Cost recovery
Tools for success: doing the right things and doing them right
CASS CENTRE FOR CHARITY EFFECTIVENESS (CASS CCE)
Inspiring transformation within the nonprofit sector.

The vision of the Cass Centre for Charity Effectiveness (Cass CCE) at Sir John Cass Business School is that of a nonprofit sector leading positive social change. We support the sector to achieve this through the services that we deliver; education, knowledge sharing, research and independent consultancy advice.

As one of Cass Business School’s centres of excellence, impactful knowledge exchange has been at the heart what we do since our inception over 20 years ago.

Cass CCE aspires to see a voluntary, community and social enterprise sector constantly extending its own knowledge boundaries and driving performance excellence – whilst developing and inspiring the next generation of leaders.
About this guide

THIS GUIDE WILL HELP YOU UNDERSTAND:
■ What cost recovery is
■ How to use cost recovery within your organisation
■ How to negotiate with funders to recover a greater level of overheads.

Cost recovery is critical to costing and pricing services and activities in charities. It enables charities to see what they should charge funders to break-even or generate a surplus or profit. In return, charities who understand their cost bases typically recover a greater level of overheads in their bid submissions. They generate more income this way.

This guide will help you understand cost recovery and how you can use it in your organisation. It has been produced to compliment the series ‘Tools for success: doing the right things and doing them right’ which provides guidance on running an effective charity.

Being able to explain your overheads and cost models in a transparent way also facilitates better conversations with funders, be that central government, local government, corporate givers, trusts or foundations. In the long-term we hope it will lead to charities properly funding their work and developing greater sustainability.

AUTHORS
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Mark has undertaken over twenty years work on cost models and cost recovery in the commercial, government and charity sectors. During this time, he has lectured and written widely on the subject of cost recovery. He has helped write two key reports on cost recovery, specifically the ACEVO report, “Funding our Future: Allocating Core Costs” (2004) and CFDG publication, “Know your cost base know your charity” (2007).

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Introduction: what is cost recovery?

Charities are rightly passionate about the causes that they exist for. They have the ambition and mission to create a better world for the poorest and most marginalised, be that providing food and shelter in emergencies, helping those with disabilities, providing education or job opportunities. However, none of this can happen without the right level of infrastructure and a sound operational platform.

This is where cost recovery becomes critical; effectively funding charities’ infrastructure and overheads to be able to deliver their work.

Our recent work at Cass CCE has identified that charities fall into three clear groups:

- 1/3 know their overheads and are good at recovering costs and negotiating with funders to cover these
- 1/3 don’t know their cost base or overhead levels, and therefore can’t negotiate effectively
- 1/3 are on the journey but need some help in developing better skills and understanding.

This “Tools for success” guide aims to develop good practice in cost recovery, so that charities can become more sustainable. It is accompanied by an excel tool through which you can calculate your overhead levels.

The average charity in the UK has overhead levels in the 15-20% range, whereas banks, for example, have 25-30% and software organisations much higher still. Work in the US has led to the concern that we are moving into a ‘starvation cycle’ with charities feeling pressure to continue cutting overhead costs and pressure to conform to funder demands’. Commercial organisations make a profit, while charities struggle to cover overheads. Can this be right?

Charities must be able to put forward transparent and appropriately costed bids with all costs covered, including a fair proportion of overheads. Alternatively, they should know the value of any shortfall they are subsidising, and know how this will ultimately be funded.

Equally, we urge funders to fund charities on a sustainable basis.

A practical example will show the power of good cost recovery – this is a real example. A charity with a contract from a local authority of £750,000 calculated its overheads as 7%. Having used the methodology from this toolkit, they calculated their overheads as roughly 20%. They gained a further £100,000 income through transparent negotiations and openly sharing their calculations with their local authority.

This toolkit will help build understanding in those charities struggling to measure their cost base and overheads. It will also operate as a good practice guide for those who are already focused on this.

The methodology is adapted from the ACEVO framework developed in 2004. It was recognised by government as good practice in both 2004 and 2006. The principles found in this toolkit are equally appropriate for small, medium and large charities.

