Financial vulnerability of Scottish charities during the COVID-19 pandemic

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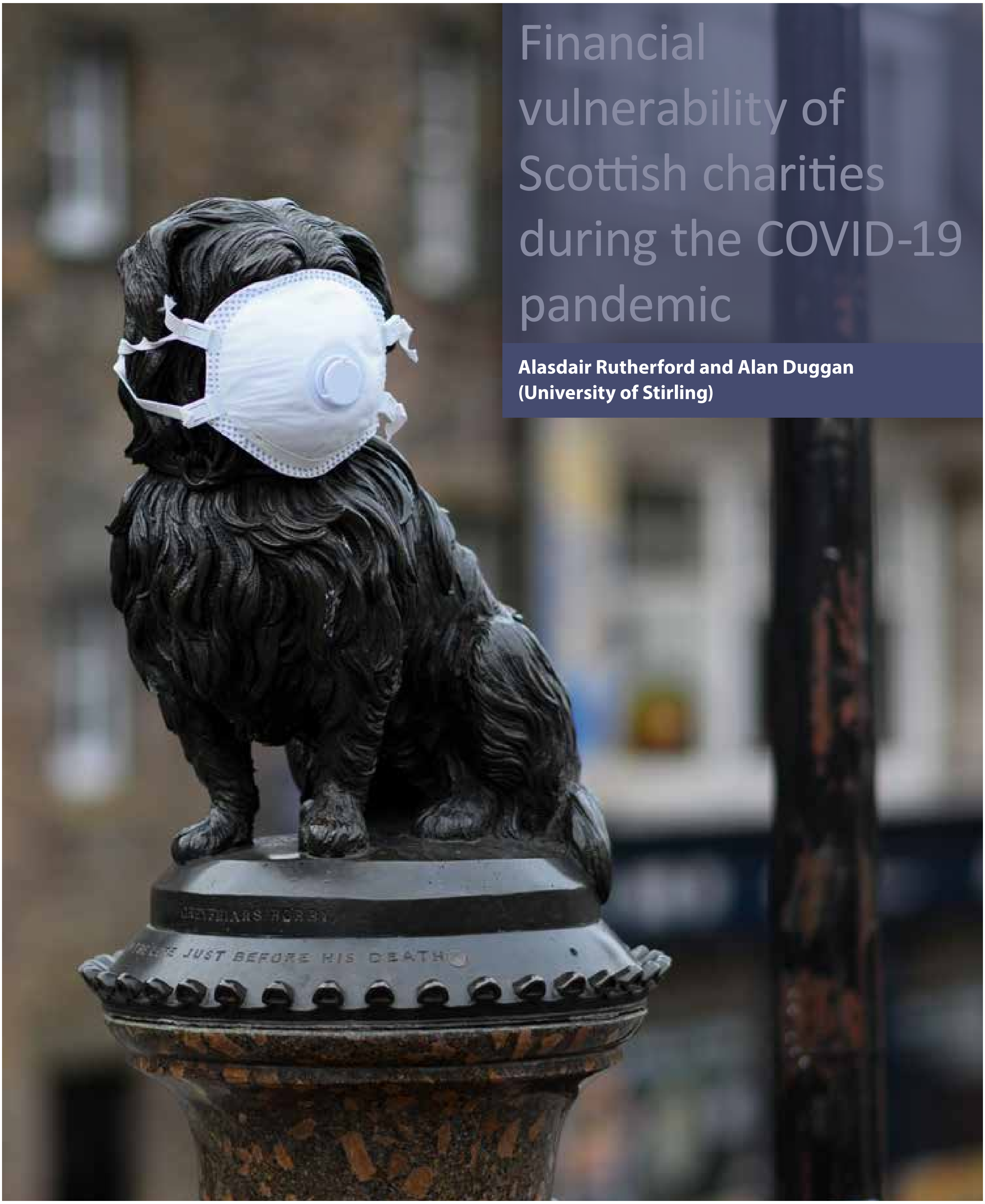

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Introduction

Charities in Scotland have been on the front line of supporting communities and individuals during the Covid-19 crisis. Those organisations faced rapidly-increasing demand for support at the same time as their incomes were shrinking dramatically.

