

# Financial Resilience in Charities *v.2*

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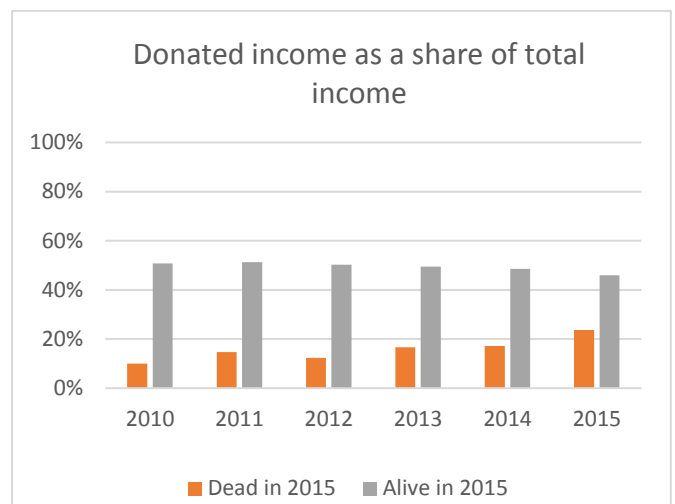
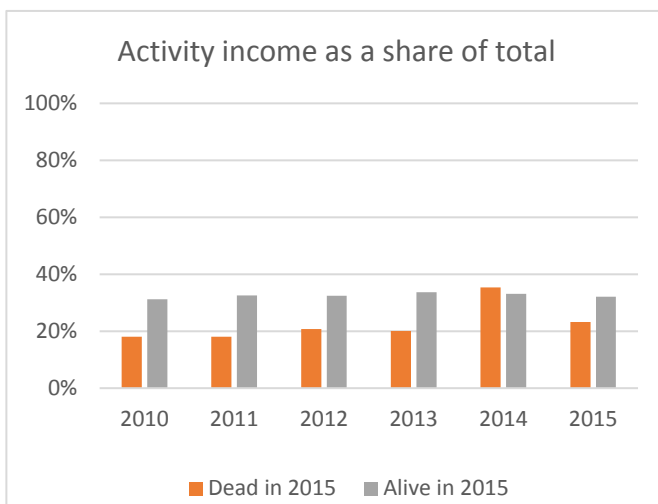
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## Summary

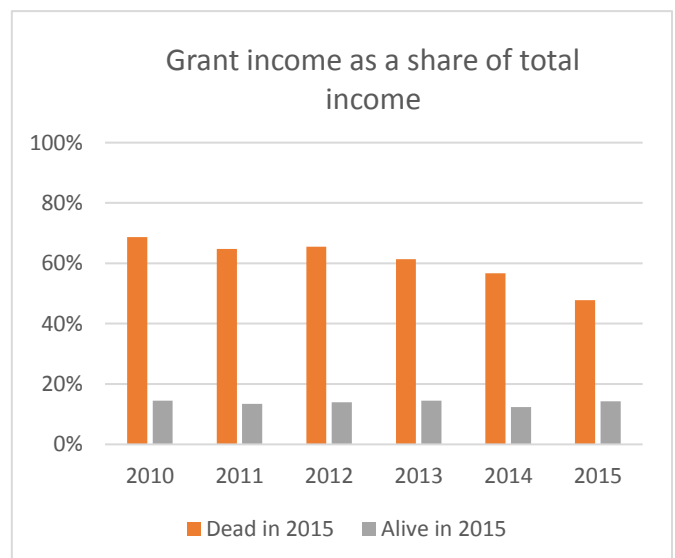
Recent work at the University of the West of England has raised questions about the financial resilience of charities; in particular, whether a mismatch between income, staff costs and reserves makes charities ill-prepared to deal with the challenges of discontinuous income and large reductions in funding arising from grant cuts. We are also concerned that charities are being given inappropriate advice about the amount of reserves they should be holding.

