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Neither true nor fair

A critique of the True and Fair Foundation's Review of Charitable Spending by UK Charities

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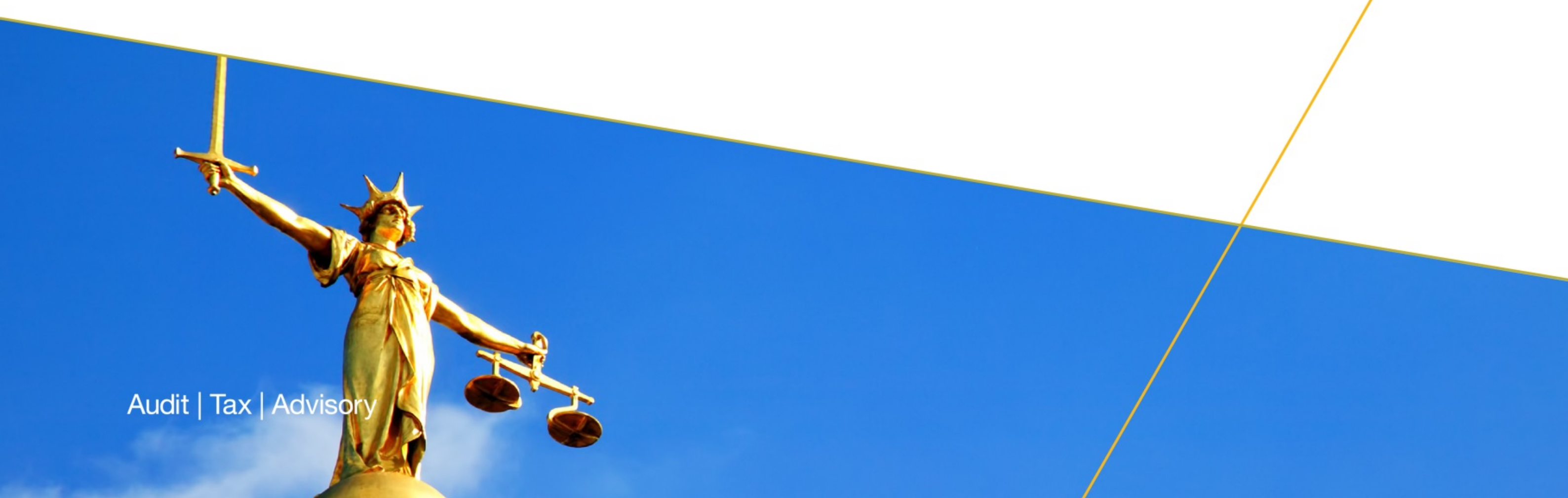

Preface

I thought hard about whether I should produce this critique and analysis to refute the methodology and conclusions reached in the True and Fair Foundation's report. My concern is that in crunching the numbers to respond to the flawed allegations I will somehow provide credibility to the notion that cost ratios drawn from sets of accounts can be used to measure the efficiency and effectiveness of a charity. This might sound like heresy coming from an accountant but financial statements alone just cannot be used to measure efficiency and effectiveness. I trust my analysis which shows just how wrong the True and Fair Foundation's report is serves to highlight the futility of using superficial benchmarks and cost ratios.

As someone who knows something about interpreting charity accounts - I think the report is neither true nor fair. In this critique I refer to the True and Fair Foundation's report as the T&F Report (I will leave it to readers to decide whether they think this this stands for True and Fair, Terrible and Flawed or Tosh and Filibuster!)

The T&F Report fails to understand how charities report financial information and also tries to make superficial analysis appear to be well considered. Unfortunately, this 'work' has been given an aura of credibility by a number of UK newspapers. The somewhat worrying aspect is that so much of what I read, written by various commentators, so called researchers and in some newspapers about charities – an area I know a fair amount about – is so wrong that it worries me that what I read in the areas I know little or nothing about may also be so wrong.

I would be more than happy to work with the Charity Finance Group to provide support for journalists and other researchers who like to report on charities to help them to understand better the operating imperatives and financial reporting issues. I have also seen a reference from one of the trustees of the True and Fair Foundation that she has been trying to debate transparency and accountability in the charity sector. There are many, including myself, who would be pleased to engage in a considered, unbiased discussion.

My aim in writing this critique is twofold. First, to correct the completely superficial and downright wrong analysis provided in the T&F Report. Secondly, to show how the use of cost ratios just does not work and that continued focus on them is damaging charities.

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19 December 2015

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Contents

1. Introduction

The True and Fair Foundation published a report on 12 September 2015 which is billed as a Review of Charitable Spending in UK charities. The report is based on a review of the accounts of a number of well-known charities and purports to show that not enough of the income is going on charitable expenditure.

The T&F Report calls for a minimum annual dispersal rate (charitable expenditure compared to total income) of 65% and has published a list of charities that they believe do not meet this arbitrary threshold. Apart from the fact that the concept itself has no merit, the analysis is full of errors and as this critique shows the T&F Report have got the conclusions hopelessly wrong.