Cost recovery is vital to the sector because it gives us the resources to allow charities to be sustainable, vibrant and to focus on achieving their missions effectively. We hope you find this toolkit useful.

**THIS TOOLKIT AIMS TO IMPROVE COST RECOVERY PRACTICES BY:**

- Providing a framework which charities can follow to maximise cost recovery
- Taking pressure off unrestricted reserves
- Helping charities price activities and services more effectively
- Ensuring that any subsidy to cover shortfalls are transparently treated and managed
- Improving conversations with funders.
Why cost recovery is important and basic definitions

WHY THIS IS IMPORTANT
Charities need to understand their costs to ensure they are effectively funded.

Cost recovery enables:
- **Sustainability** – a fair price is paid for each service or activity
- **Confidence in funder conversations** – being able to negotiate with confidence and also being transparent with costs enables charities to more easily justify costs to funders and users
- **Efficiency** – charities that know their cost base are more effective and can challenge how they spend their funds in the best way
- **Sound infrastructure** – having effective overhead funding enables a sound infrastructure to be built in order to take work to scale and to do so with real quality.

BASIC DEFINITIONS
**Infrastructure** – The platform or core from which a charity delivers its activities or services

**Overheads** – Infrastructure costs cannot always be linked directly to services or activities, e.g. finance, IT or admin costs. These costs are often referred to as ‘Overheads’ and are vital to the ongoing quality of a charity’s work

**Cost recovery** – This ensures that each activity or service is properly funded and that a fair proportion of overheads is apportioned to each

**Full cost recovery** – What charities need to charge in order to break-even and recover all costs in an activity or service, including overheads. It is therefore the true cost of doing business

**Pricing** – The full cost of the activity or service, including full cost recovery and any additional contingency or profit element

**Allocation** – Categorising costs into different levels within our framework: direct, direct support or indirect costs

**Apportionment** – The splitting of costs that are shared by two or more activities or services after allocation to the relevant framework level.

EXAMPLE OF COST RECOVERY IN ACTION
An example charity service has direct costs of £300,000 and the local authority is offering £280,000. The charity is happy to cover the £20,000 loss from other services.

The Finance Manager realises that the charity’s 15% overheads, management time and building costs are not included in this figure and have been forgotten. The cost of the service is actually £345,000 including all overheads.

The charity has to fundraise for the difference from what the local authority will pay and this costs £50,000. The full cost of the service is therefore the service costs plus overheads and fundraising costs; £395,000.

The true cost of an activity or service is often much greater than perceived.
**A cost framework**

This toolkit proposes a model split into three levels: direct costs, direct support costs and indirect costs.

In addition, charities may want to include a level of contingency (risk premium) or profit and we discuss this on page 8.

**DIRECT COSTS**

Every charity has frontline costs against which they delivers their work. These are the direct costs of the service or activity. For example, if you don’t pay staff then the service isn’t delivered. Direct costs ‘link’ directly to the activity or service.

* e.g. Staff costs (including NIC and pensions) and Travel.

**DIRECT SUPPORT COSTS**

Other costs can be identified as direct costs and link directly to the activity or service, but are shared between different activities or services. We therefore need to do some apportionment work to calculate these, dividing the costs between different activities or services based on headcount or floorspace, for example. A good example is building costs which are often shared by operational and fundraising, as well as administrative functions.

* e.g. Regulation, Training, Building Costs and Telecoms

**INDIRECT COSTS**

Indirect costs such as IT, the CEO’s time or finance costs, cannot be linked directly to activities or services. Yet, to remove any of these costs would severely impair the quality of work and sustainability of the organisation. Therefore these should be included in the cost of delivery when we consider the true cost.

* e.g. Governance, IT and Finance.
Costing and pricing are different things

With grants, charities typically need to be transparent on their costing and are normally paid no element of profit or surplus. Here, we aim to recover the true cost of the activity or service, including a fair proportion of overheads.

Costing (Full cost recovery) is what charities need to charge to break-even and recover all costs, including overheads. It is the real cost of doing business.

