

Improving financial relationships with the third sector: Guidance to funders and purchasers

May 2006



CabinetOffice



HM TREASURY



Office of Government Commerce



National Audit Office

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HM Treasury contacts

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For general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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FOREWORD

The Government's goal is to deliver world class public services through investment and reform, ensuring efficiency and value for money. Over recent years the role of the third sector in helping to deliver these services has increased substantially, with larger amounts of public funding going to the sector than ever before. But I believe it has the potential to contribute still more.

The third sector is made up of a rich diversity of organisations in both size and scope, encompassing voluntary and community organisations, charities, social enterprises, cooperatives and mutuals. But all share the common characteristic of being value-driven, where profit is principally reinvested to further social, environmental or cultural objectives. From these values often flow a responsiveness to service users and awareness of their needs, along with a capacity for innovation, which can make such organisations particularly valuable partners for government in the delivery of public services.

Yet there is still much to be done to ensure that such partnerships work as effectively as possible. The NAO report '*Working with the Third Sector*' concluded that, while the funding recommendations of the Government's 2002 Cross-Cutting Review on the role of the sector in service delivery had in the main been implemented, this has not yet been enough to bring about a widespread and substantive change in departments' funding practices. This was again underlined in the recent report of the House of Commons' Public Accounts Committee.

The Government therefore recognises that we need to do more. This Guidance is intended to provide an important element of our programme, helping to ensure that the principles of value for money, efficiency, sustainability of services and reducing bureaucracy are embedded in funding practices throughout the public sector.

The aim of this Guidance is to set out best practice and provide advice on effective and efficient use of public funds in a way that is consistent with the principles of public accountability. The Guidance is not meant to be a comprehensive guide and it is intended to supplement, not override, Government Accounting. But it is our desire that all public bodies should seek to follow it, embed it in procurement policies and finance manuals, and ensure that best practice is mainstreamed.

I hope that everyone who is involved in commissioning and delivering public services – Government departments, non-departmental public bodies, local authorities and other agencies, as well as third sector providers – will find this document a useful reference guide in the development of effective working partnerships. We realise the great strengths the third sector can bring to the delivery of services to the community. We are therefore passionately committed to enabling these partnerships to deliver the highest quality public services to our citizens.



Rt Hon, Gordon Brown, MP
Chancellor of the Exchequer

EXECUTIVE SUMMARY

The wider funding context

- The main determinant of the nature of the financial relationship is the nature of the intended outcomes.
- Social issues can legitimately be incorporated into the purchasing cycle where they are relevant to the subject of the contract.
- A grant is a financial transfer used to fund an activity that is in broad alignment with the funder's objectives. Grant-in-aid is a payment to finance the costs of a body operating at arms' length. Procurement is the acquisition of goods and services in line with the government's policy of value for money, normally achieved through competition.
- Funding bodies must be clear with recipients about the nature of the financial relationship they are entering into, both up front and as the relationship develops.
- Contracts and grants should be jointly agreed in writing before the work commences.

Stability in the funding relationship

- The length of funding should be tied to the length of the objective. There should be no standard length of contract.
- Value for money must be the overriding principle that dictates whether or not a longer-term funding arrangement is appropriate.
- Longer term planning and funding arrangements can often represent better value for money than one year funding agreements.
- Funding arrangements should be agreed between all parties if they are to be effective and offer the right incentives to deliver value for money.
- Historical tendency to fund for a certain period is not an acceptable reason to maintain short-term funding arrangements. Equally, there is a need to guard against advocating long-term funding for its own sake.
- Departments should consider fully the opportunities for cascading multi-year funding arrangements to NDPBs and agencies.

Balance of risk and the timing of payments

- It is vital that the timing of payments is considered in collaboration with, and not imposed upon, the organisation responsible for providing the service.
- Funding bodies should agree the timing of payments with funding recipients at the beginning of a programme.
- Funding bodies should make a commitment to pay within a specified time or on a specified date or dates, and such commitments should be fully honoured.
- In specific circumstances, Government Accounting allows for payments to be made in advance of expenditure.
- Payments in advance of expenditure to third sector organisations should be made on the basis of need and therefore can and should, where appropriate and necessary, be made in order to achieve better value for money.

Full cost recovery:

- There is no reason why service procurers should disallow the inclusion of relevant overhead costs in bids. Furthermore, funders or purchasers should not flatly reject or refuse to fund fully costed bids. Funding bodies must recognise that it is legitimate for third sector organisations to recover the appropriate level of overhead costs associated with the provision of a particular service.
- When grant-making, funders should assess in a simple, proportionate and equitable manner whether third sector organisations have allocated relevant overhead costs and ensure that costs are recovered only once.
- Under a competitive procurement regime, purchasers should be clear that they expect third sector providers to be aware of the risks of not bidding on a full cost recovery basis. A third sector organisation unwittingly subsidising a public service is unlikely to represent good value for money, particularly in the long term.
- Fixed percentages without any evidence base do not provide a sound basis for the calculation and award of relevant overhead costs. Clear and consistent allocation of relevant overhead costs can provide a more accurate guide to funders of the true cost of delivering a service or output.

Reducing the burden of bureaucracy:

- Funding bodies should ensure that their application procedures are clear, and wherever possible, as simple as they can be.
- Funding bodies should seek to minimise the monitoring and inspection burden on the recipients of funds to a level proportionate to the level of funding and risk, and which maintains proper control of public monies.
- Where bodies are multi-funded, co-operation between both internal and external auditors should be encouraged, and the audit burden on funding recipients minimised.
- Where organisations are multi-funded it is good practice to appoint a lead funder to streamline application processes, co-ordinate monitoring and inspection arrangements and to minimise the number of evaluation systems and visits.

Publicly funded assets:

- In providing public funds for the purposes of acquiring or developing an asset, funding bodies should, where appropriate, retain a financial interest in the asset, particularly in relation to disposal or alternative use.
- Whilst seeking to safeguard taxpayers' interests, funding bodies should be pragmatic and realistic in setting charges over an asset.
- Conditions should be flexible, and not create barriers to wider policy objectives.

INTRODUCTION

BACKGROUND

1.1 The third sector – from voluntary and community organisations, through to social enterprises, mutuals and co-operatives – makes a large and essential contribution to the economic and social life of the United Kingdom. Third sector organisations are very diverse in both size and scope, from small, locally based community groups, to social enterprises and large, national charities. Some have no income at all and rely on the efforts of volunteers whilst others are, in effect, medium-sized businesses run by paid professional staff.

1.2 The Compact¹ on relations between the government and the voluntary sector, two successive Treasury Cross-Cutting Reviews², the Gershon Efficiency Review³ and a recent National Audit Office report⁴ have all explored how central and local Government can work more effectively with the third sector to deliver high quality services, so that where the sector wishes to engage in service delivery, it is able to do so effectively.

1.3 These publications have examined the state of the funding relationship between all levels of Government and the third sector and highlighted four key concerns where further action is required:

- Stability in the funding relationship: moving from one year funding to longer-term funding arrangements where appropriate;
- Timing of payments and the balance of risk: recognising that payment in arrears often results in the third sector bearing the upfront costs of borrowing and the risks that this entails;
- Full cost recovery: ensuring that funding bodies recognise that it is legitimate for third sector organisations to recover the appropriate level of overhead costs⁵ associated with the provision of a particular service; and
- Reducing the burden of bureaucracy: streamlining access and performance management requirements for multiple, and often very small, funding streams.

1.4 The NAO report concluded that the specific funding recommendations of the 2002 Treasury Review have in the main been implemented, but this has not yet been enough to bring about a widespread and substantive change in departments' funding practices.

¹ The Compact is the agreement between government and the voluntary and community sector in England to improve their relationship for mutual advantage. Local Compacts aim to do this locally between the sector, councils and other local public bodies. www.thecomcompact.org.uk

² *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*, HM Treasury, 2002 and *Exploring the role of the third sector in public service delivery and reform: A discussion document*, HM Treasury, 2004

³ *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004

⁴ *Working with the Third Sector*, National Audit Office, 2005

⁵ Often referred to as core costs

AIM OF THIS GUIDANCE AND TARGET AUDIENCE

1.5 The aim of this guidance is to set out best practice and provide guidance on effective and efficient use of public funds in a way that is consistent with the principles of public accountability. This guidance is not meant to be a comprehensive guide and nor does it override the primacy of Government Accounting. But all public bodies should seek to follow this guidance, which has also been endorsed by the National Audit Office. Funding bodies are expected to cascade this guidance into their procurement policies and/or finance manuals to ensure that best practice is mainstreamed in departmental funding guidance.

1.6 This document is intended to be of use to the following bodies (collectively referred to hereafter as funding bodies):

- Government Departments;
- Non-Departmental Public Bodies (NDPBs) (for example the Learning & Skills Council, Regional Development Agencies or the National Lottery Distribution Bodies).

1.7 In addition, this guidance carries implications for other sub-national bodies. The following bodies should review their own funding regimes, to bring them into line with the best practice set out in this Guide:

- Local authorities, Primary Care Trusts and other executive agencies, through which central Government funding is allocated to the third sector;
- Other bodies funded wholly or in part by public monies and who, in turn, make payment to third sector bodies.

1.8 Within these organisations, this guidance will be useful for a range of actors, including grant-makers, procurers of public services, commissioners, policy-makers, Chief Executives and finance officers. Recipients of funding (i.e. the third sector) may also find the guidance a useful document, in order to understand better the considerations of funding bodies during the funding or purchasing process. They can also use it to seek clarification from public funding bodies. Finally, when organisations are acting as agents for European Union funding, they should follow the principles outlined in this guidance as far as is possible.

1.9 This guidance can also be used alongside ‘Financial relationships with third sector organisations: a decision support tool for public bodies in England’ developed by the National Audit Office⁶. This decision support tool (DST) provides practical support for ‘real-life’ decisions about the design of appropriate funding models.

⁶ The tool is web-based and available through the NAO website at www.nao.gov.uk/better_funding

The third sector:

The 'third sector', encompasses voluntary and community organisations, charities, social enterprises, mutuals and co-operatives. While recognising the diversity that exists within the sector, three core characteristics of all third sector organisations distinguish them from those in the public and private sectors. Third sector organisations:

- are non-governmental;
- are 'value-driven' - that is, are motivated by the desire to further social, environment or cultural purposes rather than to make a profit per se; and
- principally reinvest surpluses to further their social, environmental or cultural objectives.

In addition to differences in their income source, legal form and governance structures, third sector organisations also differ in other characteristics, such as size, workforce composition, etc.

GOVERNMENT ACCOUNTING

1.10 Government Accounting (GA) provides guidance (principally for departments and also for non-departmental public bodies) in the context of proper use of, and accountability for, public funds. The Cross Cutting Review 2002 showed that a common misconception amongst both funding bodies and recipients of funding is that GA represents a set of restrictive and prescriptive accounting 'rules', which militate against sensible funding arrangements. However, GA covers all central Government public expenditure, which funds many thousands of different recipients - it would be impossible to create prescriptive rules that cover each and every circumstance.

1.11 Government Accounting, therefore, should be interpreted as a range of both high level rules and principles to protect public funds from misuse, promote good practice and achieve value for money (vfm) for the taxpayer, whilst allowing a degree of flexibility within this overall framework to achieve these ends through the most sensible means.

1.12 In case of doubt, finance divisions should contact the relevant HM Treasury team for advice. The text of Government Accounting is freely available at: www.governmentaccounting.gov.uk and hard copies can be ordered from The Stationery Office, for which contact details are on the GA website.

VALUE FOR MONEY

1.13 There are three main principles in Government Accounting that funding bodies should endeavour to meet:

- Regularity: ensuring that funds are awarded and used only for authorised purposes;
- Propriety: ensuring that funds are awarded and used fairly and free from undue influence;
- Value for money: the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user's requirement. In other words, getting the best possible outcome from any given level of input. This does not mean 'cheapest'.

1.14 Of the principles set out above, value for money is of pivotal importance in the context of this guidance. Inflexible interpretation of Government Accounting by funding bodies can, and often does, cause problems in achieving effective outcomes. The result is that funding is not as effective as it could be and can perversely offer poor value for money.

1.15 In deciding what specific rules to apply to individual funding streams, in order to maximise value for money, funding bodies should consider the following:

- Proportionality: rules about controls over payments; information requirements; monitoring and evaluation; and external inspection and audit should always be proportional to the level of and risk to the funds involved;
- Well-managed risk taking: funding bodies should not be overly 'risk averse' in making funding decisions. Funding bodies should consider the level of risk associated with particular funding recipients, and be prepared to vary the framework of control (outlined in the point above) accordingly in order to ensure the most effective balance of risk between the funding body and the third sector organisation; and
- Attention to outcomes: funding bodies clearly need to focus some attention on the 'process' of awarding funds, and on the appraisal, evaluation, and audit requirements they may wish to apply. But the primary concern for funding bodies should be whether the framework they develop for funding decisions contributes to achieving the outcomes desired for those funds. Note that 'outcomes' (the generic result of any inputs or outputs) has a different meaning to 'outputs' (the measurable or numeric results from any given input).

1.16 While it is important to keep in mind the aim and objectives of Government Accounting at all times, and to maintain the principle of securing good value for the use of public money, imposing restrictive terms may not deliver value for money if they frustrate the ability of funded bodies to deliver the Government's objectives in the round. It is important therefore to understand that GA provides for flexibility in funding arrangements to reflect the increasing partnership working between the public sector and the third sector in the delivery of public and community services, whilst still ensuring that value for money can be achieved.

GOVERNMENT PROCUREMENT POLICY AND EU RULES

1.17 Procuring goods, works and services through public contracts should adhere to issues of fairness. Departments should at all times adhere to Government procurement policy, based on value for money, and the EU procurement rules which exist to ensure all providers can compete for contracts on an equal basis. This means that procurement practices should not involve preferential treatment for third sector organisations. Equally, it is important to ensure that third sector organisations engaging in public service delivery are aware of the procurement opportunities, how the procurement rules apply, and that there are no barriers to participation. Procurement will also be subject to the new public sector Disability Equality Duty coming into effect in December 2006. Departments therefore need to give 'due regard' to the duty when procuring goods and services in future, when deciding to enter into a procurement relationship, when choosing a contractor, and when drawing up and agreeing to contractual terms (including design specifications).

1.18 In relation to the impact of tax on value for money considerations, the Green Book says that the “adjustment of market prices for taxes in appraisal is appropriate where it may make a material difference to the decision. In practice, it is relatively rare that adjustments for taxation are required, because similar tax regimes usually apply to different options. It can also be difficult in practice to estimate costs net of tax. However, where the tax regimes applying to different options vary substantially, this should not be allowed to distort option choice. In such cases it is important to adjust for any differences between options in the incidence of tax arising from different contractual arrangements, such as in-house supply versus buying in, or lease versus purchase. Options attracting different VAT rates, for example, should be compared as if either the same VAT payments, or no payments were made in all cases.” So, any assessment of the value for money presented by rival bids must disregard, as far as possible, the impact of different VAT recovery arrangements on these bids.

1.19 However, as the fundamental rules in relation to VAT recovery mean that it is not possible for funding bodies, and recipients to achieve certainty as to the VAT costs they will incur over the lifetime of the funding relationship, disregarding of the impact of different VAT recovery arrangements mentioned above can only be based on a best estimate of this impact. Such an estimate may be informed, for example, by previous experience of similar service provision, VAT recovery in earlier years and projections of future costs. However, this guidance does not endorse any single methodology for calculating or evaluating the impact of VAT costs and it will be for both bidders and purchasers to consider these in a fair and realistic way, both upfront and as the relationship develops.

