

Financial relationships with third sector organisations

A decision support tool for public bodies in England

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ATTENTION! – Press Cntrl↑* or the ¶ button on your toolbar to see where the section breaks are. If you delete one, you will lose your headers, footers, front cover and page numbering.

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Introduction

What are TSOs?

The third sector is the term used to describe the range of organisations which are neither state nor the private sector. It includes voluntary and community organisations (both registered charities and other organisations such as associations, self-help groups and community groups), social enterprises, mutuals and co-operatives.

Third sector organisations (TSOs):

- are independent of government;
- are ‘value-driven’ – that is, they pursue social, environmental or cultural objectives rather than primarily aiming to make a profit;
- reinvest any surpluses in the pursuit of their objectives

TSOs can take a number of forms, such as charitable voluntary and community organisations, social enterprises, etc [[see Annex A: Note on legal forms of TSOs and charitable status](#)].

What is this decision support tool (DST) for?

What is it for?

Financial relationships between TSOs and government bodies are not as good as they should be. The government’s financial *principles* in this area are sound. But the gap between these principles and the *practical* task of designing and operating a funding model that is good for a particular set of circumstances is too large. Often working to tight time scales, officials in government bodies may rely on their organisation’s customs and practices. But these vary widely across government bodies, and for no compelling reason. As a result, public money is being wasted on funding arrangements that are not fit for purpose.

For several years, Government has been committed to an approach to financial relationships with TSOs which takes account of their special characteristics. This approach was first set out in 1998, when the Compact on relations between government and the voluntary and community sector was published. This has since been developed and revised, particularly in the Compact Code on Funding and Procurement¹ which was reissued in March 2005.

We recognise that there are many complex, interdependent issues to take into account. This decision support tool (DST) provides practical support for ‘real-life’ decisions about the

¹ References to the Compact and the Code are provided at the end of this DST.

design of appropriate funding models. It will help you ensure your programme is effective, economical and efficient.

Who is it for?

This DST is for officials in central government departments, non-departmental public bodies and agencies in England. You should use it if you have to make, or advise on, decisions relating to the delivery of programmes which involve financial relationships between government bodies and a TSO. We expect that it will be of use both to senior officials such as the Senior Responsible Owner (SRO)² of a project or programme, and to staff responsible for programme implementation.

Although the DST has been designed for officials in central government bodies in England, it may also be useful to those in other parts of the UK, in local government and in other public bodies such as Primary Care Trusts.

We hope that TSOs may also wish to use it to seek clarification from public funding bodies.

When should you use it?

You should use this DST *before* making the decision on which funding channel (grant, grant-in-aid or procurement) to use and *before* starting the process of grant making or procurement.

How has it been developed?

The DST has been developed by the National Audit Office working in partnership with the Office for Public Management (OPM), an independent not-for-profit company. Its content has been reviewed by an expert advisory panel including representatives from government and the third sector. Potential users have 'road-tested' the DST in practical workshops and the findings from these tests have been incorporated into the final version.

Disclaimer

This DST is designed to offer general support to officials in government bodies. It does not replace those bodies' own financial guidance or relevant guidance produced by central departments, notably HM Treasury, the Office of Government Commerce and the Treasury Solicitor.

Legal issues are only covered in general terms. This DST is not intended as a substitute for legal advice, which should be sought by a funder in any area of doubt, on a case-by-case basis.

² The Office of Government Commerce can provide guidance on the role and responsibilities of the SRO, available on the OGC website at www.ogc.gov.uk/sdtoolkit/seniormanagement/srorole/.

How to use this decision support tool (DST)

This DST takes you through:

- a number of **principles**, which apply to the design of any funding model
- a number of issues to be taken into account in **applying** the principles
- a four-stage **design process** (with defined sub-stages).

On the basis of your decisions at one stage, it gives you options for the next stage. Keep a record of your decisions at each stage and sub-stage. By working through all the stages, or through those stages that deal with issues that you are facing, you will be able to build up the key features needed to shape your relationship with funded organisation(s) – we refer to this as the ‘funding model’ – and to achieve your objectives. The DST is not, however, deterministic, since the range of funding circumstances which it aims to cover is very wide.

Links and notes throughout the DST will take you to more detailed information and references to source documents.

General principles

The ‘three Es’

The National Audit Office uses three criteria to assess the value for money of government spending:

- **Economy**: minimising the cost of resources used or required – **spending less**
- **Efficiency**: the relationship between the output from goods or services and the resources to produce them – **spending well**; and
- **Effectiveness**: the relationship between the intended and actual results of public spending – **spending wisely**;

Value for money is defined as the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user’s requirement.

The highest-level controls on public spending are:

- **Regularity**: financial transactions should be in accordance with the legislation authorising them, regulations issued by a body with the power to do so under governing legislation, Parliamentary authority and Treasury authority.
- **Propriety**: the concern with Parliament’s intentions as to the way in which public business should be conducted, including the conventions agreed with Parliament and, in particular, the Committee of Public Accounts.

More detailed definitions of these terms are given in the Glossary.

Applying the general principles

You should interpret these principles flexibly to achieve desired ends through the most sensible means. The important considerations are:

- **Focus on outcomes:** do not focus unduly on the *process* of awarding funds. Your primary concern should be achieving the *outcomes*³ desired
- **Empathy:** if you and the funded organisation understand each other's needs and requirements, this should help to avoid problems and achieve outcomes
- **Simplicity and proportionality:** make the funding process as simple as possible. Controls over payments, information requirements, monitoring and evaluation and external inspection should be in proportion to the level of, and risk to, the funds involved
- **Well-managed risk taking:** you should not be overly *risk averse*. You should *manage* risk: tailor it to achieve the most effective and appropriate *balance* of risk between you and the funded organisation [[see Annex B: Note on risk management](#)].
- **Commonality and co-ordination:** where possible, seek to join up or standardise the elements of your funding model with other appropriate funding models, such as those used by other government funders in allied policy areas or in funding the same organisations
- **Timeliness:** allow time for planning, decision making and action
- **Transparency and accountability:** take funding decisions on a basis that is open to both government and the interested organisations.

To achieve these, make good use of *internal* expertise in good funding and commissioning practice: involve your organisation's legal advisers, finance departments and procurement units. Also involve *external* stakeholders. You can learn a lot from the potential beneficiaries and providers of your programme.⁴ This may raise expectations among external stakeholders. However, these expectations can be managed if the process is fair and outcomes are seen to be paramount in your process of engagement.

A 'level playing-field'

Public bodies should at all times follow public 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

³ 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).

⁴ In any funding or commissioning exercise conducted through procurement, this engagement with organisations must be done outside the procurement process

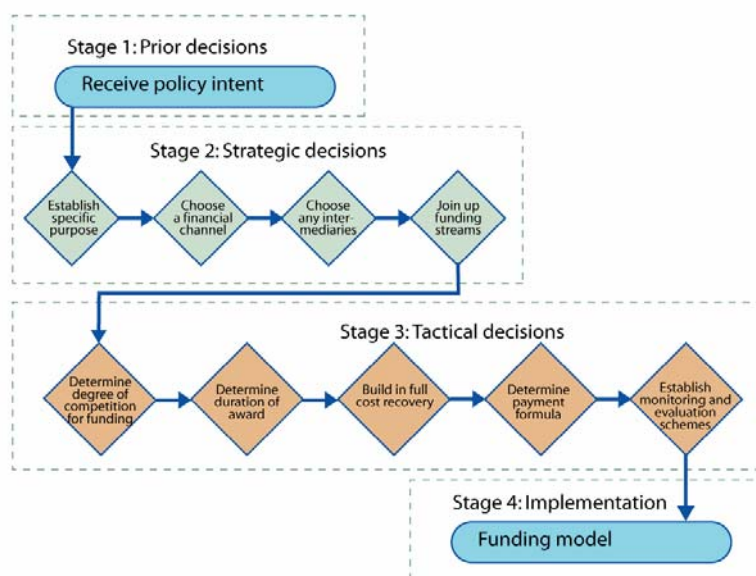
opportunities, how the procurement rules apply, and that there are no barriers to participation.⁵

The design process

The flowchart below gives an overview of the **overall process** of the design of a funding model, broken down into its separate stages (and sub-stages).

The stages are:

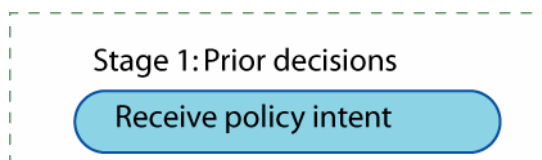
1. **Prior decisions.** These provide the starting point for the process.
2. **Strategic** considerations and decisions.
3. **Tactical** considerations and decisions.
4. **Implementation** issues.



⁵ These issues are discussed further in chapter 22 of Government Accounting and in the Office of Government Commerce's procurement policy web-pages, at <http://www.ogc.gov.uk/index.asp?id=1000084>.

Stage 1

Prior decisions – receive policy intent



Ministers formulate the government's policy intent. The first expression of a policy intent can take a number of forms, such as:

- an output of a government spending review
- a white paper
- a statutory instrument
- the results of an internal inquiry or review
- a governmental response to an external inquiry or review
- a decision by a departmental minister
- a decision by a cabinet committee.

This DST is concerned with *financial* relationships. So a policy intent that is relevant to this DST will take the following broad form: '*There will be a programme of government expenditure of £X to achieve government objective Y*'.

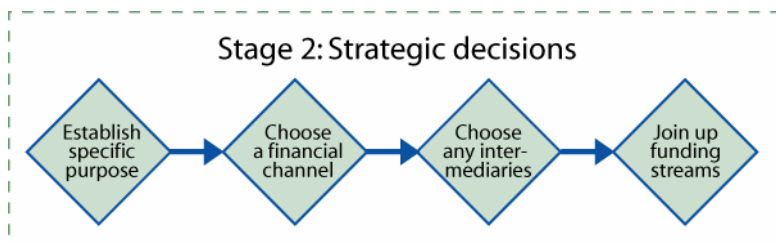
You need to know what the policy intent is. You may wish to *clarify* the policy intent.⁶ But you must not *make or change* policy intent; only ministers may do that.

The DST does not apply only to *new* government programmes. You can also use it to review and improve the design of the financial models for *existing* programmes.

⁶ see also Stage 2(a): Establish specific purpose

Stage 2

Strategic decisions



The second stage involves making some strategic decisions about the approach to funding. You should work through the considerations and decisions that need to be made at each sub-stage to achieve the policy intent.