The onset of the pandemic in early 2020, and the associated lockdown of economy and society, has led to real concerns about an existential threat to many charitable organisations. Headline figures focused on the enormous losses of income likely to be visited upon major charities, several of whom depended on sales of goods and services. But this visibility was also a source of vulnerability, since activities such as trading through charity shops were not feasible under lockdown restrictions.

Aside from the risks faced by prominent individual organisations, there was a sense from initial surveys of a potential threat to very large numbers of organisations. A survey in early April 2020 from the Directory of Social Change asserted that over half of their 300 respondents would 'go bust within 6 months' without additional financial support and over 70% of organisations anticipated that they would do so by the end of 2020. (Directory of Social Change, evidence to DCMS inquiry).

In this briefing paper we outline findings on Scottish charities drawing from research conducted as part of the ESRC-funded *Assessing financial vulnerability and risk in the UK's charities during and beyond the COVID-19 crisis* project, led by the University of Birmingham in partnership with the universities of Stirling and Southampton. We focus on three topics: levels of charity reserves; income source dependence; and the formation and dissolution of charities. All the analysis is based on data drawn from the Scottish Charity Register provided by the Scottish Charity Regulator (OSCR).

Key findings

- Many charities entered the pandemic with low levels of reserves
- Most charities are depending on one type of income, which can focus risk during a crisis
- Patterns in reserve levels and income concentration are very stable over time, but do vary across organisation size, age and area of work, with significant diversity within the sector
- There have been sharp drops in charity income during the pandemic, with more extreme falls even than during previous recessions
- Despite these risks we have not yet seen a surge in charities being dissolved. Both new formations, and the de-registering of existing charities have remained lower than usual during the pandemic period

Reserves, Risk and Resilience

Overview

The level of reserves that charities hold is an important aspect of their resilience. Reserves provide 'financial flexibility' to charities affected by a shock to their charitable income. Measuring the level of reserves helps capture how well charities are able to sustain expenditure and activity in the face of a sudden loss of income. Charities with low levels of reserves may be thought of as 'financially vulnerable' to the extent that they are more likely to resort to immediate reductions in service delivery when they experience a financial shock.

In contrast charities with higher levels of reserves are more resilient; they can smooth out imbalances between income and expenditure, and thereby maintain existing levels of activity.

> **"Between 25 and 30% of charities had less than three months of expenditure in reserves. Most notably, the bottom 10% of the sector had less than 35 days in reserves at the beginning of the pandemic."**

Charitable reserves relate to the amount of 'unrestricted funds' that are freely available for use in furtherance of the charity's objectives. They therefore exclude 'restricted funds' that can only be used for particular purposes which may have been specified by a donor. They normally exclude endowments held for the benefit of the charity with an aim to provide a longer-term income. They also exclude fixed assets, including property, that cannot be easily sold without affecting the operation of the charities' activities. They may also exclude 'designated funds' set aside for a particular use.

Unfortunately, we lack a direct data source for unrestricted funds in the Scottish charity sector as OSCR stopped collecting this data in 2016. To get around this, we use available reserves data, total funds data, and a sub-sample of unrestricted funds data for 2019/20 collected for use in this analysis. Our main measure of interest is the number of months of expenditure a charity has in reserves.

Findings

Using all three data sources, we demonstrate significant stability in both reserves and total funds over time (see **Figure 1**). This is shown to be the case both within organisations and across the sector.

Based on the available data, it is likely that many charities had low reserve levels at the onset of the pandemic. Between 25 and 30% of charities had less than three months of expenditure in reserves. Most notably, the bottom 10% of the sector had less than 35 days in reserves at the beginning of the pandemic.

Using data from the last year in which OSCR collected unrestricted funds data, we also show that older charities have higher average levels of reserves (see **Figure 2**). The longer organisations have been in existence, the more likely they are to have built up significant reserves.

