

Financial Efficiency Ratio Definitions

Definitions

We look at a number of different measures to select and analyse a charity (*see Charity Selection Strategy*). No one parameter is a make-or-break issue, but the combination of several is used to assess initial suitability for further investigation. The calculations are based on figures from the published report and accounts. A brief explanation is given below, with greater detail overleaf:

- **Programme ratio:** This is the ratio of the spending on programmes or projects relative to the total expenditure in a year. This gives an indication of how much money is being spent on helping the people that the charity and the donors intend to be helping. It shows the percentage of funds spent that went on direct beneficiary programmes.
- **Administrative expenses ratio:** This is the ratio of administrative expenses relative to the total expenditure in a year. This shows the percentage of a charity's expenses that are spent on administering the charity and its programmes.
- **Fundraising efficiency:** Slightly differently, this is the ratio of the cost of fundraising relative to the total income for the year. This is a measure of how much a charity is spending to raise every one pound of income that comes in. It is represented as a currency figure, such as, 6p spent to raise £1.

These are the three main ratios we use but we also calculate a number of others, a few of which are:

- **Percentage of income used on projects:** This shows how much of the income received was used on programmes during the year.
- **Number of months of cost coverage:** This is a measure of how many months a charity could survive and cover the running costs should there be a complete halt in income. It relates the unrestricted reserves a charity has to the expenses it incurs.
- **Reserve development:** This shows how the reserves of a charity are developing year on year.
- **Proportion of restricted income:** This is the percentage of income that is restricted in terms of what it can be used for, by programme or country, for instance.
- **'Debt' ratio:** This is the ratio of total liabilities to total assets. It indicates one level of financial risk.
- **Cost per employee:** This is the employee costs divided by the number of staff the charity has. It gives the average salary per employee.

In addition to these ratios, we examine the breakdown of programme expenditure, to show us on what or where the funds are being spent (by programme or country), and the breakdown of income by different types of donor, to show whether the charity has a reliance on any one group.

We do not underestimate the difficulties of managing a charity. But, by examining a charity's financial history this way, we can tell a good deal about what is going on. We can see changes or improvements over time, assess whether a charity is relatively stable in terms of efficiency (suggesting good management), or whether there are one-off events we investigate to get the full picture.

Those still wanting to give should be confident that we have analysed charities for their financial efficiency and effectiveness. This way, we are protecting a donor's money as far as we can.

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We feel that donors should be giving where their money is used to best effect, that is, by those charities that are efficient with the funds and effective at achieving results. Those individuals, trusts, foundations, and corporations still wanting to give in the present difficult economic climate should be confident about doing so to our charities, the Development Ratings' charity recommendations.

We use benchmarks for the different parameters to assess whether a charity is efficiently run. While we will use these to make an initial assessment of the charity's financial position, we will not rule out a charity with a weak ratio in any one respect. Allowances can be made depending on the circumstances.

Programme ratio

The Charities Commission financial accounting regulations require charities to breakdown their expenditure in their accounts into three main areas: charitable activities, cost of fundraising, and governance. However, our programme ratio is not the same as the ratio of charitable activities to total expenditure. This would be a higher figure than the programme ratio because it would include a range of support costs that are not direct programme costs. They are often very necessary to run the programmes but do not represent money actually being spent on the beneficiaries to improve their lives in various ways.

What we are trying to measure in this ratio is how efficiently a charity is spending its funds to help the people it is targeting. Some charities are more efficient than others, whether due to better management, more efficient technology, or more motivated staff. It could be a combination of these or a number of other reasons. The programme ratio helps us sift out the less efficient charities. The lower the programme ratio is, the less absolute and relative impact the charity is going to have.

All financial efficiency ratios are a snapshot in time, at the year end. We do not expect the programme ratio to vary wildly between years without there being a good reason. There can be a whole host of reasons why this ratio is weaker one year than the last, and we will always try to find out whether there is a justifiable reason for substantial differences or whether, possibly, it is due to some type of mismanagement.

We know that a donor's main aim is to be helping beneficiaries. By concentrating on this ratio, we are doing what we can to protect a donor's money and ensure that it is being used as efficiently as possible.

The average programme ratio of our portfolio of recommended charities is currently 83%.