2a): Establish specific purpose

Legal basis

Check that your programme has both the following two forms of approval from Parliament:

- **Vires.** This is power in legislation for the government body to carry out the activity envisaged in the policy intent of the programme. If you are unsure whether vires exist in a particular case, you must consult your organisation's legal adviser
- **Appropriation**⁷. This is Parliament's allocation of money to the programme. If you are unsure whether appropriation (or Treasury approval to spend) exists in a particular case, you must consult your organisation's finance department.

As well as Parliamentary approval, provision will need to be made for your programme in your organisation's internal budgeting; you should consult your finance department for advice on this.

EU restrictions on state aid⁸

Check your programme would not be a state aid. EU law on state aid aims to prevent member states from unfairly distorting competition within the EU, except in certain

⁷ See Section 2 of Government Accounting (www.government-accounting.gov.uk) for more information.

⁸ For more information see [Annex C: Note on state aid](#)

permitted circumstances. A state aid exists if all of the following four criteria apply to the proposed programme:

- It is granted by the state or through state resources
- It favours certain undertakings or the production of certain goods
- It distorts or threatens to distort competition
- It has the potential to affect trade within the EU.

You should take a sensible approach, based on risk assessment, to the application of state aid rules. If you are concerned that your proposed programme might meet the four criteria above, consult the EU or state aid advisers in your organisation.

Establish objectives for your programme

The more clarity you can achieve at this stage, the more straightforward later decisions will be, and the more successful implementation of the programme is likely to be.

In establishing objectives for your programme, you should consider six factors:

- **Form:** ensure the objectives are expressed in SMART⁹ terms.
- **Focus:** ensure the objectives focus on outcomes¹⁰.
- **Scope:** ensure the objectives meet the requirements of economy, efficiency and effectiveness (see 'General principles' in the Introduction to this tool).
- **Integration across government:** most government bodies have a *primary purpose*: for example, health or education or national security. But some objectives of government *as a whole* can only be achieved if different government bodies act together. These are known as 'cross-cutting' objectives.¹¹ If your ministers wish your programme to

⁹ Specific, Measurable, Achievable/agreed, Realistic, Time-bound.

¹⁰ Desired outcomes are the desired end result of the programme – what impact it should have. Outcomes should then drive decisions on 'upstream' issues:

- **inputs:** that is, people, money and other resources dedicated to the programme;
- **processes:** including the subject of this DST – the funding process;
- **programme outputs:** for example, the number and type of qualifications in the case of learning outcomes or the number vaccinations in the case of health outcomes.

¹¹ In theory, almost all government objectives are interdependent and so could be classed as cross-cutting. In this DST we use the term pragmatically to mean those that are most interdependent. These objectives arise, in particular, in the social and environmental domains of sustainable development, in which the causes of problems are often interrelated and the solutions are often interdependent. For example, measures to encourage the use of public transport in order to cut traffic congestion may also improve air quality, cut accident rates and reduce social exclusion by

contribute to any cross-cutting objectives as well as to the organisation's primary purpose, specify that contribution in the programme's objectives.

- **Duration of the programme:** what timescale will be needed to achieve the programme's objectives? Reach at least a preliminary view on this at the outset.
- **Reach of the programme:** are there particular groups of clients or other 'niches' that the programme needs to reach to achieve its objectives? If so, you may need to construct your funding model to facilitate the involvement of organisations with relevant expertise.

2b): Choose a funding channel¹²

Which channels can you use?

You must choose one of the following three funding channels for the programme:

- **Procurement:** used to acquire goods, works or services in line with the government's policy of value for money – "the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user's requirement" – normally achieved through competition
- **Grant:** used to fund an activity of a recipient because that activity is in *broad* alignment with the government's objectives. There is a continuum of uses of grant, although grants in general are subject to a more detailed level of control than grant-in-aid. At one end of the continuum, your organisation may wish to give money to a TSO because it wishes to offer financial support for specified aspects of the TSO's expenditure. At the other, your organisation may wish to give a grant to a TSO in return for which the TSO must deliver services as specified by your organisation¹³. *Project grants of this kind, which are given to support the provision of specific services, will need to be treated as a 'restricted fund' in the TSO's accounts; i.e. may only be used for defined purposes.*

providing easier access to employment opportunities. This was an important part of the rationale for the establishment of cross-cutting units in government, such as the Social Exclusion Unit. It is important, however, not to think of TSOs' potential contribution only in relation to social and environmental domains.

¹² For more information on the different channels and weighing up which one to use, see [Annex D: Note on channels. Chapters 9 and 22 of Government Accounting provides further information on the definitions of grant, grant-in-aid and procurement.](#)

¹³ In this situation, the term 'grant' may be used to refer to the funding agreement, but in legal and practical terms the funding agreement will be indistinguishable from a contract drawn up following a procurement process.

- **Grant-in-aid:** a payment by a government department (normally referred to as the “sponsor department”) to finance all or part of the costs of the body in receipt of the grant in aid. Grant in aid is paid where the government has decided, subject to parliamentary controls, that the recipient body should operate at arm's length. The recipient body will have activities which are in close alignment with the government's objectives and its relationship with government will be characterised by a high level of trust, often over the long term. Funding to a TSO given by way of grant-in-aid will form income to the unrestricted funds of the organisation, because it is for the support of the TSO's overall activities, not any specific project. The TSO may be committing to deliver certain outcomes or improved services to qualify for the funding, but with grant-in-aid you are not imposing restrictions on how the funds can be spent.

The decision whether to pay a grant or to provide grant in aid depends primarily on the level of detailed control which a department is required, or wishes, to exercise over the related expenditure. Grant payments are subject to a more detailed level of control than grants in aid¹⁴. In practice, there is some overlap between the three funding channels. The following framework is designed to help you make an appropriate decision.

Procurement or grant/grant-in-aid

The first choice you need to make is between on the one hand procurement and on the other grant or grant-in-aid. Working through the following issues – state of the market and funding mode – will help you to reach a view on this.

State of the market

State of the existing market

There may be an existing market for what you require that is highly competitive, with many potential providers with high levels of capacity. At the other extreme, there could be no real market – perhaps a single organisation with limited capacity, or even no (known) potential provider. Generally, the more competitive the existing market, the more likely it is you should use procurement.

Government's policy for the future state of the market

A highly competitive market gives you a choice of provider; this is likely to lead to greater effectiveness, economy and efficiency in your programme. Competition is also important in the achievement of value for money. In the absence of such a market, you may decide to adopt financial and other policies designed to encourage a broader range of better suppliers to enter the relevant market. This could imply, for example, a grant or grant-in-aid to one or more organisations to develop their capacity and hence begin to build the market ('market making'). However, you would need to be sure this was not a state aid. [see [Establish specific purpose](#)]

¹⁴ Chapter 9 of Government Accounting provides more guidance.

Funding mode

Establish which of the following three 'modes' your programme is in:

- **Service/project financing:** funding a particular service (ongoing) or project (time limited) that will contribute to government objectives. Procurement will most often be appropriate in this mode
- **Development funding:** developing a new organisation, or the capacity of an existing organisation, that will contribute to government objectives. (This may be linked to the notion of market making, discussed above.) This mode would be appropriate for the use of grant or grant-in-aid
- **Strategic funding:** supporting organisations that are of strategic importance in that they facilitate the achievement of more specific government objectives. This mode would be appropriate for the use of grant or grant-in-aid.

The mode should be clear from the objectives for the programme.

Sometimes, you may find that your programme covers more than one mode. For example, you may wish to use:

- Development funding: for instance, to enable organisations to build and equip training facilities to help unemployed people back into work
- Service/project financing: for instance, to pay the same organisations to provide those unemployed people with that training.

In such cases, you need to decide whether you wish to finance the different modes within the one funding model or whether you should be running *separate* programmes for each mode. In doing so, you must take account of proportionality: if you establish two separate programmes, you will impose additional administrative burdens on government and the provider.

It is important to bear in mind that supplying capacity-building funding and procuring services from the same organisation may give rise to conflict with EU state aid rules (see Annex C) and/or procurement rules against discrimination in favour of particular suppliers. You should seek specialist advice.

Grant or grant-in-aid: the role of trust

If you decide that *either* grant *or* grant-in-aid is appropriate for your programme, you must then choose *between* grant and grant-in-aid¹⁵. The main issues are the scale and duration of the funding, and the level of trust between government and the potential provider. In some cases, government bodies have strategic partnerships with a small number of suppliers. For TSOs in this position, there is often a high degree of longstanding trust between government and the TSO. This level of trust could imply the use of grant-in-aid,

¹⁵ See section 9 of Government Accounting (www.government-accounting.gov.uk) for more on the distinction between grant and grant-in-aid.

rather than grant. You would need to be sure this was not a state aid. [see [Establish specific purpose](#)] However, remember that any grant funding involves the government giving funds to a TSO which are entrusted to the trustees or board members of the TSO – it is always a relationship of trust rather than a contract. The difference is simply between entrusting the TSO with funding for a specific project (grant) or towards its overall work (grant-in-aid).

Check the appropriation again

You must check that the money that Parliament has allocated to your programme is in the accounting category that matches the channel you have chosen. [see [Establish specific purpose](#)] For example, if you intend to use the grant channel, the money should be allocated to the grant category. If you are unsure about this, consult your organisation's finance department.

2c): Define contract scale

Large scale contracts can bring benefits through reduced procurement and contract management costs, but they do not always offer the best value for money and may, in the long term, reduce the diversity of the supplier base. You should consider whether the contract should be divided into smaller lots; for example, to ensure that special requirements needed to deliver an effective service to the local community are fully reflected and delivered through the contract. Smaller TSOs that have strong links and experience in working with the community should be able to deliver good cost and quality bids in these instances.¹⁶

Local services are often funded by local public bodies, such as local authorities, NHS bodies and police bodies. These intermediaries between central government and the service-providers can align central government funding to local needs and align different funding streams with each other.

In some cases, where local knowledge and expertise is needed but the programme has regional or national scope, small local TSOs can operate as sub-contractors working with a prime contractor at the regional or national level.

To ensure that good practice principles are applied in this case, you must:

- **Consider** whether there would be advantages in dividing the contract into smaller lots
- **Permit** and encourage sub-contracting where appropriate
- Ensure that you and the prime contractor are **clear about the management fee** that will be charged, what they will do for it and that this is efficient.

¹⁶ The OGC guide 'Aggregation – is bigger always better?' can provide further advice.

- **Agree** with the prime contractor the way that it will behave towards the providers of the programme.

A contract with the prime contractor should be set up to define these issues.

2d): Join up funding streams

Having too many separate funding streams is inefficient. To avoid this, before you establish a new funding stream for your programme, you must check whether your programme's objectives can be met through an **existing programme**, including those provided by other public bodies. This may mean adding your programme's objectives and money to those of an existing programme.