## Dependence on income types and likelihood of survival

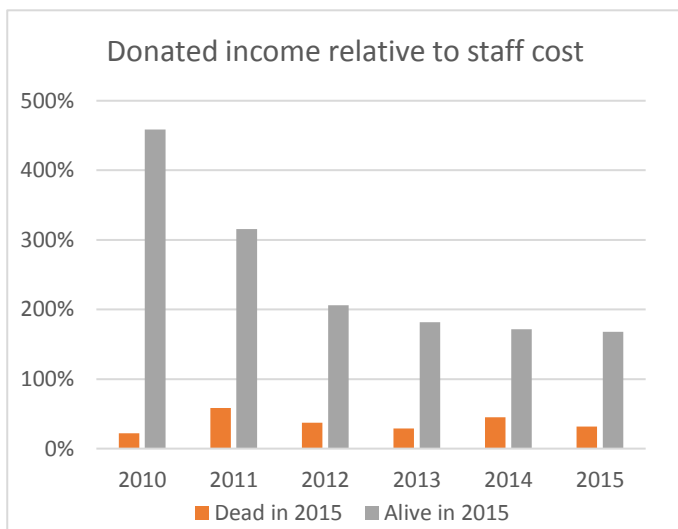
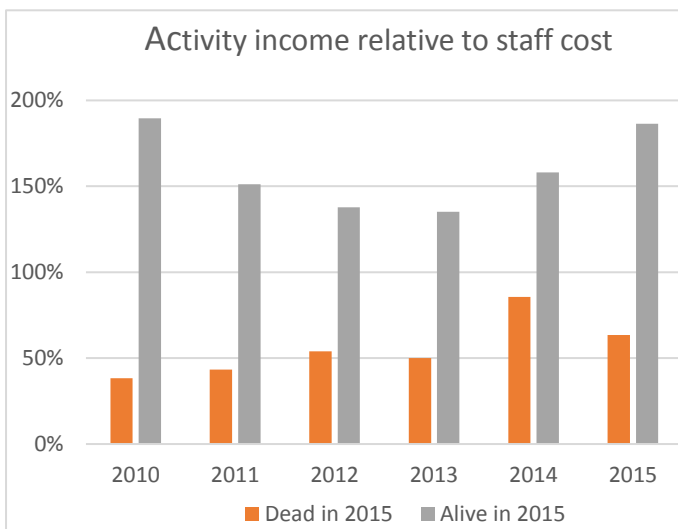
We analysed financial data from 2010 onwards for 40 charities, half of which had ceased operation since the beginning of 2015. Income streams were divided into grant income, donations, and income raised through 'activities' such as retail, service provision and ad hoc events.



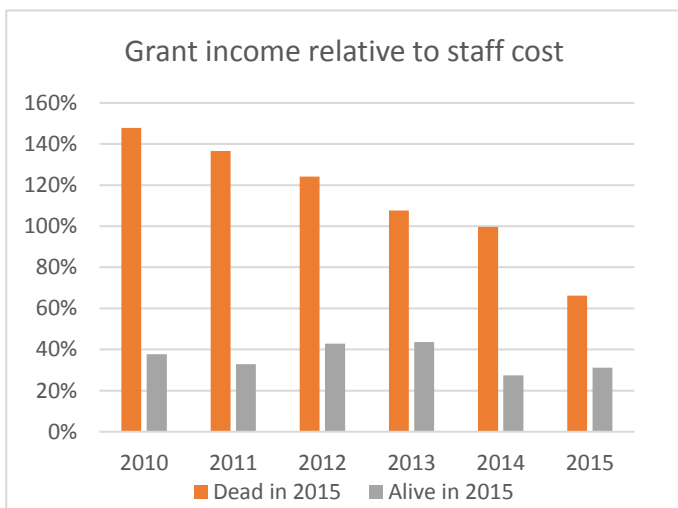
Analysis of this data shows that successful charities earn a larger proportion of their income from activities than charities which died, although not much more. Successful charities, on average receive around half of their income from donations and around 20% from external grants; both rates have been fairly stable over time, although the grant share has fallen in recent years. In contrast, failing charities are likely to receive at least half of their income from external grants; the fall in this since 2013 is more noticeable.