However, a growing amount of charities’ work is being completed under contract. Here, the funder pays against performance targets and charities can typically include an element of profit and contingency to cover the risk of delivering services.

Pricing is how much charities are willing to charge for services. It includes an element of profit and any contingency they may want to include.

RISK AND CONTINGENCY
Where there is significant risk of non-delivery against budget or outcomes, or where large uncertainties are present, charities may want to put a contingency or risk payment in place.

Pricing contingencies into contracts is a standard part of most commercial practices and should be adopted more frequently by charities, especially as more charities move towards payments by results.

Guidance on contingency and risk and pricing this into government contracts, can be sought from the government Green Book².

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Putting this into practice

The steps needed to complete cost recovery calculations are straightforward and shown below. Calculations rely on charities having good management information and an idea of their business model, activities and services at the start.

Essentially, what the calculations do is allocate costs into different levels in our framework and then apportion any shared costs into each activity or service in order to present a full cost. This is shown in Figure 2.

THE STEPS TO COST RECOVERY

**STEP 1:** Identify a cost category for each cost: direct, direct support or indirect. This is the allocation of costs into different levels.

**STEP 2:** Apportion direct support costs and indirect costs to the right levels.

**STEP 3:** Calculate the full cost of services and activities including direct support costs and indirect costs (Figure 2 below).

**STEP 4:** Include any contingency, risk or profit element.

**STEP 5:** Consider how any shortfall is funded.

Figure 2: THE STEPS TO COST RECOVERY
Steps 4 and 5 involve pricing decisions and deciding how any shortfall will be funded.

This image shows the difference between full cost recovery and pricing. Pricing is adding a risk, contingency or profit margin onto the full cost to reach a final charge.

Figure 3: COSTING AND PRICING

Steps 4 and 5 involve pricing decisions and deciding how any shortfall will be funded.

This image shows the difference between full cost recovery and pricing. Pricing is adding a risk, contingency or profit margin onto the full cost to reach a final charge.

Figure 3: COSTING AND PRICING
Guidance

COUNTING COSTS
Generally, funders are prepared to pay a fair level of overheads towards a project, but they need transparency to be able to do this. If donors choose not to fund projects fully, then charities should be transparent about any shortfall and how this is funded, e.g., from unrestricted reserves.

To ensure this, charities should count all of their costs when bidding for projects and make sure that they do not ‘cherry pick’ costs to suit them.

CONTRIBUTION BASIS
Charities tend to look at the profitability of services excluding indirect costs or overheads. This is a contribution basis and hides the true costs of an activity or service.

Charities should consider the profitability of services after apportionment of indirect costs and overheads to understand the ‘true’ cost of business.

THE STARVATION CYCLE
Many charities feel that commissioners and funders won’t pay for overheads and hold their costs at an artificially low level, or feel that donors will only pay a maximum 7% or 10%. In turn, funders see the low rates being charged so expect to see that from everyone. This forces rates lower.

This downward cycle is known as the ‘starvation cycle’.

There are concerns that low charity overheads are having a fundamental impact on their infrastructure and future resilience. Contracts and grants end up being negotiated at rates which are not sustainable and are heavily subsidised by charities without the funder fully appreciating this subsidy.

Charities need honest conversations with funders and need to explain their overheads in an open way. Knowing their overhead levels allows charities to bid effectively.

WHAT OVERHEAD PERCENTAGES SHOULD CHARITIES AIM FOR?
A recent review of a range of medium-sized charities by Cass CCE highlighted charity overheads in reports and accounts ranging from 0.3%-28.7%. However, when putting forward bids, they all said their overhead rates were around 10-15% (and different from what they reported). The risk is that funders will see a difference between bid figures and reports and accounts and start challenging numbers.

In one example, two sister charities approached the same local authority. One had a low overhead whilst the other had a higher and perhaps more realistic, overhead. The local authority refused to fund the bid with the higher rate, pointing to their sister charity who presented (albeit possibly inaccurately) a much lower rate. The damage is obvious.

