity Finance Directors' Group (CFDG) in other ways in future as an important colleague in building the quality of partnership working between the public and third sector in the interests of people and communities.

John Stoker
Compact Commissioner

INTRODUCTION

CFDG works to enable those with financial responsibility in the charity sector to develop and adopt best practice. I believe this report will provide charities with best practice tips and a robust framework in which to consider their costs. It is essential that charities know and understand their costs not just for funding purposes but also for the broader financial management of a charity.

It is very easy to generate a forecast for a project's costs by taking existing costs and inflating them, but this route could have disastrous consequences. For example, if any charity had taken this approach over recent years they would have caught a cold with the high degree of volatility around costs such as utility costs and pension costs.

This point only really scratches the surface. Costs just do not go up by inflation each year and planning on this basis will only lead to sub optimal performance by the charity. Charities are on a journey to deliver their strategy and it is important that their financial planning reflects their current position on this journey. Their costs at any one time should reflect this; they will not necessarily be the same level as the previous year or even the same costs! It is important that each year a charity looks at where it is on its strategic journey and what projects and work there is to be done. Only then should it look at the costs to deliver that work. A charity that both understands its costs and is able to understand its costs in relation to the point it is on its strategic journey will mange its costs better and fully understand the implications of new projects. This will then put them in a strong position when negotiating with funders for full cost recovery.

It is so important for a Finance Director to understand their underlying costs and income flows. They will then have a very strong feel for the implications of subtle changes in the markets that they operate in and the implications for their charity. Further they will be able to negotiate contracts and grant funding from a position of strength and know just what terms are appropriate for their charity and what are not. They will also understand the risks that are being taken and how those risks will be covered. Consequently they will help to negotiate better contracts and grant funding relationships for their charity and help their charity to deliver more and better services to their benefactors in a controlled and professional way.

Finally I would like to thank the working group, predominantly made up of CFDG members, who gave their time and expertise to develop this publication (see Appendix 1). I would like to pay special thanks to Richard Weaver, Charities Partner at haysmacintyre who did a lot of the writing for this publication and also Chris Harris, Director of Finance and Resources at Action for Blind People who chaired the working group.

Keith Hickey
Chief Executive, Charity Finance Directors' Group

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1 Introduction

1.1 THE AIM OF THE PUBLICATION

The charity sector continues to grow in activity, diversity and complexity and the pace of change for many is unprecedented. There is a growing realisation that while many charities are primarily about managing donations the increase in those involved in contract funding has been significant. In particular, recent expansion of public service delivery by charities has prompted concern over the ability of organisations to meet the management challenge and there are fears for the sustainability of the sector.

The aim of this publication is to raise awareness of the importance of understanding a charity's cost base and its implication for both funding and broader financial management.

This publication is aimed not just at the Finance Director or equivalent, but also:

- Chief Executives
- Trustees
- Other members of staff who do not have a financial background but are involved in making financial decisions or making funding applications for the charity

It will also help funders to understand some of the issues surrounding good financial management and why providing funding for an appropriate proportion of overheads is important to the sustainability of the sector.

1.2 HOW DOES THIS LINK TO GOVERNANCE?

Trustees are ultimately responsible for the financial control of charities and they need appropriate accurate and reliable financial information on which to make decisions about the charity's financial heath, strategy and direction. A proper understanding of a charity's cost base is therefore a vital component of sound financial governance.

1.3 WHAT IS THIS PUBLICATION ABOUT?

There is an existing body of work around measuring and monitoring core costs, starting from Julia Unwin's 'Who pays for Core Costs'. This brought focus on core costs and overheads and the necessity to fund these in a transparent and sustainable way. The full cost recovery initiative pursued by the Association of Chief Executives (acevo) in the voluntary sector has been successful in raising these issues with government. There have been several publications from others in the sector; namely acevo, NCVO and specific grant-making organisations which provide toolkits and "how to" guides to contracting. A further reference list of material is included as Appendix 2.

This publication is not meant to be another attempt at a 'full cost recovery' model, but rather a practical guide to factors that affect a charity's funding and financial 'health'.

In 2006 CFDG undertook a survey that identified the need for a document to explain the role and behaviour of core costs and overheads in the wider context of governance, and also in an environment where a growth or a step change in funding is occurring.

The CFDG survey also identified the need for VAT to be further explored within the funding arrangement and the implications of VAT on projects, especially cash flow, are considered in this publication.

1.4 CORE COSTS OR OVERHEADS?

This publication highlights the fact that 'core costs', 'administrative costs' and 'overheads' are roughly equivalent to each other. There is no absolute definition of what each should contain and we do not intend to add to the debate in this publication. However, we agree that these costs must be funded to allow a charity to function.

We expect and are content with the concept that commercial organisations ensure that the selling price of their goods includes a contribution towards IT, HR, finance and other overhead costs, the quantum of which will vary depending on how products or services are delivered. Why then should this not work for the charity sector?

There is no doubt that the charity sector should be funded with a fair proportion of overheads to match the services or work being delivered. This publication looks at ways of identifying the cost base of a charity so that you can then determine what a fair proportion of overheads may be for a particular service or contract.

1.5 A REFERENCE GUIDE

This publication can be used as a reference guide that provides the context of strategic and management accounting theory that is needed to understand how costs work. Some may be confident in these areas and prefer to dip in and out of the publication to gain knowledge in certain areas rather than having to read the entire document.

1.6 RECENT SURVEY RESULTS

The CFDG survey on public service delivery found that many funders still fail to fund an appropriate proportion of overheads. This burden then falls on "free reserves" or additional fundraising to meet this deficit. In addition funders are requiring greater levels of financial analysis (such as office and staff costs) before funding can be provided. This is explored in depth in this document. The survey highlighted certain other recurring issues:

1) Over half the charities surveyed believed they were not adequately compensated for the risk they undertake in delivering services. Reasons given for this are as follows:

- Additional risk transferred over and above what normally would be expected, without additional payment,
- Short-term contracts that cause difficulty in resource re-deployment when a contract ends, and
- Funder/provider relationships weighed in favour of the funder.

2) Contract lengths were felt to be inappropriate to the service being provided. Longer term contracts would provide more stability for the service providers and would allow them to make long term strategic plans which make best use of public funds and better allow identification of possible service improvements.

3) Many charities delivering public services faced having pricing budgets imposed on them by their funder. Commonly these pricing budgets only cover a fraction of the actual support costs of delivering the service. The shortfall has to be covered by core or unrestricted grant funding or additional fundraising.

Many of these themes are repeated in the survey results published by the Charity Commission in February 2007 entitled Stand and Deliver – the future for charities providing public services.

It is worth noting that funders are themselves facing greater financial pressure and uncertainty over government funding making them reluctant to sign or renew contracts. This situation is unlikely to change as the government continues its push for greater efficiency savings within government through the Gershon efficiency agenda.

So, although the level of contracting is likely to continue to rise charities will continue to face a testing competitive environment. A failure to understand the costing agenda is not an option.