

# **Financial risks in the nonprofit sector: A regulatory perspective**

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## **Introduction**

Risk is an everyday part of charitable activity. Nonprofit (hereafter known as ‘charity’) trustees are responsible for managing risk to ensure that their charities achieve their objectives and protect the organisation’s funds and assets. In Scotland, the Office of the Scottish Charity Regulator (OSCR) has responsibility for implementing The Charities and Trustee Investment (Scotland) Act 2005, and ensuring that charities and their trustees comply with the law. One of the challenges for the regulator is ensuring that their action is appropriate, and that they balance enforcement of The Act against placing an undue burden on charitable organisations.

Charities in Scotland and the UK have been the subject of intense media, political and public scrutiny in recent times. Public confidence and trust in the sector has been questioned in light of various ‘scandals’ including unethical fundraising practices (resulting in the establishment of a new fundraising regulator), morally-questionable levels of chief executive pay, politically-motivated lobbying and advocacy work, and poor financial management. The latter issue has gained traction amongst politicians and the media as a result of the demise of Kids Company, a prominent London-based charity that provided practical, emotional and educational support to vulnerable children. The charity ceased operations in August 2015 amidst accusations of, amongst other concerns, inadequate financial management (BBC, 2015). The charity’s collapse has placed the spotlight firmly on financial risks inherent in the charity sector in the UK and Scotland.<sup>i</sup> These developments have occurred against the

backdrop of increasing public scrutiny and accountability of institutions in general (Rothstein et al, 2006; Power, 2009). Consequently, charities and the institutions tasked with their oversight are under increasing pressure to demonstrate their legitimacy. In response to this pressure ‘there have been several recent initiatives, both regulatory and voluntary, to encourage and promote UK charity accountability (accountability being the requirement to be answerable for one’s conduct and responsibilities) through information communication.’ (Connolly and Hyndman, 2013a: 946) As of April 2016 OSCR publishes links to charity accounts on their website and charities are required to notify the regulator regarding what are known as ‘notifiable events’ (for example, instances of theft or fraud in a charity). An unseen (by the public, practitioners and researchers) aspect of charity accountability is the financial exceptions monitoring programme that OSCR manages. It is this data that is the focus of the study.

This paper explores the ways in which certain financial risks (such as efficient use of charitable funds, transactions with trustees, and sudden contraction of revenue) are operationalized by the regulator; in particular, it examines risks relating to alternative conceptualisations of nonprofit financial vulnerability. The paper is structured as follows. First, charitable organisations in Scotland are defined and their regulatory environment delineated. This is followed by an outline of the theoretical framework that provides necessary context and concepts for the exploratory empirical work that follows. The empirical findings are then presented and discussed with reference to the theoretical framework and the paper concludes with a consideration of the limitations of the data and findings.

## **The Scottish charity sector**

In Scotland, a charity is defined (under statute) as an organisation that is listed on the Charity Register maintained by OSCR. To register as a charity an organisation must demonstrate that it passes the charity test: it must have only charitable purposes; the organisation must or intend to provide some form of public benefit; it must not allow its assets to be used for non-charitable purposes; it cannot be governed or directed by government Ministers; and it cannot be a political party (OSCR, 2012).<sup>ii</sup> Charities make a substantial contribution to Scotland's economy and society. In 2013 the charity sector contained 23,000 organisations, employed 138,000 people, had total revenues of almost £5 billion, and spent £4.7 billion on programme expenditure (SCVO, 2014).<sup>iii</sup> It is an incredibly diverse sector in terms of organisational form, beneficiary groups, charitable purposes and industrial classification. Since 2006 the number of charities operating in Scotland has remained stable at around 23,000 in any particular year, though this masks the number of new registrations and organisations that lose their charity status or dissolve. Despite its size and significance, financial uncertainty is an inherent feature of the sector, with external stresses originating from a number of sources such as changing economic conditions, regulations, public policy and competition from for-profit providers (Chew and Osborne, 2009; Bingham and Walters, 2013; Shea and Hamilton, 2015).

Charities in Scotland are subject to regulation by OSCR, which was established in 2003 as an Executive Agency and took up its full powers when the Charities and Trustee Investment (Scotland) Act 2005 came into force in April 2006. Its responsibilities include the following: keep a public register of charities in Scotland; determine whether an organisation can be a charity; encourage, assist and monitor compliance with regulation; identify and investigate apparent misconduct and protect charity assets; give advice or make proposals to ministers about charity regulation (OSCR, 2006). The rationale underpinning these responsibilities is common to many charity regulatory environments: protect public confidence and trust in the