Administrative expenses ratio

In order to see distinctions between charities, we make an adjustment of the figures given in the accounts for the support costs so as to see more clearly how much a charity is spending on administering the programmes. This is because the differences seen between charities by looking at governance alone are very limited.

Clearly, all charities need to spend money on administration: it is necessary for a charity's efficiency to spend on accounting, auditing, legal or IT costs, or office maintenance, for example – without these things, the charity would deteriorate, fall into financial disarray or irregularities, or face significant obstacles to operating the programmes for the beneficiaries. It would then be less and less able to help the people it is focussing on. And it is clear that purely financial adjustments, such as depreciation, have nothing to do with the programme activities directly, or with fundraising, so should not be included as programme or fundraising costs.

So, while administrative expenses are necessary costs, we believe that there should be limits put on how much is spent on these types of items. Having high administrative expenses can be detrimental to the target beneficiaries, because, as we have said above, the lower the programme ratio, the less impact a charity can have. If administrative expenses are quite high, it means that the programme ratio has to be lower.

However, sometimes it is necessary to spend more on, say, developing an improved IT system to more efficiently manage programmes in the future, or on legal costs to replicate a programme or management structure in a new area. This might raise the ratio for one or more years. As a result, we are not uncomfortable with some variation in this ratio: it is the overall underlying trend that we are looking at.

As a generalisation, smaller charities spend relatively more on administering their programmes than larger charities. This is one of the reasons why we normally do not recommend charities that are very small. Clearly,

when, say, telecommunication costs or utilities have a fixed price whether they are being used by a large or small organisation, the relative cost of using these services rises for the smaller charities (and this is not counting the possible discounts that might be negotiated by the larger organisations). A smaller charity might be able to obtain free office space, for instance, for a low number of employees relative to the larger space that would be needed for a major charity, but other types of costs may still be incurred at a relatively higher rate. Unpredictable items, such as exchange rate losses from transferring funds abroad, could be more easily absorbed, or even hedged against, possibly, by a larger organisation.

Table 1: Examples of size of charity* relative to administrative expenses, from our research

Charity income	Administrative expenses ratio	Main support cost items mentioned
£97,000	41%	Exchange rate losses, bank charges, telephone & communication, office running costs, depreciation
£2.7m	14%	
£148m	10%	

* For this comparison, we attempted to choose charities that mentioned similar types of support costs in their report and accounts, and operated in fairly similar sectors (although the largest charity has a broad range of programmes).

The above example illustrates our point but we do not claim that all smaller charities are affected this way. We investigate to find out whether a smaller charity is managing its finances well or not. It is refreshing when we find a smaller charity that is being managed efficiently, perhaps because of an unusual management structure, such as a large number of committed and competent volunteers, or because of the use of a technology that keeps costs down.

We do accept that here is a place for donors funding smaller charities. However, a donor to a very small charity should be aware that what he or she is doing is 'venture-philanthropy'. A well-timed donation to a smaller charity with strong, motivated management may make all the difference to leveraging its growth and impact in the future. However, the risk of this not happening is high. With very small charities, there are much higher risks that: (a) the charity may not have a demonstrable track record of good management; (b) they are spending relatively less on the beneficiaries than a more established charity (and are therefore likely to be having a lower absolute and relative impact); and, (c) that the charity may have to fold or cease operating if it is hit by any major shocks. As a result, the donor's money may not, ultimately, have the effect that was intended.

Overall, by looking at the administrative expenses ratio, we believe we are protecting a donor's money, from this and other risks.

To some extent, the problems inherent in working in the least developed countries may cause charities with this focus to experience difficulties and costs that a charity working only in the UK would not experience. Communication and transport may be more costly, exchange rate losses may be incurred, hyperinflation, such as in Zimbabwe, can cause major financial headaches. But, by contrast, salaries and office rent in the target countries are likely to be lower, as might other regular running costs. Overall, we believe that many financial or expenses effects of working in developing countries will balance out and not penalise charities working in developing countries. In addition, in our view, the problems in places such as Zimbabwe demand more support, not less. In any case, the charities we recommend are relatively more financially efficient than many charities working in developing countries (and we have looked at over 1,400 now), and are often equally or more efficient than many charities that operate only in the UK.