A similar story arises from looking at the ratio between different types of income and staff costs:



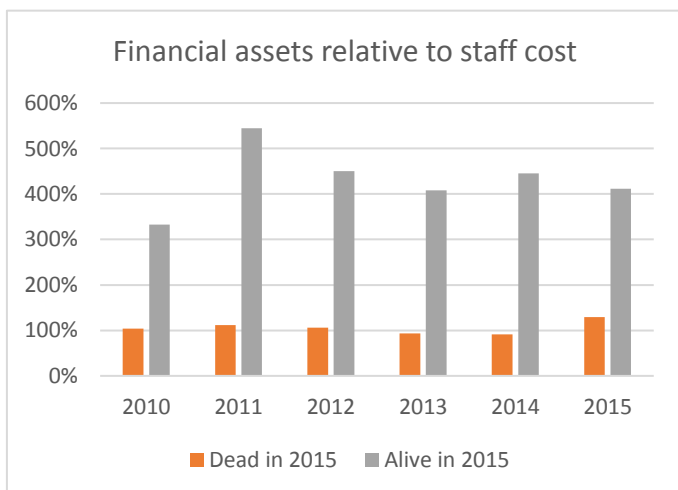
Successful charities have, on average, sufficient income from activities and donations to cover their staff costs - that is, the ratio of these types of income to staff costs is over 100%. This holds even though the amount of donated income relative to staff costs has dropped substantially since 2010. In contrast, non-surviving charities were found to be reliant upon grant income and did not cover their staff costs by donations and activities.



Finally we can compare financial resilience by looking at how the financial assets held in reserve by charities cover their staff costs.

The surviving charities were found to have sufficient assets to cover their annual staff costs roughly four times over; in contrast, non-surviving charities had only just enough assets to cover staff costs for one year.

We also carried out a more complex statistical analysis, where several factors are combined to look at the relative financial strength of the



charities. These confirmed that major factors associated with a charity ceasing to operate in the last year or so are:

- a high proportion of costs relative to income
- failing to return a surplus in anyone year
- a high proportion of income received as grants
- a high proportion of staff costs (but not total costs) relative to the amount of financial assets held

Whilst these results are only indicative (forty charities over six years is a relatively small number of observations; and a convenience sampling method was used to select the charities, which is not ideal for this sort of analysis), alternative ways of studying the data appear to produce similar results. Risk analysis confirmed that being a recipient of a grant within our sample was a significant predictor of failure.

## Discussion

As part of the wider reform process many services once provided directly by the public sector have now been outsourced to the voluntary sector with funding provided through grants. We believe this may have led to 'mission drift' in some cases where charities become focused on providing the activity attached with the external grant, as opposed to generating sustainable revenue under their own control. Our research leads us to query the sustainability of this approach.

There was a large level of grant dependency observed within the dead charities, and a lack of reserves. A drop in grant income can lead a charity into dangerous financial waters, particularly if it is highly dependent on a small number of funders. Grant income is also more likely to be linked to contracts for providing a service, providing less opportunity to build up reserves, even when this is stable.

Charities holding a larger reserve in proportion to total income were more likely to survive, perhaps related to the unreliable nature of grant income in the current environment. Compounding the challenge is the notion that holding reserves within the charity sector has been considered taboo by significant regulatory bodies and advisors to the sector.

'Holding a high level of cover for risks and unforeseen events appears sensible, but is this right if worthwhile projects are going unfunded?' (Executive Summary 'Beyond Reserves', Charity Finance Group 2012)

'To hold income in reserve rather than spending it, trustees rely on an explicit or implicit power to hold reserves and they must use that power in the charity's best interests.' (Charity Commission CC19, 2016)

'... charities should assume that they should use the funds they receive and should have good reasons for keeping funds back and *not* spending them.' (Charity Finance Group, 2012)

The Charity Commission [CC] (2016) recently published an accounts monitoring review, into 'charities with audit reports identifying that they may be in financial difficulty'. Within this report, the criteria the CC employed to identify the sample was to take any charity where the auditor's report in the accounts included a 'going concern' section. We have examined our sample of charities and have found that in the latest available accounts only 20% of those charities which had ceased operating in 2015 included a 'going concern' in the auditor's report. Furthermore, of the successful charities in our sample 20% were reported as having a 'going concern' in the auditor's report.