sector (Cordery, 2013). In order to achieve this aim OSCR has instigated a regulatory approach they refer to as ‘targeted’: ‘Our work has confirmed our commitment to a proportionate, targeted approach based first on an assessment of risk...[we] will look at the charity as a whole rather than charitable status alone, checking on all the issues we know can threaten charitable assets or a charity’s reputation and cause concern to the public’ (OSCR, 2012b: 6) This approach is grounded in what is known as risk-led or risk-based regulation, which is commonly defined as a particular strategy or set of strategies that regulators use to target their resources at those sites and activities that present threats to their ability to achieve their objectives (Black and Baldwin, 2012; see also Sparrow, 2000; Hutter, 2006; Rothstein et al, 2006). The process of identifying, measuring, and assessing financial risks in the sector is a crucial aspect of OSCR’s targeted approach to regulation. The next section places the research in the context of two key literatures: charity failure (with a particular focus on financial vulnerability concepts) and accountability.

### **Theoretical perspective**

The study of financial risk is part of the broader field of charity success and failure. Mellahi and Wilkinson (2004) identify two leading schools of thought in the study in this field which they label ‘deterministic’ and ‘voluntaristic’. Population ecology theory is deterministic and focuses on density, size and age as affecting the life chances of organisations, as well as a suite of environmental factors (such as regulation and the state of the economy). All of these variables are considered outwith the control of the organisation. ‘By contrast, the more agency-oriented voluntaristic approaches within organization studies and organizational psychology see good strategic choices as the keys to organizational success. Particular emphasis is placed on organizational structure, the role and composition of the board, and how problems are perceived and solved.’ (Mellahi and Wilkinson, 2004: 268) The construct of organisational success is an important one for the study of charities. Charity theory posits

that these organisations are mission rather than profit driven and should be evaluated against this aim (Hansmann, 1987; Oster, 1995). However, there are various methodological challenges associated with performance measurement (Weisbrod, 1998). Some authors have suggested that organisational survival is the ultimate criterion on which charity organisation success should be judged upon (Kanter and Summers 1994). Helmig et al (2014) caution that organisational survival is an artificial measure of success, as charities often do not achieve their mission and remain operational only through demand for their services and support from public funds. The same authors provide a comprehensive overview of the factors posited as determinants of organisational success in the extant literature: organisation size and age, effective governance, regulation, financial performance, number of volunteers, staff motivation, and management team diversity are all used as explanatory variables in studies of nonprofit success and failure (Helmig et al, 2014).

### *Financial vulnerability*

Research on the financial vulnerability of charities gathered pace in the 1990s and 2000s. The increasing economic heft of the sector globally (and in the US in particular), combined with the impact of global economic fluctuations on these organisations, spurred academics to develop the literature on this topic (de Andrés-Alonso et al, 2015). Consequently, much of the extant research is focused on the US nonprofit sector. Current conceptualisations of financial vulnerability have their roots in the forprofit literature, in particular studies that sought to explain and predict corporate bankruptcy (see Altman, 1968; Ohlson, 1980). Early nonprofit studies adopted these approaches, with minor alterations to the definition and operationalization of financial vulnerability. In a seminal study, Tuckman and Chang (1991) defined financial vulnerability as the likelihood of an organisation reducing services immediately in the event of a financial shock. They created four accounting measures that they posited are indicators of financial vulnerability: inadequate equity balances; revenue

concentration; low administrative costs; and low or negative operating margins. Tuckman and Chang then divided each ratio into quintiles and classified nonprofits in the lowest quintile as ‘at risk’; an organisation was considered at ‘severe risk’ if it scored in the lowest quintile of all four ratios. Though their work was a logical and important contribution to a nascent literature, there were some limitations. Perhaps most significantly financial vulnerability was treated as a relative concept, whereas it might be better to adopt a stable cut-off indicating financially distressed organisations. The predictive power of the measures was also not tested in their sample. When their approach is considered in more general terms however, it is reasonable to assume that revenue concentration, low or negative operating margins, and the level of debt are issues worth considering when assessing the financial vulnerability of a charitable organisation (Dayson, 2013).

Greenlee and Trussel (2000) contributed the next significant piece of research in this field, applying Tuckman and Chang’s accounting ratios to a modified conceptualisation of financial vulnerability. They defined a nonprofit as being financially vulnerable if it reduced program expenditures (as a proportion of total revenues) in each of three consecutive years. The results of their study found statistically significant relationships between financial vulnerability and lower operating margins, higher revenue concentration and higher debt. Over the next few years the same authors expanded on this piece of work, adjusting the financial vulnerability indicators and including additional controls in their model; of particular relevance was the inclusion of organisation sector and size (operationalised as the natural log of net assets), both of which made a statistically significant contribution to the model (Trussel and Greenlee, 2001; Trussel, 2002). The work of Hager (2001) was also important in testing and refining Tuckman and Chang’s four ratios, relating financial vulnerability to the organisational demise of nonprofits working in the arts sector. He found

that the predictive ability of the Tuckman and Chang indicators varied within this sector, with some of the measures accurately predicting the closure of some of the arts organisations.