Figure 3 also shows notable variation between different fields of activity. For example, charities operating in the research, religion, or grantmaking fields tend to have larger levels of reserves. Effects for age and field of activity are also significant predictors of reserve levels when we control for other covariates using multivariate regression.

Overall, this analysis demonstrates relative stability in reserves levels over time while also showing that many charities could have been considered to be financially vulnerable based on their reserves levels at the start of the pandemic. Additionally, we show that age and field of activity are important predictors for unrestricted funds in the Scottish charitable sector.

Figure 1. Reserves and Total Funds by Year

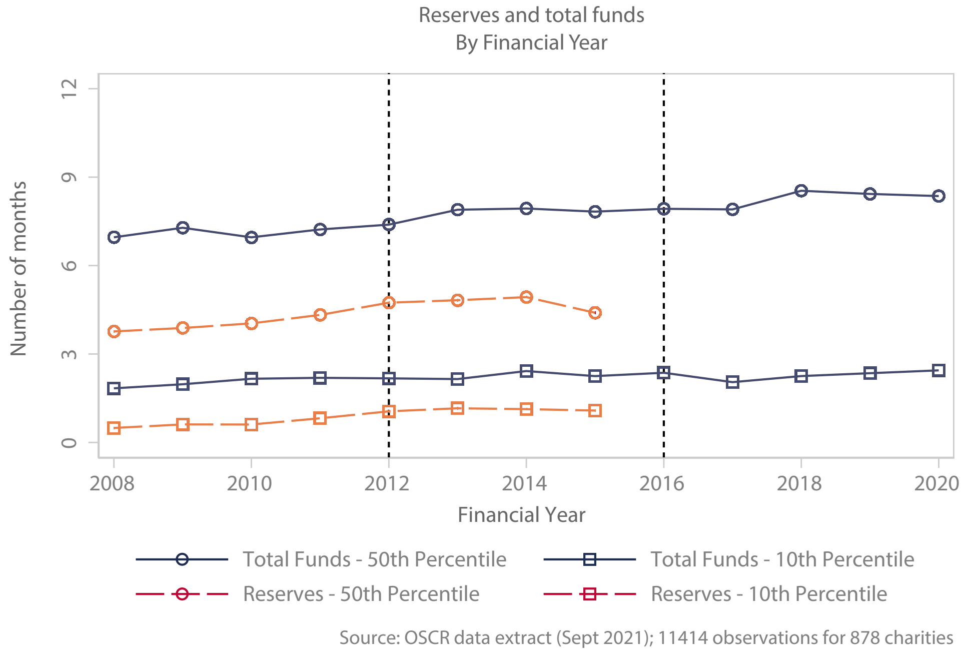
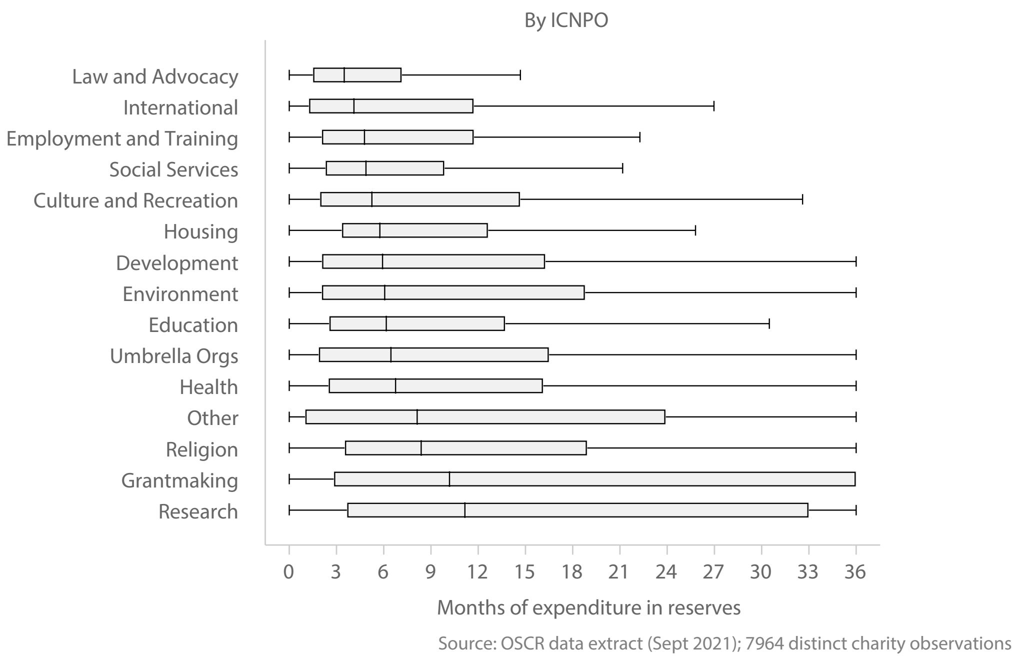