An NfPSynergy survey in 2016 identified that the public were comfortable with charities spending 14% on overheads, 14% on fundraising and 14% on campaigning. This 42% is considerably more than the average charity spends in these three areas.

One way to address this is to aim to move indirect costs up to direct costs. The balance needs to be right though as too low an overhead figure will not appear reasonable to the funder.

**APPORTIONMENT**

Costs are often shared across categories. One such example are building and maintenance costs which are partly used to deliver services and also provide room for administration. These costs need to be apportioned and split into the two or more activities or services shared by them.

Figure 4 below considers the usual costs and their associated apportionment bases.

**Figure 4: TYPICAL BASIS FOR APPORTIONING COSTS**

Basis for apportioning indirect or direct support costs

<table>
<thead>
<tr>
<th>Item</th>
<th>Basis of apportionment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building rent</td>
<td>Floor space / Headcount</td>
</tr>
<tr>
<td>Utilities</td>
<td>Floor space / Headcount</td>
</tr>
<tr>
<td>IT</td>
<td>Headcount</td>
</tr>
<tr>
<td>Stationery and office costs</td>
<td>Headcount</td>
</tr>
<tr>
<td>Chief Executive's office</td>
<td>Time</td>
</tr>
<tr>
<td>Governance &amp; strategic development</td>
<td>Expenditure</td>
</tr>
</tbody>
</table>
HISTORIC OR FUTURE COSTS
Calculations should be based on the most appropriate data. If budgets will change fundamentally in future, for example from funding being in doubt, then you may want to calculate figures based on future forecasts and future budgets, rather than past data. This basis of calculation is especially important when a large level of funding dries up. This is presently where many charities find themselves, with grant funding ‘lumpy’ or at risk of losing core grants. In this case, full cost recovery calculations are critical to see the real cost of services based on future budgets and the level of any future subsidies.

SAYING NO
Charities should follow effective sign off procedures when deciding on whether to bid for a contract or grant, ensuring that the right decisions are scrutinised and signed off by trustees.

After completing calculations, it may become apparent that the required subsidy from unrestricted reserves is too great or that the shortfall is not sustainable. Saying ‘no’ is sometimes necessary to guarantee the future viability of a charity.

Quite often funders will not pay full cost recovery, even after negotiation. Charities should not hide from having honest conversations with funders on the true cost of an activity or service. They should also be open about the size of any shortfall and the impact this may have on their sustainability.

THE COMPACT
The Compact is a 16-page document setting out ways that the government and voluntary sector work together.

Paragraph 3.8 of The Compact states that “when CSOs apply for a grant they can include appropriate and relevant overheads, including the costs associated with training and volunteer involvement.” It is this guidance which allows us to legitimately claim overheads in our bids and contracts with government.

MANAGEMENT INFORMATION
Management information is needed to run charities effectively and also to correctly determine cost recovery rates.

Many charity management information systems are not sufficiently robust to enable cost recovery to be properly calculated. Charities should review their systems to ensure they can easily and correctly calculate rates; this may take effort and time.

Cost recovery rates and pricing models are often held by the CEO or finance team alone and not shared. Charities must get better at sharing this appropriately as others in the organisation also need to be aware.

SORP and reporting in annual reports and accounts

EXTERNAL REPORTING – SORP
SORP is the reporting standard that charities must follow in their annual reports and accounts under Charity Commission guidance. Many charities get the disclosure of indirect costs wrong or omit it altogether.

In SORP they refer to indirect costs as support costs. The following disclosure is required in the notes to the accounts:

“8.13. This SORP requires that charities reporting on an activity basis must disclose:

- Details of the accounting policy adopted for the apportionment of costs between activities and any estimation technique(s) used to calculate their apportionment
- The total amount of support costs incurred in the reporting period
- An analysis of material items or categories of expenditure included within support costs, with the total amount of governance costs incurred separately identified

8.14. The information required for support costs and their apportionment may be provided in a tabular format (see Figure 5 below).”