Building on these previous studies Keating et al (2005) developed new measures of financial vulnerability that accounted for limitations in the time period covered by their data. They operationalised financial vulnerability as four dichotomous measures (insolvency risk, financial disruption, funding disruption, and programme disruption) which capture ‘dramatic adverse shifts in financial health, all of which relate to the ability of a nonprofit organization to carry out its mission.’ (Keating et al, 2005: 11) Using discrete hazard logistic regression (a form of event history analysis), Keating et al tested the predictive power of a range of financial vulnerability indicators including the Tuckman and Chang, Ohlson and Altman models. The authors found that neither model was particularly effective at predicting any of financial vulnerability measures, though the Ohlson model consistently outperformed the others. As a response to the inadequacy of these models, Keating et al developed an expanded model that incorporated additional explanatory variables such as commercial revenues and endowment sufficiency; this model improved the relative explanatory power for each measure. Dayson (2013: 25) posits that the findings of these studies ‘suggest that financial vulnerability particularly affects small organisations, those reliant on few sources of income and those that struggle to generate financial surpluses sufficient to designate unspent funds as unrestricted reserves.’ Since these oft-discussed and heralded studies, much empirical and conceptual work on financial vulnerability has been conducted (see Prentice, 2015 for a comprehensive overview). Empirical contributions include Gordon et al’s (2013) study of insolvency in the US nonprofit sector, Cordery et al’s (2013) examination of the financial vulnerability of sports clubs in New Zealand, and Mayer et al’s (2014) econometric analysis of the impact of revenue diversification on charity volatility. Important conceptual

contributions can be found in the work of Frumkin and Keating (2011), Bowman (2011), Dayson (2013), de Andrés-Alonso et al (2015) and Prentice (2015).

### *Accountability*

The study of vulnerability is contingent on having access to the financial and accounting information of charities, which necessitates an excursion into the related and overlapping literature of accountability. As Connolly and Hyndman (2013a: 947) attest: ‘while accountability, in its widest sense, is more than accounting, no matter how widely accounting is defined, accounting is clearly linked to the concept of accountability.’ It is often argued that the continued success of the charity sector depends not only on its economic and social activities but also on its ability to demonstrate accountability and transparency, which in turn can protect and enhance public confidence (Keating and Frumkin, 2003; Morgan, 2012; Cordery and Morgan, 2013; Connolly and Hyndman, 2013b). Valentinov (2011) contends that charity accountability is contingent on addressing the following questions: accountability to whom; and accountability for what. With respect to the second question, Taylor and Rosair (2000), Brody (2001, 2002), Goodin (2003), and Connolly and Hyndman (2004) have made substantial contributions, with their work converging on the need for charities to discharge two types of accountability: fiduciary (compliance with accounting standards) and performance (efficiency and effectiveness measures). Traditionally charities have discharged accountability through the disclosure of financial information and efficiency metrics (such as conversion ratios) in annual returns and reports submitted to the relevant oversight body, though there are increasing calls for the provision of alternative, non-financial narratives of performance (Keating and Frumkin, 2003; Britton, 2008; Philips, 2013; Connolly et al, 2013).



## **Aims and significance**

This study seeks to address some limitations of previous research, both in the financial vulnerability and accountability literatures. Studies of charity accountability have tended to focus on information disclosure by charities themselves (Hyndman, 1990, 1991; Connolly and Hyndman, 2013; Connolly et al, 2013); this research takes an alternative perspective by examining how a key stakeholder (the regulator) constructs measures of performance accountability from charities' mandatory information disclosures. With respect to the financial vulnerability literature, Dayson (2013) argues that effort should be made to construct indicators of financial vulnerability 'from the ground up', specific to the charity sector (and time period) in question. OSCR's financial exceptions data provides a convenient and relevant source alternative conceptualisations, indicators and measures of financial vulnerability and financial risks more broadly. This paper makes two key contributions. First, using novel data, the research describes the nature and extent of financial risks in the Scottish charity sector and asks what organisational and financial factors are associated with these risks? It utilises accurate and detailed information about charities' organisational and financial characteristics including, *inter alia*, constitutional form, organisation size and age, annual gross income and expenditure, and net assets. Second, the paper seeks to improve the statistical evidence base on the financial and accountability profile of Scottish charities more generally; this is particularly important as most of the extant research on this topic is US-centric (Mohan and Clifford, 2016).

## **Data and methods**

Charities registered with OSCR must submit an annual return form and set of financial accounts for each accounting year. The novel administrative dataset utilised for this research is constructed from two sources: financial exceptions data and annual returns information.