Figure 2. Months of Reserves by Charity Age

Figure 3. Months of Reserves by Area of Work



Income dependence, diversification and resilience

Overview

The logic of revenue diversification is simple and compelling: it hedges against uncertainty and provides flexibility in response to unstable environmental conditions (Hung and Hager, 2019). Charities with diverse income profiles are more resilient, and able to smooth out temporary imbalances between different income streams. However, diversification is not without cost (e.g., administrative, mission drift, exposure to unstable income streams).

> **“This level of income dependence may present a significant threat to charities dependent on income streams that were affected by the Covid-19 pandemic.”**

In the context of the Covid-19 pandemic, charities with a reliance on certain income streams may have been particularly affected given the impact of restrictions on trading or fundraising, and the effect of the economic downturn on household incomes. But which organisations are most affected? This will depend on the extent to which they are most reliant on particular sources of income. An organisation that draws almost all its income from outdoor fundraising events might be contrasted with one whose revenues come principally from endowments.

We analyse financial accounts submitted to the Office for the Scottish Charity Regulator (OSCR) covering 2,538 charities. This sample covers the financial years 2019, 2020, and 2021. These organisations have an annual income of at least £250,000, and they report a breakdown of charitable income, a breakdown of charitable expenditure, and information on assets and liabilities.

We measure income diversification in two ways. First, we define a binary variable that indicates if a charity has a ‘dominant’ stream (i.e. if they derive 90% or more of their income from one stream). Second, we use the Herfindahl-Hirschman index to create a measure of diversification bounded between 0 and 10,000 with larger values indicating less income diversification and greater income dependence.

Findings

We find that 51 per cent of charities have a dominant income stream (i.e. they derive 90% or more of their income from a single source). This finding is supported when we look at the HHI diversification score with around 40% of organisations almost entirely dependent on one stream for all of their annual income (see **Figure 4**).

This level of income dependence may present a significant threat to charities dependent on income streams that were affected by the Covid-19 pandemic.

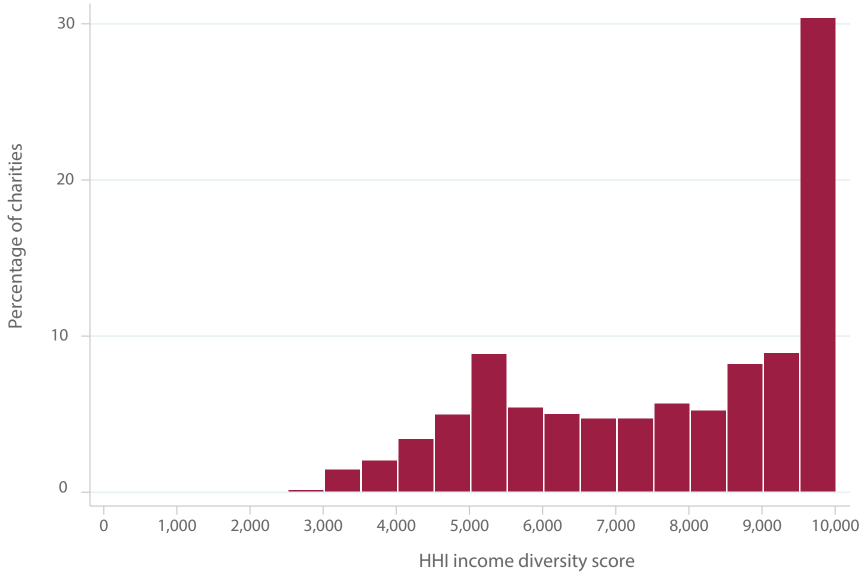
Field of activity, organisation age, and largest income stream are important predictors of income dependence and diversification. **Figure 5** shows that over three-fifths of charities that are involved in law and advocacy work, housing, umbrella organisations, those classified as other, and those operating as grant-making foundations have a dominant income stream. In contrast, charities involved in culture and recreation, environment, and religion are least likely to have a dominant income stream.