If you are concerned that the objectives of your programme may get 'lost' in the existing programme, consider **ring-fencing** your programme's money within the existing programme. Note that this may reduce the provider's ability to respond flexibly to local needs.

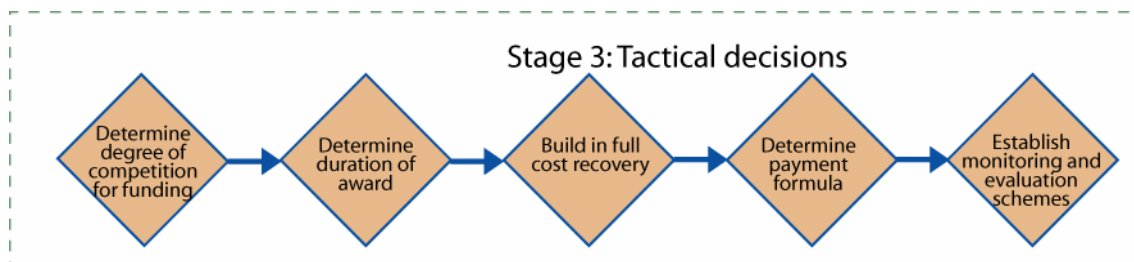
If, having considered joining-up options, you decide to establish a separate financial stream for your programme, you should ensure that your funding model is aligned with other relevant funding streams.¹⁷ For example:

- Different funders and commissioners should rely on **evidence** collected by each other, rather than duplicating monitoring or inspection requirements
- Many **terms and conditions** are not specific to any particular programme and should be broadly consistent across different financial streams.

¹⁷ One of the ambitions of this DST is eventually to be able to offer to government bodies a small number of standard funding models that can be used, with small adjustments, in any situation. Drafts of these models are set out in [Annex E: Examples of funding models](#).

Stage 3

Tactical decisions



In this third stage, you will make a series of detailed tactical decisions about the design of the funding model.

Many of the considerations and decisions in this stage apply equally to all three channels (procurement, grant and grant-in-aid). However, where they apply differently to different channels, this is shown.

3a): Determine the degree of competition for funding

Under procurement¹⁸

Above a certain financial threshold, there must, except in certain specified circumstances, be a **competition** between potential providers¹⁹. Indeed, even for contracts below the threshold values set by public procurement regulations²⁰, some form of advertising or open competition is often regarded as best practice.²¹ This helps achieve value for money. Further rules govern the **extent** of the competition. Procurement should involve **no preferential treatment** for TSOs (or other organisations or types of organisation). You should consult both your organisation's guide to procurement, which will reflect government rules and legal requirements, and Office of Government Commerce guidance. Local

¹⁸ For further information, see your organisation's guide to procurement. This will be based on the Office of Government Commerce's advice on public procurement (www.ogc.gov.uk). The values of the financial thresholds above which there must be a competitive process are given at <http://www.ogc.gov.uk/index.asp?docid=397>. The highest-level guidance on procurement is contained in HM Treasury, Government Accounting, HM Treasury, April 2005.

¹⁹ Even for contracts below the threshold value/s set by public procurement regulation, some form of advertising or open competition is often regarded as best practice. Specialist procurement staff can provide advice.

²⁰ For current thresholds please see <http://www.ogc.gov.uk/index.asp?id=1004560>

²¹ In such cases, the extent of competition should be proportionate to the value of the contract. Specialist procurement staff can provide advice.

government staff should consult 4Ps (The Public Private Partnerships Programme) which acts as the procurement adviser to local government²².

However, in designing a particular procurement exercise, you can take certain action to ensure that TSOs are not disadvantaged:

- Make sure that all potential providers are **aware** of the procurement opportunity and the rules governing the procurement process²³.
- Help the relevant TSOs to **develop the capacity** to compete effectively in the procurement exercise against other types of potential providers. This *must* be done *outside* that particular procurement exercise. It could be achieved through, for example, a separate programme of development funding to relevant organisations or of strategic funding to the relevant umbrella body
- Ensure that the focus of the procurement process is the desired **outcomes**
- Ensure you build any requirement for any relevant **social or environmental benefits** in from the start of the process²⁴
- If a pre-existing or standard contract is used, review the **standard terms and conditions** to ensure that they do not discriminate against TSOs;
- Ensure the procurement process is **proportionate** to the scale of the programme
- Make sure that all involved in the procurement understand that value for money is not the same as the lowest initial price: it is the optimum combination of **whole-life costs** and **quality** to meet the user's requirement
- Ensure, within procurement rules, that any minor terms and conditions in the proposed contract between the government body and the provider that might disadvantage TSOs can be agreed in **post-tender discussion**. All potential bidders must be told in the invitation to tender that this is part of the procurement process. Note that post-tender discussion only permits minor clarifications; negotiations on price or on any substantial aspect of the contract are not permitted.

Under grant or grant-in-aid

If the grant or grant-in-aid channels are used, the funder has more discretion about the degree of competition. However, you must still act fairly. For example:

²² The 4Ps website is at www.4ps.gov.uk.

²³ A new web portal for government contracts worth less than £100,000, www.supply2.gov.uk, will publicise many contract opportunities.

²⁴ Office of Government Commerce, Joint note on social issues in procurement, http://www.ogc.gov.uk/embedded_object.asp?docid=1004638. Office of Government Commerce and Department for Environment, Food and Rural Affairs, Joint note on environmental issues in purchasing, October 2003 http://www.ogc.gov.uk/embedded_object.asp?docid=1004666.

- If there is no competition between potential providers, there must be a good reason for this

Where there is a competition, this must be organised so that all potential providers have fair access.

3b): Determine the duration of the award

The duration of the award is an important issue for both TSOs and government bodies. It is distinct from, but linked to, the duration of programme.

A **short-term award** (one year or less) will be appropriate in certain circumstances. For example, if you enter into an agreement with an organisation to run an engagement exercise in a deprived area within the next few months, a short-term award may be appropriate. This is clearly linked to specific purpose.

A **long-term award** can reduce risk and uncertainty for providers and be more cost-effective for government bodies. In particular, the continuing use of renewable one-year agreements in a multi-year programme can lead to the diversion of valuable resources away from delivering better services. Longer-term financial arrangements are likely to be especially appropriate where finances are to be used either for major capital acquisitions or for long-term services, such as care for adults with learning difficulties. There is no 'Treasury rule' that prevents government bodies from agreeing longer-term financial arrangements, if they represent good value for money, and are necessary to achieve the objectives of your programme.

The Treasury advises that "...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" [FOOTNOTE REFERENCE TO GUIDANCE TO FUNDERS].

3c): Build in full cost recovery

Full cost recovery²⁵

The government recognises that:

- No activity can be undertaken without its provider incurring central **administrative costs**
- A funder or commissioner has an **interest** in meeting its fair share of a provider's central administrative costs because that will help to ensure that the provider can manage its activities and finances properly, and will contribute to the organisation's sustainability.

²⁵ Home Office/Compact Working Group, *Compact Code of Good Practice: Funding and Procurement*, chapter 3

This means that your programme must finance its 'fair share' of all providers' administrative costs. This principle is known as 'full cost recovery'. In addition, if the provider is a charity, you must not expect it to subsidise the cost of your programme from donations that it receives.²⁶

Under procurement

Under procurement, it is up to:

- The potential **provider** to bid at a *price* that it considers to be appropriate, taking account of all its costs
- **You** to accept (or not) that bid. In deciding this, you must consider whether the potential provider's proposed price is sustainable. You cannot give preferential treatment to TSOs. However, as part of good risk management, you must check that any award will provide the degree of continuity of service required by the objectives of the programme.

Under grant

There are two possible scenarios under grant.²⁷ The first is the one in which your organisation wishes to give money to a TSO **to contribute towards the TSO's purpose**. You must check that the proportion of the grant that will go towards administrative costs is reasonable and provides value for money.

The second is the one in which your organisation wishes to give a grant to a TSO **for provision of a service**. You and the provider must agree the full cost of the activities that the provider will carry out on your behalf and the proportion of those that will go towards administrative costs. Transparent costing, rather than pricing, based on a sound methodology, is the best way of ensuring this.²⁸

Under grant-in-aid

Under grant-in-aid, your funding is not restricted to specific activities, so it can be harder to establish the correct amounts of funding needed, including full cost recovery. However, where the funding is intended, for example, to allow the TSO to develop its services in a way that requires taking on additional staff, you and the provider must ensure that the funding will be sufficient to cover at the very least the full costs of those staff and an appropriate share of administrative costs. Transparent *costing*, based on a sound methodology (rather than pricing) is the best way of ensuring this.²⁹

²⁶ Charity Commission ruling (2004) - Applications for Registration of Trafford Community Leisure Trust and Wigan Leisure and Culture Trust

²⁷ These are discussed in sub-stage 2(b): Choose a financial channel

²⁸ HM Treasury, *Guidance to funders*, HM Treasury, 2003

²⁹ HM Treasury, *Guidance to funders*, HM Treasury, 2003

VAT

The VAT treatment of funding agreements with third sector organisations may vary from case to case and will depend upon the individual circumstances. Activities may either be outside the scope of VAT, exempt from VAT or taxable at the standard, reduced or zero rate of VAT. Factors that influence VAT treatment include the type of activities performed and whether any funding is, for VAT purposes, 'a consideration for a supply'. In some cases VAT treatment may also vary according to the nature of the supplier or the recipient of the service. Service providers and funders may be uncertain as to the correct VAT treatment of a particular activity and if so should seek clarification from HM Revenue and Customs. In theory there is also a risk that a misunderstanding about VAT may impact upon funding decisions and mechanisms.

To guard against that, you must:

- **understand** the implications of VAT for your programme, and have agreed these with HM Revenue and Customs where appropriate;
- include the appropriate amount of money to cover any VAT implications in your **projection of expenditure** for the programme
- build relevant irrecoverable VAT costs incurred by the supplier into full cost recovery.

VAT treatment is a complex issue and this DST cannot provide detailed guidance. You should seek guidance from your organisation's own specialists and from HM Revenue and Customs where necessary.

3d): Determine payment formula

Basis of payment

'Basis of payment' can include payment:

- 'Up front' to finance set-up costs
- On the completion of stages of work or the achievement of milestones (steps towards an output or outcome)
- On the achievement of outputs or outcomes
- At fixed intervals
- At the end of the period of the agreement.

Payments can:

- Vary to reflect the cost of each stage, period or achievement in question
- Be spread out over a longer period.

The basis of payment can also include:

- The arrangements for the funder or commissioner to **recover** any underspent grant. (This cannot apply to awards made through the procurement channel).