The average administrative expenses ratio for our portfolio of recommended charities is currently 10%.

Fundraising efficiency

Strictly speaking, we should really relate this year's fundraising costs to next year's income, or even the income of the year after that. This is because the cost and effort of fundraising has to be made before results are seen. It is generally said that new fundraising programmes can take around 16 months to start to show results.

But to calculate a skewed measure like this would become rather complex, particularly when dealing with relatively smaller charities, such as start-ups, where there could be a great deal of variation in spending and income one year to the next. We prefer to use the simple 'in year' calculation for all our charities, to maintain comparable measures across all of them.

Should there be big variations in this measure, or an explanation needed to justify some approach, we will make a comment in the report on this. An example is the inclusion by one charity of exchange visit costs under fundraising rather than programmes: the view was taken that these were a form of long-term fundraising. But this policy results in a reduced fundraising efficiency (a higher figure), than would otherwise be the case. The charity is therefore more efficient at raising funds than it at first appears.

It is important for a charity to fundraise to secure income, preferably growing income, for the charity to properly plan the current and future programmes. It will not benefit the target populations if multi-year programmes have to be curtailed because income has fallen due to low levels of fundraising efforts. As with administration, fundraising is a cost that must be incurred and leveraged to maintain and increase the results and impact that programmes have on beneficiaries. Growing income can mean that programmes can be expanded or replicated in new areas to multiply the impact that can be made.

Fundraising is not a science. Unfortunately, as with sales and advertising, many fundraising efforts and proposals come to nothing and it is a thankless task. But it is essential. Some of donors' funds will and must go towards fundraising expenses.

The fundraising efficiency of a charity is not the same as its fundraising ratio (the cost of fundraising to total expenditure). The programme ratio + the administrative expenses ratio + the fundraising ratio = 100%. As a result, the fundraising ratio and efficiency measures could be different, sometimes quite substantially so during times of rapid income growth. We look at the fundraising ratio as well but it does not so clearly show how much it is costing the charity to raise the income that is being brought in.

As a generalisation, the largest charities spend more on fundraising. We believe that this is due to the inherent problems and costs of maintaining a high or national profile. An example might be the need to run regular national advertising campaigns in the media. Higher fundraising costs might also be due to the generally higher salaries paid to fundraising staff and the need for more fundraising staff to raise a larger amount of money in any one year. So, as a general rule, many of the major charities that you will have heard of will have a higher figure for fundraising efficiency than many that we recommend (that is, a worse efficiency than our recommendations): they spend more on fundraising and therefore relatively less on programmes.

Table 2: Examples of size of charity relative to fundraising efficiency

Income	Fundraising efficiency	Fundraising ratio
£82,000	1p	1%
£1.9m	7p	7%
£31m	20p	21%

Similar to the case with the administrative expenses ratio, it is not always the case that larger charities have higher figures for fundraising efficiency, and plenty of smaller or medium-sized charities spend a considerable amount on fundraising. But this emphasises the need to investigate the financial figures to get the correct picture of a charity's approach and policies.

We accept that the largest charities may be having a larger absolute impact on their beneficiaries because more money is being spent, in absolute terms, on the programmes. But, given the tendency for the larger charities to spend more on fundraising, our recommended charities are relatively more efficient and more effective. Every £1 given to one of our recommended charities is likely to have a greater relative effectiveness, and produce a greater impact, than £1 given to one of the larger or less financially efficient charities. The donors' money will be put to better use in a more financially efficient charity.

As with our example in Table 2, some small charities seem to more or less manage by spending hardly anything on fundraising. They may have a large handful of loyal supporters who keep it ticking over year on year. However, low or negligible levels of fundraising effort are likely to mean that a charity is not going to grow. With inflation and other issues, the impact on beneficiaries will slowly erode over time without long-term growth.

The cost of fundraising varies between different types of donor. It is generally cheaper to fundraise from institutions, trusts and foundations than it is from individuals. This is because the cost of preparing grant proposals is relatively low and has a higher return rate – for the effort put in, the return, in terms of the grant that might result, is high. With luck, the grant includes an amount for evaluation and feedback to the institution, as well.

