Small is beautiful? Financial efficiency of small fundraising charities

Hans van der Heijden

Royal Holloway, University of London, Egham, Surrey TW20 0EX, UK

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Abstract

The study analyses potential scale efficiencies of 1196 Dutch fundraising charities for 2005–2009. The data set includes a unique group of small charities (reporting an income of less than €1 million). The study articulates and tests differences in financial efficiency between smaller and larger charities, specifically concerning program expenditure, administrative expenditure, and fundraising expenditure. The study finds that reported levels of program-spending efficiency and administrative efficiency are similar across small and large charities, with no economies of scale. In addition, the study finds that smaller charities report considerably better fundraising efficiency ratios, with the smallest charities reporting an average spend of €8 to raise €100 and the largest charities reporting an average spend of €15. The paper discusses why larger charities appear to experience scale inefficiencies in fundraising and provides directions for further research.

1. Introduction

The accounting practices of charitable organisations continue to raise much public interest. One issue that is frequently debated is the extent to which charities spend their donation money wisely. This debate is often centred on the financial efficiency of charities (i.e., the extent to which they spend their donation money efficiently in advancing the charitable cause). Public perceptions regarding appropriate efficiency levels are of great concern to charities. A lack of perceived financial efficiency may eventually cause a drop in donations (Parsons, 2007), and create a backlash from watchdogs and regulators (Forbes, 2009; Kreander, Beattie, & McPhail, 2009; Tinkelman & Mankaney, 2007).

This study contributes to this debate by providing empirical evidence on financial efficiency as reported by 1196 Dutch charities. The data set includes a unique group of small charities, defined here as those charities that generate an annual income less than €1 million. Previous accounting research has almost exclusively dealt with large and very large charities from the US (e.g. Baber, Daniel, & Roberts, 2002; Jones & Roberts, 2006) and the UK (e.g. Hyndman & McKillop, 1999; Jetty & Beattie, 2009; Sargeant & Kahler, 1999). To study the practices and the performance of these charities is therefore an important exercise in its own right.

A study on small charities is of further interest because previous research has shown that financial efficiency may be conditional on a charity’s size. Smaller charities may be less financially efficient because larger charities benefit from greater economies of scale (Kahler & Sargeant, 2002; Wise, 1997). In addition, larger charities are often older and as such their management may have gained more experience in administration and fundraising. On the other hand, smaller charities may be more financially efficient because they do not need to sustain a large set of resources to maintain their fundraising levels. The question is empirical and has hitherto remained unaddressed for small charities.
To compare the financial efficiency of the different charities, this study examines and compares three sector-specific financial ratios as a function of varying size, using data taken from the charities’ annual accounts (an approach in line with e.g. Hyndman & Mckillop, 1999). An example of such a ratio is the fundraising ratio: the expenses spent on the generation of funds as a percentage of the amount of funds eventually raised.

It must be emphasised, following Hyndman and Mckillop (1999) and others, that these ratios are subject to a degree of accounting discretion regarding cost definition and cost classification. In addition, the ratios measure a narrow definition of financial efficiency. Their interpretation should, therefore, not be confused with more liberal interpretations of efficiency, or with judgements regarding the effectiveness of the charity. Efficiency is defined here as the relationship between certain inputs (such as income) and certain outputs (such as expenses). Effectiveness refers to the relationship between those outputs and actual performance. Efficiency is therefore not necessarily connected to the effectiveness of the charity. For example, charities may exhibit very high levels of administrative efficiency, but at the same time suffer from inadequate donor registration or poorly administered fundraising campaigns.2

The study is set against the backdrop of the voluntary sector in the Netherlands, a sector that is relatively large in size in comparison to other countries (see Burger & Veldheer, 2001; for an overview of the origins and growth of the Dutch voluntary sector). The Dutch are active volunteers in charitable activities. In 2009, at least 40% of the population was engaged as a volunteer in unpaid work (Schuyl, Gouwenberg, & Bekkers, 2011). The paper studies scale efficiencies of charities by examining the annual accounts of 1196 Dutch fundraising charities for 2005–2009. These accounts are available to the general public through the website of the Dutch accreditation body for fundraising charities, the Central Bureau for Fundraising (CBF).