Figure 5: ANALYSIS OF SUPPORT COSTS

<table>
<thead>
<tr>
<th>Support cost (examples)</th>
<th>Raising funds</th>
<th>Activity 1</th>
<th>Activity 2</th>
<th>Activity 3</th>
<th>Grand total</th>
<th>Basis of apportionment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>Text describing method</td>
</tr>
<tr>
<td>Finance</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>Text describing method</td>
</tr>
<tr>
<td>Information technology</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>Text describing method</td>
</tr>
<tr>
<td>Human resources</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>Text describing method</td>
</tr>
<tr>
<td>Function/activity total</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

- The amount of support costs apportioned to each of the charity’s significant activities as disclosed in the SOFA or in the notes to the accounts.
Daily rates

**DAILY RATES**

Most contracts, charged-for-services and many grants are costed on day rates.

Many charities assume that employed staff can work 260 days per year when costing day rates. However, staff take holiday, they get sick and they are also asked to do other work as directed by the charity and management.

If not fully financially covered, each time staff work fewer than 260 days per year, the shortfall has to fall to unrestricted reserves or staff have to work overtime – which typically costs more. This toolkit suggests that using 200 days is a more appropriate basis as follows:

<table>
<thead>
<tr>
<th>Days</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>365</td>
<td>Days</td>
</tr>
<tr>
<td>104</td>
<td>Weekends</td>
</tr>
<tr>
<td>261</td>
<td>Days – most charities stop here</td>
</tr>
<tr>
<td>8</td>
<td>Bank holidays (National average)</td>
</tr>
<tr>
<td>25</td>
<td>Days Holiday</td>
</tr>
<tr>
<td>8</td>
<td>Sick days (National average)</td>
</tr>
<tr>
<td>20</td>
<td>Training days and days on charity business (typically 10% on average)</td>
</tr>
<tr>
<td>200</td>
<td>Days total</td>
</tr>
</tbody>
</table>

**UTILISATION BASIS**

Another way is to aim towards a utilisation rate for staff. A typical level of utilisation in the commercial sector would be 70%. Against 260 working days this would imply 182 working days and calculations could replace 200 days with this figure.

**CONTRACTED STAFF AND SPOT RATES**

Charities are moving away from employed staff to contracted staff or are paying at spot rates on contracts. For these staff and contracts, full cost recovery calculations are still entirely necessary to show the true cost of doing business.

**EXAMPLE 2**

A member of staff has a direct cost, including pensions and NIC, of £34,000 per year. The charity has direct support costs of 42.0% and overheads of 9.4%. This gives a full cost of £52,818, including direct costs and overheads, per annum.

Using 260 days gives a charge rate of £203 per day or £25.39 per hour (based on an 8 hour day).

Using 200 days gives a charge out rate of £264 per day or £33.01 per hour (based on an 8 hour day).

Simply using a more appropriate number of days increases income to the charity by 30%.
Technical aspects

FORGOTTEN COSTS
Cass CCE reviewed the cost recovery practices of a large number of charities and found that many were overlooking or forgetting certain costs. Specifically:

- Infrastructure costs
  - Property costs
  - Marketing, brand costs and awareness raising
  - Business development
  - Irrecoverable VAT
  - General costs: Legal, CEO, governance and internal audit

- Quality costs
  - Regulation costs, e.g. CQC
  - Cost of volunteers

- Impact measurement costs
  - Capturing data on outcomes and outputs
  - Monitoring and evaluation costs
  - Costs of turning learning into practice
  - R&D.

ADVOCACY, BRAND AND COSTS OF GIVING ADVICE
The really difficult aspects of cost recovery fall around how to handle advocacy costs, brand costs and the costs of giving advice.

Some charities feel passionately that these are genuine overheads and that they therefore should not charge contracts, service users or donors for these.

This manual would argue the opposite; that these costs are part of the cost of delivering a quality service and are therefore part of the operational platform of doing business. As such, charities should charge these as direct support costs and as legitimate costs of doing business.

The reality is that without cost recovery, many of these costs fall to unrestricted income or reserves by default.