By contrast, methods of raising funds from individuals can be expensive and time-consuming, may have a low success rate, and may show poor returns in terms of donations: examples are door-to-door or street canvassing, newspaper or magazine inserts, cold calling, etc. In addition, the cost of providing feedback to individual donors may be relatively higher in terms of printing and sending standard newsletters and so on. As a result, a charity that targets institutions may have a better fundraising efficiency than one that has a higher individual donor base.

The disadvantages of institutional fundraising are the high levels of restricted income (which cannot be spent on anything else), and their project orientation – often, the funding is for a set period of time, which is very helpful for planning the programmes, but which will inevitably come to an end. This will leave the charity needing to fill the funding shortfall at that point or end the programme. The advantage of individual donations, however, is that the cause may be dear to the donor's heart and he or she may be committed and loyal for a long period of time. The relatively low amount for the donor can add up to a substantial amount when multiplied by a high number of donors. And it is generally unrestricted. As can be seen, there is an argument for having a good balance of donors to allow for different needs, demands and conditions.

Again, we have standards and benchmarks that we use to determine whether we think a charity is over or under spending on fundraising. Within these levels, we believe that the costs will be ideal to develop a charity's income, and impact beneficiaries to the maximum extent, without wasting donors' money.

The average fundraising efficiency for our portfolio of recommended charities is currently 6p to raise every £1.

Percentage of income used on projects

A low percentage for this measure could indicate that the charity has seen very rapid income growth recently and has just not been able to spend the funds so far within the year. Over the following year, it is likely to plan and manage its programmes in such a way as to spend the income and improve the low measure. Alternatively, a substantial chunk of income may have been received near the year end and there has not been sufficient time for it to be spent on the programmes and activities it is intended for.

However, it could also be the case that the charity is struggling to manage the programmes it has and is unable to use the money efficiently on the programmes and activities it is carrying out. This could suggest a problem is developing.

Occasionally, this measure may be over 100%. This indicates a deficit for the year, that is, that more has been spent on programmes than came in in the year. If analysis of past financial history indicates that this is a common trend, then this rings alarm bells – unless reserves are high, continual deficits will undermine reserves and may lead to a rise in indebtedness. This is a sure sign of mismanagement and difficulties.

However, the percentage being over 100% may be an averaging out of past expenditure, that is, that the charity under spent last year and has made up for this during the current year. As a result, it is nothing to be worried about. Some charities go through this regular two year cycle on this measure, particularly if spending is quite 'lumpy' (the projects are substantial chunks of spending at a time), or during fast growth phases.

Other charities swing wildly between high and low figures for this measure which indicates that there is some loss of financial control. Evidence of having good financial management control systems in place is important for understanding the operations of the charity, and for having confidence that donors' money will be put to best use. As can be seen, it is important to find out what the underlying trend is for this measure to be sure of whether there are problems at the charity or not.

The average percentage of income used on projects for our portfolio of recommended charities is currently 69%.

Number of months of cost coverage

It is unlikely that a charity could cease to operate because income suddenly stops coming in. However, it might be the case that a relatively small charity spends a great deal of effort on a particular proposal, say, to a trust, only to fail at the final hurdle. This might leave a funding gap. Or it might be that the charity has not fully

complied with, for instance, the very extensive and detailed expenditure evidence requirements of the European Union, and the EU may 'claw back' parts of grants it has previously made (but which have largely been spent). Or some unexpected event might occur that undermines free reserves to a dangerous level.

As a result, planned programmes may not be able to be carried out, but running costs will continue to have to be paid until such time as new funding comes in. The months of cost coverage indicates how long the charity could survive under these exceptional, but normally hypothetical, circumstances.

To some extent, the lower the months of cost coverage, the more important it is to have confidence in the quality of the charity's management to be able to manage the charity or deal with any unusual events.

There are levels of cost coverage that we consider to be good and sensible. Below this level, there are risks that the charity may run short of funds and may need to go into debt to fund ongoing running costs, or, in extreme cases, to cease functioning. Many charities manage for years on low months of cost coverage, which may be a common feature in their particular sector, but it is a risk.

However, unless a charity is establishing an endowment, from which it intends to fund programmes from interest for many years to come, there are higher levels of cost coverage which we would consider to be unreasonable. We would assume that, unless otherwise specified, a donor intends his or her money to be used within a fairly short period of time of it being donated. Excessively high months of cost coverage might indicate that this is not happening, and we would want to know why.