The first data source captures instances where a charity's annual accounts trigger one or more exception codes (see the appendices for a list of the codes and their descriptions). These 32 codes represent certain financial risks and regulatory concerns, and are grouped under six headings: large charity or major fundraiser; sudden growth or contraction; possible failure to apply funds for charitable purposes (also contains fundraising issues for the purpose of this analysis); poor liquidity, low reserves, threats to viability; adequacy of governing board; and transactions with trustees (Table #). If an exception is triggered, charities are informed of this and offered the opportunity to provide an explanation; OSCR then decides whether this explanation is valid and whether the exception requires further investigation. Financial exceptions only apply to organisations that completed a supplementary monitoring form that captures detailed financial information from the annual accounts: charities with annual gross income of at least £250,000 (£100,000 prior to 2012) are required to complete the form. Certain charity types are also excluded from completing the supplementary monitoring form: these include Registered Social Landlords and Cross Border charities (those registered in England and Wales and thus primarily subject to regulation by the Charity Commission). Further details about the OSCR data, including a discussion of data quality and the steps involved in producing a statistically usable dataset, are provided in the online supplementary material.<sup>iv</sup> Table 2 below summarises the sample selection process.

Table 1 - Sample selection

| <b>Sample selection</b>  | <b>Observations</b>                       |
|--|---|
| Initial sample   | 155,416                                   |
| Removal of charities that didn't complete the supplementary monitoring form in a particular year | 129,708                                   |
| Removal of observations outwith analysis period  | 808                                       |
| Removal of charities listed as Cross Border or Registered Social Landlords                       | 4,231                                     |
| <b>Final sample</b>  | <b>21,322</b><br><b>(5,124 charities)</b> |

The analysis in this paper has its limitations. Observations only apply to charities that meet a specified income threshold and thus this study is unable to explore the financial risks facing the majority of charities in Scotland. The paper acknowledges the issues inherent in using charity accounts for research purposes, such as missing data, incomparability due to the adoption of different accounting standards, significant lags in reporting, and measurement changes over time (Morgan, 2011; Bingham and Walters, 2013). As the main focus is on describing patterns and trends in the nature and extent of financial exceptions, the paper also does not examine charities' explanations for why these exceptions occurred.<sup>v</sup>

## **Findings**

Table 3 provides descriptive statistics on the sample for core financial and demographic measures. They suggest that the sample is highly skewed, based on the difference between the mean and median results. It appears that a small number of very large charities (with respect to their income and expenditure) are having a disproportionate influence on the calculation of the mean. The median organisation doesn't receive any income from government funding or trading activities, spends £230,391 on conducting its charitable

activities and £4,200 on governance costs, has £129,909 in unrestricted funds (reserves), and has been in existence for 21 years. In contrast the mean charity receives £1,039,762 and £135,133 in income from government funding and trading activities respectively, spends £2,044,046 on conducting its charitable activities and £17,306 on governance costs, has £2,056,464 in unrestricted funds (reserves), and has been in existence for 31 years.

**Table 2 - Descriptive statistics**

| <b>Variable</b>                | <b>n</b> | <b>Mean</b> | <b>Std Dev</b> | <b>Median</b> | <b>5<sup>th</sup><br/>Percentile</b> | <b>95<sup>th</sup><br/>Percentile</b> |
|--------------------------------|----------|-------------|----------------|---------------|--------------------------------------|---------------------------------------|
| donations income               | 20,559   | 295,588     | 1,751,417      | 50,000        | 0                                    | 869,030                               |
| interest and investment income | 20,559   | 85,632      | 1,000,243      | 1,864         | 0                                    | 221,514                               |
| government income              | 20,559   | 1,039,762   | 8,360,373      | 0             | 0                                    | 2,237,508                             |
| trading income                 | 20,559   | 135,133     | 925,409        | 0             | 0                                    | 466,886                               |
| charitable activity income     | 20,559   | 846,693     | 7,100,497      | 12,930        | 0                                    | 2,474,755                             |
| other income                   | 20,559   | 121,332     | 1,689,662      | 0             | 0                                    | 169,501                               |
| total income                   | 20,575   | 2,522,287   | 17,383,308     | 322,398       | 110,748                              | 9,076,695                             |
| total income(log)              | 20,575   | 13          | 1              | 13            | 12                                   | 16                                    |
| voluntary funds costs          | 20,559   | 39,207      | 296,623        | 0             | 0                                    | 135,284                               |
| other funds costs              | 20,559   | 39,063      | 762,201        | 0             | 0                                    | 28,218                                |
| trading costs                  | 20,559   | 121,385     | 1,296,932      | 0             | 0                                    | 330,036                               |
| charitable activity costs      | 20,559   | 2,044,046   | 16,043,993     | 230,391       | 0                                    | 6,436,227                             |
| grants and donations costs     | 20,559   | 115,185     | 1,266,538      | 0             | 0                                    | 251,174                               |
| governance costs               | 20,559   | 17,306      | 72,580         | 4,200         | 0                                    | 62,555                                |
| other costs                    | 20,559   | 33,956      | 727,882        | 0             | 0                                    | 26,000                                |
| total costs                    | 20,575   | 2,408,344   | 16,864,223     | 298,244       | 87,966                               | 8,665,000                             |
| total costs(log)               | 20,568   | 13          | 1              | 13            | 11                                   | 16                                    |
| net current assets             | 20,572   | 624,521     | 6,010,868      | 105,831       | (39,864)                             | 2,173,000                             |
| unrestricted funds             | 20,575   | 2,056,464   | 17,721,112     | 129,909       | 0                                    | 6,732,800                             |
| charity age                    | 21,322   | 31          | 28             | 21            | 6                                    | 97                                    |