Interestingly, the True and Fair Foundations own accounts for the year ended 30 September 2013 shows that its charitable spend is 48% of total income. The same accounts show that voluntary income raised was £91,788 and the cost of raising it was £54,685. In other words it cost them 60p to raise £1. The fact that this one year is not representative of other years shows how absurd trying to set an annual dispersal rate is. Income raised in one year is often spent in another year which could lead to a dispersal rate of over 100% in the year the income was spent.

The T&F Report looks like little more than a publicity exercise - particularly since it has failed to take on board the many pieces of useful advice that were received before the report was published. Perhaps the quote from Oscar Wilde on the home page of their website sheds some light on their thinking. This says: "There is only one thing worse than being talked about and that's not being talked about". It seems that publishing a completely spurious analysis which damages the reputation of charities at an important time of giving, is okay, so long as it gets talked about.

We know that cost ratios are not the answer. However, because charities often do not provide other measures of effectiveness that consider inputs, activities, outputs, outcomes and impact, the default seems to be the use of spurious cost ratios. It is for this reason that the 2015 Statement of Recommended Practice on Accounting and Reporting by Charities (SORP) explains that "A charity's accounts focus on its financial position and financial performance. In isolation this information does not give the user a rounded overview of what has been achieved from the charity's activities and the resources used in their delivery. The report and accounts taken together should provide a picture of what the charity has done (its outputs) or achieved (its outcomes), or what difference it has made (its impact)."

Measuring and reporting on impact is not easy to do but even the measuring and reporting of activities, outputs and results are far better than using accounts to arrive at cost ratios. The concern is that in the quest for easily quantified measures, there appears to be a worrying risk that easy but flawed measures will be used and to support damaging concepts of setting thresholds for spending.

The sections that follow focus on the list of 17 'offenders' produced by the T&F Report. This list is meant to show charities with income over £50million that were found to have spent an average over the last three years of 65% or less of their overall income on charitable activities (the dispersal rate). In fact, in all cases the conclusions drawn by the T&F Report are superficial and flawed. This list of maligned charities has been widely publicised in the press and it will be interesting to see if, as expected from a fair press, any corrections will be published.

2. Summary of Findings

The T&F Report states that it used data from the charity's own Report and Accounts filed at Companies House. The findings discussed below have also been drawn from the publically available information in the published Report and Accounts from where the T&F Report is meant to have extracted information. In each case, using the correct methodology would have meant that none these charities would have appeared on the T&F Report's list of charities that supposedly did not spend 'enough' on their charitable purposes.

The sections that follow are divided into key groupings that highlight the very rudimentary errors and flaws in the T&F Report.

1. **Comparing the income of a multinational trading group with the expenditure of a charitable foundation**

   Top of the T&F Report's list of charities with a low dispersal rate is the Lloyds Register Foundation, shown as having a dispersal rate of just over 1%. A number of corporate bodies are linked to and support charitable foundations. Some are structured such that the foundation for accounting purposes is treated as the parent of large trading groups. In this case, the T&F Report has failed to recognise the distinction between Llloyd's multinational Trading Group with a turnover of over £1 billion and the charitable foundation with an income of £19 million. The charitable foundation dispersed just over £14 million for its charitable purposes – this means that the dispersal rate was over 74% rather than 1-2% as reported in the T&F Report (See Section 3 for detailed analysis).

   Comparing the income of a multinational trading group with the charitable expenditure of the foundation is a very fundamental error that has produced a completely spurious result.

2. **Failing to recognise charity and trust law requirements on income and capital**

   Next on the T&F Report's list are the Racing Foundation and the Tenth Anniversary Motability Trust. The T&F Report shows that the Racing Foundation has a dispersal rate of just under 3% and the Tenth Anniversary Motability Trust has one of just under 8%.

   Once again the T&F Report has made some basic errors. Charity law requires that income that should be spent needs to be distinguished from endowed funds (capital) that have to be invested. Both these charities have received large endowments of about £50 million in their reporting year.

   It is quite wrong to include these endowments when comparing income and expenditure ratios. The correct analysis shows that the dispersal rate is 112% for the Racing Foundation and 94% for the Tenth Anniversary Motability Trust. (See Section 4 for detailed analysis).

   The difference between the calculation done without understanding the charity and trust law requirements and one that does factor in the fact that endowments are to be invested is clearly significant.

3. Ignoring the impact of trading activities

The three charities mentioned above are followed on the T&F Report's list by many well-known names – they include: Grace Trust, British Heart Foundation, Sue Ryder, Age UK, The Royal Horticultural Society, Cancer Research UK, Shelter and Marie Curie. They are all shown as having a dispersal rate under 65%.

All these charities have significant trading operations with related costs of trading. It is only the net income (the price the customer pays, less the related costs) that is available for the charity to spend on its charitable purposes. This simple fact seems to be one that the T&F Report does not seem to accept. These trading operations have a lower margin than some other forms of fundraising but they provide valuable income to the charities and margins compare well with the private sector.