The average number of months of cost coverage for our portfolio of recommended charities is currently 7 months.

Reserve development

Restricted reserves are intended for use in future financial years and are specifically earmarked for a particular project. For the reserves development measure, however, we only use unrestricted reserves. Unrestricted reserves are available to cover general costs and unexpected eventualities. This measure is related to the months of cost coverage. If the cost coverage is low, we would want to see an increase in reserves development, over possibly several years, to counter the low figure, increase the months of cost coverage, and reduce the risk. However, reserves development can vary substantially year on year.

The savings ratio is a similar calculation referring to the surplus of income over expenditure in the year. It can indicate whether deficits are a regular occurrence and can also vary substantially. These are different areas we look at in relation to the financial strength of a charity.

The average annual reserves development for our portfolio of recommended charities is currently 31%.

Proportion of restricted income

Many charities manage for years with high levels of restricted income. Such income is normally from institutions, trusts, or foundations, and is intended to fund a particular closed ended programme or project.

However, high levels of restricted income undermine the flexibility of a charity to replicate its approach in another programme or in another region or country, for instance. What would be ideal is for a charity to be able to duplicate what it is doing elsewhere using the same management and structure. Lower levels of restricted income may allow this to happen more readily.

Low levels of restricted income suggest that a charity is more reliant on individual donors than it is on institutional donors. As mentioned above, there are advantages and disadvantages of this. Individual donations may provide flexibility but it is more costly to raise funds from individuals and to provide individualised feedback to them. There is also the risk that they are more likely to reduce charitable donations during times of economic difficulty.

The average level of restricted income for our portfolio of recommended charities is currently 60%.

‘Debt’ ratio

Too high levels of ‘debt’, or rather any long- and short-term liabilities, suggest that a charity is struggling to support the structures in place or programmes being undertaken with the current level of income. As a result, part of donors’ money may be being used to pay debt costs or repay liabilities, which is unlikely to be what the donors intended.

During a long period of declining income, one £1m income charity we are aware of had accrued liabilities well in excess of its assets and had fallen further and further into financial difficulties. It has had to cease operations while it undergoes asset sales and complete restructuring. While it does so, existing donor money is put on hold, and beneficiaries are not being helped. The donors’ money may not ultimately ever be used for programmes but instead may be used to pay off some liabilities. It is important to us to protect our donors’ money by not recommending charities like this with high ‘debt’ ratios. We would begin to be concerned if a charity’s ‘debt’ ratio rose above about 0.30 (liabilities being 30% of assets), particularly in the current economic circumstances when declining income is a distinct possibility. We would be more comfortable with a lower figure than this.

However, a certain level of liabilities is unlikely to be a significant cause for concern and can indicate a sensible deferral of payments to creditors, or taking advantage of, for instance, free or low interest loans to leverage programmes or cover inevitable funding gaps.

The average ‘debt’ ratio for our portfolio of recommended charities is currently 0.13 (or liabilities being 13% of assets).

Cost per employee

We would generally expect that the salaries of charity employees would be quite restrained compared to the private or public sectors, partly due to the vocational nature of the work. But, increasingly, and to achieve the best results, the management of a charity is a professional activity that requires a professional approach. Maintaining the programme and fundraising pipeline, as well as the financial efficiency, of an impactful charity is not a minor task. It requires high level skills that can normally not be carried out under a purely volunteer or altruistic mentality.

The cost per employee can show whether some employees tend to work part-time, or are based overseas, or in the more expensive London area, or are staffed by more highly paid fundraisers. This measure gives an overall impression of the style of the charity and its method of working.

In general, charities with higher incomes tend to have higher numbers of employees, as the income funds larger or more numerous programmes that require more staff to run them. But there is no clear correlation between size of charity (by income or employees) and average salary.

Table 3: Comparison of selected charities* income, employee numbers, and cost of employees

Income	Number of employees	Average salary
£187,000	3	£31,000
£199,000	3	£18,471
£1.1m	6	£61,502
£1.2m	33	£7,392
£3.4m	9	£21,962
£5.5m	324	£6,643
£44.9m	81	£36,012
£107m	2,130	£8,292
£290m	6,372	£13,813

*Only some of these charities are Development Ratings recommendations.

