CFG

Leading the way
for charity finance

Know Your Cost Base

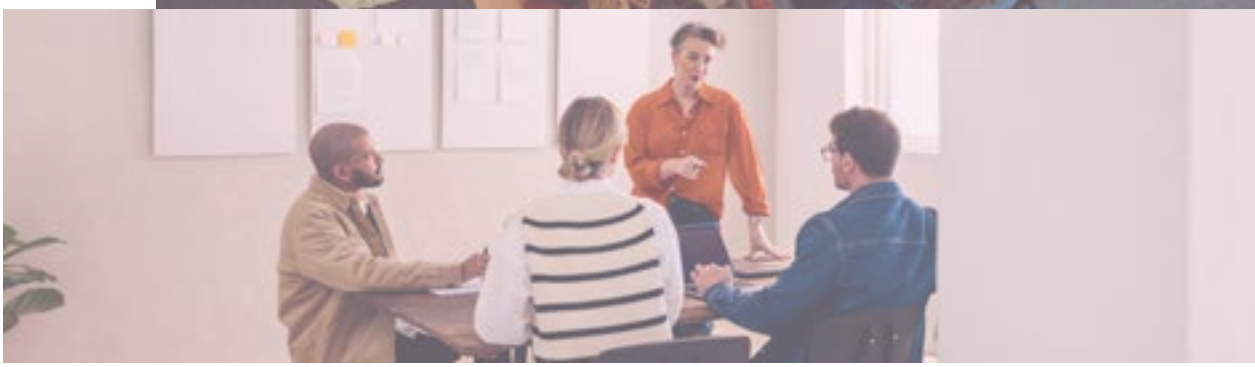
Part of the 'Mastering Charity Finance' series

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In partnership with HaysMac







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1. Foreword



Richard Sagar
Head of Policy, CFG

At Charity Finance Group (CFG), our purpose is to help charities strengthen financial leadership and embed best practice. This allows them to pursue their missions with confidence, resilience and good stewardship. We are delighted to publish this updated edition of 'Know Your Cost Base', in partnership with award-winning chartered accountancy firm, HaysMac.

When CFG first published this guide in 2008, the charity sector was navigating a very different landscape. Since then, the sector has transformed profoundly: operational complexity has increased, regulatory demands have tightened, and the cost of doing business has been fundamentally reshaped by global events, from the financial crisis to the pandemic, and most recently, by unprecedented cost pressures affecting every aspect of charity operations.

Yet, despite all this change, one core principle remains as vital as ever: understanding what your work truly costs is not merely a technical exercise for the finance team. It is a strategic capability that sits at the heart of sustainable delivery. When charities can clearly articulate their cost base, both today and over time, they are better positioned to plan confidently, govern effectively, price services appropriately, manage risk, and make decisions that protect long-term impact.

> Understanding a charity's cost base is not a technical exercise for the finance team alone; it is a strategic capability that sits at the heart of sustainable service delivery

Why this matters now

In recent years, many charities have experienced sharp and unpredictable cost shifts. Energy, pensions, pay pressures, compliance demands – none move in neat, predictable lines. In this environment, the old 'last year plus inflation' approach can lock organisations into assumptions that no longer reflect reality, creating significant delivery risk when funding fails to keep pace.

The right starting point isn't a spreadsheet uplift; it's a clear view of what you're trying to achieve and what resources – people, premises, systems, governance – must be in place to deliver safely and effectively. Just as importantly, clarity about costs supports healthier relationships with funders. It enables transparent conversations about what it takes to deliver outcomes well and why funding a fair share of overheads is essential to a strong and sustainable sector.

Our shared purpose

This publication offers a practical framework for building that understanding in a robust and repeatable way. It's designed for finance leaders, trustees, executive teams, and for funders who want to understand what sustainable partnership truly requires.

We hope this guide helps you make informed choices and have more honest, evidence-based conversations about what it takes to achieve your mission, so you can focus your energy where it matters most: creating positive change for the people and communities you serve.

2. A word from our partners

In an increasingly complex financial environment, clarity, consistency, and transparency in charity cost measurement are more important than ever. A robust understanding of cost bases underpins sound financial management, informed decision-making, and effective accountability across organisations of all sizes and sectors.

We are delighted to work with CFG to update the guidance which I initially wrote together with significant contribution from Mark Salway, to provide a practical reference point for those responsible for establishing, analysing, and applying financial cost bases within charities.

Cost bases serve as the foundation for many critical activities, including pricing, budgeting, performance evaluation, regulatory reporting, and strategic planning. When defined and applied correctly, they allow organisations to allocate resources efficiently, compare performance accurately, and ensure that financial outcomes reflect the true cost of delivering charity's products or services.

Conversely, poorly defined cost bases can lead to distorted analysis, misaligned incentives, and suboptimal decision-making particularly around the utilisation of reserves.



Richard Weaver
Partner, HaysMac

The purpose of this publication is to bring together established principles, practical methodologies, and clear simple guidance to support consistent cost base development and application. It aims to bridge the gap between technical financial frameworks and day-to-day operational use, offering readers both conceptual understanding and practical tools.

This work reflects the authors' and CFG's experiences in practice and feedback from clients and members who recognise the importance of disciplined cost analysis in a rapidly evolving economic landscape.

While the specific context may vary across charity sub-sectors the underlying principles remain universal, and we hope that you find this publication a useful tool not just for those charity finance professionals, but also others who input in bidding and quoting for charity revenue.

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HaysMac

3. Introduction



3. Introduction

The aim of the publication

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 (including sustainability of organisations across the sector).

This publication is aimed not just at the head of finance or equivalent, but also chief executives, trustees and other members of staff who do not have a financial background but are involved in making financial decisions or preparing funding applications for the charity.

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

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. Properly understanding a charity's cost base and reacting appropriately is therefore a vital component of sound financial governance.

What is this publication about?

This publication builds on previous work starting from Julia Unwin's 1999 report 'Who pays for Core Costs'. This work brought focus on core costs and overheads and the necessity to fund these in a transparent and sustainable way. Following this, there have been several publications from others in the sector; namely ACEVO, NCVO and specific grant-making organisations.

'Know Your Cost Base' publication was first produced more than a decade ago, and with all that has happened since then, including the current economic pressures charities are facing, and the advent of a new Charity SORP for periods starting on or after 1 January 2026, it was the right time to refresh the guidance. As part of this refresh, we have incorporated the survey



Introduction continued

results of a recent CFG survey into experiences of members in this area, and other insights drawn from the sector during the past few years and the prospects for the future.

This publication was never 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'.

Core costs or overheads?

This publication makes no distinction between 'core costs', 'administrative costs' and 'overheads' as phrases used to explain the same types of costs. While the words used to describe these indirect costs may be open to debate, what is not in debate is that these costs are essential to the operation of a charity, as they are with any business, and must be funded to allow a charity to function.

Most people are happy 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, and how many, products or services are delivered. The same should hold true for any charitable organisation.

What is not in doubt is that the charity sector should be funded with a fair proportion of overheads to match the services or work being delivered and this publication looks at ways of identifying what the cost base of a charity is so that you can then determine what a fair proportion of overhead's may be for a particular service, activity or contract.

A reference guide

The publication aims to approach the various subjects in such a way that it can be used as a reference guide. You may wish to dip in and out of the publication to gain knowledge in certain areas; you don't need to read the entire document from end to end to understand the issues.

Charity Finance Group's survey results

Charity Finance Group ran a survey in late 2025 to seek feedback from members on their experiences in cost recovery and the key findings were:

1. 70% of respondents considered indirect cost recovery as part of the budgeting process, but 30% did not.
2. When asked to grade the elements that would help improve cost recovery and financial planning, the two highest results were identified as being able to state the full costs of delivery in a funding application (74% of respondents thought this would be very helpful), with the second most helpful being receiving a proportion of project costs up-front (58% of respondents thought this would be very helpful).
3. It was interesting to note that 50% of respondents submitted bids as part of a consortium or partnership.
4. 60% of respondents continue to receive funding for project delivery quarterly in arrears, and 25% annually.

We address the impact of a number of these responses in this publication.



4. Setting the scene

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The charity sector (or more widely the social purpose sector, as not all readers will necessarily be working within a charity) is wide and diverse, and no two charitable organisations are the same. For the purpose of setting the scene for this publication however, three simple but common scenarios are envisaged:

1. The stable charity
2. The rapidly growing or contracting charity (organisations in a state of change)
3. The charity formed to meet a defined strategic need

This chapter develops the notion of cost bases within the three scenarios and considers the implications for each type of charity when there is a significant change in its funding model.

The questions all should consider

Every year charities need to go through a planning and budgeting process. That is, they need to agree a high-level strategic focus and, from this, formulate a series of annual plans and prepare annual budgets.

While formulating the budget, certain questions must be asked around overheads:



Where a charity is going through a period of change – either by growing the work they do or experiencing reductions in funding – this can lead to a more confusing position about how core costs are funded...

1. **What is the level of indirect costs to direct costs?** Knowing what the overhead costs are, involves understanding the framework of an organisation, the various departments and the activities that are conducted.
2. **How and why are costs changing?** Is the organisation transparent about managing its service delivery costs as well as overheads and does it understand the relationship between the two?
3. **How are core costs funded?** Are overheads being appropriately funded from funding agreements/contracts or is the charity funding these from other income generation or reserves? The last thing a charity wants is to accept a project or service delivery contract which is underquoted and depletes the charity's reserves – unless there are key strategic motivations for doing so e.g. by under-cutting other organisations to build market share, or because reserves were built up in order to meet a need that is co-funded by other organisations/contracts or grants.
4. **Other factors to consider:** there are a number of other financial and non- financial items that must be considered. Such items as cash flow and quality of service will affect not only how a charity meets its objectives, but also the impact on strategic direction, aims, objectives and financial reserves.

Once you have agreed the budget, future applications for funding will take on board the same framework for overhead costs. A simple example is that if the budget identifies that all projects require 15% of overheads to be recovered, then this should be the starting point for funding applications.

If, in practice, there is a variance between expected funding and that actually received, then the charity may need to re-forecast its surplus or deficit for the year and consider the wider implications for the charity's financial position and strategy.

