Accounts Monitoring Review

High governance costs

About our accounts monitoring reports

Charities' accounts are publicly available on **GOV.UK**. Each year, we monitor a sample to check compliance with the Charities Statement of Recommended Practice (SORP) and to identify issues of regulatory concern. We are publishing a series of reports on our findings, which will help trustees to manage the risks that their charity faces, improve reporting standards and to enhance the accountability of charities to their donors, beneficiaries and the public.

The scope and purpose of this review

This review looked at charities that have spent an unusually high proportion of their expenditure on governance costs. We chose this area because governance costs normally make up a small part of a charity's expenditure compared with the amount spent on charitable activities and the costs of raising funds. For example, charities with incomes over £500,000 allocate approximately 4% of their total expenditure to governance costs.

The 2005 SORP defines governance costs as 'the costs associated with the governance arrangements of the charity which relate to the general running of the charity as opposed to those costs associated with fundraising or charitable activity. The costs will normally include internal and external audit, legal advice for trustees and costs associated with constitutional and statutory requirements eg the cost of trustee meetings and preparing statutory accounts. Included within this category are any costs associated with the strategic as opposed to day to day management of the charity's activities'. The 2005 SORP also requires governance costs to be shown separately in the Statement of Financial Activities (SOFA).

How we carried out the review

We used the information in Part B of the annual return to identify charities that had reported both governance costs of more than 20% of their total expenditure and also reported total expenditure that was more than 80% of their total income. We have used the figure of 20% of expenditure because it produced a manageable sample size that is consistent with the purpose of the review. It is not intended to suggest that this is a benchmark for the maximum amount of governance costs that is acceptable. We used the total expenditure in excess of 80% of income criteria in order to exclude charities which are more likely to also have low charitable expenditure, which is the subject of a separate review.

Part B of the annual return provides summary information from the annual accounts, including the amount spent on governance costs. Only charities with an annual income of over £500,000 are required to complete Part B and therefore our review has only considered these larger charities. We identified 76 charities whose annual returns reported both high governance costs and high expenditure relative to income in their most recently filed accounts. At the time of the study, most of the identified accounts were for the 2012 year end. We reviewed each charity's trustees' annual report and accounts to assess whether there was a reasonable explanation for the high level of governance costs.

What we found

The proportion of expenditure used for governance costs

The total governance costs of the charities in our target sample were £29.5 million. This represents 38% of their total expenditure of £78.4 million. The charities in this sample are much smaller than those identified in the earlier reviews that we have carried out. Two thirds of them had an income of less than £1 million and only one had an income in excess of £3 million (£5.8 million). The proportion of expenditure used for governance costs across the sample is shown in the table.

Governance costs as % of expenditure	Number of charities	Total governance costs
20 - 35	47	£12.0 million
36 - 50	12	£6.6 million
51 - 75	7	£4.1 million
76 - 100	10	£6.8 million
Total	**76**	**£29.5 million**

The reasons why the charities reported high proportions of governance costs

We found that only 3 (4%) of the charities appeared to have a reasonable explanation for their high level of governance costs. The nature of their activities was a significant factor. For example, one of the charities had a large international network of branches. It was clear from the notes to their accounts that these charities had considered the SORP's definition of governance costs and had developed an appropriate methodology for allocating strategic management and support costs.

The governance costs of 7 (9%) of the charities were incorrectly stated in their annual returns. In 5 cases, their accounts reported governance costs of less than 20% of their income. The annual return categories mirror those in the SOFA and the relevant entry screen highlights that the information should be taken directly from the audited accounts, so it is not clear why these mistakes have been made. The other 2 charities had prepared their accounts in accordance with a different SORP, that which applies to social housing providers, and appear to have incorrectly calculated governance costs when completing their annual returns.

Another 7 charities (9%) appeared to have calculated their governance costs appropriately, except for the inclusion of a large unusual item. These items included the costs of dealing with disputes, foreign exchange losses and interest payable on loans. Some of these costs may have related to other categories of expenditure. Costs that cannot be allocated to the cost of generating funds, charitable expenditure or governance costs should be included in 'other resources expended'.

The remaining 59 (78%) charities in our sample appear to have equated governance costs with general management and administration costs and in some instances used this description in the SOFA rather than governance costs. These charities included large amounts for items such as staff, office, depreciation and support costs, most or all of which should probably have been allocated to other categories of expenditure. Some had also included direct charitable expenditure.

The vast majority of charities in our sample therefore appeared to be either not fully aware of the SORP's requirements for reporting their expenditure in the SOFA or did not understand the difference between support costs and governance costs. A more fundamental issue is that their supporters may conclude that these charities have a poor understanding of how to allocate their costs between the delivery of their charitable objectives and the other activities that support this work.

What action we took

Annual return errors

Charities are responsible for ensuring that their annual returns are completed accurately. However, we have checked the next annual returns submitted by the charities in this group. Two of the charities are now reporting the correct amount of governance costs and another charity's income is now less than £500,000, which means that it no longer completes Part B. Three charities have continued to report incorrect figures for their governance costs. The remaining charity has been removed from the register as it has ceased to exist.

Cost allocation errors

We have reviewed the most recent accounts submitted by the charities in this group. All except 1 of the 66 charities have submitted more recent accounts than those we reviewed. The other charity is now in administration. Fifteen charities have either clearly changed the way in which they calculate governance costs to a more appropriate basis or are no longer including large unusual items within their governance costs. The governance costs reported by these charities now typically account for 1-3% of their expenditure. We will provide guidance to the remaining 50 charities on the SORP's requirements for the classification of expenditure and ask them to consider whether their current accounting treatment is correct.

Other issues

We also found that one charity had not submitted an audit report with its accounts. We have checked its most recent accounts and these have been audited. We will be contacting the trustees of another charity to establish the basis of large payments that have been made to a trustee for consultancy services. We will also contact a third charity, which is the parent of a group, over its apparent failure to comply with the SORP's requirement to prepare consolidated accounts.

The SORP

The accounts that we reviewed are required to have been prepared under the 2005 SORP. The SORP has recently been updated to reflect the developments since then in accounting standards and practice and new SORPs apply to reporting periods beginning on or after 1 January 2015. The new SORPs emphasise the importance of charities understanding their costs and allocating them appropriately between their fundraising and charitable activities, whilst simplifying the disclosure requirements. In particular, governance costs are no longer shown on the face of the SOFA. Instead they must be separately identified within the required analysis of support costs.

Lessons for other charities

The findings from our review emphasise the importance of trustees having a good understanding of their charity's activities and how these are reported in their annual reports, accounts and annual returns. In particular, it emphasises the need for charities to understand their costs and how those costs relate to the activities that they are carrying out to achieve their objectives.

This review has also provided an opportunity for us to highlight the publication of the new SORPs, which are now in force. The SORPs and guidance to help charities comply with them are available on the SORP microsite.