- Arrangements for the provider to **compensate** the government body – over and above any clawback – for the consequential loss associated with any failure to deliver generally only apply to an award made through procurement. You cannot sue a provider for consequential loss if the award was a grant or grant-in-aid.

Timing of payment to the provider

This can be in:

- **Arrears**: after the provider has incurred the expenditure and after the product, work or service – or an agreed part of it – has been delivered
- **Advance**: before the provider has incurred the expenditure and before the product, work or service – or an agreed part of it – has been delivered. Payment in advance can be made to TSOs where there is a 'clear operational requirement' for this³⁰.

Agreeing basis and timing

A funding model must include the appropriate mix of bases and timings – called the '**payment formula**'. The payment formula must follow from:

- The objectives of the programme
- The agreed approach to risk management.

In addition, the following five criteria must be met:

- You must **agree** the payment formula with the provider
- You must **record** the agreed payment formula in the financial agreement (contract, service level agreement or grant award letter, as appropriate)
- All aspects of the payment formula must meet an identifiable **need** of the programme
- No element of the payment formula may be **novel or contentious** (unless specific approval has been given by the Treasury)
- Each element of the payment formula must be wholly **necessary** (for example, large TSOs with substantial liquid reserves may not need advance payment).

Ensure arrangements for making the payments are clear – for example, if you will need the TSO to invoice you, make clear the dates on which invoices should be raised, and give them a realistic indication of how long it will take from them raising an invoice until they can expect to receive payment.

³⁰ See Government Accounting, section 9.3.1, and the Compact Funding and Procurement Code, paragraph 5.6.

3e): Establish application process

The application process for funding, whether via grant, grant-in-aid or procurement, is an important tool in providing a 'level playing-field' for TSOs. Small TSOs in particular may be deterred by lengthy or excessively complex processes. Bearing in mind the principle of proportionality, you should consider:

- the best means of **making TSOs aware** of the funding opportunity – for example, many government grant funding schemes are now listed on a central website, governmentfunding.org.uk. Lower-value (below £100,000) procurement opportunities are listed on the Supply2gov website www.supply2.gov.uk;
- the **clarity** of information provided about the programme, particularly the **eligibility criteria** for funding;
- the length of **application forms**;
- the amount of **supporting information** (e.g. trustees' reports and financial information) required;
- whether a **'two-stage' application or bidding process** (an initial sift of applicants based on a short, easily completed form, followed by a more detailed request for information from those selected) should be used;
- the scope for **supporting TSOs in making their applications**, for example by providing training seminars or telephone helplines, or by providing funding to support TSOs in developing a bid for funding³¹;
- the process by which applications will be **reviewed or bids evaluated** and the decisions documented;
- how to provide **feedback** or debriefing about the process, particularly to unsuccessful applicants.

3f): Establish monitoring and evaluation scheme

Monitoring

Monitoring is about collecting information and assessing it. Such information may be needed for three purposes:

1. **Management of the programme.** This includes information on:
 - Progress towards the objectives of the programme
 - Use of the programme's finances
 - Your and the provider's management of risks.
2. **Wider accountability** for the programme and its associated spending to your accounting officer, ministers, Parliament and the public. This may involve information that is

³¹ It is important to note that such support in making applications must not lead to any competitive advantage over other suppliers, in a procurement process.

not necessary for the *management* of the programme but is likely to be needed, for example, to answer a Parliamentary question or to meet the requirements of your auditors³². You must strike a sensible balance here. Do not ask providers to give information that would enable you to answer *any foreseeable* question, but do build in a requirement for information that is *likely* to be asked for. (Adding a requirement for information later, particularly on an ad-hoc basis, will add to cost and create frustration.)

3. **Policy development.** It may be sensible to ask your providers to collect and give you information about the policy environment to help you to continue to develop evidence-based policy. Again, you need to strike a balance here between collecting 'everything' and 'nothing'.

Evaluation

Evaluation is the assessment of the extent to which the programme has met its objectives. This will help you and others improve the design and operation of the programme and design new programmes.

There are two sorts of evaluation:

- **Summative** evaluation makes the assessment after the programme has been in operation for some time or is completed; the length of time can be derived from the timescale element of the objectives of the programme
- **Formative** evaluation assesses the programme as it is being put in place and during its early operation.

You must:

- Design the evaluation scheme for your programme at its **outset**; otherwise you will find it hard to establish the effect it has had;
- **Embed** the evaluation scheme into your agreement/s with providers;
- **Integrate**, as far as possible, the demand for, and the collection of, information under the *evaluation* scheme with those that arise from *monitoring* requirements.

Proportionality and risk management

Follow good practice around proportionality and risk management in both monitoring and evaluation. Seek to minimise the burden on providers, while maintaining proper control of use of public money. However, do not lead a provider to believe that it will never be monitored.

Proportionality may involve:

³² HM Treasury's 'Guidance to Funders' provides further detail on the needs of auditors.

- **Relying on the provider's systems:** make use of the provider's own monitoring and evaluation procedures, rather than imposing extra ones
- **Relying on other government bodies' systems:** if the provider receives public money from another government body, you may be able to use monitoring and evaluation systems that are already in place
- **Your own contact and visits:** include direct contact and visits, as well as the provider's written reports.

Understand the **cost** of the monitoring and evaluation schemes that you agree with providers. Under full cost recovery, you should finance the provider for the portion of these costs that fall to it. [see [Build in full cost recovery](#)]

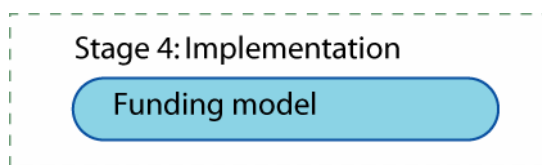
Fraud and counter-fraud

Funding relationships with any outside organisation are potentially open to abuse by fraudsters. You should consider the potential impact of fraud on your funding programme and address the following aspects as necessary:

- **information** should be provided to applicants on the organisation's policy on fraudulent claims, for example by specific references in grant application information;
- where **intermediaries** exist, their briefing and contracts need to contain appropriate provisions for dealing with fraud so that all parties are aware of their roles and responsibilities for the prevention, detection and reporting of fraud;
- **grant schemes** should be specifically fraud-proofed, particularly against the risks of multiple applications either to one organisation or to a number of different funders;
- **counter-fraud** measures should not only cover the higher risk grants but should also ensure that all grants have a chance of detailed review, although the extent of coverage of lower risk grants should be less;
- where **third parties** are involved in the award or payment of grants, organisations should overtly assess the third party's counter-fraud measures.

Your organisation's internal audit team and other functions such as a fraud investigation team have a key role in providing advice on counter-fraud measures.

Stage 4: Implementation



You have now designed the key features of a funding model that is appropriate to your programme. The implementation of funding models is outside the scope of this DST. Your next steps to implement the model will depend on the features of the model, in particular the selected channel. For example, you may need to initiate a competitive grant process or to undertake a procurement process.

However, the good intentions embodied in a well-designed financial model can be undermined if it is badly implemented. We therefore offer a small number of **guidelines on implementation**.

If you will not be implementing the financial model yourself, you need to ensure that the person or body who will be doing so **understands** its 'letter and spirit' and acts accordingly. Involve them in the design stages so they are familiar with the reasons why you have designed the financial model the way you have. This will help them to implement it in line with your intentions.

This may be particularly important if you are going to implement the financial model through an **intermediary**. In practice, however, if a policy maker chooses not to use an *external* intermediary, the policy maker may still allocate responsibility for implementation to an '*internal* intermediary' in his or her own organisation; this may be the 'central procurement unit' or 'grants team' or similar. You need to engage an internal intermediary in the same way as an external intermediary.

Examples

In annex E, we offer a small number of illustrative case studies linked to possible funding models. At present, they are examples only. However, we hope that, over time it will be possible for government to develop them into a small number of generic funding models that can be used across government. This would reduce considerably the current cost to government of administering many different funding models.

Annexes

Annex A: Note on legal forms of TSOs and charitable status

What is meant by the term ‘third sector organisation’ (TSO)?

Organisations are traditionally divided on the basis of ‘private’ or ‘public’, and ‘for-profit’ or ‘not-for-profit’. Organisations which are established on a not-for-profit basis, and which are not directly controlled by the state (not part of the public sector) are widely referred to as *third sector organisations* (TSOs).

This definition includes not just the voluntary and community sector, but also trade unions, not-for-profit trade associations, political organisations, most co-operatives and social enterprises (provided profits are retained for the benefit of the members or community served), private clubs, most sports organisations, places of worship, grant-making trusts, etc.

The Treasury’s 2004 report ‘Exploring the role of the third sector in public service delivery and reform’ defines the sector as made up of organisations that:

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

TSOs include a range of organisations: small local community and voluntary groups, registered charities both large and small, foundations, trusts and the growing number of social enterprises and co-operatives. These categories are not necessarily distinct: some charities undertake income generating activities which leads them to regard themselves as social enterprises, but for the purposes of this DST, social enterprises will be defined as organisations which trade with a social objective, but not having charitable status.

Accordingly this annex focuses on two main types of TSOs which might be considered for the delivery of public services:

- VCOs with charitable status with a focus on service-delivery
- Non-charitable TSOs operating as social enterprises.

The structures and legal basis of these categories are considered further below.

What is a charity?

A very wide range of organisations can be recognised as charities. Charity law in the UK has long recognised an organisation to be a charity if it (a) has exclusively charitable objects and (b) exists for public benefit.

The objects will be stated in the governing document of the organisation. The issue of public benefit is more complex, but to be charitable an organisation must benefit a wide

cross-section of the public, not a small limited membership, and those controlling the organisation (the trustees) must normally be voluntary, so that all the resources are applied to support the beneficiaries.

These concepts ultimately date back to the *Statute of Charitable Uses* of 1601 (Elizabeth I) as interpreted by case law over the years – especially the famous 1891 case of *Commissioners of Inland Revenue v Pemsel* in which it was decided that a charity must have objects falling exclusively within four heads:

- the relief of financial hardship;
- the advancement of education;
- the advancement of religion;
- certain other purposes for the benefit of the community.

It is expected that a 2006 Charities Act will update these definitions by extending the original four heads of charity to 13 heads and by adding greater clarity to the definition of public benefit. However, the two tests of charitable objects and public benefit remain the criteria.

It is important to note that an organisation whose objects are charitable and which is established for public benefit *is* a charity and would be recognised as such by the Courts and would be entitled to charitable tax concessions: registration with the Charity Commission is simply a means of confirming that an organisation is a charity.