Setting the scene continued

Members of staff with limited or no financial qualifications or financial training can often be asked to prepare the budgets for funding applications and this publication aims to provide practical guidance to ensure that they understand core costs and budget information. Management should ensure that specific training is provided to these staff to facilitate appropriate overhead recovery and that they understand the importance of periodic financial review of individual projects against the original funding application budget.

The stable charity

What we envisage here is a charity whose operations don't change significantly year on year; for example, a grantmaking charity that relies on its investment portfolio to deliver an investment income from which it makes grants to third parties.

Subject to any significant inflow of additional cash (e.g. large legacy or founder donations) such a charity is likely to have a stable cost base. Depending on its size, it might be solely run by its trustees, or have a small administrative team. If it is a significant grant-maker then the staff team is likely to be much larger. The larger the charity the more likely it is to do different and more complex transactions and fall within one of the other categories.

The rapidly growing or contracting charity (organisations in a state of change)

Where a charity is going through a period of change – either by growing the work they do or experiencing reductions in funding – this can lead to a more confusing position about how core costs are funded, and there are practical examples later in this publication.

Growth

Where a charity is expanding it is tempting to feel that cash flow will be stronger and that core costs will be adequately covered in the immediate future. In fact the charity should consider the length of contracts in its plans, and if funding is restricted to a particular purpose or activity. There may also be a case to consider whether some core costs have been 'double-funded'. This can occur where charities are fortunate enough to receive an element of core funding, in which case allocating costs already covered to restricted projects would be double counting. Alternatively, some charities do not accurately allocate costs within their accounting system to specific projects, so that when it comes to reporting to funders the same costs can inadvertently be extracted and reported to more than one funder.

In the long run, however, it will always be the case that overheads will need to be funded appropriately. Charities that continue to grow may experience pressure of growth on central resources and the potential increase in cost base that control over a greater number of projects will entail.

The real puzzle here is how to equitably spread overheads between projects and funders such that each pays a fair proportion of this cost for services provided.

Contraction in services

In the opposite scenario multiple short-term funded projects can lead to in-year fluctuations in the ability to recover essential core costs. With a smaller number of projects is it then fair to ask funders to accept a larger proportion of the burden of administration costs?

In an extreme example this could lead to dysfunctional cost behaviour, for example trying to recover overheads that match the profile of the gain or loss in funding in a reactive way. This approach will potentially make the charity less competitive against its rivals in bidding for future work or could make the charity appear inconsistent in bids for funding from the same funder.

It also seems appropriate to re-forecast and re-appraise the appropriate level of funding for core costs whenever a step change in funding occurs to consider the recovery for individual projects

Setting the scene continued

and to ensure future applications do not under-quote the fair proportion of overheads that need to be funded. With such contraction in operations, it is also likely to be met with restructure or cost cutting exercises which will change the nature of the charities overall cost base and reduce the costs that need to be covered.

For those organisations that are in receipt of significant restricted funding, the same is also true that they are reliant on those restricted funds absorbing a significant amount of cost recovery and so any step change in this funding will also result in a similar situation.

The charity formed to meet a strategic need

Sometimes charities come into existence where funders or local or central government identify a specific need, for example charities set up for a specific lifespan (in the run up to the London Olympics, for example) or building capacity within a marginalised community from a large, one-off block grant.

Core costs will typically be funded by the overall funding while grants are made available and strategic need is being met. But what happens when funding stops or grants are removed? Only those organisations with well thought out contingency plans will survive, emphasising the importance for sound financial models and future best and worst case scenario planning.

In all cases only sound financial planning and clear reserves management and strategic plans that are well communicated through the annual report and accounts will ensure that funders understand the dynamics of funding within an organisation and be further prepared to buy into the sustainability of the charity through their funding arrangements.

So what can go wrong?

Many things can go wrong but the two main issues identified by Charity Finance Group (then CFDG) in its 2006 survey, and by NPC in their 2024 survey, have been the following:

- The fact that many funders still fail to fund a fair proportion of overheads. This burden then falls on 'free-reserves', or general fundraising to meet the shortfall.
- Secondly, over-trading by charities. Poor financial management during periods of growth, and a lack of thought about contract closure costs in particular, can lead to a situation which the charity fails to secure adequate funding for core costs.

CFG's own follow-up survey results in 2025 showed that the majority of respondents (60%) still receive funding quarterly in arrears of performance and this leads to an inevitable draw on reserves until the funds are received.

In the second scenario, as the charity grows free reserves can be depleted to meet the demands for funding core costs and increases in administrative work. The charity eventually draws on all free reserves just leaving unexpended 'restricted' funding. To use restricted money to cover any costs that are not within the terms and conditions of the agreement will be a breach of trust and this causes even greater risk for the charity and potentially its trustees.

For this reason, the separate monitoring of restricted and unrestricted cash is critical to ensure that the charity does not inadvertently use restricted cash for broader purposes.

We know from experience that there are often cash flow implications of grants and funding being received in arrears of performance. The implication being that a charity's own reserves will be used to fund the project/activity and the interest or investment opportunity is lost – effectively the charity is then subsidising the cash flow of the service for the third party.

It is important that funders understand this fact and those involved in future funding applications consider an element of advance funding wherever possible. An example of the implications appears later in this publication.



5. Working out the cost base

5. Working out the cost base

The importance of a strategic plan

Identifying your strategy

The overall long-term aim of any charity must be to maximise the impact it has in line with its objectives and this will only be achieved with a clear strategic plan which is flexible to changing circumstances and covers more than one year ahead.

Such a strategy needs to be both operational and financial – operational in terms of delivering quality services, and financial in terms of delivering the services in the most cost effective and efficient way possible.

Funding for charities, particularly service delivery, is now more frequently being channelled through tendering processes, whether it be NHS commissioners, local government or other funding bodies. Charities need to be clear about what they can offer, what it is going to cost and why a charity should be selected rather than a commercial organisation.

Having a clear strategic plan and clearly defined objectives can help focus on the differences between a charity and a similar commercial organisation, and the way it delivers its services.

So what should be contained within your strategic plan? There are many examples, but it is really about keeping it as simple as it needs to be. Keeping it simple does not mean that it has no value, but that existing trustees, CEOs, staff and newcomers to the charity can quickly understand the charity's work and focus that it has set itself over the next few years.

Sound financial analysis should underpin any strategy and this can only be achieved by understanding your charity's cost base.

Financial plans

Once a charity has decided how it will meet its objectives and developed strategic options, it must define the financial plans (or financial underpinning) for achieving these.

This is not the same as preparing a detailed budget, but is a high-level consideration of the types and extent of funding that will be required if the charity is to succeed in achieving its strategy. The financial implications of the strategic plan must cover the length of time being considered, which is commonly between three to five years.

The financial component of the strategic plan should consider both the income and expenditure likely to be incurred, together with an idea of the annual level of reserves and, most importantly, the cash flow assumptions and implications over the life of the plan.

The plan should identify scenarios depending on the certainty of funding and be sufficiently flexible to consider changes along the way and identify the key decisions that will need to be made if x happens as opposed to y. The best and worst case scenarios enable the charity to consider whether the current financial position can support the strategies, and if not, then it provides management and trustees with the



Sound financial analysis should underpin any strategy and this can only be achieved by understanding your charity's cost base

knowledge that they must identify what needs to be addressed and/or what can be achieved within current financial boundaries. It also provides a benchmark against which to react if things start to change for the better or worse.

A good example of the extent of uncertainties in financial planning is evident in the arts. Exhibitions need to be attractive to bring in the required audiences, but audiences may be dependent on fashion or perceived interest. Budgeting may, therefore, be very much 'finger in the air', especially if the exhibition has not been tried and tested in earlier years.

Best and worst-case scenarios emphasise the extent to which sponsorship or other forms of financial support may be necessary to make the exhibition financially viable. They may also provide the fundraising department with a minimum funding requirement that they must achieve to fund any shortfall in other forms of funding.

Another example might be a planned, large conference in the lifecycle of the plan, but without a fixed date for the conference itself. What are the implications of the conference being held in say June rather than October in a particular year, considering the others forms of income and activity that the charity undertakes. Does one month lead to a greater or lesser challenge for cashflow or draw on staff that would see them stop one activity to focus on the conference?

Risk

Having identified the financial aspects of the varying strategies that could be adopted, the charity should consider the risks involved in adopting those strategies. Risks here are not only financial risks which have been discussed above in terms of best and worst-case scenarios, but also the operational and reputational risks involved. The quality of service in all circumstances is paramount and should not be forgotten in the effort to secure funding.

Budgets and planning

The general process

Once you have a high-level strategic plan, the next stage is having determined what the charity is going to do, to set detailed budgets and plans in place.

When to budget will depend entirely on how complex the charity is and the number of people involved in the process. For smaller charities, the budgets are likely to be prepared by the head of finance in discussions with project leaders or equivalent and reporting to the full trustee board. For larger charities the budgets are likely to be delegated to the heads of department who will prepare separate departmental budgets which they will feed in to the head of finance to consolidate.

Whichever model your charity adopts, one key factor should be evident – the need to link the budgets directly to the strategic plan. Budgets prepared in isolation to the strategic plan have less value or may not focus on making the best use of resources.

Negotiations should then take place about the content of individual budgets in an effort to streamline and be efficient wherever possible but because charities and the sector are ever changing, charities cannot afford to take the approach of using last year's costs and adding a rate of inflation. This approach will not result in sound financial management as it ignores the need to consider the costs of delivering the strategies set out in the plan, which may be very different to previous years and require a different mix of costs.

Departmental/project input

Budgets are often used as a benchmark for assessing the performance of particular projects, departments or individuals. In any case, these must be 'agreed' with those project leads or

Working out the cost base continued

department heads as this information will be used which to monitor and appraise.

For departmental budgets, having the buy-in of the head of department ensures that they acknowledge the financial parameters within which they have to operate. On a periodic basis, actual performance against budget can then be assessed, and the department heads should be responsible for explaining variances, both good and bad, against budget. It can only be reasonable to make someone responsible when they have agreed the parameters in advance.