Figure 6 shows that older organisations tend to have more diversified income portfolios than younger charities. This may suggest that organisations diversify their funding base the longer they have been established. Effects for age, field of activity, and largest income stream are also significant predictors when we control for other covariates using multivariate regression.

> **“Proposals that organisations need to become more entrepreneurial and diversify their funding sources may be neither helpful nor realistic in the absence of new or different sources of income.”**

There is a high level of stability in the degree of income dependence and diversification over time. This is the case if we look at time trends across the sector (using a repeated cross-sectional approach) or we look at a balanced panel (i.e. looking at same charities over time). The trends observed when looking at the same charities over time suggest significant stability with high levels of income dependence and concentration. This gives us some indication of whether individual charities become more or less dependent on a single income stream, or pursue diversification as a strategy over time. Proposals that organisations need to become more entrepreneurial and diversify their funding sources may be neither helpful nor realistic in the absence of new or different sources of income.

Figure 4. Distribution of Income Concentration



Source: OSCR data extract (Sept 2021); 2538 distinct charity observations

Figure 5. Distribution of Income Concentration

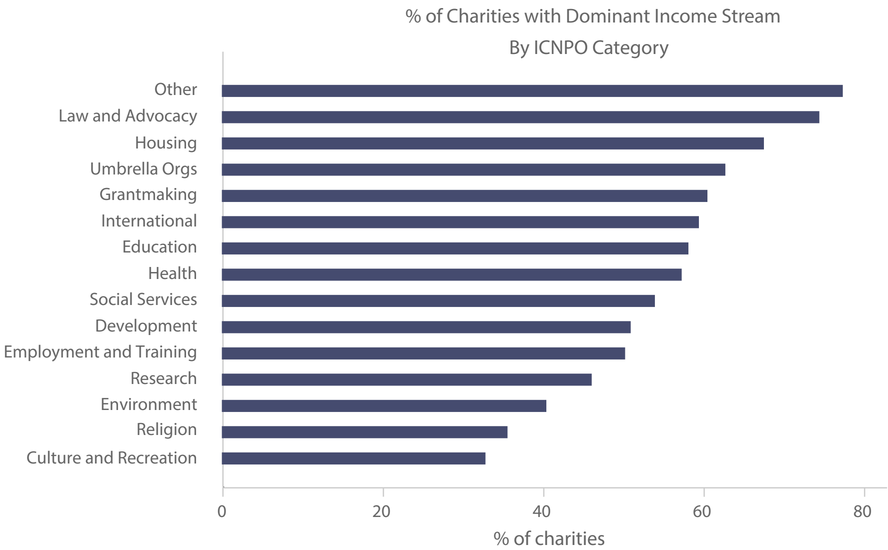
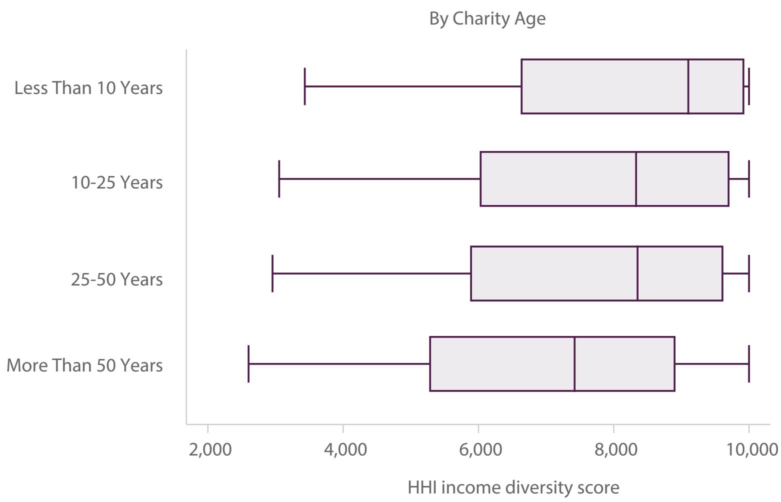