FURTHER READING

- The Compact - www.thecompact.org.uk
- *Compact funding and procurement code*, Compact Working Group, March 2005
- Government Accounting – www.government-accounting.gov.uk
- *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*, HM Treasury, 2002
- *Exploring the role of the third sector in public service delivery and reform: A discussion document*, HM Treasury, 2004
- *Working with the Third Sector*, National Audit Office, 2005
- *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004
- *Shared Aspirations*, NCVO, June 2005
- *Think Smart, think voluntary sector*, OGC and Home Office, June 2004
- *Social Issues in Purchasing*, OGC, February 2006
- *Financial relationships with third sector organisations: a decision support tool for public bodies in England*, NAO, 2006

2

THE WIDER FUNDING CONTEXT

SUMMARY OF GUIDANCE

- The main determinant of the nature of the financial relationship is the nature of the intended outcomes.
- Social issues can legitimately be incorporated into the purchasing cycle where they are relevant to the subject of the contract.
- A grant is a financial transfer used to fund an activity that is in broad alignment with the funder's objectives. Grant-in-aid is a payment to finance the costs of a body operating at arms' length. Procurement is the acquisition of goods and services in line with the government's policy of value for money, normally achieved through competition.
- Funding bodies must be clear with recipients about the nature of the financial relationship they are entering into, both up front and as the relationship develops.
- Contracts and grants should be jointly agreed in writing before the work commences.

INTRODUCTION

2.1 Over recent years third sector organisations have become increasingly involved in the delivery of a wide range of public services. Third sector organisations work in many areas, from health and social care, advocacy and campaigning, education and learning, housing, employment and welfare, to community support and safety. The experience examined by the 2004 Treasury review¹, along with a number of academic studies, has shown clearly that the use of third sector organisations to deliver some public services can bring considerable advantages and benefits.

2.2 Central government, local authorities and other public sector bodies are the principal funders of public services and, through grants, procurement and other funding mechanisms, are acquiring an increasing proportion of these services from the third sector each year. However, some funding practices can unwittingly inhibit third sector organisations' ability to successfully bid for public sector funding.

2.3 As the NAO work demonstrates, there remains a high level of confusion in Government and in the sector about "the distinction between 'grants' and 'contracts' and when it is most appropriate to use each method" and an "increasing tendency by funders to favour contract-type funding arrangements, often involving competitive tendering, over grants." This chapter will explore the specific advantages that third sector organisations can bring to the delivery of public services and address some of the confusion around grants and contracts.

¹ *Exploring the role of the third sector in public service delivery and reform: A discussion document*, HM Treasury, 2004

THE IMPORTANCE OF COLLABORATION AND VALUE FOR MONEY

Advantages of the third sector 2.4 The third sector can offer a competitive alternative to both the private and public sectors in the delivery of public services in certain circumstances. Third sector organisations can bring specific advantages to the delivery of public services, which may include:

- a strong focus on the needs of service users;
- knowledge and expertise to meet complex personal needs and tackle difficult social issues;
- an ability to be flexible and offer joined-up service delivery;
- the capacity to build users' trust; and
- the experience and independence to innovate.

Further benefits 2.5 The third sector can also bring further benefits to society and the economy when it is responsible for the actual delivery of services. These wider benefits can arise because the sector sometimes delivers services in a different way, for example by:

- involving local people to build community 'ownership';
- building the skills and experience of volunteers; or by
- increasing trust within and across communities, thereby building social capital.

Value for money in procurement 2.6 The Government's policy of achieving value for money in procurement is defined as the optimum combination of whole life cost and quality (fitness for purpose) to meet the user's requirement. This applies to the award stage of the procurement process.

2.7 It is up to individual public bodies in the context of their overall objectives, to decide what to buy and set the specifications accordingly, ensuring that their requirements are subject to the normal public expenditure tests of need, affordability and cost-effectiveness. It is at this earlier stage that there is most scope to consider social issues.

2.8 If through procurement a contract specifies delivery of a project or provision of a specific service at a set cost, and if the provider then delivers that in full while making internal savings on cost per unit for example, then the provider is free to retain the money saved.

Social issues in procurement 2.9 *Social issues can legitimately be incorporated into the purchasing cycle*, and need to be recognised by public bodies early in the procurement process². Ideally they would be best considered at the service design and commissioning stage, and then worked through into the service specifications that form the basis of the procurement exercise itself. The key points to remember when looking to incorporate social issues are:

- They must be relevant to the subject of the contract.

² *Social Issues in Purchasing*, OGC, February 2006

- Actions must be consistent with the Government's procurement policy based on value for money.
- Actions must be consistent with the EC Treaty and the EU Public Procurement Directives³.

MORE EFFECTIVE FUNDING RELATIONSHIPS

2.10 There are four fundamental factors that directly interact and which must be properly understood if funders and providers are to enter into better and more effective funding arrangements:

- Value for money (vfm): vfm can be defined simply as getting the best possible outcome from any given level of input. This does not mean 'cheapest'. Government Accounting defines value for money for procurement purposes, as "...the optimum combination of whole life cost and quality (or fitness for purpose) to meet the user's requirement";
- Outputs and outcomes: 'outputs' usually refer to measurable or numerical results from any given input of resources (e.g. more free syringes). 'Outcomes' usually refers to the generic result of any, or a series, of inputs and outputs (e.g. less risk of infection amongst drug users);
- Incentives to deliver: delivery of services only happens because of incentives, be those philanthropic incentives (e.g. a moral desire to act) or financial incentives (e.g. profit or loss);
- Risk: the risk of non-delivery, which usually manifests itself in some sort of loss, often financial in nature.

GRANTS, GRANT-IN-AID, AND PROCUREMENT

2.11 Financial relationships between public bodies and third sector organisations fall into three types: grant, grant-in-aid and procurement. A grant is a financial transfer used to fund an activity because that activity is in broad alignment with the funder's objectives. Grant-in-aid is a payment by a Government department to finance all or part of the costs of the body in receipt of the grant-in-aid and is paid where the Government has decided, subject to parliamentary controls, that the recipient body should operate at arms' length. Procurement is the acquisition of goods and services in line with the Government's policy of value for money, normally achieved through competition.

Grants 2.12 Third sector organisations may receive grants from a variety of sources, including Government departments and other public bodies, to enable them to carry out their work. The grants may be general grants, to assist with the expenses of developing and running an organisation (often grants-in-aid) or specific grants to enable it to carry out a particular project.

2.13 A grant maker is not contracting for a service that forms part of its own business. It is offering financial support in an area of work, designed and proposed by the third sector organisation, which it wishes to sponsor. The work to be carried out by the third sector organisation would be deemed to add value to a public body's overall aims or

³ EU Public Procurement Directives: www.europa.eu.int/comm/internal_market/publicprocurement/index_en.htm as implemented in the UK by the Public Procurement Regulations: www.ogc.gov.uk/index.asp?id=1004558

objectives. For example, to reduce the fear of crime in a community, grants may be awarded for improved local lighting schemes. The grant funder will still want, however, to monitor the achievement of the proposed outcomes.

2.14 A grant is a financial transfer and may not bring any strict contractual law obligations in itself. However, the terms of the grant are likely to require the third sector organisation to use the money only for a particular project or service (i.e. are restricted), and might require the recipient to pay back the grant, or part of it, in some circumstances, particularly if the project or service is fulfilled at a lower cost. This, however, needs to be made clear at the outset. But the third sector organisation might have no other specific legal obligations to the public body that made the grant to it, and retains considerable freedom in the way in which it carries out the work.

Grant-in-aid 2.15 Grant-in-aid, although an arms-length funding relationship, does not give a body complete freedom from Government control. Certain monitoring and control arrangements are still required. In some circumstances, the lighter-touch monitoring regime of grant-in-aid may be more appropriate than the tighter regimes usually associated with grants. Grants will generally be ‘restricted funds’ from the perspective of the third sector organisation, whereas grant-in-aid will normally be ‘unrestricted’.

The distinction between grants and grant-in-aid:

If a Government department decides to fund the purchase of works of art by the British Museum (a non-departmental public body) under a grant system, it would issue the grant as the Museum acquired each item. Evidence of the purchase price would be required before individual payments were made. The Museum would not have uncommitted funds in hand, nor would it be allowed to carry over grant money at the end of the year. Under a system of grants in aid, the Government department would issue the grant-in-aid in full or through instalments during the financial year, the timing and amounts of which would reflect the need for funding. The Museum would have discretion over the spending of that money within the general framework of controls agreed amongst it, the relevant Government department and the NDPB itself, and set out in a financial memorandum.

Victim Support, the national network of charities which helps victims of crime, is an example of a third sector organisation which receives grant-in-aid directly from the Home Office. The national office uses an agreed "funding formula" to then distribute the grant to its local branches. A general framework of controls is set out in the grant-in-aid letter, outlining what Victim Support must deliver and what performance and financial information it must provide for the Home Office.

Written agreements 2.16 Over the last decade, it has become more commonplace for grants to be awarded following competitive bids for funding. Funding bodies should always require some form of written grant agreement, detailing roles and responsibilities for both parties, and setting out in general terms the precise purpose(s) of the grant. These may be non-legally binding agreements or grant letters, or in some cases, legally binding contracts, which create a legal obligation⁴.

2.17 The term Service Level Agreement has been used to describe some grant contracts that set binding conditions with detailed specifications for levels of outcome

⁴ In law, a contract requires an offer and a corresponding acceptance; a consideration (meaning an exchange of payment or something else of value); and an intention to create legal relations. A simple financial transfer in the form of a grant will place the recipient under the auspices of trust law, whereas a contract agreeing payment terms will render the relationship subject to English contract law.

and output performance⁵. Care should be exercised, however, in the drafting of such agreements to ensure that the wording clearly shows that the funding body is seeking a “supply” of service rather than a more rigorous administration of a grant award⁶.

new economics foundation Social Return On Investment tool:

A new tool to measure the financial value of social and environmental as well as economic returns is being pioneered in the UK by *new economics foundation*. The SROI tool piloted by nef has potential benefits in a wide variety of applications for:

- Social enterprises - to assess and benchmark performance and the economic value of their social activities and impacts and to simplify comparisons between them.
- Grant giving and financial investment - organisations can assess their performance over time or benchmark against similar organisations. A broad range of investors, from philanthropic foundations to socially responsible investors are interested in social and environmental outcomes or the extent to which social and environmental impacts change the risk associated with their investments.
- Corporate social responsibility - the growing recognition that organisations need to account for the full range of their impacts on groups other than their shareholders or owners is throwing up a need for new standards and new tools.

nef's SROI tool builds on the work of the Jed Emerson and the Roberts Enterprise Development Fund in the United States. The Social Return on Investment (SROI) is a measure that captures the value of social benefits ('social' is used shorthand for social and environmental).

Procurement 2.18 Where a level of service is defined and commissioned by the funding body outside the grants regime this forms a conventional trading relationship. **Procurement is defined as being the acquisition of goods and services from third party suppliers under legally binding contractual terms where all the conditions necessary to form a legally binding contract have been met.** Such acquisitions are for the direct benefit of the contracting authority, necessary for the delivery of the services it provides or for the running of its own business. In addition, the EU procurement directives provide specific definitions for supplies, services and works contracts covered by them⁷.

⁵ While many local funding bodies have been using Service Level Agreements, these have no legal form and are now generally being phased out in favour of grants and contracts, particularly where procurement processes are being made clearer and further improved.

⁶ This is based on the argument that in order to ensure the proper regulation of the grants regime and public accountability for expenditure, the funding body wishes to put in place more robust arrangements to replace simple terms and conditions. If, however, there is a link between the payment of the grant and the service performed by the third sector organisation then this could be construed by HM Customs as a supply that is subject to VAT.

⁷ EU Public Procurement Directives: www.europa.eu.int/comm/internal_market/publicprocurement/index_en.htm as implemented in the UK by the Public Procurement Regulations: www.ogc.gov.uk/index.asp?id=1004558

2.19 It is important to distinguish between procurement and grants and consequently to apply the appropriate procedures. The decision on which funding stream to use should be based on a combination of factors, including:

- what level of control is appropriate;
- the state of the market; and
- the specificity of the outcomes which the funder intends and the indicators available for qualitative and quantitative measurement of these intended outcomes;

Nature of outcomes **2.20** In general, however, **the main determinant of the nature of the financial relationship is the nature of the intended outcomes.** As the NAO report concluded, “the form of funding needs to be tailored to objectives”. Public sector bodies can make payments to third sector organisations in three distinct ways :

- project funding: used to finance a specific project or outcome;
- development funding: where organisations are effectively awarded seed-corn money to support their start-up costs, or enable them to expand; and
- strategic funding: that is given to, often well established, organisations recognised to be of strategic importance and whose continued existence and activities are considered to be beneficial.

2.21 When the intended outcomes are relatively specific, and there are indicators available to evaluate the quality and quantity of those outcomes, a procurement process open to competition and leading to a conventional trading relationship under contract is more likely to be the most appropriate option. Often, this could be where the third sector is engaged in the delivery of public services and the purchaser seeks a contractual relationship in order to help manage the risk associated with a third party delivering a statutory service⁸. For the purposes of this guidance, this will be referred to as ‘purchasing’.

2.22 Grants and grants-in-aid on the other hand (which can be accompanied by Service Level Agreements establishing various conditions), are more likely to be suited to supporting third sector organisations engaged in activities aligned with the Government’s wider objectives and which the Government values, for instance in generating social capital or playing an advocacy role. Despite the trend towards open competition and contractual relationships between funding bodies and the third sector, procurement does not necessarily always represent the optimum value for money option - there is clearly an ongoing role for strategic or development funding, most commonly channelled through grants or grants-in-aid. This is referred to hereafter as ‘funding’.

⁸ It is important to note, however, that a focus on outcomes does not, per se, mean that a third sector recipient of funding is automatically ‘delivering public services’.

Shopping, Giving and Investing⁹:

Each type of relationship between funder and recipient has distinct characteristics:

- A 'giving' approach might be more appropriate where the funder wishes to provide general support or a contribution, but does not define the expected outputs, allowing the recipient to decide on the best use of the funds;
- A funder 'shopping' for a supplier – for example to provide residential care services for the elderly – will be concerned with the cost and quality of the service, and might decide to use a competitive tendering process involving a range of private and third sector suppliers;
- An 'investing' funder will be seeking a long-term outcome from the spending, such as policy change or developments in the organisation's or sector's capacity.

Clarity with third sector partners

2.23 In all circumstances, funding bodies must be clear with recipients about the nature of the financial relationship they are entering into both up front and as the relationship develops. They should also ensure that third sector partners are consulted and informed about potential impacts of moving along the spectrum of grants-in-aid to grants to procurement, including, where appropriate, any VAT impact¹⁰.

2.24 In addition, **contracts¹¹ and grants, should be jointly agreed in writing before the work commences.** The timing of decisions can also impact on value for money. Organisations being notified at the end of March, for example, that they have been successful in bidding for funding that commences in April can have a similar impact as late payments in terms of third sector organisations' ability to make progress on the objectives for which payment is being made and in their duties as employers.

⁹ Concept originated in *The Grant making tango: issues for funders*, Baring Foundation, June 2004 and developed in *Working with the Third Sector*, National Audit Office, 2005

¹⁰ Where appropriate, the funding body (and/or recipient) should seek confirmation from HM Revenue & Customs (HMRC) as to the correct VAT treatment of any funding. It should not be assumed that grant or grants-in-aid are in all circumstances outside the scope of VAT – for example if there is a link between the payment of the grant and the service performed by the third sector organisation then this could be construed by HMRC as a supply that is subject to VAT. The correct VAT treatment can only be determined with regard to the full facts of each individual case, and the method of funding is not in itself determinative. Where VAT is due, it is the responsibility of the supplier to charge and bring this VAT to account and it is in the interest of both funder and service provider to proceed on the basis of certainty in relation to the VAT treatment of the funded activity.

¹¹ This can include Service Level Agreements.