TAXATION
It is important that charities consider the tax impact of grants and contracts effectively and take appropriate advice. What may look like a grant or contract may in reality be different. This could add 20% on to all costs!

Charities should seek appropriate tax advice. Especially:

- Where a profit or surplus is being generated; and
- Where the grant or contract is for technical assistance or using consultants.

DOUBLE COUNTING
Charities must ensure that they do not double count costs. This mainly occurs where they charge both a flat rate indirect recovery up-lift on all projects and separately inflate day rates for staff to include an element of cost recovery.
Negotiating with commissioners

Downward pressure on costs continues to be intense, but armed with an understanding from cost recovery calculations, charities should be able to be honest about their negotiating position and actual cost of business. Charities should tell the story of the added social value they create and even include testimonials from customers. Without this, the funder decision defaults to a money-driven analysis. This then leads to some charities losing tenders to commercial organisations, where this decision is based on price and/or quality alone (and not the social value created).

FIVE KEY POINTS TO NEGOTIATE WITH COMMISSIONERS:

- What does your charity want to get from this and what does the funder want to get from this? What are you both willing to compromise on and what are your fundamental criteria that must be included for the project to be a success for both parties?
- What is the lowest acceptable bid amount? This requires knowing the cost base of your services and being honest with the funder as to what this is.
- Be known to the funder. Establish a relationship with them and keep them up to date with what your charity is doing, even if you aren’t engaged in a project with them at this time.
- What are your charity’s unique selling points? What makes your charity different from any others that are bidding and is the funder aware of this? Tell the story of what you do and the social value that your charity creates.
- What if you aren’t successful? You won’t win every bid that you make, so it is important to have a plan for what comes next if you are not successful in bidding for a project.
A worked example

To bring cost recovery to life we have drafted a simple worked example, which is available on the Cass CCE website. This takes charities through a step by step guide with a real example and numbers.

In this toolkit we have limited space, but we thought it would be useful for readers to see graphically how this works.

The scenario involves a charity with services, which also has a building from which it runs both admin and its services. It engages in fundraising for additional unrestricted reserves.

The charity considers its building to be an indirect cost (overhead) and starts with overheads of 33.8% – see Figure 6.

The charity identifies that the building can be linked directly to its activities and services. It therefore allocates the cost of building from indirect costs to direct support costs.

The indirect cost (overhead) level moves down from 33.8% to 23.5% just by moving the building to a different cost group.

Figure 6: EXAMPLE OF COST RECOVERY. CHARITY WITH SERVICES AND 33.8% OVERHEADS. THE COST OF THE BUILDING IS INCLUDED IN INDIRECT COSTS

<table>
<thead>
<tr>
<th>Cost area</th>
<th>Cost £</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct cost of services</td>
<td>45.4%</td>
</tr>
<tr>
<td>Direct support costs</td>
<td>15.0%</td>
</tr>
<tr>
<td>Indirect costs (overheads)</td>
<td>33.8%</td>
</tr>
<tr>
<td>Fundraising</td>
<td>5.8%</td>
</tr>
</tbody>
</table>

This is STEP 1 in the methodology on page eight – identifying an appropriate cost category for each cost. The re-allocation of building costs is shown in Figure 7 below.

Figure 7: ALLOCATION BUILDINGS AS DIRECT SUPPORT COSTS CHANGES INDIRECT COSTS TO 23.5%

<table>
<thead>
<tr>
<th>Cost area</th>
<th>Cost £</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct cost of services</td>
<td>45.4%</td>
</tr>
<tr>
<td>Direct support costs and building</td>
<td>25.3%</td>
</tr>
<tr>
<td>Indirect costs (overheads)</td>
<td>23.5%</td>
</tr>
<tr>
<td>Fundraising</td>
<td>5.8%</td>
</tr>
</tbody>
</table>
Next, they need to apportion part of the building costs back to indirect costs as they house the administrative functions. This increases the indirect cost level to (25.1%)

This is **STEP 2** in the methodology on page eight – the apportionment of direct support costs. The detail is shown in Figure 8 opposite.