For individual projects the same holds true for the project manager. Where they have estimated the costs of delivering a programme or project, whether it is funded externally or not, monitoring the actual expenditure against budget is crucial for effective evaluation and monitoring.

The manager should be responsible for explaining variances in actual spend on a periodic basis, say quarterly. This allows management and/or trustees to assess performance and, if necessary, make strategic decisions i.e. if a project is generating a deficit, to react appropriately. If the project is making a deficit, should the charity cease the project if they are able to and transfer efforts elsewhere?

What does the budget achieve?

Budgets in any organisation are important but for charitable organisations they are critical. If you are a trustee of a charity, you are responsible for the finances and for directing the strategy of the charity. Without a budget against which to monitor and assess the finances it would be very difficult to satisfy the responsibilities and duties that trustees have.

However, budgets are not only a critical means of enabling trustees to comply with their duties, they are also important for:

- Identifying measurable income and expenditure streams
- Setting and communicating targets for members of staff or departments
- Identifying capacity and allocating resources
- Effectively monitoring performance
- Ensuring responsibility for different areas of the budget
- Making strategic decisions, and
- Focusing the mind.

Budget models

Knowing what the budget is and what it achieves is one thing, but how do you go about preparing a budget in line with your strategy? This publication considers two models which hopefully meet the needs of most charities, irrespective of size.

Whichever model is chosen, there is a fundamental need to understand the cost base of the charity. The cost base includes both the direct costs of performing the activities, and the overhead (or indirect) costs in support of those activities.

Direct costs are those costs which can be directly identified with service delivery or project work.

Indirect costs are those costs which cannot be directly identified with service delivery or project work, but nonetheless are necessary to support the organisation e.g. HR or IT.

What we aim to do is allocate a fair proportion of the indirect costs (or overheads) to the direct costs of projects or services. Without knowing the level of these overhead costs it is very difficult to effectively budget, monitor performance, or make key decisions about future plans or strategies.

Charities need to know what their total costs are in order to:

- Create accurate budgets and forecasts
- Make accurate applications for funding
- Effectively monitor costs
- Understand the basic funding needs of the charity
- To aid decision making and the allocation of costs to projects/activities
- Make strategic decisions

Working out the cost base continued

We now consider two budget models which can be used:

1. Departmental budget model
2. Driver-focused model (e.g. 'unit' costing)

Department budget model

The departmental budget model looks at the entire costs of running each department of the charity, although there must be a clear distinction between those departments that are operational against those that provide support activities.

Operational departments are those that deliver the products, services and activities of the charity. The department budgets will be built up on the basis of the agreed strategies, programmes or activities that have been decided in the strategic plan.

They will include both income and expenditure forecasts – income streams that are known to have been secured, as well as those that are in the process of being applied for. Expenditure will need to be flexible depending on the success of certain funding applications and identify, crucially, the staffing requirement which commonly represents between 55-75% of charity expenditure, and also other specific costs associated with delivering the agreed strategy which may not be the same year on year.

Support departments are those departments that do not directly deliver the products, services or activities of the charity but without which the charity would not be able to function. Examples of support or service departments may be:

- Finance
- IT
- Facilities
- Headquarters/central office
- Health and safety
- Payroll
- Estates/maintenance
- Fundraising or marketing department; or
- General administration (for smaller charities)

It is important to understand that charity structures differ enormously even between charities in the same sector. Some of the departments above may be merged, for example finance and IT, into a common single department for budgeting purposes. Many smaller charities may just have one administration team.

An apportionment of cost from support functions can be added to the direct costs of services or projects to provide a true department cost – having both direct costs and a fair proportion of overheads.

Driver- (or activity-) focused model

The driver-focused model considers a budget in terms of the cost drivers. For example, a charity that aims to offer educational training will need to consider what levels of activity it wishes to achieve and what the cost implications will be. If the strategic plan sets out to run a number of training sessions, then the costs of the training sessions will be £x, because it will require:

1. Two members of staff for ten training sessions of two hours each.
2. A lecture room for two hours capable of housing 50 students per session for ten sessions
3. On-costs of delivering the programme – e.g. refreshments.

Here costs are 'driven' by the number of sessions being run, which in turn 'drives' the number of students that can be offered training. In another example, a welfare charity may wish to offer as part of its strategy sheltered housing in secure accommodation. There will be costs associated with running the service such as:

1. Rental costs/depreciation of the property for the year.
2. Maintenance, insurance and other property costs.
3. Round-the-clock staffing costs.
4. Medical inspection/survey costs.
5. Other capital expenditure to deliver the quality of service required.

Working out the cost base continued

However, the cost driver for the service delivery will be the number of residents the charity intends to house. This will determine the size of the property required, and any costs (not included above) such as the cost of heating, lighting, food, bedding etc.

In both cases, in addition to the costs identified, there will be the overhead costs of supporting and administering the projects or activities, such as the finance function, governance costs and administration costs which will need to be shared between different services or projects to arrive at the full costs to the charity of delivering them.

Sharing and allocating costs

Cost allocation

The sharing or allocating of costs has been debated at length in the charity sector as it is clear that on many occasions charities are still not receiving funding sufficient to cover all of the direct costs of service delivery together with a fair proportion of relevant overheads.
Part of this is due to funding bodies setting out very strict criteria or percentage allocations that they are willing to accept. Whilst this is still the case – and more needs to be done to ensure that funding bodies understand the costs that need to be covered – there is also the case that for some charities, they may not fully appreciate the totality of costs that need to be recovered.

This could be a result of poor financial modelling/ budgeting or that those involved in budgeting and costing for projects do not appreciate the relevance and significance of the additional support costs that need to be recovered.

'Full cost recovery: A guide and toolkit on cost allocation' published by ACEVO addresses the issue of cost allocation and provides a model template. For some, however, this model can be complicated and many have chosen a simpler method, for example total finance costs split equally between the number of projects that the charity undertakes.

The method used is not the issue here and this publication does not intend to propose a revised model. What we need to ensure is that the charity understands what costs it has to recover and a fair share of overhead costs are being apportioned either between departments or projects so that the total costs are considered in context.

Some of the common bases and where they may be considered appropriate for cost allocation are:

1. Allocation by headcount – this may be equitable for the costs of the payroll function, or the central reception which services all departments and staff, or the property costs. Complications arise where you have part-time, or volunteer staff, but you can adapt the allocation model to account of this.
2. Allocation by time – the need to keep timesheets in support of costs allocated to a project is a common requirement in many funding agreements. For example, where a finance department spends 20% of its time processing and reporting on one project, then it may be equitable to allocate 20% of the cost of the finance department to that project.
3. Allocating by expenditure – strategic management costs of the charity may be most equitably allocated in terms of the total spend on each project.

Individual costs

At this stage it is important to understand some of the factors affecting certain costs, whether they are considered direct or indirect, when building the budget. Three costs, salaries, utility costs and property costs, are considered over the page as illustration.

Salaries

When considering any salary costs, charities need to consider not only the basic salary of the member of staff but also the on-costs. Likely on-costs are:

- national insurance,

Working out the cost base continued

- pension contributions
- overtime or holiday cover
- additional benefits offered as part of a remuneration package (e.g. healthcare)
- recruitment fees.

Total salary and opportunity costs of one employee	
Salary	£30,000
National Insurance (11%)	£3,300
Recruitment fee (25%, + VAT)	£8,813
Pension - 5%	£1,500
Healthcare - 7.7%	£2,310
Total first year costs	**£45,923**

The table emphasises that considering salary alone will leave a shortfall in the recovery of £17,123.

Utility and service costs

The factors to consider in budgeting for utility and service costs are more difficult. Who could have predicted the large rises in oil and gas prices as a result of recent conflicts? What these large increases emphasised is the effect of adding a simple percentage to last year's budget, rather than attempting to consider what the likely costs in a particular area are going to be.

Again, the strategic plan may require additional considerations to be taken into account, for example a move to premises where the heating is solar or more energy-efficient than you currently occupy, or where a particular strategy will require the use of additional equipment which would impact on the budgeted costs of service delivery.

Budgeting inflationary rises in certain areas will not result in a meaningful budget. You need to consider external factors in addition to adding an inflationary uplift. Such external factors may be:

- Future strategy
- Change of utility or service provider
- Different service levels
- Potential usage due to changes in activity
- Additional staffing, affecting utility usage.

The charity must also consider whether a certain cost is going to have a material impact on total costs. Where utility and service costs are relatively small in the overall budget, time might be better spent reviewing other areas where there is likely to be a greater impact.

Property costs

Where a charity occupies rented accommodation, not only is the rental charge relevant to budgeted costs but also any associated service charges and maintenance of the building (i.e. where the charity has a tenant repairing lease).

Where there are obligations within a lease to, for example, make good the site at the end of a lease period, then in arriving at the budgeted costs, an appropriate annual provision should be brought into the calculation to enable the charity to meet this obligation at the end of the lease period i.e. dilapidations. If these costs are not considered up-front, it will lead to an under-recovery in the year in which those final costs are incurred.

Where charities own the premises they occupy, the budgeted costs are likely to include ongoing maintenance costs of the building and/or the depreciation charge for the period. The depreciation charge is then the charge for the usage of the building occupied either by staff delivering the services, products and activities of the charity or the members of staff who provide the support functions. Although not a physical cash flow, it is a charge to the accounts which attempts to reflect the cost of running the charity.

Working out the cost base continued

	Central costs	Finance	Department 1	Department 2
Staff numbers		3	10	30
Costs per department	£95,000	£150,000	£500,000	£650,000
Apportion central costs	£(95,000)	£6,628	£22,093	£66,279
Revised allocated costs		£156,628	£522,093	£716,279
Apportion finance department		£(156,628)	£109,640	£46,988
Total department costs			£631,733	£763,267

Illustration

As a quick illustration, we have assumed a simple structure of two operating departments, a finance function, and other central costs. The two operating departments conduct five projects, two in department one and three in department two.

Projects in department one are more time-consuming in terms of their accounting requirements than projects in department two, taking up 70% of the finance function's time, whilst department two takes up 30%. Other central costs are utilised in proportion to headcount.