Nevertheless charity registration is not an optional status: under s3 of the Charities Act 1993 all charities in England & Wales *must* apply for charity registration, unless the income is below £1000 (or £5000 once the Charities Act 2006 takes effect) or unless it falls into one of the categories excepted or exempted from the registration requirements such as places of worship, armed forces charities, or charities constituted as industrial & provident societies. (However, implementation of the Charities Act 2006 will gradually phase out most categories of excepted and exempted charities.)

What funds can charities receive?

The defining feature of all charities is that funds are held *on trust* to advance the specific charitable objects defined in a governing document. In many cases the objects refer to a specific class of beneficiaries (e.g. elderly people living in a particular locality) and the trustees would be committing a breach of trust if they allowed charitable funds to be applied for purposes outside the objects or for the benefit of individuals who fall outside the specified class of beneficiaries.

It follows that charities can only accept funds for the delivery of public services if the nature of the service *and* the specified beneficiaries fall within the objects of the charity concerned.

However, a charity can accept grants or donations given for a specific project or activity provided it falls within the objects: in law this constitutes a 'special trust' and must be accounted for as a *restricted fund* of the charity.

Also, there is no general prohibition on trading by charities, and hence a charity is also free to enter into contracts for delivery of services³³, including contracts with government, provided the trustees are satisfied that it is in the interests of the charity and its beneficiaries to do so. This is called *primary purpose trading* and does not create any liability to corporation tax provided any profits are applied to the support of the services provided (which will virtually always be the case, since a charity cannot distribute profits).

More complex is the situation where a charity undertakes a trading activity that falls outside its objects. This is generally permissible where the aim is to raise funds to support the charity's objects, although some charities have limits on this in their governing documents and in any case there are strict tax limits on such *trading for non-charitable purposes* and in some cases corporation tax would be payable. (This tax liability can be averted by arranging for the trade to be undertaken by a non-charitable trading subsidiary company controlled by the charity – but in that case the service is not delivered by the charity itself: for more on this see below under social enterprises.) So, trading for non-charitable purposes by the charity itself is normally limited to small scale fundraising activities: it is not appropriate for a charity to seek to deliver significant public services on this basis.

It follows that public service delivery by charities can be funded either by grants, or by contracts, but in both cases the activity must fall within the charity's objects.

What are the most common legal structures for charities?

There is no single legal structure for a charity: many different types of organisations can be charitable if they meet the tests of charitable objects and public benefit. However, most modern charities use one of three legal forms.

(a) A *charitable trust* is governed by a trust deed, and can be established simply by an initial donor ('the settlor') declaring a trust over some property (usually a sum of money) and appointing initial trustees. The trustees can subsequently raise further funds, provided all funds are applied for the specific charitable objects.

This structure is mainly used by grant-making trusts, but a number of small charities running specific projects use the structure of a trust. There is no wider membership, and usually the trustees appoint their own successors, although sometimes external organisations have the right to appoint trustees.

Charitable trusts do not have a legal personality³⁴ – so, in law, any agreements must be made with the trustees collectively, and there is no issue of limited liability.

(b) A *charitable association* is a group of members who agree to be governed by a set of rules known as the constitution. This structure is used by a very wide range of voluntary organisations. In most associations, the members elect a committee who are empowered

³³ Unless there was a specific prohibition in the governing document for trading of any kind – but a prohibition on primary purpose trading would be very rare

³⁴ It is possible in principle for the Charity Commission to make an order incorporating a body of trustees, thus allowing the charity to hold property in its own name, for example. But this is rarely used, and even when done, it does not confer limited liability

to make decisions on the use of funds, and hence the committee members are the charity trustees.

This is a very flexible structure, suitable for a wide range of small and medium voluntary organisations, including many involved in delivering public services. However, it is again not a corporate form – so agreements must be made with the trustees for the time being – and there is no limited liability.

(c) A *charitable company* is formed by establishing a company under the provisions of the Companies Act 1985, with clear charitable objects in its Memorandum, and limitations to prevent payments to trustees etc. The structure will almost always be a company limited by guarantee (rather than by shares – a company with shares would normally be distributing profits to shareholders). Provided the company meets the tests of charitable status, it can be registered with the Charity Commission: if so, the directors of the company are also the trustees of the charity.

Some charitable companies have a wide membership, where the members elect the directors/trustees: in other cases the only members of the company are the trustees themselves.

This structure is widely used by larger service-providing charities, but it has the major disadvantage of requiring dual regulation by Companies House and by the Charity Commission. However, such charities have the benefit of a corporate legal form, able to enter directly into contracts, and the trustees have the protection of limited liability provided they comply with all the relevant requirements of company law.

(d) A smaller number of organisations use the structure of a charitable industrial and provident society (IPS) – since 2003 such organisations are described as *community benefit societies*. An IPS is an incorporated body with limited liability – and the name normally ends with the word ‘limited’ – but governed by the Industrial and Provident Societies Acts, rather than the Companies Acts. If an IPS has rules with charitable objects it can be recognised as a charity by the Inland Revenue and then falls within the charity tax regime. At present, charitable IPSs are exempt charities – they are not required to register with the Charity Commission – but the forthcoming Charities Act 2006 will remove this exemption.

(e) The Charities Act 2006 will introduce a new legal form: the *charitable incorporated organisation* (CIO). CIOs will be governed entirely by charity law: all CIOs will be registered charities and regulated entirely by the Charity Commission. CIOs will have corporate status and will have the benefits of limited liability. It is likely that once the CIO form becomes available, many existing charities will convert to this form.

What legal forms are used by social enterprises?

A huge range of organisations can potentially be classed as social enterprises and there is no single regulator analogous to the Charity Commission. Some of the main categories of non-charitable social enterprises are as follows.

Because these organisations are not charities, they are free to pay fees or salaries to their directors or committee members.

(a) *Community Interest Companies (CICs)*. CICs are companies incorporated under the Companies Acts, as amended by the Companies (Audit, Investigations and Community Enterprise) Act 2004. CICs are subject to the general framework of company law, and are registered with Companies House, but are also subject to the Regulator of Community Interest Companies. CICs must trade for purposes which are for the benefit of the community, and are subject to restrictions on the distribution of their assets, although a small return to external investors is possible. A CIC cannot be a charity. It has only been possible to register CICs since July 2005, but it is anticipated that many social enterprises will choose to adopt this form in due course.

(b) *Companies limited by guarantee (CLG)*. Companies formed on a not-for-profit basis are usually constituted as companies limited by guarantee: although these are normal companies subject to company law, they do not have shareholders, but instead the members agree to guarantee a nominal sum towards winding-up costs.

(c) *Companies limited by shares but owned by a body with charitable or benevolent objects*. As noted above, it is common for charities to establish subsidiary companies to undertake trading activities which fall outside the charity's objects, but where the aim is to make a profit to support the charity. These technically fall outside the 'not-for-profit' definition, as these entities seek to make a profit for their shareholders, but where the sole shareholder is a charity or another not-for-profit entity (so no profits are distributed to individuals) they are generally seen as belonging to the social enterprise category.

(d) *Non-charitable voluntary associations*. Some groups clearly fall within the broad categories of voluntary or community organisations, but have objects which are not exclusively charitable, or perhaps fall outside the definition of public benefit because of having paid committee members, or because their activities are only open to a closed membership. Such organisations would be governed by a constitution (similar to a charitable association, but without charitable status) and do not therefore have a corporate form or limited liability. Some organisations of this kind may still be appropriate for delivery of public services, particularly at local level: tenants and residents associations often fall within this definition. However, such organisations are not subject to any statutory regulator.

(e) *Co-operatives and other non-charitable industrial and provident societies*. The IPS structure (see above) is also used by a wide range of organisations trading on a co-operative basis, or otherwise offering goods and services on a not-for-profit basis. This includes a number of trading organisations providing therapeutic work, where charitable status has been eschewed in favour of a structure allowing paid workers to serve as board members. The IPS legislation also extends to friendly societies, which are normally financial institutions, although *credit unions* also fall within this category and are generally regarded as TSOs. All these entities are regulated by the FSA.

What funds can social enterprises receive?

Where social enterprises are used to deliver public services, the funding arrangement will normally be a contract for provision of specific services, where both parties accept the obligations of contract law.

It is, however, possible to make grants to social enterprises, typically for start-up costs or purchase of specific fixed assets. In principle, a social enterprise could be grant-funded to deliver particular services, but this would imply a high level of trust in the directors or committee of the entity concerned, because there would be no regulation in terms of charity law to ensure the funds were properly applied: only in the event of a clear breach of trust could action be taken by the courts.

However, unlike charities, social enterprises can frequently accept equity investments, and there could be situations where a public sector body agreed to fund a social enterprise directly through an equity stake – although any such investment would have to fall within government accounting requirements.

Annex B: Note on risk management

Risk is uncertainty of outcome. It can arise in two ways:

- **Threats:** damaging events that can lead to failure to achieve objectives
- **Opportunities:** constructive events that can, if exploited, help with the achievement of objectives but that are also surrounded by threats.

There are two aspects of risk:

- The **probability** that a risk will materialise
- The **impact** that the risk would have on the effectiveness, economy or efficiency of the programme if it did arise.

It is impossible to *eliminate* risk from any financial arrangement. It would, in any case, be undesirable to do so: the desire on your or the provider's part to avoid a risk can create an incentive on you or the provider (respectively) to deliver the programme's objectives.

This correctly implies mutuality. When you allocate the risks in a programme between government and the organisation in receipt of finance, you must not offload as much risk as possible onto the recipient. You must allocate risk in a *balance* that is effective, economical, efficient and *fair*. You must consider:

- The **objectives** of the programme [see [Establish specific purpose](#)]. Some programmes, such as experimental pilot programmes, are inherently more risky than others. All programmes will carry some risk. It would be unfair to deal with this by allocating all the risks to the potential provider. Doing so would also undermine the achievement of the programme's objectives: you would deter some potentially good providers from taking part in the programme
- The extent to which each party has **control of the risk**. You must not expect the provider to bear all the **demand** risk (that is, the risk that the estimated demand for the service does not materialise) if you have much of the control over the demand. At the same time, it is appropriate for the provider of the service to bear the **output** risk: that is, the risk that the provider does not deliver the required outputs, leading to a loss of desired outcomes. But this must be on the basis that these outputs have been fully agreed between the funder and provider.
- The capacity of the potential provider. For example, an organisation with large reserves will be in a better position to manage cash flow than a small organisation with small reserves.

If your programme is large or complex, you should hold a **risk meeting** (or series of meetings) to apportion risks. In a risk meeting, you can share your concerns about the risks in the programme with others and reach a balanced view. It may be appropriate at times for the risk meeting to include colleagues from government and representatives of the third sector. The allocation of risk should also be embodied in the written agreement between funder and provider.