Strategic Funding Round: Active Community Unit, Home Office

The ACD 2005 Strategic Funding Round (SFR) required applications for grant-in-aid from voluntary organisations that either had a strong track record of informing the debate on national volunteering, charitable giving or the provision of voice for the sector, or could demonstrate their potential to do so.

The SFR was managed jointly by Home Office and ECOTEC Research and Consulting Ltd. The numbers of grant applications was not easy to predict, therefore reinforcing the need for the guidance and application forms to set out clearly Home Office's aims and objectives for the funding and the criteria against which applicants were assessed. The first round of the process was an assessment against these criteria and the second round consisted of interviews by Home Office officials.

About £12m of grants in 2006/07 will be managed through jointly negotiated and annually reviewed Memoranda of Understanding, based on annually signed terms and conditions. This enabled ACD to create a stable base of proven organisations able to:

- represent the VCS; and
- take forward the national volunteering and charitable giving debates over the next 3-5 years.

FURTHER READING

- The Compact - www.thecompact.org.uk
- *Compact funding and procurement code*, Compact Working Group, March 2005
- *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*, HM Treasury, 2002
- *Exploring the role of the third sector in public service delivery and reform: A discussion document*, HM Treasury, 2004
- *Working with the Third Sector*, National Audit Office, 2005
- *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004
- *Think Smart, think voluntary sector*, OGC and Home Office, June 2004
- *More for your money: a guide to procuring from social enterprises*, Social Enterprise Coalition, new economics foundation, and SOPO, 2005
- *Supply chain management in public sector procurement: a guide*, OGC, June 2005
- Simplified PQQ - www.ogc.gov.uk
- *Social issues in purchasing*, OGC, February 2006

3

STABILITY IN FUNDING RELATIONSHIPS

SUMMARY OF GUIDANCE

- The length of funding should be tied to the length of the objective. There should be no standard length of contract.
- Value for money must be the overriding principle that dictates whether or not a longer-term funding arrangement is appropriate.
- Longer term planning and funding arrangements can often represent better value for money than one year funding agreements.
- Funding arrangements should be agreed between all parties if they are to be effective and offer the right incentives to deliver value for money.
- Historical tendency to fund for a certain period is not an acceptable reason to maintain short-term funding arrangements. Equally, there is a need to guard against advocating long-term funding for its own sake.
- Departments should consider fully the opportunities for cascading multi-year funding arrangements to NDPBs and agencies.

INTRODUCTION

3.1 There has been a long-standing tendency for all levels of Government to enter into purely short-term (that is, one year) funding arrangements with the third sector. This can, and does create a climate of uncertainty in which long-term – and sustainable – planning by the sector cannot be properly considered.

3.2 While some progress has been made, the NAO report¹ concluded, “many funders still perceive barriers to setting up longer-term arrangements.” The Gershon efficiency review² concluded that “contracts for service delivery by voluntary and community organisations (VCOs) tended to suffer from an unnecessarily short-term approach” and recommended “moving to longer-term, multi-year funding arrangements where possible”.

3.3 The introduction of multi-year spending plans by the Government aims to provide certainty and flexibility for longer-term planning and management, and so reduce the tendency to be short-term and narrow in focus. The 2004 Spending Review announced the introduction of full three-year settlements for local authorities, who now also have the opportunity to cascade this stability, where it represents good value for money to do so, through to third sector organisations.

THE IMPORTANCE OF COLLABORATION AND VALUE FOR MONEY

Incentives and value for money

3.4 At all times, value for money for the taxpayer must be the overriding principle that dictates whether or not a longer-term funding arrangement is appropriate. There needs to be an appropriate balance of risk between the funding body and the recipient of funds. This balance of risk should create the appropriate incentives on the recipient

¹ *Working with the Third Sector*, National Audit Office, 2005

² *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004

of funds to deliver the best possible outcomes for the public money used, thereby securing value for money.

3.5 Third sector organisations are diverse not only in mission but also in size and organisational capacity; and they are often multi-funded from a variety of different sources. This means that it is important for funding arrangements to be:

- proportionate: it will take a greater proportion of resources of smaller groups to apply for and retain funding in relative terms, and hence the bureaucratic burden needs to be proportionate to the objective; and
- co-ordinated: repetitive annual funding rounds mean third sector organisations are required to bid every year for funding and, as they are multi-funded, often to several different sources of funding. Therefore, funding bodies need to consider whether longer-term funding – co-ordinated with other similar funding bodies – may be more appropriate.

3.6 Key to both of the above is effective collaboration between funding bodies and the recipients of funds. **Funding arrangements should be agreed between all parties if they are to be effective and offer the right incentives to deliver value for money outcomes.** This is in line with the Government’s commitment to effective co-operation and collaboration in the Compact³.

Short-term funding

3.7 Short-term contracts can lead to the diversion of valuable third sector resources into bidding for Government funds – often from multiple sources – and away from the development and delivery of better services. Annual funding means a considerable level of uncertainty for both funding bodies and providers, limits the ability of third sector organisations to engage in longer-term planning, borrowing and investment, and can put third sector organisations into undesirable financial difficulties. Both funders and providers may struggle to keep up with the annual renewal processes, and can often end up with a period of uncertainty while decisions are made on whether the funding is to be renewed. Longer-term funding will reduce the incidence of these comparatively expensive and unproductive periods.

3.8 In addition to this, many of the client groups of the services provided by third sector organisations are in need of sustained care and support, which can be put at risk by dependency on annual grants by the third sector organisation delivering the service. The lesson here is clear: **short term funding – if used inappropriately - can produce sub-optimal outcomes for both the third sector organisation and the client group that benefits.**

Long-term funding

3.9 Longer term funding can reduce such dependency, allow the third sector organisation more flexibility to carry out its core function, and produce clear benefits for the – often highly vulnerable – client groups supported by such organisations. Quite simply, **longer term planning and funding arrangements can often represent better value for money than one year funding agreements by providing greater financial stability.** Through the Compact, government has undertaken to “implement longer term financial arrangements when these represent good value for money”⁴.

³ *Aggregation - Is bigger always better?*, Office of Government Commerce, 2004, assesses the benefits and potential dangers of aggregation in procurement, and also considers the impact this may have on small firms and organisations: www.ogc.gov.uk/embedded_object.asp?docid=1004178

⁴ www.thecompact.org.uk

3.10 The fiscal framework introduced in 1998⁵ creates an environment in which funding bodies can focus on longer-term outcomes, rather than shorter term inputs. Longer-term funding – where appropriate - brings major benefits and where possible funding bodies should consider the scope for moving towards a longer funding period, with appropriate safeguards built-in to protect taxpayers' money from misuse.

3.11 Funding bodies have sometimes complained that longer contracts reduce financial flexibility. But the move to three year spending settlements (see section 3.16) when combined with end year flexibility (see section 3.17) means that central Government departments and Local Government already have considerable flexibility. Longer-term contracts can and should include termination clauses with a period of reasonable notice (for example 6 months) in order to leave flexibility. In this way they would not need to be directly tied to funding settlements, and providers will have time to plan for termination and minimise disruption and waste.

Derby PCT and Rethink

Derby Primary Care Trust has a 10-year contract to Rethink, the largest severe mental illness charity in the UK. Under the contract, Rethink has built and run two purpose-built registered care homes with nursing services, Derwent Lodge and Shipley Lodge.

The PCT retains control over performance through service reviews every 6 months, and CSCI audits and inspects the homes. The price is reviewed annually against the actual cost of providing the service.

The stability provided by the long-term contract has had numerous benefits for service users and the public purse. It has allowed the provider to control costs through long-term financial planning, and to engage in a mortgage at a reasonable interest rate. It has promoted investment in staff recruitment and development, by giving the provider the confidence to develop its own staff group and the ability to attract nurses from outside.

The solid partnership generated by the contract has provided continuity for service users, whilst enabling well-established systems for user involvement to be implemented and enhanced. The contract has given Rethink the capacity to plan in the long-term, responding to the changing needs of the client group.

Bromley Social Service and the Shaw Trust

Bromley Social Services has awarded a five year contract to the Shaw Trust to establish social enterprises in Bromley. The project will incubate and develop social businesses to provide paid employment and training for adults with learning difficulties who are currently in day care provision. This will help disabled people to develop new skills and move towards independence

The contract runs from June 2004 to 2009. Funding levels are adjusted as the social firms develop, so that trading income in later years forms a higher element of the total funding package. Stability is essential as establishing new businesses may take some time. The five year contract has enabled the Shaw Trust to plan ahead, giving service users confidence that the support will continue. The commitment it demonstrates has helped build a solid and developing working partnership between Bromley Social Services and the Shaw Trust.

⁵ The *Code for Fiscal Stability* (November 1998) is designed to address past weaknesses in the fiscal policy framework. In particular, it strengthens the openness, transparency and accountability of fiscal policy. It improves the quality of information given to the public, the lack of which in the past was an important factor underlying policy mistakes.

LONGER-TERM FUNDING ARRANGEMENTS

3.12 The length of funding should be tied to the length of the objective, and with regard to the impact on the funded organisation in the interest of securing value for money. Historical tendency to fund for a certain period is not an acceptable reason to maintain short-term funding arrangements. Equally, there is a need to guard against advocating long-term funding for its own sake.

Incentives and outcomes

3.13 So, in drawing-up longer term funding arrangements, funding bodies will need to consider carefully the incentives created to ensure effective delivery of the best possible outcomes. It is clear that if performance drops below a certain agreed threshold, the funding body should have the ability to protect the public funds involved. The incentives to deliver created by longer term funding will depend on how the funding agreement is structured. For example, in some cases it may be sensible to provide a fixed sum for the first year, a provisional sum for the second year, and an indicative sum for the third year. At suitable periods, the funding body and recipient can revisit the funding agreement and, based on performance and the delivery of agreed outcomes, confirm or revisit the commitment to continue funding.

3.14 In addition, longer term funding arrangements must be balanced not only with actual performance, but also with sustaining a dynamic third sector where new providers with innovative service delivery methods can emerge. The length of funding should therefore be consistent with sustaining a competitive market and encouraging supplier diversity in order to deliver value for money in the longer-term.

3.15 However, funding bodies should not issue explicit or implicit letters of comfort, or oral statements of comfort, that commit that funding body (and therefore Government) – in either moral or legal terms – to stand behind the recipient of funds if that recipient falls into financial difficulties. Government Accounting⁶ explains the principles behind contingent and actual liabilities⁷.

MULTI-YEAR SPENDING PLANS

3.16 The introduction of multi-year spending plans aims to provide certainty and flexibility for longer-term planning and management, and so reduce the tendency to be short-term and narrow in focus. Multi-year spending plans reinforce the shift from a fixation on available inputs to an assessment of real and tangible outputs and outcomes that could result from better planning of expenditure. The 2004 Spending Review announced the introduction of full three-year settlements for local authorities, who now also have the opportunity to cascade this stability, where it represents good value for money to do so, through to third sector organisations.

3.17 Multi-year spending plans are central to the fiscal strategy of this Government, and designed to enable departments to plan for the long-term to deliver more effective and efficient public services. The introduction of full end-year flexibility (EYF) also allows unspent funds to be carried forward from one year to the next. So, there is no fiscal barrier that prevents funding bodies from agreeing longer-term funding arrangements with recipients of funds, if it fulfils the objectives of that funding body and represents good value for money. The likely future effect of long-term funding commitments on departments' overall budgets should be clearly established. Those

⁶ Chapter 26 - www.government-accounting.gov.uk

⁷ There should be no complacency that Government funding will continue irrespective of performance or financial viability.

planning long-term funding relationships with third sector organisations should seek advice from their finance departments on this issue.

Cascading stability **3.18** Departments are expected to cascade multi-year budgets to NDPBs and agencies. Where departments do not feel able to guarantee full three year plans for budget holders, they can still help planning by providing indicative budgets and guarantees on a proportion of the forward year budgets (for example 95% in year two and 90% in year 3). Departments should set rolling three-year budgets for all key budget holders, fixed for at least the first year, and with indicative amounts for subsequent years.

ODPM Special Grants Programme:

The ODPM (Office of the Deputy Prime Minister) Special Grants Programme allocates £2.25 million per year to support innovative work by third sector organisations exploring diverse ways of involving people in improving the quality of life in towns and cities.

Focusing on the five Urban White Paper themes, the Special Grants Programme has adopted long term funding arrangements. Project funding is available for a maximum of 3 years and may include an element of development or capacity building in the first year to deliver a discrete work programme. Strategic (or core) funding is for 5 years initially, renewable subject to review after 3 years and is aimed at fostering a long-term relationship with organisations whose core work can add value in the department's delivery of urban policy objectives.

FURTHER READING

- The Compact - www.thecompact.org.uk
- *Compact funding and procurement code*, Compact Working Group, March 2005
- *Effective Local Partnerships*, HM Treasury, 2005
- *Working with the Third Sector*, National Audit Office, 2005
- *Surer Funding*, acevo + New Philanthropy Capital, June 2005
- *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004

4

BALANCE OF RISK AND THE TIMING OF PAYMENTS

SUMMARY OF GUIDANCE

- It is vital that the timing of payments is considered in collaboration with, and not imposed upon, the organisation responsible for providing the service.
- Funding bodies should agree the timing of payments with funding recipients at the beginning of a programme.
- Funding bodies should make a commitment to pay within a specified time or on a specified date or dates, and such commitments should be fully honoured.
- In specific circumstances, Government Accounting allows for payments to be made in advance of expenditure.
- Payments in advance of expenditure to third sector organisations should be made on the basis of need and therefore can and should, where appropriate and necessary, be made in order to achieve better value for money.

INTRODUCTION

4.1 The 2002 Cross-cutting Review¹ showed that:

- insufficient collaboration and/or agreement between providers and funding bodies can lead to the balance of risk being tilted towards third sector organisations; that
- payments to third sector organisations have traditionally been made in arrears, often causing cashflow problems for the third sector; and
- profile funding can be used as an alternative to payment in arrears in order to mitigate cashflow difficulties.

4.2 The NAO report concluded, “despite the widespread progress with advance payment, there is still confusion amongst some funders on the appropriate circumstances for advance payment.” The Gershon efficiency review² concluded that “contracts for service delivery by voluntary and community organisations (VCOs) tended to... place an excessive burden of risk on service providers”.

4.3 Agreeing the balance of risk, as well as the timing of payments, with the provider of the service is central to the creation of effective and agreed incentives. The Better Regulation Task Force’s ‘Access to Government Funding for the Voluntary Sector’³ recommended:

“Voluntary sector organisations, as stakeholders, should be more involved in the development of funding objectives and arrangements as part of a move towards a ‘mutuality of risk’.”

¹ *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*, HM Treasury, 2002

² *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004

³ *Access to Government funding for the voluntary sector - Better Regulation Task Force*, July 1998

THE IMPORTANCE OF COLLABORATION AND VALUE FOR MONEY

4.4 Funding bodies are required to achieve a wide array of outcomes, and to get best value for the money they spend. This means maximising the outputs or outcomes for any given level of input (or funding) they administer. To ensure operations are efficient and deliver the outputs/outcomes desired within budget and on time, incentives are required. When dealing with money, the obvious incentive is financial risk of a loss to the body responsible for delivery.

4.5 It is impossible to eliminate risk from any financial transaction. The key to success lies in ensuring that risk is handled properly and sensibly, and is at all times balanced. At the most simple level, risk can be divided into two categories:

- Demand risk: the risk associated with the demand for a particular service;
- Output risk: the risk associated with providing a specified level of outputs.

Demand risk 4.6 Demand risk is normally an external risk⁴. As neither the purchaser nor the provider can normally control demand for a service, the provider should not be expected to bear all of the risk, particularly if the purchaser has rigidly estimated the demand without consulting the provider. The purchaser should, however, ensure that sufficient demand for a service exists before providers are hired to deliver. Purchasers and providers need to agree what the demand for a particular service is likely to be, and the arrangements for sharing and/or dealing with unexpected demand.