There are three employees in the finance team, ten employees in department one, and 30 in department two. In the above illustration (see table) because central costs are also utilised by the finance department you need to allocate these first based on the headcount proportion (3/10/30) to arrive at a total cost of the finance department to be allocated across the two operating departments on the basis of 70/30.

This is a very simplified illustration, but it highlights that when funding for the five projects is sought, the charity needs to consider the allocation of costs from other support areas.

In the above example the two projects conducted by operating department one needs to recover £131,773 of costs (£22,093 + £109,640) in addition to the department costs of £500,000, whilst department two needs to recover an additional £113,267 (£66,279 + £46,988) from its three projects in addition to the department costs of £650,000.

The members of staff putting together the applications for funding need to understand the significance of support and overhead cost recovery especially when negotiating. At the very least, the head of finance should have an input into every application. Applications over a certain size or that draw on free reserves may also need the approval of the trustees, for which a cash flow statement should be prepared so that the project can be considered in the context of the strategic plan and other programmes.

There is a need to ensure that those involved in tendering are appropriately trained, not only to consider these additional costs, but also to convey the importance of overheads in the wider context of the project. Honed negotiation skills are needed to make funding bodies realise that this is not a 'donation' to the charity but a fundamental cost to deliver the quality of service being offered.

Working out the cost base continued

Example

Introduction

Having discussed the need to identify a charity's cost base and considered some of the issues and implications, this section provides an example on how it may be done. No two charities will ever have exactly the same cost base. It is the techniques and methods of finding a cost base which are shown in this example.

Maynard Hospices – background

Maynard Hospices' objective is to provide care to children who have life-limiting conditions. Based in the north of England, its main work is completed through three hospices – two based in Newcastle, and one based in Manchester:

- The Newcastle hospices offer full time children's care services to the local NHS under a service contract.
- The Manchester hospice provides short-term respite care for children while their parents take a much-needed break. The Manchester hospice is funded by donations from the general public, as well as a specific grant from a national trust.

In addition, a grant has been given by the Department of Health to the charity to map the provision of care services to children in the area. Maynard Hospices is a financially stable charity, with sufficient investment reserves to meet an unexpected fall in income or rise in expenditure in the short-term. Both contract and grant funding have been secured for a period of several years, however it is intending to grow in the near future. The cost base from 2024 is provided in the diagram below (figure 1).

Support functions

Support functions for Maynard Hospices are provided by a team of fifteen staff at a separate building in Newcastle – IT, HR, health and safety, facilities, finance and fundraising. In addition, there is a chief executive who oversees the work of the whole charity.

The Head of Finance has several roles and will 'juggle hats' between finance, IT and HR. Grant applications for any further funding may be completed by the Head of Finance or staff working at individual hospice locations – Newcastle or Manchester.

The issue

Maynard Hospices are shortly to bid for a further contract to provide similar child care provision in Liverpool. The Head of Finance wishes to develop a cost base model, with a fair proportion of overheads is allocated to all work.

Figure 1: 2024 Costs



Income

The Newcastle hospices are funded under a service contract. The contracts have been awarded under competitive tender.

The Manchester Hospice is funded 50% from voluntary income and 50% from a specific grant from the Albright Foundation – which supports organisations who work with children. This grant is not restricted.

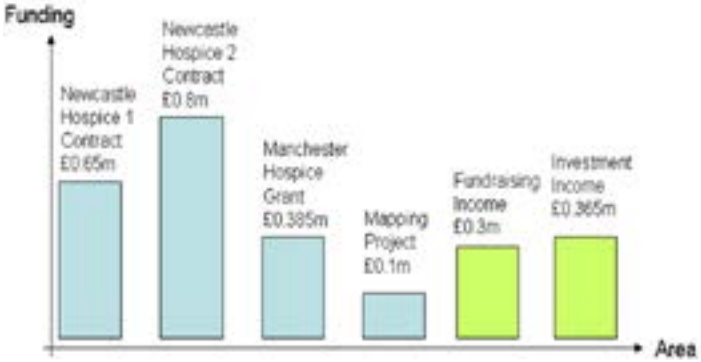
A grant of £0.1m has been received from the Department of Health to map the provision of care services to children in the area.

The charity fundraises for all other costs and has one or two major donors it relies on for funding. It also has some investments which generate investment income. The charity generated a surplus of £0.1m at the end of last year (2024).

Working out the cost base continued

Income streams for the charity are presented as figure 2.

Figure 2: 2024 Income



Costing services

The question is: How do we allocate a fair proportion of overheads to the various services? Firstly, we must understand our overheads. In each hospice there are direct staff and delivery costs, together with specific overheads such as heat, light, water, telephone and council tax. These can be identified with the individual hospices and allocated as such by breaking down invoices and bills.

At the administration site there are a number of indirect costs supporting the work of the hospices for example IT, HR and health and safety. Without this spend the work of the hospices would be impaired (and possibly could not continue) but it is difficult to identify these costs with specific services. For example how would we allocate IT usage to an individual hospice?

We could allocate these costs on the basis of time, headcount or any other number of ways, but first we must identify all costs which need to be treated in this way. Figure 3 provides a breakdown of these costs.

Figure 3 (opposite): Breakdown of administration and fundraising costs

Fundraising costs

There has been some debate as to whether fundraising costs are general administrative costs, like any other, and should be apportioned equally over all services, or if they should only be allocated against those services which make a deficit. The logic here is that we must fundraise only for those services that make a deficit, or are a draw on the charity's reserves.

The true cost of services that make a deficit is the direct costs, indirect costs and a proportion of fundraising cost to meet any deficit. In the case of Maynard Hospices, the Newcastle hospice 1 makes a surplus even after overheads have been allocated. It would not seem equitable to apply further fundraising overhead to this service.

	£	£
DIRECT COSTS		
Salaries (including pensions and NIC)		
- CEO	50,000	
- Fundraising	60,000	
- Head of Finance	40,000	
- Other admin staff	100,000	
		250,000
Specific costs		
- Specific fundraising Costs (direct marketing etc.)	80,000	
- Specific finance & legal costs (audit, contracts etc.)	40,000	
		120,000
INDIRECT COSTS		
General staff costs (training, etc.)	10,000	
Rent	45,000	
Heat, light and power	15,000	
Council Tax	10,000	
Stationery, printing	8,000	
Telephone	8,000	
IT costs	30,000	
Trustees expenses	1,000	
Other	3,000	
		130,000
		500,000

Working out the cost base continued

Equally, the Manchester hospice runs at a considerable deficit and a fair proportion of any fundraising overhead should be apportioned to show the true cost of the service.

The Head of Finance has made the decision that fundraising costs should **not** be allocated as a general overhead, but rather allocated only to those services making a deficit.

Allocating costs

So how do we allocate our administration costs and fundraising costs to the services provided?

The Head of Finance considers that there are really three areas of cost which are distinctly different within the administration building:

- CEO's costs
- Fundraising costs; and
- General administration costs

They consider that all general overheads should be allocated on the basis of headcount as the fairest method of apportionment (but also felt floor space could work just as well).

The general office has 16 staff as follows:

- CEO
- Head of Finance
- Three fundraising staff; and
- 11 general admin staff

Using the cost areas as defined above gives the following division:

- CEO's costs – one staff member (6.25%)
- Fundraising – three staff members (18.75%)
- General administration staff (including Head of Finance) – 12 staff members (75.00%)

Using this division over the general administration and fundraising costs gives the following allocation in figure 4 opposite:

	£	£
CEO'S COSTS		
Salaries (Inc. Pension and NIC)	50,000	
Indirect Costs (6.25% x £130,000)	8125	
		58,125
FUNDRAISING COSTS		
Salaries (Inc. Pension and NIC)	60,000	
Specific Fundraising Costs (Direct Marketing etc.)	80,000	
Indirect Costs (18.75% x £130,000)	24,375	
		164,375
GENERAL ADMINISTRATION COSTS		
Salaries (Inc. Pension and NIC)	140,000	
Specific Finance & Legal Costs (Audit, Contracts etc.)	40,000	
Indirect Costs (75% x £130,000)	97,500	
		277,500
		500,000

Figure 4: Allocating costs to CEO, fundraising and general administration

Remember all we have done so far is re-cut the administration and fundraising costs in a different way! We now need to allocate these costs into the hospice services and projects.

Allocation based on time

Having identified that we have three areas of cost we now allocate these to the projects. In our example the Head of Finance has asked the administrative staff and CEO to keep timesheets for a few weeks. This enables the costs to be allocated to hospices and services on the basis of time evidenced by a sample of timesheets over a sufficient period to give a reasonable estimate of usage.

The timesheet exercise estimated that the CEO spent 10% of their time looking after each hospice,15% of their time on the mapping exercise and 10% fundraising. The remaining 45% of their time is spent managing the charity and working with the trustees to provide strategic direction (governance costs).

It is also estimated that general administration spends time as follows: 20% supporting each hospice,10% on the Department of Health mapping exercise and 15% supporting fundraising efforts. The remaining 15% is spent managing the charity and working with

Working out the cost base continued

the trustees to provide strategic direction (governance costs).

Figure 5 below shows the allocation of administration costs to the hospices, other services, fundraising and governance costs.

The important point to note is that administration costs sit throughout the charity and cannot be removed from the hospices without impairing the quality of service provision.

Secondly, if a different basis of allocation had been chosen then a slightly different result would have resulted, but the theory would have been the same. In our example we allocated on headcount and time, but we could have equally allocated costs on the basis of floor space, bed space or expenditure.

When allocating costs it is these cost drivers that determine how costs are allocated and are the key decisions that need to be made. Once a basis has been decided the rest should be routine calculations.

Of course, the Head of Finance could just apply a percentage (say 20%) overhead to each service, but this neglects the dynamics and real costs associated with each service.