Guidance on risk is available from HM Treasury's 'Orange Book'³⁵, from HM Treasury's 'Guidance to Funders' and from the Office of Government Commerce publication 'Management of Risk: Guidance for Practitioners'.

The risk of fraud in funding programmes is discussed in section 3f) of this tool.

³⁵ HM Treasury, The Orange Book: Management of Risk – principles and concepts, HM Treasury, October 2004.

Annex C: Note on state aid³⁶

EU restrictions on state aid

EU law on state aid derives from the Treaty of Rome and aims to prevent member states from unfairly distorting competition within the EU, except in certain permitted circumstances. Where a state intervention distorts competition, this will usually constitute a state aid. The Treaty expressly prohibits the granting of state aid except in certain circumstances where the European Commission has discretion to approve state aid that does not unacceptably distort the internal market.

A state aid exists if all of the following four criteria apply to the proposed funding:

- It is granted by the state or through **state resources**
- It favours certain undertakings or the production of certain goods
- It distorts or threatens to distort competition
- It has the potential to affect trade within the EU.

These are discussed below.

State resources

The subject of this DST is spending by government. This criterion applies, therefore, to all the funding covered by the DST. However, the use of government spending which constitutes a state aid is allowed in certain circumstances. There are a range of instruments through which approval of a state aid may be achieved. These include existing approved schemes, the 'block exemption regulations', the 'de minimis regulation' and seeking approval for a particular aid or aid scheme directly from the European Commission (see below).

State aid policy evolves over time. So, for each public programme involving the use of government spending, there is a need to test compatibility with current state aid policy.

Favouring an undertaking

An 'undertaking' is an entity that undertakes 'economic activity'. An economic activity is an activity that could be carried out for profit. As such, many TSOs carry out activities that qualify them as 'undertakings'. Whether or not a TSO will be an 'undertaking' will be related solely to the nature of the activities it carries out. Legal form or constitution (such as charitable or not-for-profit status) does not have a bearing on whether or not an entity is an 'undertaking'.

Economic activity is activity for which there is a market in comparable goods or services. It can include voluntary and non-profit-making public or private bodies, such as charities or universities, when they engage in activities that have commercial competitors. It can include activity by the self-employed/sole traders, but generally not employees as long as the aid does not benefit the employers, private individuals or households.

³⁶ www.dti.gov.uk/ccp/stateaid/pdfs/sariskreport04.pdf

So you need to determine whether or not your proposed programme is an economic activity. There is case law to help interpretation here: for example, air traffic control is *not* determined as an economic activity.

To count as favouring an undertaking, the aid must:

- Be available to certain undertakings but not others in the member state. It must select individual businesses, sectors, areas, sizes of business, or production of certain goods. A benefit available to all businesses is not state aid but a general measure;
- favour undertakings by conferring an advantage on them. An advantage may be direct (eg grants) or indirect (eg favourable loan terms or services provided at less than market cost, or relief from charges a business would normally bear).

Distortion of competition

This test will be met, if state resources potentially or actually strengthen the position of the recipient in relation to competitors.

Almost all selective aid will have potential to distort competition – regardless of the scale of potential distortion or market share of the aid recipient.

If a policy objective is to *make* a market, funding plans will have to be assessed on a case-by-case basis. In some cases, moving from a monopoly to a market would suggest a non-economic activity that is intended to become an economic activity. However, market making *in itself* is likely to represent a state aid.

Intra-EU trade

Any programme proposed by a funder should not inhibit trade between members of the EU. This includes potential effects. Most products and services are traded between member states. Aid for almost any selected business or economic activity is capable, therefore, of affecting trade between states, even if the aid recipient itself does not directly trade with member states. The only likely exceptions are single businesses, such as hairdressers or dry cleaners, with a purely local market not close to a member state border. The case law also shows that even very small amounts of aid can affect trade.

Options where a state aid is present

If your programme may constitute state aid, to deal with the problem you can:

- Consider developing or adapting proposals to omit or minimise the element of state aid
- Design or adapt the proposed aid to fit within the terms of one of the state aid schemes which the European Commission has approved for the UK
- Design or adapt the proposed aid to fit one of the existing 'block exemption' regulations
- Seek formal approval for the aid from the Commission. (This may be on the basis of the Commission's various state aid frameworks or guidelines or on the basis of the relevant articles of the Treaty of Rome.)

Block exemption regulations

There are three 'block exemption regulations' that allow certain, limited types of aid to be granted without prior Commission approval provided they comply with the criteria set out in the regulations. The three regulations relate to aid for:

- Investment in SMEs and research and development aid to SMEs
- Training
- Employment.

For state aid measures that satisfy all the conditions of the SME, training or employment regulation, the member state is required to send to the Commission standard summary information about the aid measure within 20 working days of the implementation of the measure. This should be sent to DTI's state aid branch for onward transmission to the Commission.

De minimis

The '*de minimis*' regulation in state-aid rules allows undertakings in all sectors (other than agriculture) to receive up to a maximum of 100,000 Euros '*de minimis*' aid from all public sources over a rolling three-year period. Again, this is subject to compliance with the terms set out in the regulation; these include a requirement for the keeping of records of all '*de minimis*' aid granted for ten years.

Separate rules exist regarding '*de minimis*' aid in the agriculture sector.

Seeking approval for state aid from the Commission

Where it is not possible to redesign a measure to avoid state aid or to fit it under an existing scheme or the block exemptions, it may be possible to seek approval from the Commission. Where this is necessary, aid cannot be granted to potential recipients until Commission approval has been received.

Seeking approval can be a complicated and lengthy process. A straightforward notification to the Commission can take on average five to six months to achieve approval. Where a case is more complex or does not fit easily within the Commission's state aid guidelines, the approval process can take considerably longer. You will need to ensure that you allow sufficient time to obtain Commission approval within your policy timetable.

If you think your programme may require state aid approval from the Commission, you should consult the EU or state aid advisers in your organisation. **All notifications** for Commission approval **must** be prepared on the correct forms and submitted to the relevant state aid branches in DTI, DfT or DEFRA for transmission to the European Commission via the UK Permanent Representation in Brussels.

Annex D: Note on channels

Principles

Government bodies' use of the three channels (procurement, grant, grant-in-aid) available for funding the activities of TSOs has been highly inconsistent in relation to TSOs. There are a number of reasons for this:

- Many actual cases do not fit neatly into any one of the three channels
- Until recently, there has been little good guidance to funders and commissioners on the appropriate circumstances in which to use a particular channel
- In recent years, for good policy reasons, governments have extended the concept of grant to include grant with conditions about levels of service and grants awarded following competition between potential recipients. This has blurred the distinction between grant and procurement.

In addition, funders and commissioners use terminology loosely, in two ways:

- Following procurement, the government body and the provider reach a financial agreement known in law as a 'contract'. Because of this, the procurement channel is widely referred to as 'contract funding'. Following the award of a grant, the government body will send the provider a 'grant letter', 'award letter' (or a similarly-named document. For grant-in-aid, a formal financial memorandum will set out the terms and conditions. However, the courts may well decide that a grant or grant-in-aid is a contract, if it has the legal substance of a contract, whatever it is called;
- The term 'service level agreement' (SLA) is sometimes used to describe an agreement between funder and recipient. SLA is not a term with any specific status. Both contracts and grant letters may contain agreements on service levels to be delivered by the recipient.³⁷

Funders and commissioners sometimes do not know which channel they are using or believe that they are using one channel when they are in fact using another.

EU law has had a major impact on UK procurement law, and the knock-on impacts on other channels are still being fully worked through. The Treaty of Rome covers all public sector procurement contracts within the European Union and sets down principles of non-discrimination, equal treatment and transparency. The new EU procurement Directives [2004/18/EC](#) and [2004/17/EC](#), which were implemented in UK law on the 31 January 2006, support the Treaty principles with detailed provisions relating to specifications, selection and award of contracts above certain thresholds.

³⁷ In this DST, an SLA is either:

- An agreement on service levels within either a grant-in-aid letter, a grant letter or a contract
- A 'quasi-contract' between two organisations that have the same legal personality (for example, two government departments) and so cannot enter into an actual contract with each other.

The situation continues to develop: for example, the NAO's recent report on government's financial relationships with TSOs suggested that, as more TSOs established strategic partnerships with government, grant-in-aid might become more widespread for funding TSOs.³⁸

In principle, the distinction between financial channels is technical: all the money in question is public funding. However, there are practical consequences. In particular:

- When you choose the procurement channel, your decisions are governed by a large and detailed body of EU and UK law. Guidance from the Office of Government Commerce (OGC) explains both this and the government's Value for Money policy.³⁹
- Grant and grant-in-aid can allow more flexibility and discretion to the funder to vary the required outputs;
- The choice of channel affects what recipients are able to do with any surpluses (i.e. whether or not the funder will seek to 'claw back' surpluses).⁴⁰
- The VAT position may differ: sometimes the amount of irrecoverable VAT incurred by the TSO may be less under the procurement channel (see Annex F: Note on VAT, for details).

There is no hard-and-fast rule as to which funding channel is appropriate for a particular situation. However, some factors tend to make procurement more suitable while others favour grant or grant-in-aid. Procurement is often favoured where:

- Funding is being provided primarily for specific service or project objectives, rather than for 'development' or 'strategic' purposes;
- The market of potential suppliers is well-developed – there are several potential suppliers to choose from, who have the capability to meet your objectives, can respond easily to new demands and where there is little risk of market failure during the period of your programme. A well-developed market should also mean that price benchmarks for the service will be available;

Conversely, grant or grant-in-aid is often more suitable where development or strategic funding is emphasised. Other factors which tend to favour grant or grant-in-aid are:

- A desire for innovative or experimental products or services;
- Outcomes (the desired end results) rather than outputs (the measurable or numerical results of a given input) are to be specified.

Grant-in-aid is particularly favoured where the funding situation is 'non-contestable', i.e. where there is a unique supplier.

³⁸ NAO, *Working with the Third Sector*, TSO, 2005

³⁹ www.ogc.gov.uk

⁴⁰ This is covered in sub-stage 3(d): determine payment formula.

Annex E: Examples of funding models

Generic funding model 1: 'straightforward procurement'

Key features	
Channel	Procurement
Intermediaries	No
Degree of competition	Open
Duration of contract	Three years
Payment formula	Linked to outputs/outcomes Mainly in arrears
Monitoring and evaluation	Focus on outputs/outcomes Inspection (risk-based)

Illustrative scenario

Strategic decisions

The objectives of your programme are clearly specified as outcomes or outputs. There are no particular social factors associated with these objectives but Ministers want the programme to have demonstrable environmental benefits in addition to its core purpose. The programme is likely to take around five years to achieve its objectives. It is a national programme.