All these charities could achieve the T&F Report's arbitrary target of 65% simply by giving up their trading operations but this would mean that they have a lot less money for their charitable activities. (See Section 5 for detailed analysis).

Clearly an analysis that would lead to such a suggestion is seriously lacking in understanding of the many different ways that charities need to use to raise funds.

4. Failing to recognise that charitable expenditure includes amounts spent on fixed assets

A number of charities incur expenditure on fixed assets that are relevant to their charitable purpose. This expenditure has not been included in the calculations that drive the dispersal rates in the T&F Report. Expenditure on a research institute for Cancer Research UK, lifeboats for the RNLI or Rehoming Centres for the Dogs Trust is as much charitable expenditure as making a grant or employing nurses and care workers.

Correctly including this expenditure would significantly increase the dispersal rates shown by using the T&F Report's approach as follows:

- Cancer Research UK's rate calculated from its last published accounts would increase from 67% to 73% (the real increase is higher if one makes the trading correction referred to in point 3 above)
- Dogs Trust's dispersal rate would increase from 67% to 75%
- RNLI's dispersal rate would increase from 64% to 85%.

(See Section 6 for detailed analysis).

5. Ignoring the impact of donations in kind

The Oasis Charitable Trust has been shown as having a dispersal rate of 58%. This is because the T&F Report has failed to take account of a donation in kind valued at £112 million relating to properties donated for use as Academies. The report includes this donation in kind as income but fails to recognise that there cannot be an equivalent related expenditure as the properties are included in the balance sheet as a fixed asset and do not feature in the expenditure statement. The corrected dispersal rate taking account of this would be 98% rather than 58% (See Section 7 for detailed analysis).

In conclusion

The T&F Report's list of 'underspending' charities shows the income and charitable expenditure from the last published set of accounts. It then calculates a dispersal rate based on three years accounts supposedly to smooth out year to year fluctuations in income or charitable spending. As shown in this critique the methodology used by the T&F Report is patently flawed. It demonstrates a singular lack of understanding of charity law and financial reporting requirements. It also shows a lack of understanding of how charities operate and raise and use their funds.

In all the cases reviewed, using the information from publically available accounts, it should have been apparent that the dispersal rates shown were above the arbitrary 65%.

It is to be emphasised that showing that the charities have in fact spent more than 65% of their income on charitable expenditure does not endorse the concept of using dispersal rates and cost ratios. This critique shows that the use of such ratios is fraught with problems and as explained in Section 8 of this critique, they just do not work.

3. Foundations and corporate bodies

The T&F Report demonstrates a complete lack of understanding of financial reporting requirements as well as the structure adopted by foundations that are part of or are set up by a trading group or corporate body. The Lloyd's Register Foundation (LRF) is one such body that has been 'analysed' in the report.

It is interesting to see what The T&F Report says about the Foundation and how this stacks up against an unbiased and reasoned analysis.

Percentage spend on charitable activity

The T&F Report shows the income of the LRF is £ £1,062,537,000 and that its charitable spend was £14,490,000. This would indicate that in the last reported year it has spent 1.36% of its income on charitable purpose. In fact this is far from true or fair.

What do the LRF's accounts show?

Table 1: Lloyds Register Foundation - income and charitable expenditure

	2015 £'000	2014 £'000
Gift Aid from Trading Group	11,461	4,000
Other investment income	8,055	7,991
Total income of the Foundation	19,516	11,991
Charitable expenditure of the Foundation	14,490	17,846
Percentage of charitable spend to income	**74%**	**149%**

I reiterate that simple percentages and cost ratio comparisons are not particularly useful. Notwithstanding this, the correct comparable analysis shows that the LRF has a dispersal rate which is incomparably higher than that presented in the T&F Report. The need is to compare its own income with the amount that it has expended.

The fact that the previous year shows a dispersal rate of 149% serves to highlight how pointless it is to try and use this as a benchmark. Obviously, if in one year they are dispersing a lot more than the available income in other years the dispersal rate will be comparatively much lower.

So where do the T&F Report's figures come from?

LRF is structured so that for statutory accounting purposes it is regarded as the parent of the Lloyds Register Group. In 2012 Lloyd's Register converted its status from an industrial and provident society to a company limited by shares, called Lloyd's Register Group Limited. The shares in Lloyd's Register Group Limited are owned by the Foundation. This investment had a nominal value (cost) of £50,000.

Lloyd's Register Group Limited operates worldwide through a network of bodies (the Trading Group) which deliver products and services to its clients. The Lloyd's Register Group's website explains that its clients range from local businesses to multinational companies. They generally manage large, high-value assets where mistakes could prove much more than just financially damaging – at risk could be worker safety, local communities and the environment.

The trading turnover of this Trading Group is over £1 billion and to generate this revenue there are all the normal costs of running a multinational global commercial operation. The T&F Report has chosen to compare the trading turnover of the complete worldwide Trading Group with the charitable expenditure of the charitable foundation. This is not even comparing apples with pears and is a patently spurious comparison which would seem to have been designed to make a point which is completely misleading.