Based on 21,322 charity-years. All figures are in £ and rounded to the nearest whole number. See the appendices for a codebook of the variable names and descriptions.

61 percent of charities (42 percent of observations) in the sample triggered at least one financial exception over the period 2007-2013. For charities that experienced an exception, it is likely that they will trigger more than one over the whole period: the mean number of exceptions per charity is 9 (s.d. 10) and the median is 8. However, charities that do experience exceptions tend to only trigger a small number per annum: the mean number of exceptions per charity per annum is 2 (s.d. 1) and the median is 1.

#### *Trends over time*

The table below outlines the percentage of charities that triggered each group of financial exception. Encouragingly financial exceptions are uncommon for any year and the period as a whole. A possible failure to apply funds for charitable purposes is the most common exception group; the majority of the 22 percent of observations that experienced this exception were triggered by exception codes 5 and 8. There is some evidence of financial vulnerability in the sector, with at least 13 percent of charities in any particular year triggering exception codes relating to poor liquidity, low reserves, and threats to viability; there is a more even distribution of exception codes in this category, with concerns relating to debtors and creditors (codes 13 and 14) being slightly more common than other exceptions. There appears to be no association between each type of financial exception and the year in which the exception occurred (Cramer's  $V < 0.1$ ). The proportion of charities triggering each type of exception does not vary substantially over time or from the average for the whole period. The increases for 2012 and 2013 across some of the exception groups are explained by a change in the denominator (that is, a reduction in the number of charities completing the supplementary monitoring form) rather than an increase in the number of charities triggering these exceptions.

**Table 3 - Distribution of financial exceptions 2007-2013**

| Type of exception                                       | %                               |                                 |                                 |                                 |                                 |                                 |                                 | Overall                          |
|---|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|----------------------------------|
|   | 2007                            | 2008                            | 2009                            | 2010                            | 2011                            | 2012                            | 2013                            |                                  |
| Possible failure to apply funds for charitable purposes | 24.66                           | 22.71                           | 19.91                           | 20.71                           | 20.56                           | 22.17                           | 22.93                           | <b>21.84</b>                     |
| Poor liquidity, low reserves, threats to viability      | 14.74                           | 13.19                           | 13.72                           | 13.59                           | 14.10                           | 16.35                           | 15.92                           | <b>14.26</b>                     |
| Transactions with trustees                              | 9.75                            | 10.38                           | 9.83                            | 10.04                           | 8.85                            | 12.50                           | 10.37                           | <b>10.06</b>                     |
| Large charity or major fundraiser                       | 5.91                            | 6.29                            | 6.30                            | 6.29                            | 6.19                            | 13.30                           | 12.25                           | <b>7.36</b>                      |
| Sudden growth or contraction                            | 1.36                            | 1.38                            | 1.17                            | 1.14                            | 1.55                            | 3.37                            | 3.66                            | <b>1.71</b>                      |
| Adequacy of governing board                             | 1.71                            | 1.38                            | 1.40                            | 1.43                            | 1.50                            | 1.44                            | 1.31                            | <b>1.46</b>                      |
| <b>Total</b>  | <b>100.00</b><br><b>(3,386)</b> | <b>100.00</b><br><b>(3,563)</b> | <b>100.00</b><br><b>(3,491)</b> | <b>100.00</b><br><b>(3,496)</b> | <b>100.00</b><br><b>(3,604)</b> | <b>100.00</b><br><b>(1,872)</b> | <b>100.00</b><br><b>(1,910)</b> | <b>100.00</b><br><b>(21,322)</b> |

*Patterns in exception triggers: relationship with covariates*

Our attention now turns to the correlation between each exception type and organisational characteristics. Table 4 displays the results of this analysis. It appears that there is an absence of correlation between many of the most common charity characteristics and each exception type, giving the impression that occurrences are stochastic in nature in the context of the data we have. There is weak correlation between trusts and being financially vulnerable; ditto for grant-making bodies. It would also appear that large charities are most at risk of triggering exceptions relating to transactions with trustees.