Output risk 4.7 Output risk is an internal risk⁵. The provider of the service controls the output and bears the risks of failing to deliver the required outputs or outcomes. Such outputs should be fully agreed between the purchaser and provider before the funding arrangement is entered into.

Agreeing the balance of risk 4.8 This can be especially true for third sector organisations because they often operate in areas with an inherently high degree of risk (i.e. their client groups are often amongst the most socially excluded people in society). Regular and open discussion of risk issues between funding bodies and third sector organisations is critical to the delivery of value for money. The risk management approach should include the following elements:

- Risk identification and assessment: is there a common understanding of the risks and how they can be managed? Is this based on a common understanding of the objectives of the partnership? Are there agreed standards for assessing risk?
- Ensure partners share their assessments of risks: a joint risk register provides a good basis for this, giving the opportunity to come to agreed judgements, allocate responsibility for action and trigger monitoring information.
- Allocation of risk ownership: is there clarity about who is carrying which risks, and what the requirements are for providing information? This should be incorporated in partnership agreements/contracts.

⁴ An example of demand risk would be the number of passengers using a community transport service. While it is generally the case that demand risk is external, the purchaser may sometimes influence risk for example through determining eligibility criteria for the end user. Providers may also exercise potential influence through marketing or promotions.

⁵ This is conditional on a given level of demand. A corresponding example of output risk would be the risk that the community transport service is not able to deliver passengers to a destination.

Incentives 4.9 The timing of payments can be varied for a whole variety of reasons, related to cost, the type and size of the organisation providing the service, or simply practicalities of making the actual payment. **It is vital that the timing of payments is considered in collaboration with, and not imposed upon, the organisation responsible for providing the service.**

4.10 The aim is to develop the best possible incentives through an appropriate balance of risk, in order to get the most efficient outcome and secure value for money. An inappropriate balance of risk in favour of the funding body (e.g. arrears payments) can sometimes create overly harsh incentives on the recipient of funds, compromising outcomes and value for money. For example, a small, community-based group delivering services for Government might not be in a position to borrow sufficient funds to cover activities until an arrears payment is made and could get into financial difficulty, perhaps becoming overdrawn and suffering penalty charges. The cost (including the interest on a loan or penalty charges) might then be greater than the interest foregone to the public purse.

4.11 In some cases it may be more appropriate for the funding body to make an advance payment and build-in other incentives, or follow an interim payment method such as profile funding. This can be true for third sector organisations which, by often providing predominantly non-market activities, do not always receive an income stream that can be used to service a loan taken out in advance of an arrears payment. At all times, funding bodies should consider whether the timing of payments affects the balance of risk in the right way and, if not, consider alternative options in order to create the right incentives to get the best possible outcome, thereby ensuring vfm.

4.12 In addition, end loading of payments can discourage third sector organisations from working in partnership with Government. Payment arrangements that disadvantage third sector organisations can lead to poor value for money if organisations which may be best placed to deliver a service are discouraged from entering into partnership with Government.

4.13 When making the decision whether to fund in advance, funders need to be aware that third sector organisations which may appear not to need payment in advance, may in fact require it if their other funding streams are restricted for specific purposes, and cannot be used elsewhere.

The Compact commitment 4.14 The Compact Funding and Procurement Code⁶ expresses the Government's commitment to payment in advance:

“Government will consider the timing of payments to create the right incentives for delivery. Government undertakes that payments to voluntary and community organisations can and should (where appropriate and necessary) be made in advance of expenditure, rather than in arrears, in order to achieve better value for money.”

Funding bodies should honour this commitment and ensure that they create an environment conducive to the agreement of effective funding arrangements with the third sector.

FUNDING PRINCIPLES

Four key principles apply to the payment procedure:

⁶ *Compact funding and procurement code*, Compact Working Group, March 2005

- agree payment terms at the outset of the deal and stick to them;
- explain the payment procedures to suppliers;
- pay bills in accordance with any contract agreed with the supplier, or as required by law (see below); and
- tell suppliers without delay when an invoice is contested and settle quickly on receiving a satisfactory response.

Agreeing timing of payments **4.15** In particular, funding bodies should agree the timing of payments with funding recipients at the beginning of a programme. Under a grant regime, timing of payments, as with other factors in the relationship, should be negotiated early, and should not come as an unwelcome surprise to the recipient. Funding bodies should make clear to recipients that they are amenable to representations with regard to payment in advance, including under procurement, where potential arrangements for timing of payments should be made clear at the beginning of the tender process. Purchasers should remember, however, that they are bound to offer equal payment terms to all bidders, and cannot give preferential terms solely to third sector organisations to the detriment of other suppliers.

Making payments on time **4.16** In general, the agreed date of payment(s) should be set out in any financial memorandum, contracts or grant conditions. If no such memorandum exists, payment should take place within 30 days of receipt of goods or services. **Funding bodies should make a commitment to pay within a specified time or on a specified date or dates, and such commitments should be fully honoured.**

4.17 Once funding bodies and recipients have agreed payment terms (e.g. amount, timing etc) the agreement is subject to English contract law (see section 2.16). The Late Payment of Commercial Debts (Interest) Act 1998, which came into force on 1 November 1998 and is a statutory addition to the common law of contract, provides a statutory right for suppliers to claim interest on late payments of **commercial** debt. The provisions of the Act apply to the whole of the public sector.

PAYMENT IN ADVANCE

4.18 Government Accounting describes payment in advance as one “made to contractors before the customer has received the equivalent value in return. An advance payment provides a contractor with working capital, to enable commitments under the terms of the contract to be fulfilled”.

4.19 As a general rule payments by funding bodies have been made in arrears of actual expenditure. This is to avoid a financial cost to the Exchequer (and hence the taxpayer) through borrowing. Government is not a source of loan finance, and should aim not to compete with markets or be in contravention of EU procurement rules which are present to protect the right of all potential suppliers to compete on equal terms.

Criteria for payment in advance **4.20** It is however possible to make a payment in advance under Government Accounting.⁷ This will either be because the payment falls into one of the exempt categories, or because doing so represents better value for money⁸. For example, many third sector organisations do not have the resources to both undertake work and receive

⁷ Annex 16.1 of Government Accounting - www.government-accounting.gov.uk

⁸ However, the financial viability of the organisation, taking account of its other activities and general financial footing, must be considered before making a payment in advance as the funds are technically at risk until the service is delivered and could therefore be lost (this will matter particularly for larger sums).

payments afterwards, and can usually demonstrate a clear need for the funding before the work can begin. If the recipient falls into one of the exempt categories⁹ payment in advance will be appropriate when these five criteria are met:

- Payment arrangements must be agreed between provider and contractor, or grant-maker and recipient;
- Payment arrangements must be recorded in financial memorandum, a contract or grant conditions;
- Payment in advance must meet an identifiable need to spend (see section 4.20);
- Payment in advance must not be novel or contentious (see section 4.22); and
- Payment in advance is wholly necessary (e.g. large third sector organisations with substantial liquid reserves may not need an advance payment).

Identifying need **4.21** For payments to be made in advance of expenditure to be justified, need must be determined and identified. . The identification of need should not be a burdensome task, nor should it necessarily take place immediately prior to the spending. Generally, need has been determined on the basis of incurred expenditure, but can also be determined on the basis of forecast needs to incur expenditure over a foreseeable period¹⁰.

4.22 Both funding and funded bodies should therefore consider timing of payments carefully when drawing up contracts or grant conditions. **Payments to third sector organisations should be made on the basis of need and therefore can and should, where appropriate and necessary, be made in advance of expenditure, in order to achieve better value for money.** A blanket exemption for all third sector organisations is obviously inappropriate. Where funding in advance is not appropriate - as in the case for when value for money is not clear - then funding bodies should enter into dialogue with recipients to explain this¹¹.

Novel or contentious payments **4.23** In particular, care must be taken over the interpretation of the phrase “novel or contentious”. Payments will not be novel or contentious purely on account of being made in advance. A payment may be novel or contentious if it is to fund a new or different way of delivering goods or services that are unusual or uncommon. Funding bodies should consider advance payments on a case-by-case basis and when in doubt, seek advice from their relevant Treasury team.

4.24 Where departments wish to make advance payments but are not satisfied however, that the above criteria have been met and therefore requires HM Treasury approval, funding bodies should provide:

- a financial appraisal to prove that the advance payment represents value for money;
- evidence of compliance with EU procurement rules and law, which protect the right of all potential suppliers to compete on equal terms;

⁹ One exempt category includes payments to voluntary and community sector bodies.

¹⁰ There has often been confusion in the past between ‘payment in advance of need’ – which is not acceptable - and payment in advance (of expenditure). Payment in advance (of expenditure) is acceptable under the conditions set out in this guidance.

¹¹ Funding bodies should consider carefully the relationship between funding in advance and the calculation of full costs and how advance payment can affect price – see also checklist of costs at Annex A.

- assurance that adequate steps are taken to protect taxpayers' money in the event of the recipient going into liquidation or failing to meet contractual obligations; and
- assurance that the advance payment is not used for the purpose of avoiding an underspend in a particular financial year by making a payment before the liability has matured.

Being proportionate **4.25** In deciding timing of funding, the funding body should consider the proportionality principle at all times. The need for payment in advance of expenditure will depend on the individual circumstances on a case-by-case basis, and therefore will necessarily have to be based to a large degree on discretion and judgement. A small, community-based group with a very low turnover will be in a very different position to a large, national charity with a substantial amount of liquid reserves, and the decision about payment timing will have to take account of such circumstances.

INTERIM PAYMENTS

4.26 An interim payment is a payment which is “made at a prescribed stage or at intervals during the progress of a project. Such payments are normally linked to work done and/or physical progress satisfactorily achieved, as defined in the contract”. This definition covers such payment methods as ‘profile funding’ where funding is provided in scheduled payments of a proportion of a total sum paid at prescribed stages or intervals (for example, 10 per cent payment every month for 10 months). Interim payments can be made in advance or arrears as agreed between the parties involved.

4.27 Interim payments can assist in alleviating cashflow difficulties that are associated with arrears payments, and can sometimes allow greater flexibility to create appropriate incentives to deliver in comparison to a payment wholly in advance. Government Accounting does not preclude such interim payments being made. As with wholly advance payments, if the interim payments are to be made in advance rather than in arrears, it is necessary to have identified a need to spend and to have met the criteria set out in paragraph 4.20.

4.28 If funding bodies decide to make use of an interim payment method there are several considerations to take into account¹². Two of these are especially pertinent:

- Payments “on account” towards the total price rather than payment for part of the work done may be considered, allowing review and recovery of the funds in the event that the outcome has not been delivered;
- Interim payments related to value received and the delivery of tangible outputs rather than simply the passage of time.

Terminology **4.29** Two terms are often used in interim payment methods:

- Profile: this refers to when the interim payments are made;
- Formula: this refers to how the payment profile is calculated.

4.30 The profile can make the payments more suitable for third sector organisations and the formula can satisfy the need to have in place suitable incentives to deliver through a balanced application of risk. For example, the formula could take into account the delivery of tangible outputs. The payments along the profile could then be

¹² Annex 16.1 of Government Accounting - www.government-accounting.gov.uk

adjusted to increase for greater than expected performance, or decrease for poorer than expected performance. The formula then is a tool that allows funding bodies and recipients of funds to agree upon an appropriate balance of risk. Such a balance of risk should create the right incentives to deliver the best possible outcomes, thereby securing better value for money.

4.31 Again, it is of utmost importance for the profile and formula to be agreed between the funding body and the recipient of funds at the outset if interim payments are to be successful. This is not only in order to create an appropriate and agreed balance of risk but also because interim payment methods can often be more complicated and therefore need complete understanding of how they are to operate. In addition, if funding is reduced because of – for example – lower than expected demand for a service, care must be taken to ensure that the funding body and the recipient of funds discuss and agree the ongoing nature of overhead costs (which may not decrease by the same proportion) and/or downsizing costs.

Profile funding 4.32 There are many examples of profile funding that account differently for different elements of providing a service, such as overhead costs, variable payments associated with the project (to create incentives to perform to minimum standards), and bonus payments (to create positive incentives to exceed minimum standards). It is important to note that funding on an output basis does not preclude funding in advance. With a sensible approach to risk, a proportion of the payment could be made in advance if this was necessary to ensure value for money, with further payments following the delivery of the required outputs or outcomes.

Endowments and dowries 4.33 In general, funding bodies should provide cash on the basis of need in a particular financial year. Exceptionally, there may be a case for considering funding by way of endowment or dowry, that is, making a one-off grant which will often represent a clean break between the donor and funded body whilst enabling a funded body to set up a fund from which to draw down over several years. Such funding can only be made with the prior agreement of the Treasury. Where a donor decides, with Treasury agreement, to make an endowment or dowry, its terms should:

- provide clarity – the funded body should know where it stands and not have to approach the donor for annual funding;
- maintain clean boundaries between the funder and the grant recipient.

Herefordshire

Herefordshire is implementing a Compact Funding and Procurement Code of Good Practice for health and social care. It was published in November 2005 by the Primary Care Trust, relevant directorates of Herefordshire Council and third sector organisations through their membership organisation, The Alliance. The Code heralds significant changes in working practices for all parties to improve the funding relationship. As part of this process, purchasers have moved to a regime of making payments quarterly in advance; in addition, in a small number of cases, payments are made annually in advance.

Learning and Skills Council, Entry to Employment (E2E):

Entry to Employment (E2E) is a programme introduced nationally in 2003/04. It replaces life skills, preparatory training and national vocational qualification (NVQ) learning at level 1 for those aged 16–18. The funding arrangements for E2E are designed to contribute to the fixed costs of having places available, and to the learner-associated costs, for example allowances and expenses, and to incentivise achievement and progression. To achieve this the weekly cost for E2E is split into two parts:

- **Planned places payment:** this payment is profiled by month taking into account the number of E2E weeks the local LSC wishes to make available. If insufficient students are attracted to the programme, funds will not be taken back by the funder since the provider will have used them to make the places available, despite the low uptake. Planned places may be adjusted for the future depending on past delivery.
- **Provider bonuses:** provider bonuses are paid to recognise the achievements of providers in helping learners achieve qualifications and to progress into positive destinations. The bonuses can be claimed up to three calendar months after the learner leaves E2E. Providers may claim a maximum of one progression and one qualification bonus per learner. Bonuses are profiled and are reconciled based on achievements.

FURTHER READING

- Government Accounting – www.government-accounting.gov.uk
- *The Orange Book, Management of Risk: Principles and Concepts*, HM Treasury, October 2004
- *Risk Management Assessment Framework: A tool for departments*, HM Treasury, October 2004
- *Managing risk with delivery partners*, HMT, 2004
- *Compact funding and procurement code*, Compact Working Group, March 2005
- *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004
- *Working with the Third Sector*, National Audit Office, 2005
- *EU Public Procurement Directives:*
www.europa.eu.int/comm/internal_market/publicprocurement/index_en.htm
- *UK Public Procurement Regulations:* www.ogc.gov.uk/index.asp?id=1004558

5

FULL COST RECOVERY (FCR)

SUMMARY OF GUIDANCE

- There is no reason why service procurers should disallow the inclusion of relevant overhead costs in bids. Furthermore, funders or purchasers should not flatly reject or refuse to fund fully costed bids. Funding bodies must recognise that it is legitimate for third sector organisations to recover the appropriate level of overhead costs associated with the provision of a particular service.
- When grant-making, funders should assess in a simple, proportionate and equitable manner whether third sector organisations have allocated relevant overhead costs and ensure that costs are recovered only once.
- Under a competitive procurement regime, purchasers should be clear that they expect third sector providers to be aware of the risks of not bidding on a full cost recovery basis. A third sector organisation unwittingly subsidising a public service is unlikely to represent good value for money, particularly in the long term.
- Fixed percentages without an evidence base do not provide a sound basis for the calculation and award of relevant overhead costs. Clear and consistent allocation of relevant overhead costs can provide a more accurate guide to funders of the true cost of delivering a service or output.