Figure 6. Income Concentration by Charity Age



Source: OSCR data extract (Sept 2021); 2407 distinct charity observations

Financial Vulnerability, Registration and Dissolution of Scottish Charities

Overview

The onset of the COVID-19 pandemic in early 2020, and the associated lockdown of economy and society, prompted concern about an existential threat to charities. Surveys suggest expected large impacts on income, as well as increasing demand for services, leading to estimates such as "half of charities going bust within six months." We present emerging findings showing evidence of steep drops in charity income during the pandemic greater than the loss of income during the great recession in 2008 to 2010. However, we also show much lower levels of charity dissolution during the pandemic.

The main phenomenon of interest is the impact the COVID-19 pandemic had upon formation and dissolution rates of charitable organisations. Here we define 'formation' as the registration of a charity with OSCR; and 'dissolution' as the de-registration of a charity with OSCR. Dissolution is a general term for the wide variety of ways in which a charity can cease to exist (e.g., it can merge with another organisation, revoke its charity status but continue operating, change legal form, become insolvent and wind up). We also show the distribution of income growth and decline over time, by showing the percentage change in income for charities across the distribution.

Findings

The formation rate – the number of new charities registered in a given year divided by the number of charities that filed a non-zero annual return in the previous year - has remained steady at c. 4% per annum, including for 2020. In a given year 901 new charities would be expected to be formed in Scotland (based on the 2015-2019 averages).

Figure 7 shows the monthly number of Scottish charities added to the register as points in the scatterplot. There is a clear seasonal pattern in the number of formations, with these highest during October/November, and lowest in February/March/August. There does not appear to be an immediate post-March 2020 decrease in formations. The blue line shows the predicted level of formations before COVID-19. The dashed blue line shows the forecast of this prediction beyond March 2020, assuming that the pre-pandemic patterns had continued. The red line shows the ITSA model, which estimates changes in the level of and trend in formations as a result of the pandemic. Scotland shows a small drop in new charities, with registrations historically low but relatively level through the COVID lockdown.

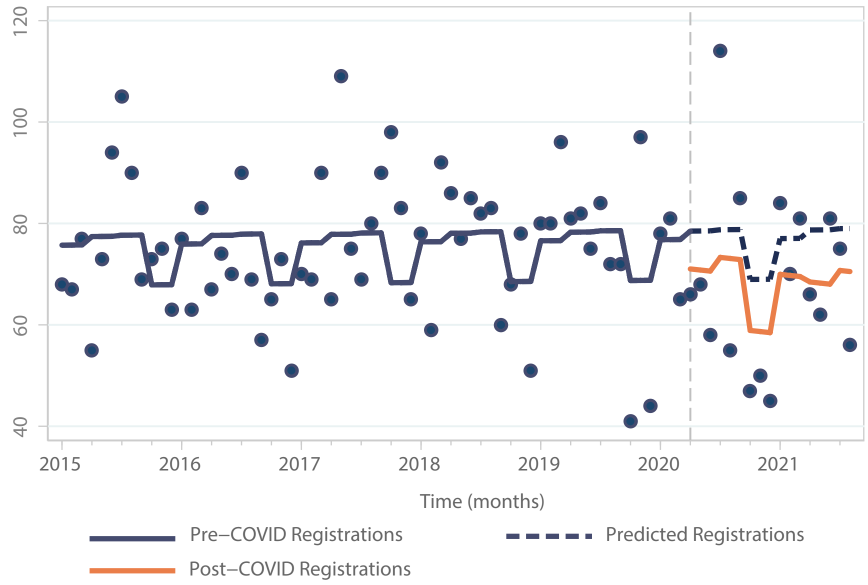
The dissolution rate – the number of charities de-registered in a given year divided by the number of charities that filed a non-zero annual return in the previous year – shows some minor fluctuations around the average of c. 3%, in particular for 2019 and 2021. In a given year about 690 charities would be expected to dissolve in Scotland (based on 2015-2019 averages).

