Due Diligence Lessons Learned - Updated February 2014

1. Demonstrating results and impact

1. Many of the Civil Society Organisations (CSOs) assessed have invested in developing their ability to measure the results and impacts of their activities. Good practices identified included:

- Knowledge sharing across and between CSOs and their partners;
- Inclusion of partners, beneficiaries and other stakeholders in developing Monitoring & Evaluation (M&E) plans;
- Focus on outcomes and impacts as well as activities and outputs;
- Recruitment of specialists and inclusion of M&E costs in grant proposals; and
- Organisation wide methodologies.
- Independent monitoring unit.

2. A number of CSOs assessed felt over-burdened with reporting required of them as a result of: manual processes, no consistent M&E approach, different donor requirements, or having too many indicators.

Most organisations also had processes in place to verify the accuracy of M&E data, although some of the organisations felt they were under-resourced in this area.

While programme-level M&E was generally strong, most CSOs had difficulty demonstrating overall organisational impact and a quarter had no process to monitor against organisational objectives. While CSOs of differing levels of complexity and focus clearly face difference challenges, these factors did not appear to correlate to the ability to demonstrate results and impact. Those that were strong in this area tended to have clearly articulated organisational mission and objectives that were actively used in selecting and developing programmes.

3. More recently (second half 2013), organisations have generally been aware of the need to question the accuracy of the financial and operational data they themselves captured and that which they received from their partners. The majority of organisations working through partners intended to enhance the assurance they received through regular reporting with monitoring visits, internal assurance and external audits. In response to financial pressure, and the need for more timely analysis, a number of organisations developed innovative assurance techniques which ensured low cost, regular review:

- Benchmarking of operational and financial performance between peers, at the organisation and partner level to identify anomalies between reported results for further targeted scrutiny.
- Transparent and accountable reporting of results to beneficiaries with a clear methodology for capturing feedback and following up on questions.
- Peer review over programming activities, policies and procedures.

The strength of assurance relies on the quality of reporting, the frequency and depth of review, the robustness of the methodology and the level of independence of the reviewers.

2. Value for Money

1. Across the sector there continues to be a significant commitment to ensuring value for money, and many CSOs have recently undergone a cost reduction programme, largely driven by funding pressures.

Organisations which can most clearly articulate their value for money have clearly defined objectives towards control of underlying costs and delivering maximum, sustainable change through programmes. When working through partners, this is enhanced by having agreed common priorities and approach to value for money.

2. Despite the many good practices outlined below, CSOs often find it difficult to articulate their value for money. Comparability is a key challenge for the sector, with numerous approaches to calculating indirect

costs - making comparison difficult. In addition, widely differing interpretations of what value for money means add further complications. However, a number of DFID-funded CSOs are working together through organisations such as Bond and New Philanthropy Capital (NPC) to develop guidance in this area.

- In recent due diligence assessments, many organisations had robust financial monitoring and procurement procedures aimed at securing the best quality product at the lowest quality price. However, a small number of CSOs did not have a procurement policy in place. In most of these cases there was either a small number of staff responsible for procurement and "informal policies", or limited procurement.
- Organisations which most clearly articulated their desire to achieve a low cost base had gone beyond installing good policy and practice by fundamentally restructuring the way they conduct their business including through implementation of shared /pooled services on information technology, human resources and procurement. This approach seemed to be limited to larger international organisations, although these models could be adopted by smaller organisations working in partnership.
- In most cases, consideration of different options, appraisals and cost-benefit analyses were rare. This could partly be explained by the fact that 30% of the programmes being implemented were extensions to on-going work or adoption of tried and tested methods in new locations, where the planned programmes had been adapted in response to learning from previous work.
- Organisations had considered innovative ways of using volunteers. One example included UK mentors working with beneficiaries. Around a fifth of CSOs included volunteers in fundraising activities while a small number of organisations saw the use of community volunteers as a vital aspect of their approach to sustainable programming.
- CSOs could generally articulate how partners had been selected, although a number needed to strengthen their own due diligence and monitoring processes. A small number of organisations did not have partners' roles established at the time of site visits.
- Nearly all CSOs had considered how they might ensure long-term sustainability of their programmes, working closely with local community groups and government departments and many had committed time and resources to build capacity of their partners. Nevertheless, the majority of programmes could still do more to generate more funding locally in the areas of operation.

3. Fundraising challenges

1. Many of organisations that were assessed had experienced increased pressure on funding since the global recession in 2008-09. This included reductions in overall funding from donors and the public, but also an increasing shift by donors towards restricted funding. A number of organisations were reliant on funding from a small number of donors. Approximately a third of CSOs had identified funding constraints as a key challenge but did not have a clear strategy to address this.