In addition, the Trading Group's activities are instrumental in discharging the charitable purpose of the Foundation through the safety related activities of the Trading Group. This includes, safety inspections on ships, the development of rules for the safe construction and maintenance of ships, verifying the safe design and operation of oil rigs etc. These activities themselves could be seen to be for the benefit of the public and environment.

How misleading is the T&F Reports analysis?

Table 2: Lloyds Register Foundation – analysis of charitable spend %

Income as shown in the T&F Report	£1,062,537,000
Charitable spend as shown in the T&F report	£14,490,000
Charitable spend % based on the T&F report	**1.36%**
Foundation income (excluding Trading Group)	£19,516,000
Correct Charitable spend %	**74.25%**

In fact the LRF's annual report and accounts make this abundantly clear and there is a useful graphic that shows the income of the charitable foundation so it is indeed surprising that the T&F Report chose to ignore this.

What else has the T&F Report got wrong about the Lloyd's Register Foundation?

The T&F Report goes on to say "It could be said this analysis is unfair as most of the income relates to commercial trading activities – but that is the point. Why should this organisation have charitable status and any taxable advantages pertaining from this status?"

What is clear to anyone who understands charity structures is that it is the Lloyd's Register Foundation that is the charity and not the Trading Group. It is the charity that can avail itself of the tax advantages of being a charity and these do not extend to the Trading Group. The Trading Group would be treated as any other trading company in the various countries in which it operates, including in UK, and would be subject to the same tax rules as other trading companies

The T&F Report makes reference to the tax exempt status of the Foundation but rather seems to ignore that the accounts show that the Trading Group has incurred a tax charge of £43 million in the last two years.

Understanding foundation structures

Many private sector corporate bodies have charitable foundations and this is laudable. Some are structured so that the financial reporting requirements do not require the presentation of the full revenues and expenditures relating to the trading operations. In other cases the structure is such that the accounts also show the full revenues and expenditures relating to the trading operations. In almost all cases it is immediately apparent what the relevant numbers are so as to distinguish between the charitable and non-charitable aspects.

It is either a very sloppy analysis or intentionally flawed comparisons that would lead any reasonable commentator to compare the charitable expenditure of a corporate foundation with the total income of the linked multinational trading group, rather than the income of the charitable foundation itself.

Some of the largest and most effective foundations are linked to private sector organisations and It would be damaging to many good causes if poor media coverage and the worry of unwarranted negative publicity were to deter corporations from setting up and/or supporting charitable foundations.

4. Understanding the impact of endowments

There are special charity law and financial reporting requirements that require charities to distinguish between income, which they are required to apply within a reasonable time of receipt, and endowments, that are to be invested for the future. In most cases, endowment cannot be spent immediately and there are special requirements that need to be considered.

Whilst it may be that those that compiled the T&F Report may not be familiar with the rules, the accounts of the charities that they have cited have provided the necessary information to allow correct analysis by any competent researcher who wants to represent the correct position.

High on the T&F Report's list of charities that supposedly do not spend enough of their income on charitable activities is the Racing Foundation. The Racing Foundation was established in January 2012. It is funded by an endowment of £78 million from the net proceeds of the UK government's sale of the Horserace Totalisator Board ('Tote'). The objectives are to support charitable purposes associated with the horseracing and thoroughbred breeding industry. It explains that it does this by investing funds to generate investment income and using the income to make grants to appropriate charities.

How did the T&F Report fail to spot the inclusion of £50 million that was invested for the future?

The T&F Report shows the income of the Racing Foundation was £50,932,901 and that its charitable spend was £1,146,153. This purports to show that in the last reported year it has spent 2.25% of its income on charitable purpose.

Comparing the £51 million with the £1 million is wrong and this is obvious from the report and accounts. In the year 2012, the Racing Foundation received almost £50 million from the sale of Tote. The Report of the Foundation's trustees clearly states "As with prior year receipts, these funds have been placed with investment managers, with the aim of preserving the capital over the long term and generating income to fund grant making activity." This should have clarified that this money is not income available to spend but rather that it is to be treated as endowment.

The investment income available to spend in the year is shown and is £1,027,589. This is less than the charitable expenditure of £1,146,153 which would mean that the spend percentage was over 100% (as shown in Table 3) rather than the 2-3% shown on the list which has been presented as a true and fair analysis by a number of newspapers.

Surprisingly, for a report produced by a foundation, The T&F Report seems not to recognise that most foundations have an endowed fund. The Trustees' report and accounts of the Racing Foundation explains this very clearly in a number of places.

Another £50 million that was to be retained and invested is ignored

Next on the T&F Report's list is the Motability Tenth Anniversary Trust. The principal object of the Trust is to promote and support the objectives of Motability, which is a separate, registered charity, by making grants and investing in research and special projects to facilitate mobility needs.