The paper proceeds as follows. First, a brief review of the financial ratios under study is given, followed by hypothesis development regarding the levels of these ratios for smaller charities. Second, the Method section discusses the data set in more detail. The Results section provides the findings of the study. The paper concludes with a discussion of the results and implications for research and practice.

2. Background and hypothesis development

Many national accounting standard-setters have developed a standard structure for the charity income statement (Connolly & Hyndman, 2004). For example, in the UK the Accounting Standards Board developed Statements of Recommended Practice (SORPs, Charity Commission For England and Wales, 2005). Adherence to these guidelines has done much to improve the quality and comparability of UK charities (Connolly & Hyndman, 2000; Hines & Jones, 1992). There is also a recommended structure for the charity income statement in the Netherlands, first established in 1998 by the Dutch Foundation for Annual Reporting (“Raad voor de Jaarverslaggeving”, RJ). According to the structure (Richtlijn 650), charities are advised to divide their income into six categories: [1] income from fundraising activities, [2] income from joint activities with other charities, [3] income from third parties, [4] subsidies from governments, [5] income from investment, and [6] miscellaneous income, all leading to [7] total income. The expenses are divided into three categories: expenses directly related to programs advancing the charitable cause [8], expenses related to the generation of income [9] (which includes cost of fundraising [10]), and general administrative expenses [11], all leading to [12] total expenses.3

Much public debate centres on the proportion of money spent on advancing the charitable cause. A ratio expressing this proportion is the program ratio (PR): program-related expenditure divided by total income, or [8]/[7]. Often this ratio is also expressed as program-related expenditure to total expenditure (see Baber, Roberts, & Visvanathan, 2001; Jones & Roberts, 2006). The program spending ratio (Dutch: “bestedingsratio”) is one of two major ratios prescribed by RJ in Richtlijn 650.

The second ratio used in this study is the administrative cost to total expenditure ratio (ACE for short) and defined as [11]/[12]. This ratio measures the extent to which charities spend money on management and administration. Kahler and Sargeant (2002) study this ratio in detail. An alternative version of the ratio puts administrative cost as a percentage of total income, but to preserve comparability with previous research, notably Kahler and Sargeant (2002), this study uses the ACE ratio.

High administrative cost ratios are known to negatively affect donor contribution levels. Their interpretation should, therefore, not be confused with more liberal interpretations of efficiency. For example, charities may exhibit very high levels of administrative efficiency, but at the same time suffer from inadequate donor registration or poorly administered fundraising campaigns.4

The third and last ratio, called Fundraising ratio (FR) is defined as the Fundraising Expenditure divided by Fundraising Revenues, or [10]/[11]. Fundraising expenditure is a subset of total revenue generation expenditure. Alternatively, this ratio is to be understood as the amount of euros spent by the charity to raise €100 in funds. It is the second of two major ratios that the RJ recommend that charities disclose (Dutch: “fondsenwervingsratio”).4

It is worth drawing attention to the difference in interpretation between the first ratio and the other two. The first ratio is to be interpreted as a measure of financial efficiency in the sense that higher levels indicate that more income is directed towards programs and less income to other, non-program related activities. In contrast, the last two ratios are to be interpreted as measures of financial in-efficiency, with higher levels indicating less income is directed towards programs and more income is directed towards administration and fundraising respectively.

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2 See a report by the Nonprofit Overhead Cost Project (2004) for a critique of the use of fundraising ratios as measures of efficiency.
4 Often this ratio is also expressed as Fundraising Expenditure to Total Expenditure. From 2011 onwards, the Dutch Richtlijn 650 also requires the publication of this ratio.
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