INTRODUCTION

5.1 The 2002 Cross-Cutting Review¹ recommended that “funders should recognise that it is legitimate for providers to include the relevant element of overheads in their cost estimates for providing a given service under service agreement or contract”. As an action point it made clear that all Government departments must incorporate the review’s funding recommendations fully into their procurement policies by ensuring that the price for contracts reflects the full cost of the service, including the legitimate portion of overhead costs.

5.2 The National Audit Office report² concluded, however, that “Full cost recovery continues to be a major problem”. It noted that existing guidance to funders has tended to focus on principles rather than practice, leaving practitioners unclear as to how to take this forward. This chapter is intended to address this issue, and provide further help to funders.

5.3 The Government and the public depend on the third sector to provide a range of innovative and well-managed services that respond to the needs of service users. Third sector organisations often receive the funding with which to provide such services from a variety of sources.

5.4 All organisations in the public, private and third sectors have indirect overhead as well as direct costs associated with the delivery of goods and services. As the

¹ *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*, HM Treasury, 2002

² *Working with the Third Sector*, National Audit Office, 2005

Compact makes clear³, the Government accepts that it is legitimate for service providers to factor in the relevant element of overhead costs into their cost estimates for services⁴ and in bids for grants. All Government departments should incorporate this fully into their procurement policies.

THE IMPORTANCE OF COLLABORATION AND VALUE FOR MONEY

5.5 The issue of overhead costs remains as vitally important to third sector organisations as it does to any others. In the past, many third sector organisations have experienced difficulty in securing funding towards their core management and administration costs. One reason for this is that the debate has historically and typically been based on a false principle that overhead costs are somehow unrelated to an organisation's 'real work'. Many funding bodies have traditionally paid only for the marginal costs (see below) of the services they are seeking. But if funding bodies follow this practice, necessary overhead costs cannot be met, or are met from donations and other sources of income that were not intended for this purpose. But no activity can be undertaken without support functions, and funding bodies have an interest in ensuring that organisations are able to manage and administer activities properly.

5.6 The National Audit Office report⁵ pointed out that "Failure to recover full costs can mean that third sector organisations have to divert funding intended for service provision into paying overheads, or subsidise service provision from other sources such as donor income. Ultimately, failure to cover overheads may lead to organisations shrinking or collapsing".

5.7 All third sector organisations should always aim to recover the full cost of delivering services for public sector bodies, including overhead costs (and irrecoverable VAT costs), unless they understand⁶ and accept the risks of not doing so, and are satisfied that this is in their interests⁷.

5.8 In essence, full cost recovery entails:

- funded bodies presenting applications for funding, or bids for contracts, on the basis of robust and evidence-based calculations of the costs of the funded activity or service (including irrecoverable VAT costs); and
- funding bodies or purchasers assessing applications, or bids, on the basis of their value for money (which is not necessarily the cheapest option).

5.9 It is reasonable for third sector organisations to expect a funding body to fund the full cost of the services it delivers for that public sector body. Under-funding of overhead costs can be detrimental to third sector organisations as it may reduce their ability to maintain their infrastructure and retain quality in management and service

³ The Compact - www.thecompact.org.uk

⁴ This also applies in respect of the service provider's irrecoverable VAT costs.

⁵ *Working with the Third Sector*, National Audit Office, 2005

⁶ Charity trustees have specific legal duties to act prudently in the interests of the charity and its beneficiaries, and to use charity assets effectively. The Charity Commission has produced specific guidance for charities.

⁷ For example, there may be limited circumstances in which, for VAT purposes, a charity may prefer to provide certain welfare services on a 'significantly below cost' basis, and thereby to subsidise this provision by at least 15%. This reflects the fact that certain welfare services provided 'significantly below cost' by a charity are 'non-business' for VAT purposes and are outside the scope of VAT. This may entitle charities to certain VAT reliefs on purchases that are not available to other charities that provide services on a 'business' basis.

delivery, compromise their duty as responsible employers, and stifle innovation⁸. Overhead costs can include accommodation, human resources, utilities, premises maintenance, and monitoring requirements among others (see Annex A). Such overhead costs need, however, to be both relevant and reasonable. Costs should only be recovered once by the third sector organisation. So if one department is covering the overheads of the organisation via the funding it provides, recovery of these costs should not again be sought elsewhere.

Legitimacy of Full Cost Recovery **5.10** There is no reason why service procurers should disallow the inclusion of relevant overhead costs in bids. This also applies in respect of the service provider's irrecoverable VAT costs. Funders or purchasers should not flatly reject or refuse to fund fully costed bids. They would not do so for a private sector bidder, and the playing field should be level for the third sector. Equally, the same level of information should be requested of third sector organisations as private and public sector bodies. Clearly, different providers will want the autonomy to decide how to structure individual bids and funding bodies will want to award service contracts on a value for money basis to ensure that public money is used as effectively as possible.

5.11 A clearer understanding of the full costs associated with the activities required to deliver a particular objective can enable a better understanding within Government of the cost of delivering a particular policy outcome. The implementation of the principle of full cost recovery will therefore lead to a clearer understanding of the impact of public spending and allow more evidence-based policy decisions as, without full cost recovery and confusion over the prices of various outcomes, a multiplicity of funding bodies can assume responsibility for the same outcomes and thus distort decisions over public spending. This is another reason why funding bodies have a clear responsibility to ensure that any funding of third sector organisations is on a FCR basis.

Sustainability **5.12** Full cost recovery will also empower service providers in their negotiations with funding bodies, supporting the Government's policy to promote a healthy and vibrant third sector and thereby minimising the potential for the non-delivery of important services. Historically, third sector organisations have found it difficult to 'walk away' from financial relationships offered on a sub-FCR basis, as they feel duty-bound by their charitable objectives in the short-term, despite the risks and the potential for sub-optimal outcomes in the longer-term. But a more accurate understanding of the relationship between prices and outcomes brought about by funding on a FCR-basis will mean that, despite limited budgets, funding bodies can still secure a certain level of service proportionate to the level of funding, rather than continuing to fund on a sub-FCR basis and thereby exacerbating an unsustainable relationship with greater potential for non-delivery of services in the longer-term.

Why FCR? **5.13** Why should FCR be an issue for funders and purchasers? Those responsible for public spending decisions are ultimately concerned with the price being paid for the delivery of certain outcomes. Costs are primarily an issue for the third sector organisations themselves. However, funders cannot always make sound judgements solely on the basis of prices and outcomes. This is because:

- under a grant-making regime, bidders are not necessarily in direct competition to deliver the same service or the same outcomes. So funders cannot rely solely on market mechanisms to set a price which represents

⁸ NCVO recommends that 'voluntary and community sector organisations need to use the resources available to them, including the acevo/ NPC full cost recovery template, to understand the true costs of their work, and then to negotiate their price for delivering a particular service. Voluntary and community sector organisations may choose to subsidise an underfunded contract, they may offer a lower level of service or they may choose to walk away.'

value for money. Funders need to turn to cost structures to understand whether public resources are being employed efficiently and effectively.

- Under a procurement regime open to competition, the purchaser can, to various degrees, rely on the market to set a fair price. However, purchasers require some understanding of whether the bids are properly costed in order to demonstrate that they are sustainable, do not put the delivery of the intended outcomes at risk and therefore represent good value for money. (This applies equally to procurement from the profit-distributing private sector where the risks from providers who do not full cost their services can include lower than expected quality outcomes, attempts to re-negotiate contracts at a higher price after the event, and failure to deliver.)

FCR in grants and procurement

5.14 FCR is therefore relevant for funders and purchasers under both grant-making and procurement regimes. Under a grant-making regime, funders will need to ensure they are not ‘paying over the odds’. Whilst under a competitive procurement regime, the purchaser assesses the bids on the basis of value for money which includes a judgement on the robustness of the cost structure of the bids and of the provider to deliver. So in all cases, third sector organisations need to be encouraged to think through their true costs properly.

The Big Lottery Fund and FCR:

The Big Lottery Fund is committed to supporting Full Cost Recovery in order to leave a legacy of greater financial sustainability and management efficiency in the organisations it funds. Overheads cover all the costs that generate efficient and effective oversight of projects within organisations: if they are not supported, the work they fund suffers and is less likely to be maintained, thus making a bad investment. To implement this commitment they:

- worked closely with New Philanthropy Capital to understand the kinds of costs they could and couldn't contribute to, and the methods of allocating overheads which were acceptable;
- developed a training module for grants officers in assessing the financial aspects of an application;
- commissioned Sayer Vincent to write a small guidance booklet for applicants that explained the policy and provided an entry level method of allocating costs for very small organisations.

Putting in place the principles of a full cost recovery approach to funding was not a complex thing to do. However, as with any financial policy, there is a certain amount of detail to work through and a significant amount of staff training and guidance required. In addition to this, funding bodies need to provide clear guidance to applicants about what they will accept and signpost to other sources of help, particularly if they are targeting community organisations with low levels of financial literacy.

Other guidance

5.15 This chapter does not set out detailed guidance for bidders on how to construct a full cost recovery bid. The Association of Chief Executives of Voluntary Organisations (acevo) and New Philanthropy Capital jointly published in November 2004 ‘*Full cost recovery: a guide and toolkit on cost allocation*’ which provides a template to enable third sector organisations to apportion their overhead costs in a fair and transparent way. Other guidance, including guidance aimed at the private sector can also be useful.

Rather, this guidance is intended to inform funders how to assess and evaluate bids based on FCR in a proportionate and way whilst ensuring value for money.

Methodologies 5.16 This guidance does not seek to endorse one true methodology for the calculation and payment of full cost recovery. Some methodologies are more likely to be appropriate than others in certain circumstances. However, funders should always be willing to fund on a full cost basis and work with the recipient to find the best way to achieve this. For example, tariffs can also represent a transparent and consistent way to measure the real cost of delivering a service. Tariffs can be developed in consultation with third sector providers and should be sufficiently sophisticated to take on board variations in cost.

5.17 The overhead costs for the work that third sector organisations undertake on behalf of funding bodies needs to be relevant, proportionate and to have been incurred by the organisation in meeting the objectives of the funded activity. The checklist of costs at Annex A gives examples of expenditure items that are likely to be incurred in providing services.

Additional outcomes 5.18 It is worth noting that there can be circumstances when a third sector organisation wishes to provide services that include outcomes additional to those that the public body wishes to purchase. In such circumstances the third sector organisation may obtain finance to meet the costs of those additional outcomes from other sources.

FCR IN GRANTS AND GRANTS-IN-AID

5.19 Under a grant or grant-in-aid regime, where the market is often less developed and the outcomes are often more intangible, it is normally necessary to show that the price is reasonably related to the cost of providing the particular service in order to satisfy the funder that they are securing value for money for the taxpayer. As the NAO concluded, “Costing, rather than pricing, is likely to be the more appropriate basis for funding decisions” and an analysis of the full costs should inform the bidder’s dialogue with the funder about FCR.

5.20 However, **the funder should not be concerned with the details of overhead costs** (job descriptions, stationery or utility bills, for example) but rather assess in a proportionate manner. The methodology chosen by funders to assess whether third sector organisations have accurately allocated relevant overhead costs should follow the following principles:

- **The method should be simple.** Both funders and service providers should be able to calculate the amounts without disproportionate resource.
- **The method should be equitable** between providers where there are several funders of different services.
- **The costs should be recovered only once.** So where for example one funder provides a strategic grant specifically for overhead costs, those costs should not be taken into account when calculating the amounts due from other funding bodies⁹. Equally, the funding body should not fund the same activity twice as part of a fixed overhead and again as a variable cost.

⁹ This could have state aid implications if not properly considered. Further information can be found in *The State Aid Guide: Guidance for state aid practitioners*, DTI, September 2005.

Audit and monitoring **5.21** Funding bodies should also be aware that - as audit and monitoring are legitimate elements of FCR - increasing the burden of bureaucracy on third sector organisations can have repercussions for the costs associated with undertaking these activities, and can thus increase the costs of delivering the outcome for the funder or purchaser. Funding bodies need to find a balance between being satisfied that funding is used for the agreed purpose in order to secure value for money on one hand, and taking a proportionate attitude to risk on the other.

Lead funder **5.22** Where two or more organisations are funding the same third sector organisations, it may be appropriate for the major (lead) funder to shoulder the overhead costs associated with the work being undertaken on behalf of other funding bodies in order to reduce unnecessary bureaucracy. Such an arrangement should be agreed between all parties.

Accuracy **5.23** In principle, full cost should be recovered each year. However, it is legitimate in the interests of administrative efficiency to apply a degree of tolerance to this principle. It is accepted that funders may not be able to provide full cost precisely, given the limits on the speed with which they can react to changes in demand or the level of activity of the funded organisation. Another potential cause of uncertainty is the rules governing VAT recovery, under which a service provider may not be aware of the precise irrecoverable VAT costs until the end of a VAT accounting period. Therefore, the level of payment may be more or less than the full cost for a period, particularly if that can be shown to reflect the price in a competitive market. Alternatively, a fee may be rounded even though this may produce a small surplus or deficit.

5.24 But a fundamental review of costs could be undertaken periodically to ensure that the service continues to provide value for money (for example, that efficiency improvements are effectively managed, to avoid a “last year plus x per cent” approach, and to assess whether the level of resources used to provide the service remain appropriate in the light of changing demand and other factors) and to avoid double-counting.

5.25 If monitoring indicates a significant surplus is likely to occur, is found to have occurred at year-end, or results from the rounding of costs, and where such a surplus will not be used for the agreed purpose in a subsequent period, then the funding body is required to claw back the surplus. If, however, the funding relationship extends into a new financial period, then the funder can adjust the future level of payment in order to represent full costs more accurately over the full funding period.

Average cost **5.26** Clear and consistent allocation of relevant average costs can provide the most accurate guide to the true cost of delivering a service or output. Funding the clearly calculated cost of activity is a more transparent and sustainable means of funding important work than arbitrary fixed percentages or marginal funding.

5.27 Average cost is the most accurate representation of the true cost of delivering an outcome. But recalculating the average cost every time a third sector organisation takes on new work, or when a project comes to an end, can be unnecessarily bureaucratic and may not be justified for short-term project work. Funders should seek to be proportionate and, if agreed with the recipient, base prices on marginal costs in the short-term, with periodical readjustments at sensible intervals to match average cost over the long-term. It is worth noting that third sector organisations' levels of activity can go down as well as up!

Costs can be viewed in different ways:

Full cost is the total cost of all the resources used in providing a service. It is made up of two components:

- **Variable costs** - which vary according to the volume of activity (e.g. salary costs, varying with the number of staff);
- **Fixed costs** - which remain constant whatever level of service is provided (e.g. cost of domain name registration for organisation's website)

Marginal cost is the additional cost of taking on new activity (e.g. costs associated with each new member of staff taken on).

Another way to understand full cost is to think about:

- **Direct costs** - costs associated directly with an activity and which are relatively easy to identify. (e.g. the cost of caseworkers' salaries)
- **Indirect or overhead (or core) costs** - those costs which are not easily identified with particular outputs. (the costs of head office HR staff's salaries)

Average cost, on the other hand, represents the full cost of the activity divided by the volume of service. This takes into account both fixed and variable costs - direct and indirect - and therefore can often represent a more accurate reflection of the cost of activity.