Next, they need to apportion the indirect costs to the extent they can link to direct costs, direct support costs or fundraising. The apportionment could be done on headcount, for example.

They apportion out those indirect costs and this reduces indirect costs (overheads) to 11.8%.

This is finalising **STEP 2** in the methodology on page eight – the apportionment of indirect costs.

The final results are shown in Figure 9 opposite.

The end result is that indirect costs (overheads) are 11.8%.

This is the final figure that should be used in grant and contract submissions (**STEP 3** of the methodology on page eight).

**STEPS 4 and 5** of our methodology follow next, but we do not have the room to demonstrate them here. Simply put, they are to include any contingency, risk or profit element and consider how any shortfall is funded.
Problem solving

Issues with cost recovery are typically driven from three different perspectives:

- **Business Model** – Often a charity’s business model is not understood in terms of function, form and how money is generated and spent. Secondly, the resource and costs of the operational ‘platform’ required to run the charity are not understood. Here, cost recovery builds a financial model and ensures that functional areas are understood, the operational platform is properly funded and cost recovery reflects this.

- **Management information** – Charities typically have information that focuses on cost centres, e.g., utilities, travel or staff, but does not tell the story of the activities the charity does or the costs behind this. Equally, management information may be poor or not easily available. Cost recovery here develops an understanding of activities and re-cuts the numbers to apportion costs into a ‘full costed’ operational model; bringing finance and operations together. Alternatively it works to develop improved management information and basic accounting.

- **Cultural or technical understanding** – In this case, either the charity lacks the understanding of what cost recovery is or the technical skills to calculate this. Secondly, culture may be holding the organisation back – typically staff see the charity as purely nonprofit rather than generating revenue to break-even.

The net result from each of these three issues is that charities lack sound information for decision-making and insight. In extreme cases, this can lead to organisations severely underfunding their work and even potential closure.
Guidance and recommendations

The following points are the key takeaways from this toolkit:

Guidance 1: Charities should not hide the real costs of their work and should consider the profitability of services after allocation and apportionment of indirect costs and all direct support costs to understand the ‘true’ cost. Charities should discuss these costs honestly and transparently with funders.

Guidance 2: Charities should ensure that all costs are counted and do not ‘cherry pick’ costs to go into bids. Knowing their overhead levels allows them to bid effectively.

Guidance 3: Charities should not hide any shortfalls and will decide strategically if they will sign this off from unrestricted reserves. They will be transparent about any shortfall with funders.

Guidance 4: One size does not fit all, and each charity must know its own overheads and cost base and be able to justify these.

Guidance 5: Aim to move indirect costs up to direct costs. The balance needs to be right though as too low an overhead figure will not appear reasonable to the funder.

Guidance 6: This manual believes that charities should treat advocacy costs, brand costs and the costs of giving advice as direct support costs to ensure they are funded.

Guidance 7: Charities should seek appropriate tax advice. Especially:
- Where a profit or surplus is being generated; and
- Where the grant or contract is for technical assistance or using consultants.
CONCLUSION
Charities need to know their overhead levels and be able to justify these to funders. By doing this, they can achieve greater cost recovery and improve their future sustainability.

Equally, charities should know the subsidy they provide to funders where funding gaps exist and be transparent about this.

We hope that you have a better understanding of cost recovery after reading this toolkit and can take on board the guidance within.

SIGNPOSTS
Publications
CFDG (2007) “Know your cost base know your charity” (CFG)
Palmer, Young, Finlayson, Rajani (2014) “Good guide to financial management” (NCVO)

Where to go for advice
Cass Centre for Charity Effectiveness (Cass CCE) offers training in many aspects of management including cost recovery: www.cass.city.ac.uk/cce

The Charity Finance Group (CFG) specialises in helping charities to manage their accounting and related functions, and their website has up-to-date information: www.cfg.org.uk

KnowHow NonProfit has a useful section on Finance: www.knowhownonprofit.org/funding

“Charities need to ‘mind the gap’ and ‘close the gap’ to become more viable.”
Tim Boyes-Watson

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