2. Many organisations continue to identify income growth as a short term objective and diversification of income streams and access to new income sources as a medium term objective. Accessing funding continues to be a key challenge for organisations, with over 50% reliant on a small number of donors. In some cases, organisations had depleted their unrestricted reserves or gone into deficit for a period (which means restricted funds are effectively diverted). This emphasises the value of increasingly rare strategic funding to CSOs and the importance of incorporating sufficient indirect costs in restricted grant applications. Without this, important aspects such as M&E are likely to be underfunded and, in some cases, there may be a risk of insolvency.

3. Success in accessing and diversifying funding streams was most clearly evidenced where an organisation had adapted its way of working in response to a targeted fundraising strategy aimed at a clearly defined donor. The organisation was then able to monitor and report on its actions and the impact of this work.

4. Targeting institutional donors saw partnerships established with more experienced organisations or the enhancement of internal skills through targeted recruitment. Strategies to raise public awareness and funding often involve innovative use of social media. Corporate partnerships were extended by accessing pro-bono gifts and services alongside cash grants.

4. Managing costs

1. Driven by funding pressures and increased focus on value for money, nearly all CSOs had recently reviewed core administrative costs and/or headcount.

CSOs that regularly reviewed their financial performance and updated trading and cash flow projections were better able to plan ahead and implement cost saving measures before matters became critical. Several CSOs that had not responded in a timely manner had found themselves with significant financial challenges and had been 'forced' to reduce staffing as a result.

A small number of organisations were identified as having weak budgetary controls, for example, not providing forecasts of expenditure or forecasting over to short a period.

2. Responses to managing costs included:

- Revising forecasts on a regular (monthly or quarterly) basis allowing decisions to be made using more up to date information;
- Raising awareness of constraints across the organisation including tailored reporting for Trustees and timely budget updates from programme staff;
- Working with partners to reduce programme and administration costs;
- Tendering/renegotiating supplier contracts
- Switching non-core posts to short term contracts or outsourcing (especially internal audit or M&E roles);
- Obtaining more pro-bono support, particularly specialist skills such as legal. (Many corporates are increasingly favouring pro-bono support over cash donations).

3. A number of organisations have also considered mergers to achieve economies of scale and reduce duplication.

5. Organisational risk management

1. The quality of risk management strategies has been mixed. A small number of CSOs either had no risk register or management did not consider this as an essential requirement from the organisation's board. At the other end of the spectrum, 10% had strong risk registers with risk management strongly embedded within the organisation.

2. Effective risk strategies included:

- Regular (quarterly or 6 monthly) review of organisational risks by Senior Management and/or Board of Trustees;
- Combination of localised, bottom-up, programme based risk management and top-down assessment to prioritise and manage risks material at the organisational level.
- Risk registers that identified actions for managing risks and owners of those action, with a process for monitoring progress of actions.
- Ensuring that risk monitoring is seen as a key element in improving organisational effectiveness is vital.

6. Formal policies

1. A number of organisations did not have policies in place to manage key activities and risks. For example, a number of organisations working with children or vulnerable adults did not have safeguarding policies in place. Some CSOs did not have a Conflict of Interest Policy as recommended by the Charity

Commission. In addition, a number of organisations were unable to demonstrate that policies and procedures were applied outside the UK.

2. Although many organisations appear to have informal processes in place, the formalisation and monitoring of the implementation of these processes is crucial to be able to demonstrate effective management, and, in some cases, to comply with UK legislation.

Strong policies included details of relevant regulatory frameworks, identified responsible individuals and clearly outlined sanctions for breaches. They also included, or were accompanied by, guidance and practical examples, and supported by appropriate and well-communicated reporting and/or whistle-blowing mechanisms.

7. UK Bribery Act

1. Over a third of CSOs did not have an Anti-Bribery Policy in place. Several that had policies did not have supporting guidance for staff. Most CSOs assessed during the 6 months to July 2011 did not have policies in place or had not updated them for the UK Bribery Act which came into force on 1 September 2011 (after most of the due diligence assessments took place). In the 6 months to September 2012, significantly more organisations had revised their policies in response to the UK Bribery Act. However, several failed to address facilitation fees in addition to bribes through their guidance. More recently absence of formal anti-bribery policies has been less prevalent but none the less remains a high priority.

2. A number of DFID-funded CSOs have developed and published sector guidance through a Bond working group which provides a recommended approach to addressing bribery risks in line with the Act.

Strong anti-bribery policies included:

- A clear anti-bribery stance communicated throughout the organisation, from trustees to partners/sub-grantees;
- Risk-based approach to identifying and managing bribery risks;
- Clear policies, reporting and whistle-blowing procedures, and sanctions for non-compliance;
- Due diligence on key employees, partners, agents and contractors; and
- Monitoring processes and audits.

8. Working with partners

1. In general, CSOs appear to have strong relationships with implementing partners with regular interaction and programme monitoring. However organisations must ensure that documentation supporting their partnerships up to date and signed off. Many also actively worked to provide long-term value by helping to build capacity (where appropriate) with the partner.