Table 4 - Pearson correlations between charity characteristics and exception type

| Variable                            | Exception group 1  | Exception group 2  | Exception group 3  | Exception group 4  | Exception group 5  | Exception group 6  |
|-------------------------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| Charity age                         | .03***<br>21,322   | (.02)**<br>21,322  | .01<br>21,322      | (.03)***<br>21,322 | (.03)***<br>21,322 | .02**<br>21,322    |
| Engaged in fundraising              | .01<br>20,575      | (.03)***<br>20,575 | .04***<br>20,575   | (.08)***<br>20,575 | (.06)***<br>20,575 | (.05)***<br>20,575 |
| Hire fundraising agency             | .14***<br>20,575   | .00<br>20,575      | .03***<br>20,575   | (.01)<br>20,575    | (.01)<br>20,575    | (.01)*<br>20,575   |
| Parent charity                      | (.06)***<br>21,322 | (.01)<br>21,322    | (.01)<br>21,322    | (.03)***<br>21,322 | (.01)*<br>21,322   | (.01)<br>21,322    |
| Removed                             | .03***<br>21,322   | (.02)*<br>21,322   | (.03)***<br>21,322 | .03***<br>21,322   | .01<br>21,322      | .02**<br>21,322    |
| Grant-making body                   | .12***<br>21,322   | .07***<br>21,322   | .07***<br>21,322   | .11***<br>21,322   | .08***<br>21,322   | .03***<br>21,322   |
| Operates overseas                   | .14***<br>21,322   | .03***<br>21,322   | .04***<br>21,322   | .03***<br>21,322   | .12***<br>21,322   | .10***<br>21,322   |
| Large charity (total income > £10m) | .76***<br>21,322   | (.01)<br>21,322    | .01<br>21,322      | (.01)<br>21,322    | (.01)<br>21,322    | .25***<br>21,322   |
| Trust                               | .03***<br>21,322   | .08***<br>21,322   | .05***<br>21,322   | .10***<br>21,322   | .06***<br>21,322   | (.03)***<br>21,322 |
| Company                             | (.06)***<br>21,322 | (.03)***<br>21,322 | (.05)***<br>21,322 | .01<br>21,322      | .01<br>21,322      | (.08)***<br>21,322 |
| Unincorporated association          | (.10)***<br>21,322 | (.02)***<br>21,322 | .01<br>21,322      | (.08)***<br>21,322 | (.04)***<br>21,322 | .04***<br>21,322   |
| Social services                     | (.08)***<br>21,322 | (.04)***<br>21,322 | (.06)***<br>21,322 | (.09)***<br>21,322 | (.03)***<br>21,322 | (.07)***<br>21,322 |

Note: n for each correlation is shown below each value. Legend: \* p<0.05; \*\* p<0.01; \*\*\* p<0.001.



We now turn our attention specifically to financial vulnerability triggers. Table 5 explores the financial profile of charities that triggered a financial vulnerability exception (poor liquidity, low reserves, threats to viability) and compares it to those that did not. It appears that there are not many substantial differences across key financial metrics. Whether there is a substantive or statistically significant difference between these charities is dependent on the measure of central tendency considered most appropriate. For example, financially vulnerable charities have less annual gross income if using the difference in means; however they have higher levels of income according to the median difference, while our natural log measure of income (which transforms the skewed distribution to one that is approximately normal) suggests that there is no difference between financially vulnerable charities and their counterparts with respect to total income. There are some clear, substantive differences across other measures. Financially vulnerable charities have not been in operation as long, spend more on governance costs, and considerably more on grants and donations costs.