The T&F Report shows the income of the Trust is £54,376,000 and that its charitable spend was £4,093,000. This purports to show that in the last reported year it has spent 8% of its income on charitable purpose. As with the Racing Foundation the Trust received £50 million as an endowment in the year and it is required to retain and invest this.

How misleading is the T&F Report's analysis

Table 3: Impact on charitable spend % correctly excluding endowments

	Racing Foundation	Motabality Tenth Anniversary Trust
Income as shown in the T&F Report	£50,932,901	£54,376,000
Charitable spend as shown in the T&F Report	£1,146,153	£4,093,000
Charitable spend % used in the T&F Report	**2.25%**	**7.53%**
Available income (excluding endowment)	£1,027,589	£4,376,000
Correct Charitable spend %	**112%**	**94%**

The T&F Report says "The team were staggered to find 292 charities, with a combined income of £2.4 billion in their latest reported accounts, that spent 10% or less on their charitable activities."

Well, for all three of the charities that they have cited as being under 10% Tables 2 and 3 show that the T&F Report has got it hopelessly wrong.

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5. Charities with trading operations

Included in the T&F report's list of charities that don't spend enough of their income on charitable activities are number of charities that have diversified and increased their income base through the use of trading operations. For many of the charities singled out by the T&F Report this trading is usually carried out through charity shops.

The retail trade, even when selling a proportion of donated goods, has a number of related costs. If a supporter buys a pack of Christmas cards and a second hand tea set from their favourite charity shop the amount they pay is not the amount that is available for the charity to spend on charitable activities. There are costs associated – these include rent and rates, utility bills, collection costs, cleaning and sorting, staff costs and other costs of managing the shops.

Now, charities could say to all donors who wanted to donate their second hand items, "Please don't bring them to us – sell all your items at the car boot sale or on eBay and give us the money instead". This is not a realistic idea and would generate less net income.

So the reality is that it is only the net income (the price the customer pays less the related costs) that is available for the charity to spend on its charitable purposes. This simple fact seems to be one that the T&F Report is not ready to acknowledge.

All the charity high street names highlighted as the worst offenders in the T&F Report fall into this category and any one could be used to demonstrate the point.

Using the British Heart Foundation to demonstrate the point

The British Heart Foundation's last published accounts show that it raised £288.2 million in the year; of this £170.2 million came from its trading operations. Their Annual Review explains that staff and over 20,000 volunteers transformed over 60,000 tonnes of used clothes, books, DVDs, furniture etc of variable quality, into over £29m of cash. There is a cost to do this and the net profit on trading was £29.3 million. This means that the income less the costs of trading was £147.3 million. The charitable spend in the year was £113.7 million which gives a percentage spend of 77% (113.7 ÷ 147.3). British Heart has explained this in terms of income raised showing that 78% is available for their charitable work.

See British Heart's response to the T&F Report here.

The T&F Foundation, in a response to the many critics of its report, has said that all this means that charity shops are too expensive and asks whether there are not "more efficient ways to fundraise". The fact is that charities do not run shops instead of other ways of raising funds. Most large charities use a mix of methods such as direct mail, social media, events, big gifts, retail and legacies. Legacy fundraising is widely recognised as having the lowest cost ratio (most efficient in the T&F Foundations terms) but it would be an unusual charity that did not diversify its income streams and focused only on legacies.

The T&F Report advocates that there should be rules requiring charities to spend at least 65% of their annual income on their charitable activity. This might sound a good idea but what does it mean in practice? As shown in Table 4 below the British Heart Foundation could achieve this immediately if it closed down its charity shop chain and tried to generate only non-trading income.

This table does not attempt to explain how British Heart Foundation manages itself or allocates its charitable expenditure. Specifically, British Heart Foundation does not allocate its trading and non-trading income to charitable expenditure in this way. The table has been produced simply to show what the number might look like without the £29.3 million contribution to charitable expenditure from trading activities. The rest of the charitable expenditure, when compared to the income, using the dispersal rate methodology in the T&F Report, would be far above the arbitrary 65%.

Of course, as shown in Table 4 below, this would mean that it would have £29 million less to spend on its vital work. Based on these figures the charitable expenditure would have reduced from £113.7 million to £84.4 million. So although the amount of charitable expenditure would have reduced significantly the dispersal rate would have increased significantly. This further highlights the absurdity of using dispersal rates in this way.

Table 4: What would happen if British Heart Foundation were to stop its trading activities

	Non Trading £m	Trading £m	Total £m
Income	118	170.2	288.2
Costs of raising income	-31.5	-140.9	-172.4
Available income	86.5	29.3	115.8
Charitable expenditure	84.4	29.3	113.7
Charitable expenditure %	**72%**	**17%**	**39%**

As an aside, the 17% profit margin on trading is one that most commercial retail traders would aspire to.

Civil Society Media produces an annual survey of charity shops. The last survey included 75 charities with 6,625 shops producing a net profit of almost £200 million. Surely, the authors of the T&F Report do not think this is worth giving up simply to achieve the 65% rate.

Each charity with trading operations that have been listed amongst the 17 ‘under 65%’ offenders could immediately raise their % above this arbitrary number but as shown in the British Heart example above there would be millions less for their charitable work.