You establish that the programme does not qualify as a state aid. There are many potential providers. Collectively, these potential providers have a high level of capacity. There is no particular provider or group of providers with which you have a relationship that is relevant to the achievement of the purpose of your programme. You choose procurement as the funding channel.

Suppliers will need to demonstrate they can respond flexibly to the needs of a diverse customer base – which will include those from harder-to-reach communities that may be distrustful of statutory services. You decide the programme will be more effectively delivered through smaller lots, rather than through an aggregated programme of national delivery, and work to ensure a level playing field for all providers, by ensuring local organisations, that may have particular expertise in this area, are also fully aware of contract opportunities. Most risks that arise at the provider level are controlled by the provider and are, therefore, to be allocated to the provider.

There is no strong case at present for an intermediary.

Tactical decisions

You decide on open competition using the procurement channel. You make the environmental issues, which are linked to the subject of the contract, clear in the tender documents. You offer initial three-year contracts. It is down to the organisations that bid to include their full costs in their pricings. In selecting the winning organisations, you will want to check that these pricings are sustainable. However, this is not a major issue for you because of the competitive provider market and because you have structured the contract to prevent your organisation from becoming locked into the funding relationship if the service fails to deliver.

You explain in the tender documents that payment will be on the basis of the provider's achievement of programme outcomes and outputs. You also explain that you will consider some initial payments in advance, depending on needs of the provider and the other criteria for deciding on the funding formula.⁴¹

Monitoring will focus on the achievement of agreed outcomes and outputs, so it can be closely integrated into the payment system. But you will also carry out risk-based inspections to assess wider quality issues. In addition, you will require providers to send you information on the total volumes of clients, analysed by age, gender, ethnicity, as this is directly linked to the successful delivery of the programme, and so that you can report to ministers and Parliament on these issues.

Finally, you decide that you will design a separate funding model for the national evaluation of the programme.

⁴¹ Please see HM Treasury's 'Guidance to funders' for more details on payment in advance.

Generic funding model 2: 'procurement with demand risk'

Key features	
Channel	Procurement
Intermediaries	No
Degree of competition	Open
Duration of award	Three years, with annual review
Payment formula	Minimum payment guarantees Other payments linked to outputs/outcomes
Monitoring and evaluation	Focus on outputs/outcomes Inspection (risk-based)

Illustrative scenario**Strategic decisions**

The strategic issues in model 2 are the same as those in model 1, with one exception. In the risk meeting, you identify that overall demand for the programme may fluctuate greatly. Furthermore, your organisation can strongly influence the flow of work to individual providers but cannot forecast this with confidence. This uncertainty could place an unacceptable demand risk on providers, which could deter good, potential providers from taking part in the programme and be unfair to providers that did take part. The risk meeting decides, therefore, that the government as funder must carry this demand risk.

Tactical decisions

The tactical issues in model 2 are the same as those in model 1, except for the need to design a mechanism to allocate the demand risk to the funder. At the risk meeting, you decide to how manage this risk: you will maintain the element of 'payment-by-results' used in model 1; but you will adjust it to give a minimum payment guarantee to providers. This makes an annual review appropriate, because the minimum payment guaranteed must be proportionate to actual demand.

Generic funding model 3: 'procurement with investment in capacity'

Key features	
Channel	Procurement
Intermediaries	No
Degree of competition	Open
Duration of award	Three years
Payment formula	Payment in stages for development funding Payments for services linked to outputs/outcomes
Monitoring and evaluation	Focus on outputs/outcomes Inspection (risk-based)

Illustrative scenario

Strategic decisions

The strategic issues in model 3 are the same as those in model 1 with one exception: in the risk meeting, you identify that, to deliver the programme, many providers will need to commission new facilities, such as buildings and ICT systems, before they can start to receive actual clients. Many of the kinds of *potential* providers that you have identified as desirable for the success of the programme do not have the internal capacity to do this under 'payment by results'. They would need to be supported to *develop* those facilities.

You consider dealing with this by establishing two programmes, with separate funding models: one for the development of the facilities, the other for ongoing delivery. You decide that this would be disproportionate. You therefore decide on a single programme with a single financial model but with two elements.

It is important to bear in mind that supplying capacity-building funding and procuring services from the same organisation may give rise to conflict with EU state aid rules (see Annex C) and/or procurement rules against discrimination in favour of particular suppliers. You should seek specialist advice.

Tactical decisions

The tactical issues in model 3 are the same as those in model 1, except for the need to design a mechanism to accommodate the strategic decision about supporting development of facilities. You explain in the tender documents that the programme has two separate elements and ask organisations to price these separately in their bids⁴². Payment in the development stage will be on the basis of completion of agreed stages in the work.

Note

In this scenario, if capital investment is required, the appropriate model could be a prime contractor providing the investment, plus either separate contracts for services or sub-contracting opportunities offered by the prime contractor.

⁴² You could decide to make the funding for the development of facilities a grant, for capacity-building, rather than using procurement processes.

Generic funding model 4: 'competitive grant'

Key features	
Channel	Grant
Intermediaries	No
Degree of competition	Open
Duration of award	Three years, with annual review
Payment formula	Linked to activities or outputs/outcomes Advance or arrears as appropriate
Monitoring and evaluation	Activities and outputs/outcomes Inspection (risk-based)

Illustrative scenario

Strategic decisions

The objectives of your programme are quite complex but, with effort, they can be expressed as outcomes or outputs. However, you would like to test them in delivery. They include social and environmental factors. The programme is likely to take around 10 years to achieve its objectives. It is a national programme.

You establish that the programme does not qualify as a state aid. There are a fair number of potential providers within the third sector and, collectively, these providers have a reasonable level of capacity. But this is not a fully functioning market. One of your development objectives is to build the strength of the supplier base. You choose grant as the financial channel.

In a risk meeting for the programme, the main risk that you identify at national level is that no providers are well developed at this stage to deliver your whole programme. You therefore decide to deliver the programme through a series of local organisations. Most risks that arise at the provider level are controlled by the provider and are, therefore, to be allocated to the provider.

There is no obvious intermediary at present, however, you wish to keep this option open for the future.

Tactical decisions

You decide on a two-stage competition for local awards among potential providers. This allows any organisation to take part in a fair process and allows you to identify those with greatest capacity. You offer initial three-year awards, to be renewed annually. The costing process is transparent between you and potential providers, ensuring that both parties are content that appropriate central administrative costs are covered.

You decide to make payments quarterly in advance, based on anticipated activities. However, in the grant documents, you indicate that grant funding on these lines will only be provided for a maximum of a certain number of years, and that in the long term you may wish to switch to a procurement model of funding, with payment by outcomes or outputs, made in arrears

Monitoring will focus on both the completion of activities and the achievement of agreed outcomes and outputs. This will allow you and providers to test the validity of the output and outcome measures in delivery, and also means that monitoring can be closely integrated into the payment system. But you will also carry out risk-based inspections to assess wider quality issues. In addition, you will require providers to send you information on the total volumes of clients and on their ethnic origins, so that you can report to ministers and Parliament on these issues.

Generic funding model 5: 'allocated grant'

Key features	
Channel	Grant
Intermediaries	Yes
Degree of competition	Allocation
Duration of award	One year, with indicative figures for next two years
Payment formula	Linked to related programmes Linked to activities and outputs/outcomes Advance or arrears as appropriate
Monitoring and evaluation	Activities and outputs/outcomes Inspection (risk-based)

Illustrative scenario

Strategic decisions

The programme has a balance of both service and development objectives. The *service* objectives are quite complex, but, with effort, they can be expressed reasonably precisely as outcomes or outputs. However, you would like to test these in delivery. They include social and environmental factors. The *development* objectives include extending the range of services for the future and building other capacity: they are less easy to define in terms of outputs and outcomes. The programme is likely to take around 10 years to achieve its objectives. It is a national programme.

You establish that the programme does not qualify as a state aid. This is not a functioning market. Providers are localised and lack capacity. In any single area, there is either one or a small number of potential providers. In areas where there is more than one provider, you would like them to work in partnership to maximise capacity. Collectively, the sector shares the programme's objectives and there is a good level of understanding between the sector and government about the issues involved. You choose grant as the funding channel.

In a risk meeting for the programme, the main risk that you identify is that the sector is underdeveloped at this stage to deliver your programme. You therefore decide to deliver the programme through a series of organisations. Those organisations that have the most capacity will be financed to work to develop the capacity of other organisations and the sector as a whole. You will finance this as part of their grant. Most risks that arise at the

provider level are controlled by the provider and are, therefore, to be allocated to the provider.

You establish that many local authorities finance local organisations in their area to undertake activities that are similar to those of your programme. They do this under another programme that is run by another government funder (the 'existing programme'). Those authorities are also well placed to understand the needs in their area and the capacity of local organisations to address them. You therefore decide to deliver your programme through the existing programme. This will also help those local authorities to join up the delivery of your programme with that of the existing programme and of other relevant programmes that they deliver.

This is a substantial change in the design of your programme. You therefore decide to hold another risk meeting, where you establish that there is a risk that local authorities will come under pressure to use your funds for purposes other than the objectives of your programme. You therefore agree with the government body that finances the existing programme that it will adjust the performance management framework of the existing programme to include the objectives of your programme. You will receive regular reports on this.

Tactical decisions

Awards will be made annually, with indicative funding for years two and three.

Monitoring will focus on both the completion of activities and the achievement of agreed outcomes and outputs. This will allow you and authorities to test the validity of the output and outcome measures in delivery. It also means that monitoring can be closely integrated into the payment system. But you will also carry out risk-based inspections of the providers to assess wider quality issues. In addition, you will require local authorities to send you information on the total volumes of clients and on their ethnic origins, so that you can report to ministers and Parliament on these issues.

Generic funding model 6: 'allocated grant-in-aid'

Key features	
Channel	Grant-in-aid
Intermediaries	No
Degree of competition	Allocation
Duration of award	Five years, with annual reviews linked to monitoring
Payment formula	Linked to activities Advance
Monitoring and evaluation	Annual monitoring of activities Quinquennial review

Illustrative scenario

Strategic decisions

The programme has mainly strategic objectives. These can be expressed reasonably precisely as outcomes or outputs. They include social and environmental factors. The *strategic* objectives will be ongoing but progress on particular fronts can be measured. It is a national programme.

You establish that the programme does not qualify as a state aid. This is not a functioning market: there is limited capacity in the public and third sectors to deliver the programme. You wish to develop capacity in the third sector for this task. To maximise economies of scale and the capacity on the provider side to deliver the objectives, you are seeking only one provider at this stage. But its strategic role will be to strengthen certain capacity within the sector as a whole. There is one highly respected provider in the third sector with which you have a long-standing and trustful relationship. You choose grant-in-aid as the funding channel.