PROCUREMENT

5.28 Under a competitive procurement regime, purchasers should be clear that they expect third sector providers to be aware of the risks of not bidding on a FCR basis. As the NAO concluded¹⁰, “A Third Sector Organisation (or a private company) bidding for a contract should submit a price based on a clear understanding of the overhead costs that the organisation needs to cover, as well as the direct costs associated with delivering the contract. In general, however, the details of overhead costs would not be disclosed to the funder, nor should the funder seek this information since it would not normally be expected from a private sector supplier”.

Value for money **5.29** Ultimately, however, purchasers can only evaluate the bids on the basis of value for money. Whether the bidder has a sophisticated understanding of the full costs associated with delivering the proposed outcomes reflects upon the third sector organisation's financial management and is therefore relevant to the purchaser's decision-making process. This assessment of the general financial and technical capability of a bidder should take place at selection, while evaluating tenders for award on the basis of best value for money should require purchasers to concern themselves (to a proportionate extent) with ensuring that bidders have a sustainable and realistic understanding of their cost structures, including the relevant overheads.

5.30 If purchasers are not satisfied that a bidder has properly calculated their costs (either by bidding too low or too high), this could call into question the risks associated with the bid, the sustainability of the delivery of the intended outcomes and therefore

¹⁰ Working with the Third Sector, National Audit Office, 2005

the value for money. Under EU procurement rules¹¹, purchasers should not dismiss abnormally low bids. The purchaser should ask for - and consider - the constituent elements of the bid price and consult with the bidder before taking a decision. Ultimately, if any organisation knowingly decides to subsidise the service or take on work as a loss leader and the purchaser believes that it represents good value for money - as the outcomes are not put at risk - then the purchaser should go ahead. Making an informed bid on the basis of FCR, choosing to bid with the intention of earning a surplus to reinvest or making a calculated loss - so as to secure the contract - is ultimately the decision of the third sector organisation. A third sector organisation unwittingly subsidising a public service, however, is unlikely to represent good value for money, particularly in the long term¹². These principles apply, whether the bidder is a third sector or private sector organisation.

Grant followed by procurement **5.31** Occasionally, a third sector organisation bidding into a procurement process and seeking full cost recovery, may have had some of its overhead costs met from pre-existing grant funding. There is therefore a risk here of 'double coverage' of overheads. Funders should be aware of this risk and should ensure that they have the information they need in order to avoid it.

Other FCR advice:

NCVO recommend¹³ that voluntary and community sector organisations use the resources available to them, including the acevo/ NPC full cost recovery template, to understand the true costs of their work, and then to negotiate their price for delivering a particular service, (which could include full cost recovery, earning a surplus to reinvest or making a calculated loss).

The Charity Commission agrees that charities should always know their full costs but also emphasises that they should only enter into contracts which do not cover these costs when they are fully satisfied that this is in their beneficiaries' interests. Charity trustees have specific legal duties to act prudently in the interests of the charity and its beneficiaries, and to use charity assets effectively. The Charity Commission has produced specific guidance for charities.

PERCENTAGE MARK-UPS

5.32 The use by third sector organisations of a fixed percentage overhead cost add-on to the direct costs of the service has the appeal of simplicity. **But fixed percentages without an evidence base do not provide a sound basis for the calculation and award of full costs.** This is because they are arbitrary, fixed and not based on evidence. The relationship between direct and overhead costs will depend on variables such as the service area or geographical variation. Therefore this guidance does not suggest that an arbitrary standard percentage mark-up for overhead costs should be used where there is no clear understanding of what that percentage represents.

Fixed percentages **5.33** Fixed percentages not based on evidence can mean that the costs are underestimated, or equally, that costs are recovered more than once. As such, arbitrary fixed percentages are corrosive: they undermine transparency and trust between

¹¹ EU Public Procurement Directives – www.ogc.gov.uk

¹² In the case of a charity, it could be a breach of the trustees' duty to act in the interests of the charity and its beneficiaries.

¹³ *The Reform of Public Services: the Role of the Voluntary Sector*, NCVO, 2005

funders and the recipients, threatening the sustainability of both funded activity and organisations.

5.34 However, individual funders may find it informative to develop their own indicative percentages which they feel represent value for money – provided these are evidence based, transparent, and applied flexibly. A standard mark-up, when soundly based, can avoid the need for detailed overhead costing exercises and subsequent monitoring. If individual providers wish to argue for a higher mark-up then they would need to do so on the basis of evidence, and be prepared to compete with other potential providers who may be happy to use the “standard” rate of mark-up.

5.35 Funders could make an informed estimate for an appropriate level of overhead cost associated with the delivery of a certain service by:

- forecasting future costs on the basis of out-turn from previous service providers for the last complete accounting period;
- considering the latest estimate of the out-turn for the current accounting period; and
- taking into account whether the underlying assumptions remain valid in the light of changes in circumstances (e.g. in demand),

FURTHER READING

- *Compact funding and procurement code*, Compact Working Group, March 2005
- *Full cost recovery: a guide and toolkit on cost allocation*, acevo and New Philanthropy Capital, 2004
- *Think Smart, think voluntary sector*, OGC and Home Office, June 2004
- *Working with the Third Sector*, National Audit Office, 2005
- *Shared Aspirations*, NCVO, June 2005
- *The Reform of Public Services: the Role of the Voluntary Sector*, NCVO, 2005
- *Policy Statement on Charities and Public Service Delivery*, Charity Commission, June 2005
- *The Green Book: Appraisal and Evaluation in Central Government*, HM Treasury, January 2003
- EU Public Procurement Directives –www.ogc.gov.uk
- Full cost recovery - www.fullcostrecovery.org

6

REDUCING THE BURDEN OF BUREAUCRACY

SUMMARY OF GUIDANCE

- Funding bodies should ensure that their application procedures are clear and, wherever possible, as simple as they can be.
- Funding bodies should seek to minimise the monitoring and inspection burden on the recipients of funds to a level proportionate to the level of funding and risk, and which maintains proper control of public monies.
- Where bodies are multi-funded, co-operation between both internal and external auditors should be encouraged, the audit burden on funding recipients minimised.
- Where organisations are multi-funded, it is good practice to appoint a lead funder to streamline application processes, co-ordinate monitoring and inspection arrangements and to minimise the number of evaluation systems and visits.

INTRODUCTION

6.1 Whilst the third sector can be characterised by its diversity, an aspect that many organisations often have in common is that their funding is received from a number of sources including national Government, local Government, charitable trusts, the private sector and contributions from the general public.

6.2 There are two principles that funding bodies should consider at all stages of the funding chain:

- simplicity and proportionality: the funding process should be as simple as possible, and funding bodies should be mindful of being proportionate when dealing with a wide variety of organisations often classified under one very broad heading;
- commonality and co-ordination: where possible funding bodies should endeavour to ‘join-up’ or standardise the elements of the funding chain so as to minimise burdens upon multi-funded organisations such as third sector organisations.

6.3 The Gershon review¹ concluded that “front line service delivery bodies often had to deal with a plethora of bodies as funders and regulators leading to significant additional delivery costs” and recommended that “the Government improves its funding relationship with the VCS by streamlining and rationalising monitoring, regulatory and reporting requirements”.

VALUE FOR MONEY AND THE IMPORTANCE OF COLLABORATION

6.4 Rationalising funding streams, or encouraging third sector organisations to pool their resources in some bidding, would reduce the transaction costs of securing income and allow third sector organisations to spend more on frontline services. There is a

¹ *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004

strong case for public bodies to streamline and co-ordinate funding criteria and performance monitoring systems. ‘Funders forums,’ bringing both public and charitable funders together to co-ordinate approaches, can be particularly useful.

Gloucestershire County Council:

Gloucestershire's six Districts and County Council meet together regularly in a Funders Group which has mapped all the grants to the voluntary sector with a view to joining up around the monitoring of groups which receive funding from two or more Councils.

An example of this is Gloucester Dial-a-Ride: both Gloucester City Council and Gloucestershire County Council fund this voluntary organisation, and both had been monitoring it separately. When officers from the two Councils met up to see how they could rationalise this, they discovered that the County Council primarily monitored quantitative data such as numbers of journeys, passengers etc, whereas the City Council mostly monitored more qualitative data such as the outcomes/differences made to the lives of the users of the service. They therefore agreed to reduce the overall burden of monitoring and reporting, thus ensuring Dial-a-Ride could spend more time on providing its services.

For further information contact: Rachel Hankins at Rachel.Hankins@gloucestershire.gov.uk

Admin costs as part of FCR

6.5 Monitoring, evaluation and audit costs are legitimate elements of the full cost of providing a service. This provides a concrete incentive for funders and purchasers to implement the lead funder principle in order to drive down costs, whilst retaining the same level of accountability for public funds and without compromising outcomes.

APPLICATION

6.6 Funding bodies should ensure that their application procedures are clear and, wherever possible, as simple as they can be². This is to minimise the unnecessary costs of submitting an application, and to avoid undue complexity which can cause small or first time applicant groups to be put off applying for funding at all.

6.7 Funders naturally need to gather information about potential applicants to establish proper use of public funds and that the applicant’s proposal is in line with objectives. Nevertheless, the amount of information required should be proportionate to the amount of funding and the ultimate objective. Funding bodies should be clear about why they are asking for particular information and should avoid asking for information that they will not use or that does not relate to the objectives of the fund. Thus, applications for small amounts of money should not involve complex, lengthy and off-putting procedures.

² OGC has developed a standard Pre-Qualification Questionnaire for use in below threshold procurements. Please see www.ogc.gov.uk/index.asp?docid=1003755 for more information.

Wigan Metropolitan Borough Council:

Wigan Council have developed a partnership approach to grant aid in the Borough. Potential applicants can contact the Council's Corporate Grant Aid Co-ordinator, who acts as a sign-poster to the correct source of funding. The main aim of the approach is to ensure that existing and particularly new groups in the Borough can access grant funding from the Council and its partners as easily as possible.

- A simple application form has been developed in consultation with the community and voluntary sector, which all the grant schemes use. Once an application is received it can then be treated as an application to any of the schemes. This means groups do not have to search around for which is the most appropriate source.
- All applications are logged onto a central database overseen by the Grant Aid Co-ordinator. All the schemes input onto the database and all information can be shared. Officers from the Council and its partner agencies meet every 2 months to share information and to network.
- A joint grant panel meets every month which includes representatives from the voluntary and community sector. All grant applications over £500 are brought to the panel for consideration. This ensures that all partners are involved in the decision making process.
- Small grants of less than £500 are fast tracked and once all information has been received from the applicant organisation these are paid within 2 weeks.

For further information contact: Anne Roberts at A.Roberts@wiganmbc.gov.uk

Multiple funders **6.8** Applicants that rely on funding from several bodies often have to present their application information in a variety of ways, creating an administrative burden. There are a number of means by which commonality can be achieved:

- application form: if possible, the development of a common application form used by a range of funding bodies would offer simplicity, improved access and reduced transaction costs for both providers and recipients of funding. However, it is clear that not all funding bodies are able to use a common form as funding streams often have different origins and different targets. Some may be governed by statute meaning that they are required to ask for particular information and others may be directed solely at charities, which will mean questions relating to charitable status will be necessary;
- data standards: where a common application form is not appropriate, it is good practice for funding bodies to use standard terminology and classifications in their application procedures. Funding bodies may want to develop a standard 'kit' of application questions. It is unlikely that any application form would utilise all the questions in the kit, but those that were used would be in the same format. At the very least this will mean multi-funded applicants are asked for information in a consistent way, but could also allow an easier exchange of information between funding bodies;
- guidance to applicants: a significant problem for applicants is the waste of time and resource involved in applying for funds to which they are not entitled, because eligibility was not made clear at the application stage. Clear guidance for applicants will help reduce ineligible applications, thereby helping to reduce over-subscription.

Lead funder concept:

This comprises three distinct but inter-related strands:

- Strand One: Passporting – the theoretical principle that information held by a Lead Funder could be ‘passporting’ to other funders and where possible, assured by one funder on behalf of all funders.
- Strand Two: Joined-up Monitoring and Audit – in which the Lead Funder would take responsibility for co-ordinating monitoring and audit visits by itself and other funders.
- Strand Three: Customer Relations – in which the Lead Funder takes responsibility for helping to smooth operational issues faced by the provider in respect of joined-up relationships with other funders.

Lead funder 6.9 Where recipients receive funding from more than one funding body (or from different parts of the same funding body), **it is good practice wherever practicable to appoint a lead funder to streamline application processes and co-ordinate monitoring and inspection arrangements.** This rationalises both the administrative requirements on funding bodies and the control burden on recipients of funds.

6.10 Contributing funding bodies will, of course, need to satisfy themselves that the arrangements meet their internal accountability standards. Where there are formal accountability arrangements – such as those of Accounting Officers of Government Departments – the arrangements should be written down in a Memorandum of Understanding or similar document, making clear the responsibilities of the participants.

Health and Social care

In 2005-06 the Department of Health introduced an electronic two stage process for grant applications from voluntary and community sector organisations working in health & social care. Applicants were able to complete and submit an outline of their funding bid online through the department's website.

These Stage 1 applications were then sifted against the published funding criteria with results notified by email 4-6 weeks after the closing date. Applicants who are progressed to the full application stage can again complete and submit more detailed information online.

Feedback from the sector after the first year was positive and the number of applications increased. Applicants were asked for comments on the usability of the on-line system which led to enhancements implemented for the 2006-07 funding round. For example, applicants can now save their work as draft and only submit when they are happy with the final version. This has helped organisations with staff in different locations as they can log on in turn to complete different sections of the form. It also meant organisations with no internet access could use internet facilities in local libraries and complete the form in short periods over a few weeks.

Using an on-line system for the first time involved a steep learning curve for some organisations. However the experience was that organisations were keen to try it and, with helpline support from a central team in the Department of Health, quickly came up to speed. The success of the online system can be measured in that no organisations asked to use paper forms once they had tried the online version.

6.11 Other application approaches are being developed that involve a greater level of interaction between the funding body and the applicant. Such approaches can help reduce wastage of time and resources of both the funding body and the recipient of funds. They also enhance the likelihood of the application, and subsequent activity – being in-line with the objectives of the funding body.

The funding and support process in Hertfordshire:

Hertfordshire County Council (HCC) conducted a Best Value review of their funding relationship with the voluntary and community sector and worked with the Herts Compact Group on the development of a county-wide Compact. Changes included:

- HCC now publish a funding prospectus which outlines funds available from the various council departments;
- Third sector organisations fill in a common application form;
- There are named fund managers for each of the funding departments; and
- Hertfordshire External Resources Network (HERN) has been set up with HCC support to provide funding advice and information to third sector organisations. HERN brings together fund managers from the county, district and borough authorities as well as external trusts, other public sector sources and CVS funding advisors.

The Best Value review gave HCC a better overall understanding of where and how it funded the sector. Bringing funding mechanisms together via the new streamlined process has aided consistency and helped the council to be more accountable, ensuring that it funds activities based on identified priorities. Greater provision of information through HERN has helped to strengthen smaller organisations and is helping to promote greater stability in the sector through more diverse funding. It is hoped that in future there may also be scope for earlier funding decisions (and, where appropriate, longer term funding arrangements) as local authorities receive three year settlements³. HCC also stressed the importance of looking to the future and not using the past as an excuse to avoid change.

For further information contact: Ann Jansz at ann@stevengcevs.solis.co.uk or Andrew Burt at andrew.burt@hertsc.gov.uk

Better processes **6.12** There are other ways in which funding bodies may be able to improve their application processes, for example:

- using a two stage application process so that only a minimum of information is requested ahead of a funding decision (for example, an expressions of interest stage);
- more use of ICT in the application process, including use of interactive forms and electronic application and monitoring procedures; and/or - seeking evaluation/feedback on their application procedures from users, with a view to improvement in future years.