Sue Ryder, Cancer Research UK and Guide Dogs have provided their own responses refuting the T&F Report.

6. Expenditure on mission related fixed assets

Most users of accounts know that accounting statements showing income and expenditure do not include capital expenditure. This means that when land and/or buildings or other fixed assets that are expected to have a useful life of several years are purchased or built by an organisation, the expenditure will not show in the revenue statement (for charities this is the Statement of Financial Activities). In some cases this expenditure may be on a mission related fixed asset, such as a hospice, a research laboratory, a lifeboat or kennels. Doing what the T&F Report has done ignores that this expenditure is as much charitable expenditure as making a grant.

This is nothing special for charities and the same would apply in any commercial accounting statement. It is surprising that the team that produced the T&F Report did not factor this in. Table 5 below shows the cost ratio calculation using the T&F Report's flawed methodology and the cost ratios after making the relevant adjustments.

Investing in a research institute is as much charitable expenditure as making research grants

Cancer Research UK has for some years been investing in the Francis Crick Institute. Due to open in 2016 in London's King's Cross, the Crick will bring together world-class scientists to tackle the most significant diseases affecting people today, including cancer, heart disease and infectious diseases. The charity is contributing £160 million towards the construction of the Crick. The 'Create The Change' fundraising campaign aims to raise £100 million. The accounts show that the investment in the Crick in the year was £41.7 million.

Taking this into account would increase the cost ratio in the last published accounts from 67% to 73%. This is without the further significant adjustment for trading operations highlighted in the section on Charities with trading operations.

Expenditure on rehoming centres is charitable expenditure for the Dogs Trust.

Using the T&F Report's methodology on The Dogs Trust's last published accounts would provide a dispersal rate of 67%. However they are included in the T&F Report's list of charities with an under 65% dispersal rate as over three years the average is 63%. The Dogs Trust spends a significant amount on its rehoming centres. Information in the accounts shows that this is £22 million over the last three years. If this is factored in the three year average dispersal rate becomes over 72%. Using the numbers in the last published accounts this would have increased from 67% to 75%.

Expenditure on lifeboats and lifeboat stations are charitable expenditure for the RNLI

RNLI has to make significant investment each year in fixed assets that are essential for it to deliver its charitable purpose. The last published accounts show that RNLI spent £64.7 million on lifeboat stations, lifeboats and launching equipment, all-weather Lifeboat Centres and other equipment and property. The expenditure in the Statement of Financial Activities only includes the annual depreciation of £24.7 million. Taking this into account, the charitable expenditure used by the T&F Report should have been £40 million higher. This would increase the dispersal rate from 64% to 85%.

RNLI would also have a small adjustment for merchandising that would further improve the ratio.

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Table 5 below highlights the significant under statement of the % charitable spend for these three charities using the methodology in the T&F Report based on the last published accounts.

Table 5: Impact of correctly adjusting for fixed assets that should be included as charitable expenditure

		Cancer Research UK	Dogs Trust	RNLI
		£'000	£'000	£'000
Income per Statement of Financial Activities	A	£634,900	£84,743	£190,100
Expenditure per Statement of Financial Activities	B	£422,700	£57,185	£122,200
Add: Expenditure on mission critical Fixed Assets	C	£41,700	£6,500	£40,000
Adjusted charitable spend	D	£464,400	£63,685	£162,200
T&F methodology charitable spend % (B/A)		67%	67%	64%
"Correct" charitable spend % (D/A)*		**73%**	**75%**	**85%**

* The Cancer Research UK dispersal rate percentage would be even higher if the adjustment was made for the cost of its retail operations as discussed in Section 5.

Similarly, the accounts for Marie Curie show expenditure on new hospices. In some years this is significant, for example, capital expenditure for the year 2012/13 was £14.4 million. This included £7.3 million towards the cost of a new hospice for the West Midlands which was completed in January 2013. The T&F Report has failed to take that into account. If they had the dispersal rate would have meant that they should not have been included in the list.

7. Charities that receive donations in kind

A number of charities receive donations in kind. These can range from gifts of goods and services, to the provision of free accommodation. Usually this will mean that the value of the donation is recorded as both income and expenditure. However, if the donated items were fixed assets then as discussed in Section 6, there would be no equivalent expenditure showing in the revenue statement (Statement of Financial Activities). Therefore, when land and/or buildings are gifted to a charity the total income will increase but there will be no equivalent expenditure shown in the Statement of Financial Activities. As a consequence, comparing the income with the expenditure without taking this into account, as done in the T&F Report, will produce a spurious result.

The T&F Report has listed the Oasis Charitable Trust as having a dispersal rate of 58%. The Oasis Charitable Trust has wide charitable objectives and activities. Key amongst these is the advancement of education. The largest member of the group is Oasis Community Learning that was responsible for 40 Academies during the last financial year. During the year the Trust's income shows donations in kind of almost £112 million. This represents the cost of new buildings provided by Local Authorities for existing academies to operate within. The T&F Report fails to recognise that this income can have no equivalent expenditure. Therefore including it in the income number used to compare with expenditure and arriving at a dispersal rate of 58% is patently wrong. Matching charitable expenditure with the correct attributable income would show a dispersal rate of 98%.