2. Although programmatic monitoring has generally been considered to be of good quality, a number of CSOs did not have robust systems in place to ensure partners had appropriate policies in place to manage key risks. Some more decentralised CSOs also found it challenging to manage risks in field offices.

3. Good practice included due diligence and on-going monitoring that covered a range of governance, financial, systems and operational aspects; several CSOs also provided their own policies and procedures to assist partners and ensure minimum standards are met. As such, those organisations with stronger risk management processes and robust policies in place were better placed to manage risk at the partner level and build capacity.

Some organisations also developed creative ways of building capacity at the partner and field office level with minimal resources including sharing of good practice, peer reviews between field offices and using head office staff to provide financial training.

9. Financial control environment

1. The ability to demonstrate a strong financial control environment is key to the due diligence process. Examples of good practice were observed at CSOs of all sizes and levels of complexity. Good linkage and communication between the financial and operational aspects of CSOs work tended to be observed at stronger organisations.

2. Ensuring the following would help to overcome some of the more common weaknesses observed:

- There is a documented and up to date finance manual;
- Authorisation limits are set over procurement and cash receipts/disbursements;
- Key financial controls are documented and adhered to (override by senior executives was a key risk in smaller organisations);
- Unused or unnecessary bank accounts are closed;
- Monthly bank reconciliations are performed and all discrepancies are followed up on; and
- Potential segregation of duties identified and steps taken to reduce risks.

10. Managing performance

1. In most recent rounds, organisations were able to show how organisational level strategies embedded at all levels of the organisation could be used to drive operational improvements aimed at delivering the organisation's overall strategy. However, a small number of organisations did not have a defined set of Key Performance Indicators (KPIs) against which to monitor progress across the organisation towards its objectives.

2. Nearly all CSOs had clear KPIs in place to monitor the DFID grant but many of these were KPIs adopted specifically for the programme and were not unified metrics within the organisation.

3. KPIs were most effective when one metric met the needs of multiple stakeholders; beneficiary (impact delivered), donor (grant performance), management (programme/staff/partner effectiveness) and the board (organisational strategy). Often KPIs were chosen to meet the donor's needs but fell short of metrics for benchmarking between programmes or reporting back on the effectiveness of the programme to beneficiaries. Organisations feeling overburdened by reporting often failed to adopt unified metrics between programmes. This meant that in many cases organisations were reverting to project based methodologies which delivered pockets of data which did not facilitate good management or strategic planning.

11. Board Effectiveness

1. CSOs are coming under more financial, operational and reputational pressure in a sector which sees competition for funds and changing donor demands. An effective board must understand the context in which the organisation works and have the mix of expertise, experience and opinion to address the organisation's changing business needs and provide appropriate challenge to the executive team.

2. Evidence of board effectiveness has been mixed. Many organisations had established boards that provided adequate challenge to the senior management team. However in recent rounds of due diligence, around a quarter of CSOs had identified key deficiencies in the board skills set.

3. Examples of effective strategies to manage board effectiveness included:

- A regular review (6-monthly or annual) of board effectiveness including the identification of skills gaps.
- Planned board rotations.
- Defined board roles and responsibilities.
- Long lead succession planning.

In smaller organisations there was often the challenge of maintaining board independence. Trustees, who had often helped establish the organisation, remained heavily involved in day to day operations. As they grow, boards must be able to adapt their operating style and governance arrangements to remain effective.

12. Cash Management

1. CSOs are challenged to manage both their foreign exchange exposure and funds flow to ensure that at any one time they do not over commit resources and minimise their exposure to foreign exchange fluctuations.

2. The short term nature of funding (funding is largely spent within six months of being received) means many organisations manage cash management through budgeting controls and payment authorisations. Where cash flow became tight, payment authorisation levels were reduced to require more senior approval, effectively holding back cash payments pending donor cash receipts. This is a very reactive methodology and exposes the organisation to poor credit risk ratings to which suppliers might respond by requesting more stringent payment terms.

3. Good cash management was more clearly demonstrated where organisations had identified where cash shortfalls existed through cash flow projections and were directing unrestricted funds as a working capital buffer to provide short term resources. This was most effectively managed where cash was held and managed centrally rather than within country programmes or at partners.

During due diligence reviews carried out in 2012/13 it was noted that few CSOs actively managed their foreign exchange exposure and 25% had no documented policy. However a number of organisations provide example of good cash management including;

- A clear understanding of the quantum, impact and exposure to foreign exchange risk the organisation faced.
- A consistent approach to managing foreign exchange exposure and methodologies adopted.
- Back to back contracting matching donor currency to supplier contract currency.

As part of DFID's/KPMG's lesson learning on due diligence, we are continuing to collect feedback from organisations that have been assessed. DFID will continue to update and share lessons from its due diligence work with CSOs. Further updates will follow.

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