In examining commonality of application processes, funding bodies should also consider mechanisms that the sector has developed to improve uniformity, such as Guidestar UK⁴.

³ The first two year settlement for local authorities agreed in 2005, provides stability and predictability in funding for the years 2006/07 and 2007/08. The 2004 Comprehensive Spending Review announced the introduction of full three-year settlements for local authorities from 2008/09 onwards.

Futurebuilders:

Futurebuilders England Ltd uses a two stage process and an online application system. Their online system takes people through initial eligibility questions to allow applicants to decide whether it is worth proceeding and then uses an online form supplemented with online guidance which requires relatively little time and effort on the part of the applicant. Applicants can cut and paste text into the form, can pause and print off work in progress at any time. The outcome has been that Futurebuilders has used this stage one process to longlist approx 44% of all the applicants who apply, thus for the unsuccessful 56% there is a very limited transaction cost on the part of the applicant or Futurebuilders. The online system is supplemented by a helpline and in the rare circumstances where applicants are unable to use the system (e.g. visual impairment), Futurebuilders receives applications in other formats

MONITORING

6.13 As a general principle, funding bodies should seek to minimise the monitoring and inspection burden on the recipients of funds to a level proportionate to the level of funding and which maintains proper control of public monies. Monitoring should be proportionate to the sums involved and the perceived risk. This may mean that more attention would be paid to larger payments (although less, proportionately, to their size, and dependent on other risk factors), and that small payments may receive a lighter touch. Under a grant regime, funding bodies should seek only information that is necessary for the purpose of verifying that grant conditions have been met.

6.14 Where possible, funding bodies should rely on monitoring information which a third sector organisation would, as a matter of good practice, report in any case its own Board of Trustees (or other governing body), rather than requiring the transfer of information to a new format. Where providers find that information provided to trustees is inadequate then they should, as a condition of funding, require that standards are improved. This in itself is good practice in managing the risks of poor governance or financial control that might jeopardise the proper delivery of a service.

A risk-based approach

6.15 It is important, however, that no funded body is led to believe that it will never be monitored or inspected. One possible solution could be a risk based programme of assessment, monitoring and checking accompanied by an ex-post random check especially for smaller sums. This would involve monitoring a selection of organisations after the funding is in place. The random sample provides both a control over those recipients that might be tempted to believe they will never be checked because they receive less, and allows the funding body to extrapolate the sample results to ensure that the lighter touch has not led to widespread abuse. For funding schemes which involve many small payments, where minimal checks can be justified, funding bodies may also wish to consider methods for looking at patterns in applications (e.g. use of same or similar addresses or contact names) to identify systematic abuse.

Multiple funders

6.16 A lack of commonality amongst funders' monitoring requirements means that multi-funded bodies have to record their information in a variety of different ways. This can be a significant administrative burden as entirely separate accounting systems may have to be established in order to record and supply the information required by different funding bodies.

⁴ www.guidestar.org.uk

6.17 It is important that funding bodies co-ordinate monitoring and inspection arrangements to try wherever possible to reduce disruption to recipients who receive monies from several sources. This can be achieved through joint inspection activity or by sharing of information on recipients. Where recipients receive funding from more than one funding body (or from different parts of the same funding body), the funding bodies should consider whether there is scope to appoint a lead monitoring officer to carry out this role on behalf of all funding scheme managers. This would lessen the burden of inspection on both recipients and funding bodies alike.

6.18 The Institute for Chartered Accountants in England and Wales has produced Audit 3/03⁵ in consultation with government, the NAO, Audit Commission and accounting practitioners, which explains the grant funding context and makes the point that monitoring and assurance requirements must be agreed up front by funder, recipient and the body providing assurance and that monitoring and assurance requirements must be proportionate to funding⁶.

Herefordshire:

Encouraging professionalism, accreditation, or quality assurance in third sector organisations makes it easier/less risky for funding bodies to contract with the third sector. In Herefordshire, funding bodies responsible for commissioning health and social care services are encouraging service providing third sector organisations to become accredited through The Alliance⁷ for inclusion on a register of approved providers⁸. The purpose of the register is for providers to demonstrate that they are 'fit for purpose' to deliver services, and how they add value to the service; and for commissioners and purchasers to have a pool of strongly performing providers from which to procure services. The benefits of being on the register include:

- early notification of new service opportunities;
- a stronger voice for providers;
- third sector organisations being in a position to take on more services; and
- more streamlined processes for accessing funding. Transaction costs will be reduced since the funding bodies don't have to 'vet' the providers individually and providers do not have to provide supporting documents each time they put in proposals as part of the procurement process.

AUDIT

6.19 This section refers to internal and external audit of the funding body, as opposed to funders' own monitoring and evaluation processes. Auditors expect that grants are:

- awarded and used only for authorised purposes (the principle of regularity);

⁵ *Audit 03/03: Public Sector Special Reporting Engagements – Grant Claims*, Institute of Chartered Accountants in England & Wales, September 2003

⁶ Audit is not the same as assurance. Assurance is the process by which an accounting firm gives assurance to the grant recipient and funder that the grant has been used for designated purpose.

⁷ Third sector organisations working collaboratively for improved health and social care services in Herefordshire

⁸ See also *Third Party Supplier Accreditation Study*, OGC, December 2005 for issues around accreditation.

- that awards are made and used fairly, free from undue influence (the principle of propriety); and
- secure the most cost-effective outputs (the principle of value for money).

6.20 Auditors would also expect to see evidence that funding bodies have sought the necessary assurance that the payments have been used for their agreed purpose and paid on the basis of need. Public assets need to be sufficiently secured and any contingent liabilities notified to Parliament in the appropriate way.

6.21 Third sector organisations are independent organisations, frequently charitable, and their financial statements require audit or independent examination in accordance with the requirements of the Charities Act 1993⁹ (for charities which are not companies) or the Companies Act 1985¹⁰. They are not normally subject to public sector audit regimes. The auditing of the financial accounts of a charity will include consideration of whether they comply with relevant accounting standards - including the Statement of Recommended Practice on Accounting and Reporting by Charities (the Charities SORP - latest version 2005)¹¹.

6.22 The above includes requirements for proper accounting for restricted funds, and individual disclosures on each material fund. So where a funder has provided a grant for a particular asset or project, the normal review of the charity's accounts will include consideration of whether it has been properly spent - or, if not fully spent by year end - a check that the appropriate balance has been carried forward to the following year in the same restricted fund. Funders should not rely upon audit alone for assurance that funds have been spent correctly, however, since whether or not a particular grant is reviewed by the auditors will depend upon the significance and materiality of the grant - broadly speaking, the size of the grant relative to other sources of funding.

6.23 The Public Audit Forum identified¹² the principles that public sector auditors should apply in order to minimise the burden on the organisations that they audit and on other bodies in the public, private or third sectors that have received public grants, or which undertake functions on behalf of the body being audited¹³.

Principles 6.24 Principles include:

- working closely with other auditors (the Treasury and NAO have agreed a Good Practice Guide on Co-operation between Internal and External Auditors, and the Audit Commission has published a good practice guide on this subject);
- using the work of auditors of related entities;
- exploring ways to work together across the range of financial and value for money audit;
- making use of the work of regulatory and inspection bodies; and

⁹ www.charity-commission.gov.uk

¹⁰ www.dti.gov.uk

¹¹ www.charity-commission.gov.uk

¹² *What Public Sector Bodies can expect from their Auditors*, Public Audit Forum, March 2000

¹³ The following Statements of Auditing Standards set out what auditors are expected to do - in some detail - when relying on others' work for their assurances: SAS500 Considering the work of internal audit; SAS510 The relationship between principal auditors and other auditors; and SAS520 Using the work of an expert.

- working closely with the European Court of Auditors to minimise the burden on UK public sector bodies.

6.25 The auditor's desire to see controls that ensure achievement of regularity, propriety and value for money is tempered by the need to encourage well managed risk taking. In general, HM Treasury, the National Audit Office and the Audit Commission support the idea that the weight of assessment, monitoring and review should be subject to the proportionality principle. This means that auditors should support control regimes based on proportionality and the assessment of risk.

6.26 Where bodies are multi-funded, co-operation between both internal and external auditors should be encouraged and the audit burden on funding recipients minimised. External auditors such as the National Audit Office (NAO) and auditors appointed by the Audit Commission place reliance on the work of other auditors and review mechanisms in order to minimise the audit burden. There may be scope for the auditors of the various funding bodies and the funding recipient to work together to lessen the audit burden. The Gershon Review concluded that "it ought to be possible to make fewer, more targeted, inspections and audits... where multiple separate audits are necessary they should be coordinated".

EVALUATION

6.27 Evaluation refers to retrospective analysis of a policy, programme or project at its completion, conclusion or revision. Evaluation examines what the policy, programme or project has achieved against what was expected, and is designed to ensure that the lessons learned are fed back into the decision-making process. Good evaluation will necessarily involve examining how money was spent and what was achieved as a result.

Inputs and outputs **6.28** Conventional applications for grant funding, or contractual relationships between a funding body and third sector bodies, can sometimes focus to an unhelpful degree on inputs (that is, how much resource is to be applied to a problem). Similarly, conventional evaluation is often primarily focussed on outputs (i.e. quantitative measures of a good or service provided). A funding body can disburse monies in accordance with recognised 'best practice', yet still not be wholly sure that desired outcomes have been achieved.

6.29 The definition of the qualitative results desired as a result of funding, and the measurement of performance against these targets (analysis by outcome), can be an effective way of demonstrating that value for money has been obtained. Approaches that examine the outcomes of funding, as well as the numerical outputs – using qualitative as well as quantitative measures, are increasingly well established.

Outputs, Outcomes and Objectives:

Objectives should be stated so that it is clear what proposals are intended to achieve. Objectives may be expressed in general terms so that the range of options to meet them can be considered. The objectives of individual proposals should be consistent with statements of government policy, departmental or agency objectives, departmental Public Service Agreements (PSAs), and wider macro-economic objectives.

There is usually a hierarchy of outcomes, outputs, and targets that should be clearly set out. Outcomes are the eventual benefits to society that proposals are intended to achieve. Often, objectives will be expressed in terms of the outcomes that are desired. But outcomes sometimes cannot be directly measured, in which case it will often be appropriate to specify outputs, as intermediate steps along the way. Outputs are the results of activities that can be clearly stated or measured and which relate in some way to the outcomes desired, and meet the requirements for regularity and propriety in government spending.

Targets can be used to help progress in terms of producing outputs, delivering outcomes, and meeting objectives. Targets should be SMART:

- Specific;
- Measurable;
- Achievable;
- Relevant; and
- Time-bound.

6.30 Funding bodies should bear in mind that data collection to assist the evaluation of a particular programme will place an additional burden on funding recipients, particularly where only small amounts of funding have been allocated. Funding bodies might consider issuing guidance on evaluation appropriate to that programme, bearing in mind the administrative burden and that such requirements will place on both providers and recipients of funding. Effective monitoring and evaluation is essential regardless of the size of grant and applicants should seek funding to do this properly in proportion to their activity

6.31 Co-operation between funding bodies is encouraged and can follow the ‘lead funder’ arrangements outlined in section 6.9. **Where an organisation is multi-funded, funding bodies should seek wherever possible to minimise the number of evaluation systems and visits.** Where visits are undertaken, lead funders should seek to gain an understanding of the wider operations of the recipient of funding. Wider knowledge gained at such visits by the lead funder can reduce the need for repetitive, detailed data collection by several different funding bodies.

FURTHER READING

- *Compact funding and procurement code*, Compact Working Group, March 2005
- *The Green Book: Appraisal and Evaluation in Central Government*, HM Treasury, January 2003
- *Think Smart, think voluntary sector*, OGC and Home Office, June 2004

- *Independent Review of Public Sector Efficiency: Releasing resources to the front line*, Sir Peter Gershon OBE, July 2004
- *Working with the Third Sector*, National Audit Office, 2005
- *Fruitful Funding*, NCVO, May 2005
- *Joining up to improve public services*, National Audit Office, 2002
- *Audit 03/03: Public Sector Special Reporting Engagements – Grant Claims*, Institute of Chartered Accountants in England & Wales, September 2003
- *What Public Sector Bodies can expect from their Auditors*, Public Audit Forum, March 2000
- Simplified PQQ - www.ogc.gov.uk
- www.governmentfunding.org
- www.charity-commission.gov.uk
- Social Accounting & Audit - www.cbs-network.org.uk
- www.guidestar.org.uk

7

PUBLICLY FUNDED ASSETS

SUMMARY OF GUIDANCE

- In providing public funds for the purposes of acquiring or developing an asset, funding bodies should, where appropriate, retain a financial interest in the asset, particularly in relation to disposal or alternative use.
- Whilst seeking to safeguard taxpayers' interests, funding bodies should be pragmatic and realistic in setting charges over an asset.
- Conditions should be flexible and imaginative and should not create barriers to wider policy objectives.

INTRODUCTION

7.1 Public bodies must take suitable and proportionate steps to safeguard their financial interests and those of the taxpayer when giving funds to others to acquire or develop assets. Bodies providing such funding should therefore carefully consider setting conditions on their grants that are realistic and proportionate to the value of the grant, the use of the asset being publicly funded and the potential future value, thus safe-guarding the funding body's financial interest over the asset.

7.2 The most common way of safeguarding financial interests is to include in the grant conditions a clause that gives the funding body a charge over the asset, i.e. the asset may not be sold or put to an alternative use without the prior agreement of the funder.

THE IMPORTANCE OF COLLABORATION AND VALUE FOR MONEY

7.3 Whilst it is important to maintain the principle of securing good value for the use of public money, it remains in the general public interest to encourage more flexible funding arrangements to reflect the increasing practice of public sector funding bodies working in partnership third sector organisations. Imposing restrictive terms on grants to such bodies may not deliver value for money, if they frustrate the ability of grant funded bodies to deliver the Government's objectives in the round. Funding bodies should therefore consider terms that:

- are realistic and proportionate to the value of the grant;
- are proportionate to the use and potential future value of the asset being publicly funded; and
- take account of achievement of the grant's original objectives.

7.4 Departments and other funding bodies should avoid setting simplistic clawback conditions, such as a diminishing charge over the expected life of an asset, without exploring the scope for more imaginative terms that provide good incentives for future collaboration.

7.5 Given the different types of public sector funder, and diversity in the population of funded bodies, the terms of grants need to be adjusted to suit the circumstances of the case, if the aim of improving public and community services is to be achieved. Allowing as much flexibility as sensible can enhance recipients' capacity to develop and

provide services over the longer term or to become independent of public funding. Terms on grants therefore need to be set in ways that enhance funded bodies' ability to work with government bodies to deliver services: over-rigorous terms may be counter-productive and not achieve overall value for money.

7.6 Terms and conditions should therefore be tailored to the circumstances, aiming to avoid unnecessarily onerous terms, which can detract from the achievement of the Government's policy objectives. Such terms should be agreed at the outset, so that both parties have a clear and common understanding about what is expected under the terms of the grant offer. Funders may wish to take appropriate legal advice on the scope for recovery of the proceeds of sales.

7.7 In some circumstances, third parties' creditors could receive a benefit at the expense of the Exchequer if grant recipients became insolvent. Public sector funders should therefore consider setting terms and conditions for grants that entail legally enforceable charges over the proceeds of disposals of publicly funded assets.

CHARGE AND CLAWBACK

7.8 A charge is a common way of safeguarding financial interests by setting a condition on a grant that gives the funding body a charge over the asset. Such a condition could be expressed as the funded body agreeing to refund the grant or, more usually to return the proceeds from the sale of the asset to the donor, (i.e. for the donor to clawback the proceeds). When setting such a clawback condition, the funding body should clarify the broad circumstances in which it would consider the proceeds being retained or recycled back to the recipient.