Table 5 - Financial profile

| Variable                       | Financially Vulnerable |           |         |       |           |         | Mean difference | Median difference |
|--------------------------------|------------------------|-----------|---------|-------|-----------|---------|-----------------|-------------------|
|                                | No                     |           |         | Yes   |           |         |                 |                   |
|                                | n                      | Mean      | Median  | n     | Mean      | Median  |                 |                   |
| donations income               | 17,519                 | 289,991   | 50,153  | 3,040 | 327,840   | 49,663  | >               | <                 |
| interest and investment income | 17,519                 | 78,503    | 1,769   | 3,040 | 126,714   | 3,050   | > *             | > ***             |
| government income              | 17,519                 | 1,132,270 | 0       | 3,040 | 506,655   | 0       | < ***           | n/a               |
| trading income                 | 17,519                 | 137,136   | 0       | 3,040 | 123,590   | 0       | <               | n/a               |
| charitable activity income     | 17,519                 | 876,552   | 13,000  | 3,040 | 674,626   | 11,988  | <               | <                 |
| other income                   | 17,519                 | 119,375   | 0       | 3,040 | 132,610   | 0       | >               | n/a               |
| total income                   | 17,534                 | 2,631,694 | 311,463 | 3,041 | 1,891,458 | 396,387 | < **            | > ***             |
| total income(log)              | 17,534                 | 13        | 13      | 3,041 | 13        | 13      | n/a             | n/a               |
| voluntary funds costs          | 17,519                 | 38,517    | 0       | 3,040 | 43,187    | 0       | >               | n/a               |
| other funds costs              | 17,519                 | 42,694    | 0       | 3,040 | 18,138    | 0       | <               | n/a               |
| trading costs                  | 17,519                 | 122,166   | 0       | 3,040 | 116,883   | 0       | <               | n/a               |
| charitable activity costs      | 17,519                 | 2,178,539 | 229,890 | 3,040 | 1,268,985 | 235,314 | < **            | > **              |
| grants and donations costs     | 17,519                 | 84,083    | 0       | 3,040 | 294,417   | 0       | > ***           | n/a               |
| governance costs               | 17,519                 | 16,605    | 3,996   | 3,040 | 21,342    | 5,452   | > ***           | > ***             |
| other costs                    | 17,519                 | 34,453    | 0       | 3,040 | 31,092    | 0       | <               | n/a               |
| total costs                    | 17,534                 | 2,514,984 | 286,975 | 3,041 | 1,793,474 | 383,168 | < *             | > ***             |
| total costs(log)               | 17,531                 | 13        | 13      | 3,037 | 13        | 13      | n/a             | n/a               |
| net current assets             | 17,531                 | 545,711   | 107,436 | 3,041 | 1,078,852 | 88,308  | > ***           | < ***             |
| unrestricted funds             | 17,534                 | 2,018,871 | 127,940 | 3,041 | 2,273,218 | 146,417 | >               | > ***             |
| charity age                    | 18,281                 | 31        | 21      | 3,041 | 28        | 19      | < ***           | < ***             |

Based on 21,322 charity-years. Legend: \* p<0.05; \*\* p<0.01; \*\*\* p<0.001. All figures are in £ and rounded to the nearest whole number.

## **Discussion**

Leveraging regulatory data on performance accountability of charities provides a novel and detailed insight into some of the financial risks prevalent in the sector. Deterministic factors such as size, age and constitutional form do not appear to have much explanatory power with regards to which charities trigger financial exceptions. Voluntaristic factors – such as staff motivation (Packard, 2010), governance procedures and practices (Callen et al, 2010), and number of volunteers (McHargue, 2003) – are unfortunately absent from this analysis. This data is captured in qualitative form in the Trustee Annual Report (TAR) submitted to OSCR by every active charity and could be rich source of more powerful explanatory factors for analysing financial vulnerability and other exceptions.

### *Data source*

From a risk-led regulation perspective, organisational and financial characteristics that are associated with above-average rates of financial exceptions may be used as indicators that shape OSCR's resource allocation for certain regulatory activities. Though there is some overlap with the financial vulnerability literature in terms of definitions (insufficient net assets, reduction in revenue), the thresholds differ and many of the measures adopted by OSCR could be considered arbitrary; it could also be argued that some of the measures only capture extreme shifts in the financial performance of charities over a 12-month period and may not capture gradual increases in vulnerability. OSCR should also consider what measures of financial vulnerability or other financial risks are not captured such as reductions in programme expenditure and an overreliance on one source of income. Due to the lag in reporting of annual accounts, financial exceptions will often not be representative or indicative of current financial risks; supplementary monitoring forms are received several months after a charity's financial year end and therefore the organisation is likely to be aware of, and acted upon, any concerns raised by the financial exceptions. On a similar note,

financial exceptions are merely potential indicators of misconduct, mismanagement or impropriety; further analysis is needed of the justification for an exception occurring. Despite these limitations, utilising OSCR's administrative data offers a number of significant benefits including: reliability of charity definitions and variable measurements over the entire study period; all charities that operate in Scotland are captured by OSCR, leaving no hidden subpopulations; and the data is generally of high quality.