Table 6: Oasis Charitable Trust impact of adjusting for donations in kind

		£'000
Income per Statement of Financial Activities	A	£271,709
Adjustment: Buildings donated for charitable activity	B	-£111,588
	C	£160,121
Expenditure per Statement of Financial Activities	D	£156,893
T&F methodology charitable spend % (D/A)		58%
"Correct" charitable spend % (D/C)		**98%**

More generally, even where the equivalent expenditure is shown in the Statement of Financial Activities, the classification of the expenditure recording will be determined by the nature of the gift and how it is to be used. For example, if a charity receives free public relation services or free advertising then it would need to consider what these were for. If they were for a fundraising purpose then the equivalent value would be shown as a fundraising cost. If on the other hand the services were to publicise mission related information then the equivalent expenditure would show as charitable expenditure.

This means that the dispersal rate as calculated by the T&F Report would change according to the nature of the donation in kind. This is usually out of the control of the charity and highlights that there are many factors that can impact on cost ratios.

8. Why cost ratios just do not work and what are the alternatives

It is important to reiterate that the provision of the tables and analysis in the earlier sections should not imply that cost ratios drawn from a set of accounts can be used as a measure of effectiveness.

There continues to be a spurious belief that charities can be measured by looking at expenditure such as fundraising costs or charitable expenditure in the financial statements and comparing it to the income raised. Regrettably, the Charity Commission's beta site compounds the problem by displaying simple cost ratios. Fortunately, this is a beta site and the Commission has asked for views and the site is to be changed. The fact is that any endorsement from the regulator of a cost ratio based approach will be a retrograde step. This has been tried elsewhere and has been seen to be confusing, even damaging. There are just too many issues to factor in that can make such comparators unworkable. It is not possible for the Commission to cater for all the nuances that would give credibility to the percentages shown.

The T&F Report states that they used a "research team who possess accounting and investment research and analysis expertise." The fact that the supposedly expert team got their analysis so wrong shows the futility and indeed danger of trying to use cost ratios to evaluate charities. It is also telling that the failed Kids Company's last published accounts shows a dispersal rate of over 93% using the T&F Report's methodology.

There are examples of waste and poor practice in charities but these are the exception rather than the rule. Regrettably, the focus is on these and not on the vast number of charities that demonstrate good practice and are profoundly impacting, in so many exemplary ways, the causes they support.

The analysis in this critique has shown the errors and spurious conclusions that arise when ill-informed comment is made based on trying to compare charitable expenditure with total income. Whilst this critique has identified the glaring and obvious errors made in the T&F Report it does not attempt to explain all the many normal issues of charity operations that mean that using ratios of this kind add no value and lead to erroneous judgements and conclusions. Cost ratio analysis has been tried elsewhere in the world and the futility of trying to use them as a performance measure has been recognised.

Income is often unpredictable and it is not practical to match expenditure in a way that would guarantee a spend percentage. A charity could receive a large donation or legacy in the last part of the year and may not spend it until future years. Some charities may be trying to build up reserves and therefore be budgeting for surpluses whilst others may be planning deficits to make investments for the future or to run down excessive reserves. Some charities operating model requires them to spend all the funds they receive as soon as they can, others have longer term projects and programmes that need to be funded in future years. The same charity can correctly have different approaches at different times or even at the same time for different areas of its work.

Cost ratios are influenced by a number of factors and the fundraising mix is an important one. For example, legacy fundraising has a very low cost ratio whilst cost ratios for special events and dinners are usually much higher. However, some types of charities, such as medical charities, do better at raising legacies than others such as international aid charities and this has little to do with their fundraising skills or effectiveness. Therefore, some types of charity will have an inherent fundraising mix that predisposes to a lower fundraising cost ratio.

Financial Reporting Standards do not usually allow fundraising costs to be carried forward to be matched against future income and the reality is that with most forms of fundraising there is very little correlation between what the accounts report as fundraising costs in a year and the actual amount raised in a year. The most extreme example is a legacy campaign where the money is spent in one year and income comes in much later. Even direct mail campaigns show little correlation between reported income and expenditure. Acquisition and cold mailings can lead to poor, even negative cost ratios, in the first year. Yet such investments can be important as they generate new donors and yields are justifiable when considering the lifetime value of the donors.

The financial reporting date can also be significant. Consider fundraising where the donor signs up to pay a fixed amount per month. The mechanics can involve an upfront payment to an external fundraising company which can equate to several months' income. If this campaign is run a few months of the year end the costs charged will inevitably exceed the income recorded. The following year the accounts will show a full year's income but no donor acquisition costs.