Applicability 7.9 When considering whether to introduce a charge over an asset and/or a clawback condition, funders should bear in mind that funding by public bodies can take place in several different ways, and not all would lead to a charge over the asset. For example, it would be reasonable to have a charge where tangible or intangible assets are financed directly by grants or grants in aid; or where such assets are developed by the funded body itself, and financed indirectly by a grant for a related purpose or by grant in aid.

7.10 Charges or clawback terms would not be applicable in the procurement of goods and services (where any liability would have been adequately discharged once the goods and services have been provided), or where a grant is provided for research and the successful conclusion of the research might be regarded as an adequate return.

7.11 Funders should also consider introducing a charge on an asset where the donor needs to be satisfied that the grant for acquisition or development of an asset would not be diverted without its endorsement; or to avoid giving the recipient an uncovenanted benefit by using public funds to acquire or maintain an asset that was sold shortly thereafter.

CONSIDERATIONS

7.12 In deciding whether to introduce a charge on an asset, funders should consider:

- the nature and purpose of the payments to the body in question;
- the type of assets, if any, acquired or created by the funded body;
- the use to which these assets are put;

- the objectives for the funding and the relation of the asset to securing these objectives;
- the proportion of the funded body's total expenditure covered by Government grants;
- how long it is reasonable for the funding body to maintain an interest in the asset; and
- whether the recipient is an asset-locked body, e.g. a charity or Community Interest Company¹

Grant conditions 7.13 Funders need to consider the different circumstances in which assets may be disposed of, and the purpose of the Government support underlying the original grant when setting terms. Clawback terms should therefore reflect the extent of public funding, the nature and expected life of the asset being developed, and how to assess when the agreed objectives for the funding have been delivered. The objectives should be agreed at the outset as part of the process of assessing the application for grant. Funders should always keep a register of clawback arrangements and have a mechanism to identify when they should be applied.

7.14 In setting terms and conditions for grants, funders should consider:

- whether grant conditions should deal with whether, when, how and to whom assets may be sold, how to get the best price, whether the property may be disposed of by way of gift, whether the asset may be sold at a price less than the best price reasonably obtainable, and whether there is a “lock” over the asset, e.g. because it is owned by a charity or CIC;
- whether grant conditions should include circumstances in which the use of assets may change and hence whether the funded body would need to consult the funder;
- the feasibility of enforcement, with due regard to the legal powers available;
- whether conditions should be imposed to cover the position if the funded body were wound up or went into liquidation, so that the funder would have priority over unsecured creditors;
- whether, where the grant was paid to improve, rather than acquire, an asset, it would be prudent for the asset to be valued before and after the improvements have been made to provide a basis for calculating any repayments to the funder;
- seeking legal advice about prospective conditions from the perspective of both UK and EU law, including any implication for state aid.

DETERMINING THE NATURE OF CHARGE OR CLAWBACK CONDITIONS

7.15 The terms and conditions of funders' grants should reflect the likely change in value of the assets over time to ensure that there is no uncovenanted benefit from the use of public funds. However, such terms, on their own, can also create a disincentive

¹ The Community Interest Company (CIC) is a new type of company, designed for third sector organisations that want to use their profits and assets for the public good.

for the recipient to take on an asset where the asset is dilapidated or in need of significant expenditure, but where it is likely to appreciate in value.

7.16 There are a number of options for determining the nature of the charge:

- setting the terms of charge (including clawback if appropriate) relative to the period over which community services are expected to be delivered rather than relative to the life of the asset;
- as above, but agree that if the asset's market value increases, the recipient might use the difference between the original grant and latest market value to support its borrowing. Where this approach is used, the donor's interest in the asset is relative to the market value of the asset thereby enabling the grant recipient to lever in funding from other sources over time;
- any amounts to be clawed back would decrease by an agreed proportion each year until they vanish to zero (e.g. 10 years and reducing any potential amount of clawback by 10% each year);
- reduce the amount to be clawed back by an agreed proportion each year, based on the estimated time of delivery of the agreed objectives of the grant rather than the life of the asset;
- base the charge period on the life of the asset;
- where there is a risk of third party creditors gaining an uncovenanted benefit at their expense, funders may need to set charge or clawback periods proportionate to that risk, and consider whether to withhold agreement to the asset being used as collateral if the risks of uncovenanted benefits are too great.

Reviewing 7.17 In addition, funders should consider:

- agreeing a break clause that would allow the funder and recipient to agree that the objectives of the funding have been achieved, allowing the funder to relinquish its interest over the asset;
- allowing for scope to retain the charge and review the clawback period if the project has not met the agreed objectives;
- enabling the funded body to use the assets as security for lending, once the charge or clawback period is agreed to have ended.

MAKING A CLAIM ON THE ASSET ENFORCEABLE

7.18 In order for the charge to be enforceable when the funded body disposes of an asset or changes the terms of its use, the funder should ensure that the terms of the grants include appropriate requirements, such as:

- imposing suitable conditions at the time when the grant is paid in, for example, offer letters; or
- introducing such conditions in the Financial Memorandum and Management Statement;
- introducing a formal legal charge on the asset.

7.19 If appropriate, funders may secure a formal legal charge on the asset, particularly where giving funds to enable others to acquire assets for high-risk projects, or to minimise the risk of third party creditors deriving a benefit which otherwise would have been returned to the funding body. Legal charges are normally taken to mean a registered charge on land in the terms of the Land Registration Act 2002 and the Rules under it. In addition, where a grant recipient is a company under the Companies Act 1985, a donor might wish to consider securing a sum as a charge on the book debts of the company, i.e. a registered charge under the Companies Act 1985.

7.20 Funders should seek legal advice if they want to introduce formal legal charges and to ensure that any condition that they include in a financial memorandum is legally enforceable and is within the terms of any relevant statutory powers.

USING ASSETS AS COLLATERAL OR TO GENERATE INCOME

7.21 Although funders need to be satisfied that funded assets are used for their agreed purpose, they may also take into account that the use of assets as collateral may help the transition from a short-term social project to a viable third sector body. Equally funders may need to consider the appropriateness of giving grants to finance asset acquisition when it is being used solely to lever in income or provide security for lending. Funders should also be alert to the risk of third party creditors gaining a benefit at the expense of the funder, in the event of a funded body becoming insolvent and having used publicly funded assets as security. Therefore whilst they have a live charge or clawback clause over a public funded asset, funders should ensure the funded body seeks their agreement to publicly funded assets being used as security whilst the charge or clawback condition still applies.

7.22 Similarly, funders may set conditions on the ability of the recipient to generate income from the publicly funded asset. Such conditions should be proportionate and weigh up the balance between impeding a funded body's ability to be self-supporting against the appropriateness of using public funds for the body to acquire an asset solely for the purpose of generating income.

SALE OF ASSET OR BODY AS A GOING CONCERN

7.23 Where a grant funded asset is to be sold, but the funder considers that the proceeds should not be clawed back, the funder should make a deliberate and considered decision about how to proceed rather than letting the disposal go by default. The onus of proof in justifying a proposal to allow a funded body to retain proceeds will be on the funder concerned. In such cases, funders should ensure that sums to be reinvested are subject to the same controls (e.g. in terms of investment appraisal and costs) as investments requiring new grants. An alternative approach may be for the funder to agree not to recover the grant but to deduct a similar amount from other future grants it may make.

7.24 Where the body owning the assets is being sold as a going concern, funders should take legal advice on whether they can recover the proceeds. They may also take into account whether the potential purchaser is one that has its assets locked and whether its objectives (charitable or as a social enterprise) are in line with the original owner's. Funders should consider carefully whether any other steps could be taken. For example, if a department is in a position to influence the decision to sell, its endorsement of the sale should be taken consciously in the light of all the facts.

APPLICATION TO CHARITIES

7.25 The application of legal charges and clawback conditions may differ in relation to charities. Public sector funders of charities should therefore consider seeking legal advice to ensure that all possible steps are taken to protect the position of the funding body and hence the Exchequer before entering into agreement.

Yorkshire-Forward (Y-F) social enterprise funding: Y-F has a charge over the asset, but it is limited to the value of grant paid and for a definite period. The length of the period is based on the grant payer making a sound and robust assessment based on when the benefits will be derived. Over time, as market value increases and assuming grant was no more than original market value when paid, the enterprise may use increasing equity (in this case, the difference between original grant after taking account of inflation and latest market value) to support its borrowing. Y-F has adapted its clawback conditions in order to help TS bodies move away from a 'grant culture', and sets a clawback condition in such a way that will enable assets to be used later as security for lending.

Third sector organisations have a vital role in supporting local authorities and the communities they represent. Together we share ambitions and a determination to make a difference to the lives of people across the country.

We hope the advice within this guidance will help funders across the public sector to make more effective and efficient use of public funds. Local government has made significant steps in efficiency, as shown by the achievements made in efficiency savings, and in working with the third sector. This guide helps to bring these two agendas together which will ultimately be of good to local residents.

Local government is already making huge steps to improve the way that services are commissioned and procured locally; they are now far smarter and outcomes focused. To achieve excellence in service provision local authorities should use the guidance to review their own funding regimes to draw on the experience of best practice, with the aim of building strong and productive relationships with the third sector. Nearly all local authorities are covered by a local compact which already sets out codes around procurement. This guidance builds on the compact and provides a clear basis which funders can work from.

Cross-departmental, organisational change and effective partnership working is required to implement these changes over the longer term. We hope that the guidance will be used widely amongst practitioners: grant-makers, procurers of public services, commissioners, policy makers, chief executives and finance officers, amongst others.

Local authorities are determined to build a productive relationship with the third sector. This will not be an overnight transformation but with support from national, regional and local organisations it can be achieved across the public sector.



Sir Sandy Bruce-Lockhart

Chair, Local Government Association

A

CHECKLIST OF COSTS

The following checklist of costs gives examples of expenditure items that are likely to be incurred in providing services. Any overhead costs included in bids should be both relevant and reasonable:

- Accommodation costs;
- Depreciation, start-up, financing costs¹ and the cost of capital²;
- Financial management, accounting and audit;
- Furniture, fittings and equipment;
- Governance, and registration and accreditation fees or membership fees of professional bodies;
- Human resources, recruitment, training and development;
- Insurance and bank charges;
- Monitoring, evaluation and reporting requirements;
- Premises maintenance and management including fire and security;
- Project management, corporate planning and senior management;
- Research and development;
- Staff costs – pay, pensions, NI contributions and redundancy payments where appropriate;
- Stocks and raw materials;
- Sub-contracted services such as consultancy and legal services;
- Telecommunications, postage, reprographics and IT;
- Travel, subsistence and transport;
- Utilities such as heat, light and council tax;

Fundraising would not be considered as a relevant overhead cost. Likewise, campaigning is unlikely to be a relevant cost as it is neither directly nor indirectly related to the delivery of a particular service. However, in exceptional circumstances where campaigning may be allowable, this should be made explicit within the funding agreement³.

Value Added Tax (VAT) is not simply an overhead cost as it can be incurred on both indirect and direct costs. But irrecoverable VAT costs incurred on expenditure

¹ This could include loan repayments directly related to the activity - such as those repayments associated with a Futurebuilders investment loan.

² Under this area, particular care must be taken to avoid double counting.

³ Exceptional circumstances in covering campaigning costs might include instances where the funder is providing strategic funding – for example for an organisation to act as the ‘voice’ for the sector, which could also help inform funders about their own objectives.

associated with the delivery of an objective should form part of the full cost of delivering that objective.

B

FURTHER READING

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- *Access to Government funding for the voluntary sector - Better Regulation Task Force*, July 1998
- *Good grant making practice*, Association of Charitable Foundations, 1997
- *The Grant making tango: issues for funders*, Baring Foundation, June 2004
- *The Green Book: Appraisal and Evaluation in Central Government*, HM Treasury, January 2003
- *Guidance to Funders*, HM Treasury, September 2003
- *Funding Our Future ii: Understand And Allocate Costs*, acevo, 2002
- *Full cost recovery: a guide and toolkit on cost allocation*, acevo and New Philanthropy Capital, 2004
- *Guide for Funders*, Disability Rights Commission, July 2005
- *Think Smart, think voluntary sector*, OGC and Home Office, June 2004
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- *Effective Local Partnerships*, HM Treasury, 2005
- *Supply chain management in public sector procurement: a guide*, OGC, June 2005
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- *Working with the Third Sector*, National Audit Office, 2005
- *Shared Aspirations*, NCVO, June 2005
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- *The Orange Book, Management of Risk: Principles and Concepts*, HM Treasury, October 2004

- *Risk Management Assessment Framework: A tool for departments*, HM Treasury, October 2004
- *Managing risk with delivery partners*, HMT, 2004
- *Policy Statement on Charities and Public Service Delivery*, Charity Commission, June 2005
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- *More for your money – a guide to procuring from social enterprises*, Social Enterprise Coalition, New Economics Foundation, 2005
- *Financial relationships with third sector organisations: a decision support tool for public bodies in England*, National Audit Office, 2006

WEBSITES

- Government Accounting – www.government-accounting.gov.uk
- Government funding portal - www.governmentfunding.org
- The Compact - www.thecompact.org.uk
- Full cost recovery - www.fullcostrecovery.org
- www.charity-commission.gov.uk
- Social Accounting & Audit - www.cbs-network.org.uk
- Prove it! - www.neweconomics.org
- EU Public Procurement Directives – www.ogc.gov.uk
- Simplified PQQ - www.ogc.gov.uk
- www.guidestar.org.uk
- NCVO Action Points for Public Services – www.ncvo-vol.org.uk
- NAO Decision Support Tool – www.nao.gov.uk/better_funding

C

PARTICIPATION

ADVICE AND GUIDANCE

- Grace Williams National Audit Office
- Joe Cavanagh National Audit Office
- Peter Deans Futurebuilders England Ltd
- David Gold Futurebuilders England Ltd
- Kevin Ashby The Big Lottery Fund
- Nick Aldridge acevo
- David Hunter acevo
- Martin Brookes New Philanthropy Capital
- Elaine Garfitt Surrey County Council
- Richard Hebditch Compact Working Group
- Mark Blake Compact Working Group
- Jessica Stewart The Alliance, Herefordshire
- Helen Horton The Alliance, Herefordshire
- Kevin Treeby House of Commons
- Ian Hickman Audit Commission
- Mubeen Bhutta NCVO
- Doug Anthony SCVO
- Neal Green Charity Commission
- Howard Long Place 2 Be
- Catherine Roche Place 2 Be
- Gareth Morgan Sheffield Hallam University
- Helen Hughes IDeA
- Romilly Rogers Local Government Association
- Amanda Little London Development Agency
- Sally Collier Office of Government Commerce
- Kate Nutt Office of Government Commerce
- Anne Turner Office of Government Commerce
- Anne Roberts Wigan Metropolitan Borough Council
- Paul Crowther Department for Education and Skills

- Paul Lewis Social Enterprise Unit, DTI
- Victoria Roberts Social Enterprise Unit, DTI
- Carolyn Heaney Department of Health
- David Rayner Office of the Deputy Prime Minister
- David Hall Her Majesty's Revenue and Customs
- Rachel Hankins Gloucestershire County Council
- Steve Dunwell Home Office
- Pat Samuel, Sue Warrington, Mark Franks, Phillip Mind, Sarah Howard-Jones, Marius Gallaher, Catharine Worsley, John McLoughlin, Hina Akhtar, and Michael Jacobs, at HM Treasury.

AUTHORS

- Dan Gregory, HM Treasury
- Debbie Edwards, Home Office
- Jim Duncan, HM Treasury
- Michael Contaldo, HM Treasury

PREVIOUS VERSIONS:

- Dan Micklethwaite, HM Treasury
- Tim Weetman, Home Office
- Andrew Dick, ODPM
- Nicola Coy, National Audit Office
- Ian Wait, National Audit Office