## Appendices

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| <b>Exception code</b>  | <b>Description</b>   |
|--|--|
| <i>Large charity or major fundraiser</i>                       |  |
| 1  | Total incoming resources are over £10M.  |
| 2  | Total donations gifts and legacies received over £1M.  |
| <i>Sudden growth or contraction</i>                            |  |
| 3  | Total incoming resources are over £250,000 and over five times the previous year's.                              |
| 4  | Total incoming resources previous year were over £250,000 and this year's are under one fifth.                   |
| <i>Possible failure to apply funds for charitable purposes</i> |  |
| 5  | Cost of generating voluntary funds is over 50% of donations plus legacies.                                       |
| 6  | Cost of trading in order to raise funds exceeds income from trading in order to raise funds.                     |
| 8  | Total resources expended are under 67% of total incoming resources.  |
| 9  | Governance costs are over 25% of total resources expended.   |
| 10   | "Other" is more than 50% of resources expended.  |
| <i>Poor liquidity, low reserves, threats to viability</i>      |  |
| 11   | Total resources expended are over 150% of total incoming resources.  |
| 12   | Negative total net assets.   |
| 13   | Debtors more than 30% of total incoming resources.   |
| 14   | Creditors payable within one year more than 50% of total resources expended.                                     |
| 15   | Negative net current assets (ie net current liabilities) more than 20% of total incoming resources.              |
| 16   | Unrestricted fund negative and more than 1% of total incoming resources.   |
| <i>Fundraising issues (also 5 and 6)</i>                       |  |
| 17   | Unauthorised fundraising answered yes.   |
| <i>Adequacy of governing board</i>                             |  |
| 18   | Two or fewer trustees and either total incoming resources over £1M or total net assets over £1M.                 |
| 19   | No trustees normally residing in Scotland.   |
| <i>Transactions with trustees</i>                              |  |
| 20   | Payments to trustees settling outlays greater than £50,000.  |
| 21   | Payments to Trustees for professional services to the charity greater than £50,000.                              |
| 22   | Payments to Trustees for professional services greater than 30% of total resources expended.                     |
| 23   | Payments to Trustees for any other work done for the charity is greater than £50,000.                            |
| 24   | Payments to Trustees for any other work done for the charity is over 30% of total resources expended.            |
| 25   | Payment to Trustees for any other reason over £50,000.   |
| 26   | Payments to Trustees for any other reason over 30% of total resources expended.                                  |
| 27   | Payments to trustees for professional services, work done or "other", and no specific authority in constitution. |
| 28   | Money owed by Trustee at any time greater than £5,000.   |
| 29   | Sales of properties to Trustees greater than £50,000.  |
| 30   | Property gifted to trustee(s) value over £500.   |
| 31   | Purchase of properties from Trustees greater than £50,000.   |
| 32   | Charity occupied property belonging to a trustee and paid more than £20,000.                                     |
| 33   | Services made available to one or more trustees.   |

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| <b>Exception group</b> | <b>Description</b>                                      |
|------------------------|---|
| 1                      | Large charity or major fundraiser                       |
| 2                      | Sudden growth or contraction                            |
| 3                      | Possible failure to apply funds for charitable purposes |
| 4                      | Poor liquidity, low reserves, threats to viability      |
| 5                      | Adequacy of governing board                             |
| 6                      | Transactions with trustees                              |

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| <b>Variable</b>         | <b>Label</b>   |
|-------------------------|--|
| donationsincome         | Income derived from donations                            |
| interestandinvestincome | Income derived from interest and investments             |
| govincome               | Income derived from government funding                   |
| tradingincome           | Income derived from trading activities                   |
| charactivityincome      | Income derived from charitable activities                |
| otherincome             | Income derived from other sources                        |
| totalincome             | Total income listed in the accounts                      |
| totalincome(log)        | Total income listed in the accounts (natural log)        |
| voluntaryfundscosts     | Cost of generating voluntary funds                       |
| otherfundscosts         | Cost of generating other funds                           |
| tradingcosts            | Cost of trading activities                               |
| charactivitycosts       | Cost of charitable activities                            |
| grantsanddonationscosts | Cost of generating grants and donations                  |
| governancecosts         | Cost of governance                                       |
| othercosts              | Other costs  |
| totalcosts              | Total costs listed in the accounts                       |
| totalcosts(log)         | Total costs listed in the accounts (natural log)         |
| netcurrentassets        | Net current assets                                       |
| unrestrictedfunds       | Amount of unrestricted funds (reserves)                  |
| charityage              | Length of time - in years - a charity has been operating |

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More information on the form used to collect this data can be found at:

<http://www.oscr.org.uk/charities/managing-your-charity/annual-monitoring> .

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<sup>i</sup> The collapse of Kids Company has prompted the UK Government to promise that there will be greater scrutiny before it awards grants to charities (Civil Society News, 2016).

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<sup>ii</sup> When determining what constitutes public benefit, OSCR must consider: the extent of private benefit and its ratio to public benefit; whether there is any disbenefit to the public; and whether there are any undue restrictions to accessing the public benefit provided by the charity (for example, unreasonable service fees).

<sup>iii</sup> These figures are a conservative estimate. The true values for income and expenditure are higher on account of certain types of charities being excluded from the calculations (such as universities and registered social landlords); this is due to definitional issues surrounding the third sector in Scotland.

<sup>iv</sup> Insert link.

<sup>v</sup> This information (qualitative) is captured for some of the financial exceptions in the dataset and may provide insight into whether an exception warrants detailed investigation by the regulator.