Allocation of fundraising costs

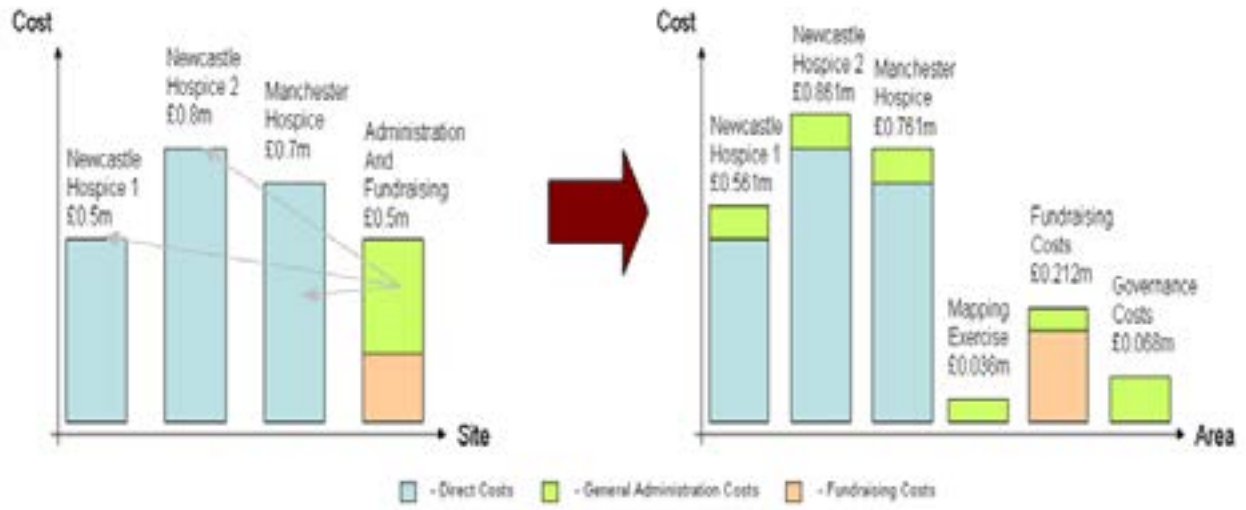
We now need to allocate our fundraising costs to the hospice services and governance costs to show the true costs of running the hospices.

Earlier in the example we considered fundraising costs and if all projects should pick up a proportion of the costs as a general overhead or only those projects making a deficit.

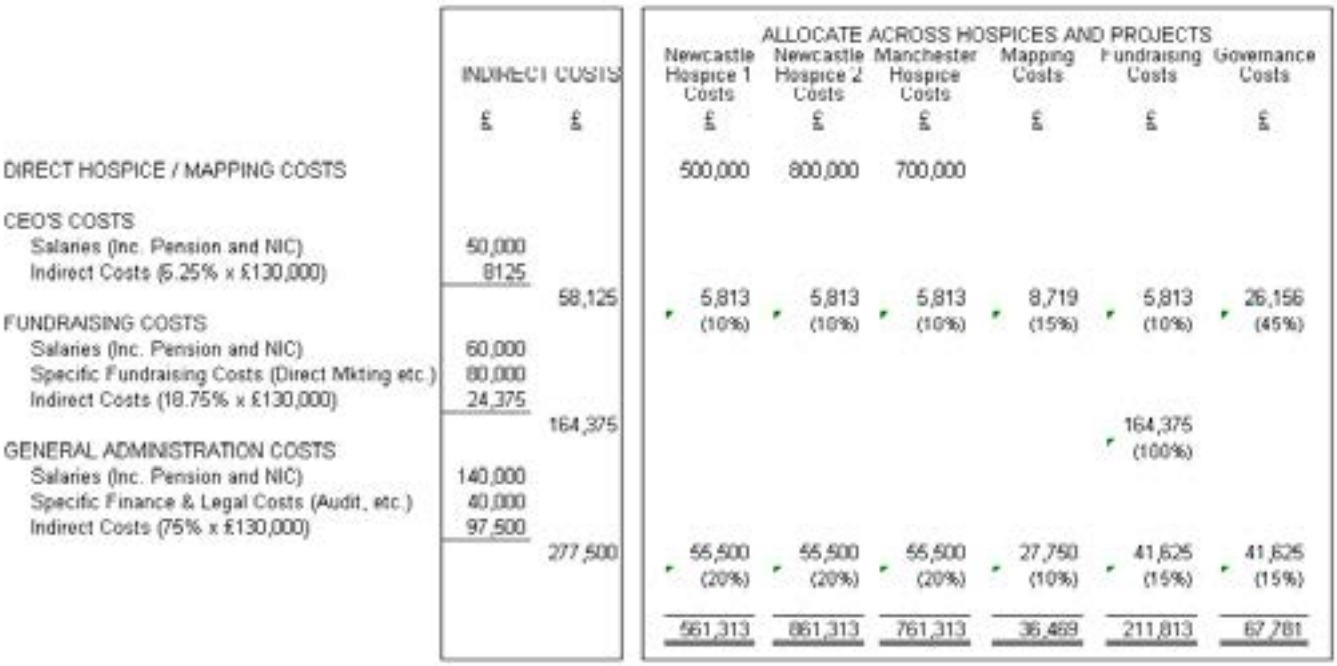
Newcastle Hospice 1 is clearly generating a surplus with income of £0.650m against direct costs (including overheads) of £0.561m. Similarly, the mapping exercise is generating a surplus. However, on the same basis both Newcastle Hospice 2 and the Manchester Hospice are in deficit.

We only need to fundraise where a service or contract is in deficit to meet the balance of funding, and so in this example we allocate only to those services in deficit. The simplest way to allocate fundraising costs is pro-rata across project expenditure and this is shown over.

Figure 5: Allocation of administration costs against hospices, services and fundraising costs



Working out the cost base continued



	INDIRECT COSTS		ALLOCATE ACROSS HOSPICES AND PROJECTS					
			Newcastle Hospice 1 Costs	Newcastle Hospice 2 Costs	Manchester Hospice Costs	Mapping Costs	Fundraising Costs	Governance Costs
	£	£	£	£	£	£	£	£
DIRECT HOSPICE / MAPPING COSTS			500,000	800,000	700,000			
CEO'S COSTS								
Salaries (Inc. Pension and NIC)	50,000							
Indirect Costs (6.25% x £130,000)	8125							
		58,125	5,813 (10%)	5,813 (10%)	5,813 (10%)	8,719 (15%)	5,813 (10%)	26,156 (45%)
FUNDRAISING COSTS								
Salaries (Inc. Pension and NIC)	60,000							
Specific Fundraising Costs (Direct Mkting etc.)	80,000							
Indirect Costs (18.75% x £130,000)	24,375							
		164,375					164,375 (100%)	
GENERAL ADMINISTRATION COSTS								
Salaries (Inc. Pension and NIC)	140,000							
Specific Finance & Legal Costs (Audit, etc.)	40,000							
Indirect Costs (75% x £130,000)	97,500							
		277,500	55,500 (20%)	55,500 (20%)	55,500 (20%)	27,750 (10%)	41,625 (15%)	41,625 (15%)
			561,313	861,313	761,313	36,469	211,813	67,781

Figure 6: Calculations to allocate indirect costs to services (allocation table)

Points of interest

The interesting point to note is that once a fair proportion of fundraising costs are apportioned, the Manchester Hospice becomes the most costly service. That is because no other service has to fundraise to this extent to meet its deficit.

If the Maynard Hospices had funding problems and was unable to fundraise to meet its liabilities, it is the Manchester hospice which is the greatest draw on reserves and voluntary funds. Only by allocating fundraising costs does the true cost of the service become apparent. Equally, there is a need to raise funds for governance costs which must be acknowledged.

Typical funding from local authorities is a fixed percentage mark-up on cost, say 10%. This ignores the subtlety of allocating a fair proportion of overheads to each project.

Each charity has different needs and different cost bases. For example, a small regionally-distributed charity will have proportionally large overhead costs compared to a national charity which may have economies of scale to deliver its services. Funders should be expected to share in this burden in an equitable way.

It is therefore imperative to allocate costs in a transparent and methodical way and to complete this before any decisions can be made, or funding conversations started.

And that's it! It's as simple as:

- Identify your costs.
- Allocate these costs using cost drivers such as headcount or time.
- Ensure a fair proportion of all costs have been allocated.



6. Special considerations

Special considerations

Restricted and unrestricted funding

It is important to understand the distinctions between restricted and unrestricted funding. Being able to identify a restricted project is important because of the legal constraints placed on monies received for a restricted purpose. Restricted monies are received to carry out a specific purpose and you cannot and must not use any of this money for another purpose. To do so would be a breach of the trust placed on the charity and unless it has express permission from the Charity Commission is potentially illegal. But once you know which projects are restricted and which are unrestricted, the trustees should receive sufficient information in order to understand how this impacts on the overall results of the charity.

It is a key element of financial reporting to trustees that management accounts should show separately the income and expenditure by fund so that trustees can see what funds remain available in an unrestricted form that they can make decisions on.

Make life easy for yourself. Don't make your management accounts so detailed that the trustees won't have time to read all the information or make it so complicated that it is incomprehensible other than to another accountant. Trustees should have at least the following information:

- Overview of income and expenditure by type split between unrestricted, restricted and endowed funds, essentially a summarised Statement of Financial Activities.
- Supporting analysis of any large (or material) restricted funded project(s). Depending on the number of projects being undertaken, this detail could be by project, or where there are large numbers of restricted projects, by grouping projects/programmes by activity. The analysis should show the income received, and the expenditure incurred to date together with estimated income and expenditure to the end of the project to highlight any anticipated overruns.
- The analysis should be accompanied by a narrative and explanations for any under or overspends on projects and the course of action being taken. Heads of department or project managers should be responsible for writing the narrative and explaining any variances for large projects which are material to the charity.
- A cashflow forecast for the next 12 months which, split by fund type, identifies any shortfall in funding for each fund so that trustees make conscious decisions about how to manage the cashflow.



Make life easy for yourself. Don't make your management accounts so detailed that the trustees won't have time to read all the information

Cash flow

Charities funded by regular incoming resources such as investments can, to a certain extent, estimate income fairly accurately. The investment managers will be given an income target and the charity can plan effectively. Where however, funding is uncertain, i.e. charities rely on legacy income, voluntary donations or funding from external sources, the nature and timing of the income streams are critical factors in a charity's success.

Special considerations continued

A monthly rolling cash flow forecast for a 12-month period will highlight peaks and troughs in the cash requirements of the charity which may influence a decision to accept or cease a particular project or activity.