"Scotland shows a decline in the level of dissolutions in the immediate post-pandemic period but it appears that dissolutions are returning to typical levels"

Figure 8 shows the monthly trends in dissolutions since 2015. There is a clear seasonal pattern in the number of dissolutions, with these highest during January/February, and lowest in May/August/September. The blue line shows the predicted level of dissolutions before COVID-19. The dashed blue line shows the forecast of this prediction beyond March 2020, assuming that the pre-pandemic patterns had continued. The red line shows the ITSA model, which estimates changes in the level of and trend in dissolutions as a result of the pandemic. Scotland shows a decline in the level of dissolutions in the immediate post-pandemic period but it appears that dissolutions are returning to typical levels (though perhaps without months where dissolutions are particularly high).

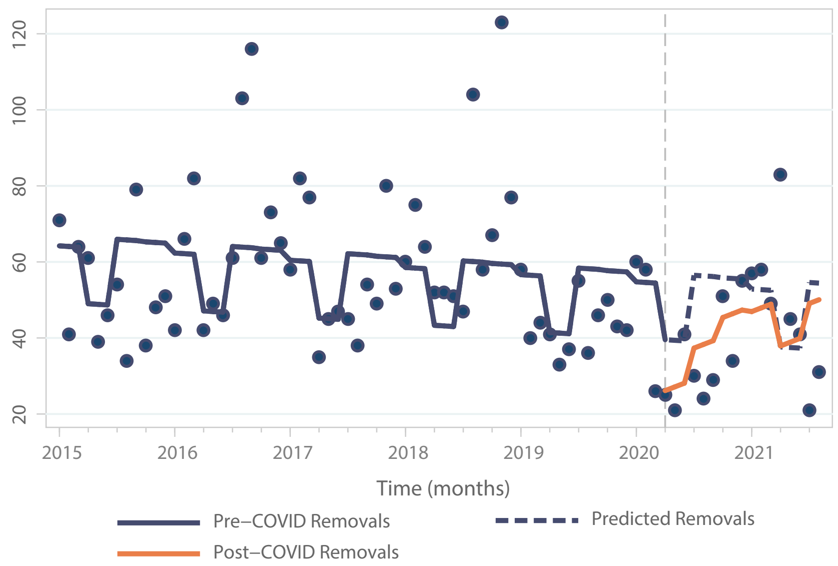
Figure 9 shows the income growth and decline for charities across the distribution. The central lines, with points marked by squares, shows the growth rate of the median charity. Over time these charities in the middle tend to stay around the same size, but in 2020 they saw real terms decline in income comparable to the decline observed in 2010. The lower lines, marked with circles, shows the 25 percentile. That is, 25% of charities declined in income at this level or worse. This shows a loss in income of around 35%, larger even than that observed in 2010. The top line, marked with diamonds, shows the 75th centile, or the charities with some of the highest growth. These charities did all grow their income by around 18% during the pandemic, but this is lower than the longer term average for the largest charity growth.