In a risk meeting for the programme, the main risk that you identify at national level is that the provider will be in a monopoly position and so may become inefficient and lack the incentive to develop other capacity. You agree that you can take some comfort from the degree of trust between you and the provider and from its values. However, you will need to manage the risk through the monitoring scheme. Most risks that arise at the provider level are controlled by the provider and are, therefore, to be allocated to the provider.

There is no case for an intermediary at present. You establish that the provider receives another grant from another government funder. You wish to keep your financial stream separate to maintain the focus of your programme at this stage. But you agree with the other government body to align conditions of the grant as closely as possible.

Tactical decisions

The award process is allocation. You decide to make the award for five years with annual reviews as part of the monitoring process.

The costing process is transparent between you and the provider. This ensures that both parties are content that appropriate central administrative costs are included.

You decide to pay on the basis of planned activities and three months in advance.

Monitoring will focus on the completion of activities, the achievement of agreed outcomes and outputs and on efficiency in the use of the grant. You ask for and are given observer status on the board of trustees. You review the provider's effectiveness, economy and efficiency in its use of the grant-in-aid once a year, in a fairly light touch way. You decide to hold a full quinquennial review at the end of the first five years of funding.

Glossary of terms

Accountability	Means by which individuals and organisations report their actions and are answerable to others for what they have done.
Advance payment	Payment made before the provider has incurred the expenditure and before the product or service – or an agreed part of it – has been delivered.
Appropriation	Parliament's allocation of money to a programme, which may be a specific or general allocation.
Arrears payment	Payment made after the provider has incurred the expenditure and after the product or service – or an agreed part of it – has been delivered.
Capacity building	In this case, a resourced approach (typically through staff training and development) boosting the sector's ability to manage projects, deliver services or engage in consultation and policy processes, partnerships and social enterprise by ensuring that voluntary and community organisations have the skills, knowledge, structures and resources to realise their potential.
Channel	Three types of funding channel – grant, grant-in-aid or procurement – that are available to public bodies in funding TSOs. See Annex D.
Charitable incorporated organisation (CIO)	A new legal form of organisation which is expected to be introduced by the forthcoming Charities Act 2006. CIOs will be registered charities and regulated by the Charities Commission. CIOs will have corporate status and the benefits of limited liability. It is likely that once the CIO form becomes available, many existing charities will convert to this form.
Clawback	The concept that where an asset financed by public money is sold, all or part of the proceeds of the sale should be returned to the funder.
Community benefit society (CBS)	Community benefit societies were formally known as charitable industrial and provident societies (see IPS definition below).
Compact	The voluntary and community sector's written agreement with the government (or local public bodies) which has undertakings on both sides, shared principles and values such as recognising the sector's

	independence, and mechanisms for making it work.
Contract	Legally binding agreements between (in this case) a government body and a TSO to provide services on behalf of the public body. A contract will specify the services to be provided and what the contractor is to be paid for providing them. It will also include provisions, in greater or lesser detail, setting out the legal obligations which each of the parties accepts in order to fulfil the purposes of the contract.
Development funding	Investing in new organisations or new capacity in existing organisations to develop their ability to contribute to a funder's policy objectives.
Evaluation	The assessment of the extent to which the programme has met its objectives: that is, has been effective, economical and efficient. There are two sorts of evaluation: summative and formative . Summative evaluation makes the assessment after the programme has been in operation for some time, or is complete, while formative evaluation assesses the programme as it is being put in place and during its early operation.
Full cost recovery (FCR)	Full costs are the direct costs of your project or service plus a relevant portion of organisational overheads (central administrative costs). FCR is the process of costing activities to include the appropriate share of overhead or indirect costs, as well as the direct costs of delivering a service.
Funding model	See 'model' definition below.
Funding stream	A sum of money allocated by government for a defined purpose.
Grant	Payments to outside bodies should be made in the form of grants where a department is required, or wishes, to maintain detailed control over the expenditure and where a procurement approach is not suitable. For more detail see Sub-stage 2(b): Choosing a funding channel .
Grant-in-aid	A payment by a government department (normally referred to as the "sponsor department") to finance all or part of the costs of the body in receipt of the grant in aid. Grant in aid is paid where the government has decided, subject to Parliamentary controls, that the recipient body should operate at arm's length. The sponsor department does not therefore seek to impose the same detailed controls over day-to-day expenditure as it would over a grant.

Infrastructure	Physical facilities, structures, systems, relationships, people, knowledge and skills that support, develop, co-ordinate, represent and promote front-line organisations to enable them to deliver their missions more effectively.
Industrial and provident society (IPS)	An organisational form sometimes used by TSOs; charitable IPSs are usually known as community benefit societies. A charitable IPS is an incorporated body with limited liability, governed by the Industrial and Provident Societies Acts. Charitable IPSs are exempt from registration with the Charity Commission, but the forthcoming Charities Act 2006 is expected to remove this exemption.
Match funding	A requirement by funding agencies that any contributions they make towards programme or project costs should be matched by other funders, or by the applicants from their own resources.
Milestone	A point at which you can measure progress on the way to achieving a goal or objective.
Mode	A term used in this tool to refer to three broad types of objective that a policy programme may have: financing a service or project; development funding or strategic funding. See Stage 2, sub-section 'Choose a funding channel'.
Model	The form that the funding programme takes when implemented in practice, once the questions raised in this tool have been answered. Annex E gives examples of various funding models.
Monitoring	In this case, the ongoing collection of information about the programme and assessment of the implications. Such information may be needed for three purposes: effective management of the programme; wider accountability for the programme; and policy development . For more detail see Sub-stage 3(e): Establish monitoring and evaluation .
Objective	Something you need to achieve in order to meet your goal. To be effective, objectives should ALWAYS be written so that they are SMART (S pecific, M easurable, A chievable/Agreed, R elevant and T ime-bound).
Outcome	The term used to describe the totality of what a programme or project is set up to deliver or achieve.
Output	The end result of carrying out an activity – usually a product. It is important to distinguish what has been produced (the output) from the effect that it may be designed to help achieve (the outcome).

Payment formula	A financial model must include the appropriate mix of bases and timings – this is called the payment formula. The payment formula must follow from the objectives of the programme, and the agreed approach to risk management . In addition, five criteria must be met – see Sub-stage 3(d): Determine payment formula.
Procurement	Acquisition of goods and services from third party suppliers under legally binding contractual terms. Such acquisitions are for the direct benefit of the contracting authority, necessary for the delivery of the services it provides or the running of its own business. Procurement is normally achieved through competition, and will be conducted in line with the government’s policy of value for money and in line with the Public Contracts Regulations 2006.
Programme	A portfolio of projects selected, planned and managed in a co-ordinated way.
Project	A temporary organisation formed to produce a unique and pre-defined outcome, or result, to a pre-specified timescale, using predetermined resources. It is important to understand that a project is something that can be planned and is something with a specific end in sight and which is managed to deliver as a single coherent whole.
Proportionality	The principle of not burdening funded organisations out of proportion to the amount of funding, which applies especially to monitoring. Guidance states that monitoring arrangements etc. should be proportionate to the level of, and risk to, the amount of funds involved.
Propriety	Linked to regularity, it is the further requirement that funds must be handled in accordance with Parliament’s intentions and Parliamentary control. Decisions must be taken fairly and be free from undue influence.
Regularity	Linked to propriety, it is the requirement for funds to only be used for the purposes for which they were awarded.
Restricted funds	These are funds which must be spent on a specific purpose within a specified time. If this type of fund is not spent within the specified time or for the specified purpose, it may have to be returned to the funder.
Ring-fencing	
Risk	Uncertainty of outcome (whether positive opportunity or negative threat). It is the combination of the chance of an event and its consequences.

Risk meeting/s	Meetings held before a project begins, to identify and describe each of the relevant risks, in terms of likelihood and impact, and who is best placed to manage each one.
Risk register	A document used to record the risks facing a project or programme, usually produced as a table. It should, as a minimum, record a description of each risk, an assessment of its likelihood and impact and the management actions to be taken to minimise the risk, though it can be more sophisticated.
Senior Responsible Owner (SRO)	The single individual with overall responsibility for ensuring that a project or programme meets its objectives and delivers the projected benefits.
Service/project funding	Paying for a particular service (ongoing) or project (time limited).
Service level agreement (SLA)	A memorandum, often accompanying a grant letter or contract, which sets out the understandings of the public body and the TSO about the service to be provided.
SMEs	Small and medium-sized enterprises, a term used to refer to smaller private sector companies.
Spending review	A statement of the government's spending plans for a particular period.
State aid	<p>EU law on state aid aims to prevent member states from unfairly distorting competition within the EU, except in certain permitted circumstances. A prohibited state aid exists if all of the following four criteria apply to the proposed programme:</p> <ul style="list-style-type: none"> • It is granted by the state or through state resources • It favours certain undertakings or the production of certain goods • It distorts or threatens to distort competition • It has the potential to affect trade within the EU <p>For more detail on state aid, please see Sub-stage 2(a): Establish specific purpose and Annex C: Note on state aid.</p>
Statutory bodies	Organisations created by Acts of Parliament which define their powers and duties.

Strategic funding	Financing for organisations recognised to be of strategic importance in that they facilitate the achievement of other, more specific government objectives.
Stream / funding stream	A sum of public money which has been allocated for the achievement of a particular objective or the implementation of a particular policy programme.
Target	Something you are aiming for – usually the numerically measurable part of an objective.
Third sector organisation (TSO)	TSOs pursue social and environmental objectives; do not distribute any surpluses to shareholders; reinvest any surpluses in the pursuit of their objectives; and are independent of government. TSOs can take a number of organisational forms, with or without charitable status – see Annex A.
Unrestricted funds	Funds held for the general purposes of an organisation, with no specific restriction on the purpose to which they are applied.
Value for money (VfM)	The optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user’s requirement. Assessed by the National Audit Office using the criteria of economy, efficiency and effectiveness. .
Vires	The power in legislation for the funder to carry out the activity envisaged in the policy intent for a programme. This may be a power that is specific to the programme; or it may be a more general power that may be used to fund a range of programmes, including the one at hand.
Voluntary and community organisation (VCO)	A general term used to refer to registered charities, non-charitable non-profit organisations, associations, self-help group and community groups.
Whole life cost	The full cost to an organisation of a solution to a requirement over the full period that the requirement will exist. Whole life costs will take into account running costs such as energy usage, maintenance requirements, staff training needs, and disposal costs such as recycling, as well as the initial purchase price. The life span of the product will also need to be considered.

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