Some of the smaller charities have higher average salaries due to the skewing effect of the small number of employees (such as in a start-up charity), but, by contrast, some smaller charities may also employ more part-time staff which would lower the average figure again. More overseas staff tends to lower the average salary as well, as salaries and the cost of living are lower in the target countries (and part-time working or multiple jobs

are also common). Charities managed out of London might have higher staff costs due to the higher cost of living there.

In general, our analysis shows a closer correlation between average salary level and charitable income per staff member: the higher the charitable income per employee, the higher the charity's average salary. This relationship does not always hold up but it tends to strengthen the conclusion that higher pay is related to a charity's fundraising functions and abilities.

Table 4: Comparison of selected charities* average income per staff member and average salary

Income per staff member	Average salary	Income
£15,047	£5,837	£2.3m
£34,979	£11,156	£50.6m
£65,416	£16,181	£31m
£292,669	£33,899	£43.3m
£520,655	£34,385	£1m
£567,529	£32,544	£38.6m

*Only some of these charities are Development Ratings recommendations.

We can generally tell if a charity is the UK fundraising arm of a larger charity as its average salary will tend to be higher (due to more, higher paid fundraisers). As such, it would be of less interest to us as the UK operation would be mainly raising funds. It would be less likely that the UK office would be highly involved in the management of the charity's activities, which is what we are looking for.

In addition, we look at the salary of the top executives if it is mentioned (salaries over £60,000 must be disclosed in the accounts). To our surprise, some top salaries, even of nationally known charities, seem to bear no relation to the size of the charity or the number of employees. The chief executive of Oxfam, for instance, a charity which employs over 6,000 people and has income of nearly £300m, is not particularly highly paid given the complexity of the operations its size would suggest. We have come across smaller, less complex, and less well-known charities where the chief executive is considerably more highly paid than Oxfam's head. Another senior charity director that we are aware of is paid in the same salary bracket as Oxfam's chief executive but, in comparison, runs a charity of just 7 staff in total and £1.5m in income so far. For this, and various other reasons, this charity will not become a recommendation of ours.

Although from our interviews we have found out that the senior managers of our recommended charities are professional and competent, and, in some cases, highly inspirational, we see lower average top executive pay for the charities we recommend, rather more in keeping with the charities' lower complexity levels. This by no means implies that the charities are relatively less effective, however.

The average cost of employees for our portfolio of recommended charities is currently £17,917 per member of staff.

Programme expenditure and income breakdown

By looking at the programme expenditure breakdown, we are able to see where a charity operates in terms of country and sector. This helps us ensure that the charity is targeting the countries with the most need, and is operating in sectors that we have identified as being of greatest usefulness for supporting the disadvantaged.

Unfortunately, there is no standard method used in charities' reports and accounts about how they show expenditure breakdown data. Charities most often show their breakdown of expenditure only by restricted funds. This is a limited measure, given that the restricted funds are only one part of the total programme expenditure. However, it can give a general idea of where funds are being spent. Ideally, we would like to encourage charities to give greater detail about where and on what they are spending the funds.

By analysing the income breakdown, we can more fully understand the type of donor that is supporting each charity. We can see if there is a good balance between different types of donor, or if there are gaps in the charity's fundraising approach. We check how donations from different donors change over several years and the changes in overall income development.

External impacts can affect income development. In 2005, after the Asian Tsunami on Boxing Day 2004, many disaster relief charities saw their income rise very substantially, as individual donors from the general public tried to help those affected. Subsequently, income for 2006 dropped. Those charities that did not have a disaster relief focus generally saw slight drops or more steady income development over the two years. The recession of 2008/9 will also be likely to affect charity income, as individuals tighten their belts, and foundations and trusts see lower interest income on their investments. However, institutional donations from governmental development departments may remain steadier and more reliable. This is due to their commitment to development and poverty alleviation in the long term and specifically towards the next Millennium Development Goal deadline of 2015. As a result, those charities with higher institutional funds may be more likely to maintain their programmes and help beneficiaries over the next few years. As mentioned above, there are advantages and disadvantages of donations from different types of donor.

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