There are many other confused messages and some commentators try to make the public believe that high staff costs are always indicative of waste. I am often called by journalists wanting a comment on a charity that "seems to be spending most of its income on paying its own staff". There is of course far more to consider as many charities employ their own staff to deliver mission critical services. Others may work with partner organisations that deliver the services. Some charity operations are labour intensive and some others say campaigning or grant making may require less staff. There are no easy comparisons.

In her response to critics of the T&F Report, Gina Miller, the Founding Partner of the True and Fair Foundation refers to organisations in the USA, such as Charity Navigator and the Better Business Bureau, saying that they crunch the numbers in the same way. In fact, a number of commentators in the US nonprofit sector, such as GuideStar, Charity Navigator, and the Better Business Bureau Wise Giving Alliance have recognised the concerns about cost ratios and a couple of years ago these three organisations launched the "Overhead Myth" campaign.

In an open letter to charity donors they say: "We write to correct a misconception about what matters when deciding which charity to support. The percent of charity expenses that go to administrative and fundraising costs—commonly referred to as "overhead"—is a poor measure of a charity's performance. We ask you to pay attention to other factors of nonprofit performance: transparency, governance, leadership, and results".

They followed this up with a second open letter to US Non Profit Organisations (charities). This says, "We write to ask for your help to end the Overhead Myth—the false conception that financial ratios are a proxy for overall nonprofit performance. Last year we wrote a letter to the donors of America asking them to consider the results (especially outcomes and impact) created by nonprofits, and to not judge you solely on percent of charity expenses that go to administrative and fundraising costs. While overhead can help us identify cases of fraud or gross mismanagement and serve as a part of an organization's dashboard of financial management metrics, it tells us nothing about the results of your work (i.e., how you meet your mission)."

The letter goes on to talk about the "Nonprofit Starvation Cycle" - a spiral of donor demands, underinvestment in core costs, and limited results. They ask charities to do three things

1. demonstrate ethical practice and share data about performance.
2. manage towards results and understand true costs.
3. help educate funders (individuals, foundations, corporations, and government) on the real cost of results.

A billboard campaign in the US uses the message - "Don't ask if a charity has low overhead. Ask if it has big impact." and the increased focus on impact and effectiveness in charities worldwide is challenging the overhead myth. But, progress is painfully slow and ill informed comment such as seen in the T&F Report, particularly when it is publicised in the national press, causes damage, impacts on trust and confidence and hinders what charities are trying to achieve. Regulators, standard setters, funders and umbrella organisations in the sector have an important role in moving the agenda on – away from spurious and limiting measures to more focus on how effective charities operate, the massive amount they achieve and the positive change they create.

The Charity SORP is trying to raise the bar on better reporting of achievements and performance and explains that, "the Trustees' report must contain a summary of the main achievements of the charity. The report should identify the difference the charity's work has made to the circumstances of its beneficiaries and, if practicable, explain any wider benefits to society as a whole. The SORP goes on to explain that good reporting sets out how well the activities undertaken by the charity and any subsidiaries performed and the extent to which the achievements in the reporting period met the aims and objectives set by the charity for the reporting period. Good reporting provides a balanced view of successes and failures along with the supporting evidence, and demonstrates the extent of performance and achievement against the objectives set and the lessons learned."

Although the SORP is billed as recommended practice It is important to recognise that the law through Charity Accounting Regulations and also Financial Reporting Standards makes the SORP mandatory for charities over a certain size. There are certain options in treatment (where the words 'should' or 'may' are used) but the SORP as a whole is not an optional extra and will continue to drive and inform good practice in reporting.

There are no stereotyped solutions or yardsticks that would work for all charities and all circumstances and the task of setting spending priorities for charities will remain as difficult as ever: matching the demands to satisfy short-term needs against pressure for the resources required to achieve long-term solutions. It is in this context that charity trustees and management have to make difficult decisions and explain their thinking. For too long these decisions, biased by concerns about cost ratios, have been suboptimal and trustees and management have shied away from making good choices simply because they believe it would impact on how their cost ratios are perceived.

This has led to an under investment in vital infrastructure and in areas considered 'overheads' such as information technology, skills training, good fundraising processes and effective governance and management. This in turn leads to a vicious cycle that exacerbates the problem. The press and other commentators and, through their reporting, donors and others have unrealistic expectations about what it takes to run an effective charity. Charity trustees often react to these unrealistic expectations and fail to invest in vital infrastructure. This in turn leads to increasing the unrealistic expectations of doing more and more with less and less.

Charities are also to blame, further perpetuating these unrealistic expectations and poor understanding by highlighting their financial ratios as a measure of effectiveness. This is because it is thought to be what donors want to see and as a result the more difficult reporting on performance falls by the wayside. The narrative needs to move on and the vicious cycle needs to be broken. Charities need to be bolder in their messaging – explaining operating realities, costs and what they are really achieving. We need to stop talking about good and bad expenditure and focus instead on performance.

Charity trustees and management, considering good practice, must decide on what works for them, and should be able to transparently explain what they have chosen to do and why they have chosen to do it rather than be concerned that their ratios will not look good.

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