To explore this phenomenon we have examined the contents of the text on going concerns. There is a notable variation in content of concerns between the successful and ceased charities:

<b><i>Successful Charities</i></b>	<b><i>Charities which ceased in 2015</i></b>
Concern surrounding dependency on government grants	Significant loss in the previous financial year and small loss that financial year.
Difficulties in profitability due to economic climate	Charity has no endowed funds.
Difficulty in modelling income from donations.	Limited secured funding
Difficulty in predicting income from donations and legacies.	Companies reliance on external funding

**Table 1: Message contained in the content of 'going concerns' section of auditor reports on charities**

The table above demonstrates the variation in what is considered as a 'going concern' by auditors. In the charities which ceased operations in 2015 a 'going concern' was explicitly represented as a business viability warning. In contrast, in successful charities 'going concern' often represented a potential fall in profit, effectively similar to the 'profits warning' that may be declared by a listed company to its investors. The ambiguity of the 'going concerns' as an indicator demonstrates the complexity and viability of using such a criteria from auditors reports as means of identifying financial difficulty.

Our analysis suggest that charities should be holding a significant proportion of reserve assets, particularly if they are expected to support outsourced service through grant funding: resilience does not seem to be consistent with maintaining minimal reserves. This

raises wider concerns surrounding the advice given to charity trustee's and the evidence informing this guidance.

We would recommend that much clearer guidelines are issued on what constitutes as going concern for auditors, with a distinction made between business viability and profitability forecasting. Further, auditors could draw upon the analysis presented here with regards financial dependency on grants and income from activities as indicators of how viable a charity is likely to be.

The analysis provided here has focused only upon the financial perspective. We have not considered in this piece the wider sustainability context. A financial deficit does not exist in isolation; it is symptomatic of multiple failures within a system which has, through intention or otherwise, turned a number of charities into service providers.

## Actions

- This work was restricted by the limited information made available by the Charity Commission on the financial activity and performance of charities; we recommend the Commission substantially improve its data strategy and encourage engagement with the academic community
- A robust review of guidance provided to charitable organisations on financial management should be carried out:
  - charities need to be aware of the sustainability implications of a grant-funded income model
  - advice on minimising surpluses in particular should be reviewed
- The Charity Commission may consider developing a financial model specifically for the UK charitable sector to predict financial risk and to enable them to target their limited resources effectively
- Auditors need guidance on what should be considered as a 'going concern', and provide consideration of what should be reported under such a section heading.
- There is a need for a wider review of the implications for the charity sector of the continued drive to third-party provision of government services

## Methodological note

Very little has been written comparing the financial performance of charities. Most analyses concentrate on taking a single charity as a case study; this is a valid methodological approach for understanding charities but does not allow us to generalise easily, as we have done here. We believe this is the first study to identify system risk factors in charity finance, although we acknowledge that this research is a preliminary scoping study.

There is a substantial lack of current, robust, and longitudinal studies surrounding financial resilience and risk within the charity sector. The literature available focuses predominately

on qualitative case studies and lacks generalisability. Modelling of financial data to predict organisational survival was conducted by Tuckman and Chang (1991) and identified the indicators of risk were equity, revenue, administrative costs and operating margin; the model has been supported for the charitable organisations by Greenlee and Trussel (2000). Another model developed by Gilbert, Menon and Schwarz (1990) indicated that a negative net income over a consecutive three-year period was a predictor of financial vulnerability. It is important to consider that both these models were created in the USA, using USA charitable data. Analysis of the UK dataset used for this paper supported neither of the models. This could be attributed to many possible causes including the variation in reporting and governance of the charity sectors in the USA and the UK.

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