Charities reliant on funding from external sources in arrears of performance have additional cash flow considerations i.e. they will need to fund the project until such time as the funder accepts the request for payment for performance and this will require the charity to utilise its own unrestricted working capital for a period of time.

Funding bodies have historically advanced grant monies after satisfactory performance or an interim, usually quarterly, report on progress. By the time the quarterly accounts have been prepared and this report has been written, considered by the funder and the money released, it can be up to five or six months after the initial outlay by the charity. Charities should, wherever possible, request an advance from the funding body in order to provide a buffer for this eventuality. It is not unreasonable to expect this, and it has been more common recently.

Any project should be considered not just in terms of total cash in and out, but also in terms of the monthly cash effect on the organisation to ensure that as a whole, the charity can operate effectively and within its banking and or other financial arrangements. Such cash flows should not only consider the year in question, but cover a period until the end of all current projects. It should at least cover the period of the strategic plan.



It may be an old saying but it is one which charities do well to remember and that is 'cash is king'.

Not considering the effects of this potential timing lag has caused a number of charities to fail. It may be an old saying but it is one which charities do well to remember and that is 'cash is king'.

There is also a self-fulfilling prophecy for charities funded almost entirely by restricted project income. If restricted projects are costed on the basis of support costs or overheads being attributed to say ten projects, then a successful charity that manages to gain additional new projects in a particular period may end up in the peculiar situation that its projects are over funded if they can perform them without any increase in overheads. Conversely, if a charity is less successful i.e. only nine projects, it will recover only 90% of the costs it needs to.

For example, if you have support or overhead costs to be allocated across operational projects or programmes of £500,000 and you have budgeted to run ten projects with each utilising 10% of core costs, each project may be allocated £50,000 of these costs.

If the charity is then successful in achieving an additional five projects, each project cannot be allocated £50,000 of costs as this would over-recover: £50,000 x 15 projects is £750,000 and this would be double counting the costs incurred. Each project in this simple example may be allocated £33,333 (£500,000 divided by 15 projects) and if the projects were budgeted to break even, the result would be a £16,667 underspend on each project. This underspend may then need to be repaid to the funder under the terms of the agreement.

If the charity only achieved five projects rather than ten, the £500,000 of costs would be £100,000 per project. Even if you could allocate additional costs to the project it is still likely

to result in an overspend of up to £50,000 on each project that would need to be met from unrestricted reserves or unrestricted fundraised income.

It is for this reason that it is imperative that each project report to the funding body is reconciled back to the charity's accounts.

VAT

Irrecoverable VAT

If a charity supplies goods or services that are taxable i.e. standard or zero rated, it will be recovering all VAT on its costs. However, most charities incur some irrecoverable VAT either because they are engaged in activities that HM Revenue & Customs regards as non-business (e.g. grantmakers) or provide services that are exempt (e.g. welfare, education). Any irrecoverable VAT cost is a real cost to the charity and must be taken into account when considering total costs to be allocated.

Charities with mixed activities will already be familiar with the concept of allocating direct and indirect costs to determine their recoverable VAT, along the lines of cost allocation models shown in previous chapters of this publication. A method of apportionment will need to be agreed with HM Revenue & Customs when completing such calculations. Although charities may use a simplified method which is acceptable to HMRC, it may not be appropriate for the purposes discussed in this document for conversations with funders.



If the charity generates income from the provision of services or the sale of goods it may have to charge VAT on its invoices depending on whether the supplies are taxable or exempt

VAT on sales and services

If the charity generates income from the provision of services or the sale of goods it may have to charge VAT on its invoices depending on whether the supplies are taxable or exempt. The VAT exclusive amount of income should be included in budgets.

Local authorities are meant to ignore the VAT cost to ensure a level playing field when considering the costs of outsourcing. It is therefore important that a charity is able to identify the irrecoverable VAT element of its costs in any quotation for services.

Identifying irrecoverable VAT

Being able to identify where irrecoverable VAT arises has several benefits, including:

- Providing a basis for negotiating with HMRC to increase VAT recovery.
- Bidding for local authority service contracts, see above.
- Identifying where VAT planning opportunities might have the most impact.
- Providing a statistical analysis of VAT costs.

Capacity and quality

Where the opportunity arises to undertake a new programme which fits with the charity's aims and objectives, the charity should consider not only the financial considerations but also whether it has the capacity to carry out the work within its existing means.

The strategic plan is the starting point to see if the opportunity fits with the long-term aims and objectives. If it does, then two questions need to be considered:

Special considerations continued

- Can the charity accommodate the project within its current financial and staffing capacity? If so, then the overhead costs are going to be spread across a larger number of projects, as detailed above.
- Are additional premises and staff needed to take on additional projects? If so, then the charity will need to consider not only the additional direct/operational costs involved but also the requirement for additional indirect costs and the impact this will have on total costs to be allocated to all projects, activities or programmes.

These two questions should address the issue of capacity, but what of quality? The charity sector prides itself on quality and innovation in service delivery. However, sometimes charities have found themselves in positions of chasing funding because of the economic climate or financial position they find themselves in. The quality of the service should be a key factor for any charity when applying for funding.

There is a need for funding bodies to appreciate that, in contrast to commercial organisations who aim to make a profit which is distributable amongst its members, any unrestricted surplus that a charity makes is reinvested in supporting its beneficiaries. In addition, the need for working capital and expediency of payments to fund projects needs to be brought home to funding bodies.



There is a need for funding bodies to appreciate that, in contrast to commercial organisations, any unrestricted surplus that a charity makes is reinvested in supporting its beneficiaries

Transfer of risk

In addition to charities considering strategic and funding implications of new activities or services, the risk of accepting any new contract needs to be considered and understood. Here the risk of delivering a quality service, with the required impact and to budget must be assessed against the financial benefit of accepting a new contract.

The increase in 'service delivery contracts' involves charities delivering a product or service on behalf of another organisation, local authority or government department, for example an NHS body. This transfer of risk to the charity sector is three-fold:

Financial. There is a financial risk involved in accepting service delivery contracts, especially where the project is not sufficiently funded. The charity must fund any deficit on the project from its unrestricted funds, whether by utilising unrestricted reserves, or finding other unrestricted income to plug the gap. The funding body has essentially secured a fixed price contract and is unlikely to accept liability for any cost overruns. This is why it is so important to ensure that all costs of delivering the contract are considered when quoting for work, including a fair proportion of support or overhead costs. It can also be fundamental to understand any pension scheme arrangements that come with the funding agreement. Can these be negotiated away as part of the agreement to minimise the organisation's exposure to future costs?

Reputation. Where the public knows that charities are delivering services which they perceive are being delivered by other organisations, this may affect their view of the charity. A survey carried out by the Charity Commission in 2025 involving public trust in charities found that:

- 57% of people had high trust in charities (1% down on the prior year), and the low trust in charities score increased from 9% to 10% since the previous year.
- Charities are ranked second in the list of organisations that the public trust the most, the highest rank continuing to be doctors.
- The most important factor in trust in charities continues to be whether the money raised is spent directly of the causes the charity supports (53%), but importantly for this document is that 39% of the public consider it is important in their consideration of trust that it is easy to see how much the charity has raised and how it has been spent.

Charities have a reputation to uphold and need to ensure that the quality of service is paramount in any consideration on whether or not to deliver a new contract.

Resource. The charity must choose to use its resources in this way. There is, of course, a missed opportunity cost of using resources in another way or for another project/activity with any such decision.

In transferring service delivery to the not-for-profit sector, the operational and administrative risks are also transferred.



Charities have a reputation to uphold and need to ensure that the quality of service is paramount in any consideration on whether or not to deliver a new contract

Staffing, growth and closure

Staffing

Where a project is for a fixed period it is likely that employment contracts will also be for a fixed period to match the project term. It is important that the full costs of the fixed term are considered in estimating the costs of the contract, and these will include the initial advertising and recruitment fee for filling the post at the start of the term, together with any redundancy or employment termination costs there might be at the end.

TUPE (Transfer of Undertakings – Protection of Employment)

Where a contract for services is re-tendered, it is possible that the staff currently employed by another organisation will move to the organisation which secures the contract. Staff are likely to be transferred under TUPE arrangements. Where charities are involved in this kind of agreement, they need to ensure that they are fully aware of the existing terms and conditions of employment, especially pay scales, pension rights and benefits which are currently being paid. This is important for two reasons:

- To ensure that the staff being transferred are not treated less favourably as a result of the move from one organisation to another;
- If the staff being transferred have more favourable terms and conditions than existing staff, this may result in existing staff requesting consistency and increase the existing employment costs of the charity.

Pension provision is a particularly important area, as whilst the historical cost of pension provision may be met by the old organisation, the new organisation may be responsible for future movements in pension costs which might be difficult to cost at the point of the transfer i.e. defined benefit pension costs.

Special considerations continued

Project closure

The vast majority of service delivery or project activity delivered by the not-for-profit sector is positive. To the extent that a project is for a fixed period, the cost of running down the project in the final year needs to be budgeted for in the funding agreement. The charity should not be left funding the cessation out of its own funds.

Where this is the case, the charity needs to have in mind the costs of an exit strategy i.e. redundancy costs, cancellation costs for contracts and services, lease termination costs etc. We have also seen the chaos in 2025 caused by a change in government policy (USAID).

Reserves policy

As part of SORP requirements, charity trustees have to disclose the reserves policy for the charity in the statutory accounts. This policy must be stated in terms of the level of free reserves (unrestricted funds, less any designated funds less any unrestricted fixed assets). The current level of free reserves must be stated together with an explanation of how any shortfall is to be addressed.

Some charities have become a lot more sophisticated over the years in how they view and set reserves policies. Strategic reserves policies are now very common rather than a set number of month's worth of expenditure.

For example, a charity will consider the type of funding it receives, the likelihood of recurring income, the impact of income mix changes and place weighted values to those streams to arrive at a reserves target that they can justify in order to meet their strategic aims. The Charity Commission also updated its guidance in 2023 on charity reserves and CC19 is always worth referring to.