Figure 7. Number of Charity Registrations by Month



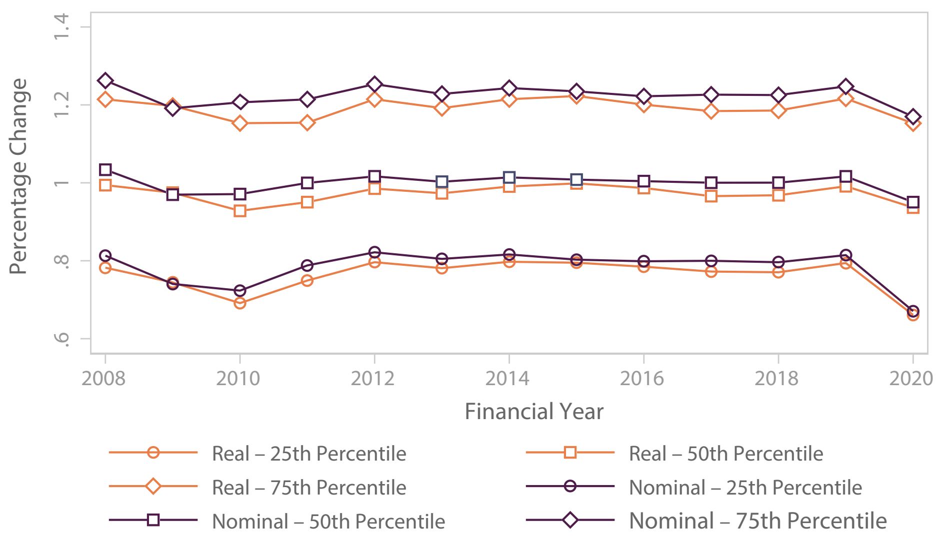
Data from the Scottish Charity Regulator | September 2021

Figure 8. : Number of Charity Dissolutions by Month



Data from the Scottish Charity Regulator | September 2021

Figure 9.Charity Income Growth and Decline by Year



Source: OSCR data extract (September 2021); 279183 observations for 31470 charities

Conclusions

In considering these patterns data, we are faced with two questions. What does this tell us about the state of the Scottish charitable sector during COVID? And what does it lead us to expect to happen to the sector as we come out of the pandemic period?

Our analysis shows that many charities maintain a low level of reserves, while most have dependence on particular types of income. These factors can make weathering a storm challenging. However in a challenging economic climate diversifying, or developing new income sources, is not straightforward. And building up reserves, particularly to replace those used during the crisis, is a challenge for organisations dependent on restricted income. The majority of charities saw a decline in their income in real terms during the pandemic, and the biggest drops were more extreme even than past recessions.

> **"it is possible that policies such as furlough and some emergency COVID grants have allowed charities to continue who might otherwise have ceased due to dwindling reserves or falling income"**

While patterns are very stable over time, we also show significant variation between organisations. Younger organisations tend to be more dependent on one type of income. Young organisations, and those in fields such as law & advocacy, international work, employment & training and social services have the lowest levels of reserves.

Despite this picture of income drops and financial risk, we have not yet seen a significant increase in charity dissolutions. On the contrary, both registrations and dissolutions are significantly down, and only now starting to return to normal. This seems counter-intuitive given the observable implications of the pandemic response (e.g., shutting of charity shops, cessation of much volunteering activity) and the wider concern about the health of the sector throughout 2020. But it is possible that policies such as furlough and some emergency COVID grants have allowed charities to continue who might otherwise have ceased due to dwindling reserves or falling income, even in normal times. This might hint at a situation where significant numbers of voluntary organisations are in stasis: currently not operating and perhaps no longer intending to, but yet to notify the charity regulator. This would imply a coming surge in charity dissolutions on the horizon.

In considering what might lie in wait for the UK charitable sector, this is the key unknown. While we would expect charity formations to begin to return to normal as pandemic restrictions are eased we do not anticipate a surge in formations that would make up for lost ground. However, we would expect that there will be a peak in stored-up dissolutions whose administration has simply been delayed by the pandemic given the steep drops in income observed. A significant number of these will simply be organisations that we might have expected to cease even in normal times. The open question is how many charities ceased to exist because of the pandemic, with this effect yet to be seen in the data.

About this project

Our research is being funded by the Economic and Social Research Council as part of the UK Research and Innovation call for studies that can contribute to understanding and alleviating the social impact of the pandemic. The project is providing analyses of the variegated impacts on charities of the very severe financial constraints they will experience due to the immediate and longer-term economic effects of the COVID-19 crisis. Building on our extensive prior research on the finances, distribution and exposure to risk of charities we are utilising large-scale databases constructed since 2008 to assess the distribution of financial vulnerability across the population of charities.

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