When budgeting for contracts of service or grant funding for certain specific activities, achieving full overhead recovery has often been an ideal. Sector bodies have forced the issue and there is a general acceptance that this has to be the way forward to attain sustainability for the sector. However of not-for-profit organisations surveyed, 40% replied that the proportion of funding received to deliver a service was less than 75% of the true cost, a further 17% said it was between 75-85% and a further 38% were between 85-100%. It is fair to say that appropriate costs for service or project delivery are not being fully funded yet.

The inevitable consequence of a shortfall in funding is that the additional costs must then be recovered from the unrestricted funds of the charity or met by other unrestricted income generation. Would the charity have made the decision to accept the contract if they thought that they would have to meet a certain percentage of the total costs from unrestricted funds?

Reserves policy is therefore relevant in a decision to bid or apply for a contract or grant funding. Where charities have built up significant unrestricted reserves there may well be strategic reasons for accepting a project or programme which is underfunded or under-quoted. Reserves may have been set aside to carry out a future activity (designated funds) to help fund the programme.



7. Simple case studies

Simple case studies

Restricted and unrestricted funding

The distinction between unrestricted and restricted funding has been set out earlier in this publication. To emphasise the importance of the distinction even for a charity that is operating in a stable environment we shall build on the simple example used to illustrate the allocation of costs. As a quick illustration, we have assumed a simple structure of two operating departments, a finance function, and other central costs.

The two operating departments conduct five projects – two in Department 1 and three in Department 2. Projects in Department 1 are more time-consuming in terms of their accounting requirements than projects in Department 2, taking up 70% of the finance function's time. Department 2 takes up 30%. Other central costs are utilised in proportion to headcount. There are three employees in the finance team, ten employees in Department 1 and 30 in Department 2.

Now consider that the funding received by the charity is a mixture of unrestricted and restricted funds. One of the projects conducted by Department 2 is an unrestricted service delivery contract generating £210,000 of income and accounting for 28% expenditure, and all other projects are funded by restricted monies totalling £1,150,000 for the year.

	UR £	R £	Total £
Voluntary income	50,000		50,000
Project income	210,000	1,150,000	1,360,000
	260,000	1,150,000	1,410,000
Charitable Activities			
Activity 1	0	(631,733)	(631,733)
Activity 2	(213,715)	(549,552)	(763,267)
	(213,715)	(1,181,285)	(1,395,000)
Net Operating Result	46,285	(31,285)	15,000
Transfers between funds	(31,285)	31,285	
Result after transfers	15,000	(0)	15,000

The original SOFA which allocated all central and finance costs across the two departments would have looked as above.

If however the unrestricted voluntary income of £50,000 was in fact a core funding grant of £50,000 per annum, the issue of allocation will need to be reconsidered.

Because £50,000 of costs are now funded by the core grant, those costs should not be allocated to the other projects otherwise the costs would be double funded. The allocations therefore need to be reconsidered. By allocating the £50,000 core grant to the central costs, it leaves only £45,000 to be recovered from the projects.

The revised allocations would look as follows:

	Central costs	Finance	Department 1	Department 2
Staff numbers		3	10	30
Costs per department	£95,000	£150,000	£500,000	£650,000
Costs covered by core funding	£(50,000)			
Apportion Central Costs	£45,000	£3,140	£10,465	£31,395
Revised allocated costs		£153,140	£510,465	£681,395
Apportion Finance Department		£(153,140)	£107,198	£45,942
Total Department Costs			£617,663	£727,337

Note: 28% of Department 2's costs are unrestricted (£203,454) and 72% restricted (£523,683).

If the £50,000 of costs met by the core funding are £20,000 governance and £30,000 'other', the 'other' costs need to be allocated for the purposes of SORP to the unrestricted activity i.e. all support costs need to be allocated to the activities that they support, which results for disclosure purposes in total unrestricted activities costs of £233,654 (unrestricted project costs of £203,654 plus the £30,000 of other costs already funded by the core grant).

This would result in a revised SOFA (see over).

Simple case studies continued

	UR £	R £	Total £
Voluntary income	50,000		50,000
Project income	210,000	1,150,000	1,360,000
	260,000	1,150,000	1,410,000
Charitable Activities			
Activity 1	0	(617,663)	(617,663)
Activity 2	(233,654)	(523,683)	(757,337)
Governance costs	(20,000)	0	(20,000)
	(253,654)	(1,141,346)	(1,395,000)
Net Operating Result	6,346	8,654	15,000
Transfers between funds	0	0	
Result after transfers	6,346	8,654	15,000

Due to the £50,000 core funding, the reallocation of costs produce an end result of £6,346 surplus on the unrestricted project (£210,000 income less costs of £203,654) and an underspend on restricted fund contracts of £8,654.

This example illustrates that impact of differences in funding and the statutory accounting requirements and it will be important to understand what the restricted funded project terms and conditions say about any unspent balance.

There may be a requirement to repay the funders £8,654 being moneys not incurred on the restricted project rather than in the first example an overspend of £31,285 which would have been met by a transfer from unrestricted funds.

The net result of £15,000 surplus does not change but the split between restricted and unrestricted after taking account of the core funding produces a critically different result.



Simple case studies continued

Capacity and quality, and forecasting for growth in a growing charity

The considerations that need to be considered where a charity is growing, and forecasting for additional growth, cannot easily be illustrated in a simple example.

Here we consider a charity involved in a range of educational and welfare services to the local community. The charity is funded by a mix of service delivery contracts and grants from local authorities and other institutions. The charity has been in existence for many years and owns its own property. The charity has grown from a turnover of £1m to £3m, and currently employs 50 staff plus external consultants as required to deliver its services and programmes.

The property it occupies is split into a series a meeting rooms to accommodate different size groups and the depreciation charge is broken down into floor space per room. Other central overhead costs are recovered on the basis of a set charge per room per day with an allowance made for voids. The current charge is £40 per day per room.

The charity had the opportunity to bid for a three year grant to provide a series of skills training courses to those in the local community who were unemployed. The bid was successful and funding was to be drawn down on a quarterly basis following satisfactory completion of a quarterly report.

At the time the charity bid for that grant, it also had applications in for other grants and service delivery contracts, some of which were successful. The charity originally quoted for the grant on the basis of costs set out opposite. The charity bid £78,000 for the three years allowing for an element of inflation at 3%. Although the charity had bid for other contracts it did not expect to be successful in so many and the implications had not been fully considered. Staff are now fully engaged on other

				£
Staff costs:				
£38,000 pa. two days per week.				15,200
Property usage				
Total floor space and Depreciation Charge	2500	£150,000		
Floor space utilised	100			6,000
Overhead charge				
2 day per week x £40 x52 weeks				4,160
Annual cost				25,360

contracts and all rooms are utilised. The charity will therefore have to use a sub-contractor to carry out the training sessions which will incur management time in contracting the right person to deliver the intended quality of service, and additional room hire in another building close by.

The result is that the costs have increased to £15,000 for the consultant who is VAT registered, and so the charity suffers the total cost of £2,625 of VAT per annum. The room hire charges are significantly higher than the notional depreciation charge and the charity did not consider the additional costs of reporting to the funder on an annual basis i.e. the requirement for a reporting accountant's certificate on costs, which depends on the type of report required.

What this example illustrates is that:

- The capacity to undertake additional work and the staffing requirements need to be considered in full not only for the contract being tendered, but also alongside other bids.
- Rather than a notional depreciation charge, the charity should have used an equivalent rental charge for the room. The depreciation charge may have been based on the original purchase price of the building 20 years ago. The charge does not represent the true opportunity cost of using the room i.e. the price that could have been charged to a third party for use of the room.
- Because costs have increased, the overspend will need to be met from the unrestricted fund.
- VAT needs to be considered carefully depending on your status as it can have a significant impact on total costs.

Simple case studies continued

Transfer of risk

In recent years it has become ever more popular for charities to undertake contracts for service delivery on behalf of public sector bodies such as local government. Whilst this has increased opportunities for charities to expand their work, it has also brought about additional risks.

The risks to charities involved in service delivery contracts now includes the financial risk of not getting the price right because costs were underestimated, the operational risks of whether the contract can be delivered given current resources, and the risk of reputational damage if the service delivered is not of the required quality.

In this example, we consider a charity involved in delivering care services in the local community. Up until now the charity has delivered its own care services in two day-care centres but wishes to expand its services to home care by recruiting three members of staff on a TUPE agreement from the existing providers. The activities are deemed to be within the charity's objects and central overhead costs are not anticipated to increase, although it will require additional time on the part of the front reception managing calls. It will also increase the volume of work on the finance staff processing payroll, and reporting the number of people supported by the project on a monthly basis in order to raise an invoice. A 10% charge for the central overheads is deemed sufficient.



The risks to charities involved in service delivery contracts now includes the financial risk of not getting the price right...

The contract states that the charity will receive a fixed sum per visit, and will be paid on the basis of satisfactory completion of a monthly report confirming deliverables. Costs are anticipated as follows:

		£
Staff 1		35,000
Staff 2		35,000
Staff 3		35,000
		105,000
Pension	3%	3,150
Central cost		10,000
		118,150
Number of visits		500
Cost per visit		236.3
Quoted per visit		£240

The staff were transferred under TUPE arrangements. Although the charity had budgeted for the staff to become members of their pension scheme arrangements – to which the charity contributes 3% – due to TUPE the existing pension arrangements for the three members of staff need to be continued.

The three staff were part of a local government final salary scheme and required contributions of 15% per annum. This has resulted in additional costs of £12,600 per annum.

The charity also agreed under the contract to deliver 500 visits per year. In the first year the charity delivered 485 visits. As a result of the increase in pensions and the lower than anticipated visit numbers, the charity's finances will look as follows (see over):

Simple case studies continued

		£
Income		
485 visits @ £240 per visit		116,400
Expenditure		
Staff 1		35,000
Staff 2		35,000
Staff 3		35,000
		105,000
Pension	15%	15,750
Central cost		10,000
Total costs		130,750
Net result		(14,350)

This net deficit on the project will directly impact on the unrestricted reserves of the charity unless it is able to renegotiate the terms of the fee per visit, which will now need to be £270 per visit in order to recoup the additional pension contributions and account for the lower level of activity.

This highlights financial risk, but in addition there is reputational and resource risk to consider. If the quality of service is poor then this will reflect badly on the charity. All this must be considered before any contract is accepted, and needs to be monitored through the life of the contract.

Cash flow impact and VAT

When considering the cash flow effect of a series of projects the VAT position can, although neutral overall, cause cash flow issues for charities. In this example there are two projects, one which is VATable and one which is not.

The income and expenditure over the life of the projects are neutral. Project 1 is a restricted non-VATable project and funding is received in advance in the first month of the quarter. Project 2 is billed following satisfactory completion of the work and is received in the month following the quarter end. In pure SOFA terms the project would appear as follows:

	Total
	£
Incoming resources	
Project 1	100,000
Project 2	240,000
Other income	10,000
	350,000
Resources expended	
Project 1	100,000
Project 2	240,000
Other costs	10,000
Net incoming resources	350,000

However, the cash flow is not neutral and this example has been extended to show the month of July for illustration:

	Total	Jan	Feb	Mar	Apr	May	Jun	Jul
	£	£	£	£	£	£	£	£
Income								
Project 1	100,000	50,000			50,000			
Project 2	240,000				168,000			80,000
Other income	10,000	1,667	1,667	1,667	1,667	1,667	1,667	
VAT	42,000	0	0	0	28,000	0	0	14,000
	392,000	51,667	1,667	1,667	239,667	1,667	1,667	94,000
Expenditure								
Project 1	100,000	10,000	20,000	40,000	20,000	5,000	5,000	
Project 2	240,000		110,000	50,000	10,000	50,000	20,000	
Other costs	10,000	1,667	1,667	1,667	1,667	1,667	1,667	
VAT	42,000	0	19,250	8,750	1,750	8,750	3,500	
VAT payments/Receipts					(28,000)			14,000
	392,000	11,667	150,917	100,417	5,417	65,417	30,167	14,000
Cash flow:								
Net cash for the month		40,000	(149,250)	(98,750)	234,250	(63,750)	(28,500)	80,000
Opening cash		150,000	190,000	40,750	(58,000)	176,250	112,500	84,000
Closing cash		190,000	40,750	(58,000)	176,250	112,500	84,000	164,000

The charity had £150,000 of unrestricted reserves in cash at the start of the period. Up until the end of February everything is fine, but in March a number of events happen:

1. The charity goes overdrawn because it is

Simple case studies continued

incurring expenditure on Project 2 but has not yet received the cash.

2. The VAT on purchases has been paid, but cannot be reclaimed until after the VAT quarter which ends in March. A claim is submitted to HMRC to reclaim this VAT, but it will not be received in cash until April.
3. The charity has by definition breached the terms of trust on the restricted project. This is because Project 2 has incurred £160,000 in the first three months, but the charity only had £150,000 in unrestricted cash to support the project. It must therefore have used £10,000 of the restricted cash received in January to fund the project.
4. Finally, although Project 1 is restricted and monies are received in advance, the charity has spent £60,000 in the first three months which can only be supported by the unrestricted fund. As we saw in point three above, this has already been spent on Project 1. The result is that the charity is overdrawn by £58,000, £28,000 of which is the VAT effect, and £30,000 being expenditure incurred over and above the cash held at the start of the period.

What this example illustrates is not only the VAT effect but also the potential to breach the terms of trust on a restricted fund. It is therefore vital that a cash flow forecast is maintained by all charities and that it is rolled forward regularly.

When new projects are being considered, the cash flow effect should be taken into account and incorporated into the charity's existing cash flow so that the cash needs of both the charity and the project can be considered.





8. SORP 2005 and 2026

SORP 2005 and 2026

The Charities Statement of Recommended Practice (SORP) 2005 was a significant change, and for the first time charities had to consider reporting the financials in terms of the activities or programmes that they deliver in achieving the aims and objectives of the charity.

As of 1 January 2026 we now have SORP 2026. This standard introduced two significant changes to the way in which charities need to report, both of which could have an impact for financial performance.

The first change concerns income recognition. A new five-step model is introduced which requires a more methodical process for identifying performance obligations within a contract. It defines more clearly the difference between non-exchange transactions (such as donations) where the donor does not receive anything in return or nothing of equivalent value, as opposed to exchange transactions (grants and commercial contracts) where the recipient is more likely to receive an equivalent value. It is the second type of funding – exchange transactions – where the new standard might lead to a difference in the way charities account for income.

The second change relates to leasing. Operating leases where charities account for the amounts they incur on an annual basis to profit and loss are largely removed, and so the majority of leases will need to be treated as a finance lease, capitalising the asset and accounting for the full repayments the charity will make under the agreement as a liability.

In substance, those charities will still make the same value of payments over the term, but the charge to the profit and loss account is likely to be higher in the earlier years and lower in the final years of an agreement as the interest element of the charge to the profit and loss decreases over time.

This needs to be considered carefully where an asset has a longer life that the contract/project funding that is being applied for as if it is in the earlier years of the lease, the charge will be higher.

Charities will need to comply with the guidance in the preparation of year-end financial statements. There are a number of ways to ensure that the preparation of the year-end accounts is a smooth, undaunting task:

- However you record the charity's transactions, ensure that individual projects or programmes are separately identifiable. This could be either by a coding reference, or by using department codes within an accounting package.
- Account for your support or overhead costs separately. At the end of each month or quarter, allocate these costs in line with the contract or funding agreement. This can either be carried out on spreadsheet or by processing journals within the accounting software to the relevant department. Where you have included a charge for the use of rooms then you should make an internal charge to the project to reflect this, otherwise your year-end results will not agree with the report to funders.
- Do not introduce too many nominal ledger codes. Although 'if in doubt open an

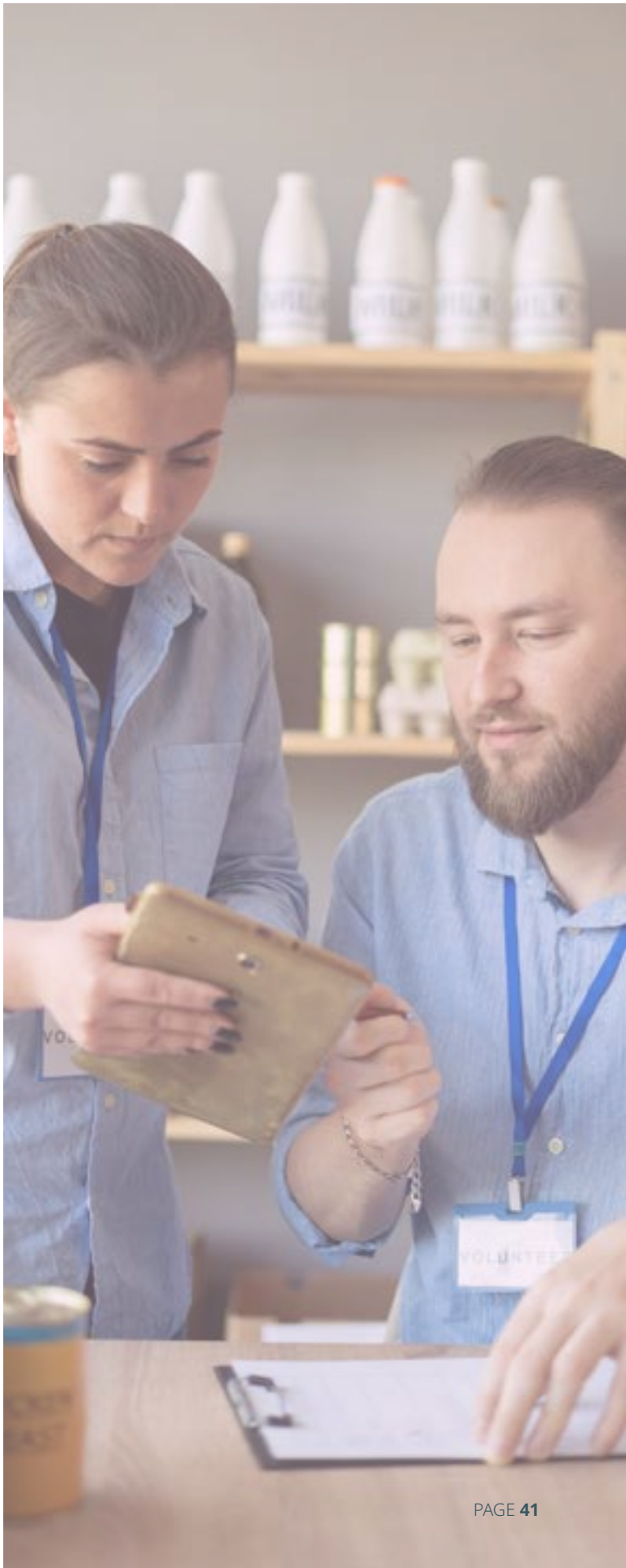
"

However you record the charity's transactions, ensure that individual projects or programmes are separately identifiable

SORP 2005 and 2026 continued

account' is good advice in most cases, there are occasions where coding structures can become so unwieldy that they are unworkable. Your trial balance should be of a manageable size and enable you to identify the information you want easily, without having to trawl through pages and pages of information. Utilise the department functionality of your accounting software wherever possible.

- It is also advisable to consider the impact of the 2026 SORP now even though you may not have to apply its provisions until a later accounting period. Then you can assess the potential impact on your costs, particularly around leases, but more importantly any potential impact the change in treatment might have on year-end results and negotiations with banks or other funders, especially where there are financial covenants in place.



> However you record the charity's transactions, ensure that individual projects or programmes are separately identifiable

9. Conclusion



Conclusion

Experience has shown that understanding costs and the underlying cost base of a charity continues to be fundamental for effective financial management of any charity, and more so where the charity is reliant on programme and project funding which spans a number of years.

Economic factors can be difficult to predict and since the first version of this publication the world has changed greatly. The pandemic, working from home, high inflation and government changes have all led to increased uncertainty and unpredictability in financial management.

We hope this guidance increases your confidence in understanding your charity's cost base and helps to embed and improve financial modelling and budgeting, to ensure that we continue to have a thriving and financially viable charity sector where trust is high and delivery is second-to-none.



> We hope this guidance increases your confidence in understanding your charity's cost base...

Questions or feedback?

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