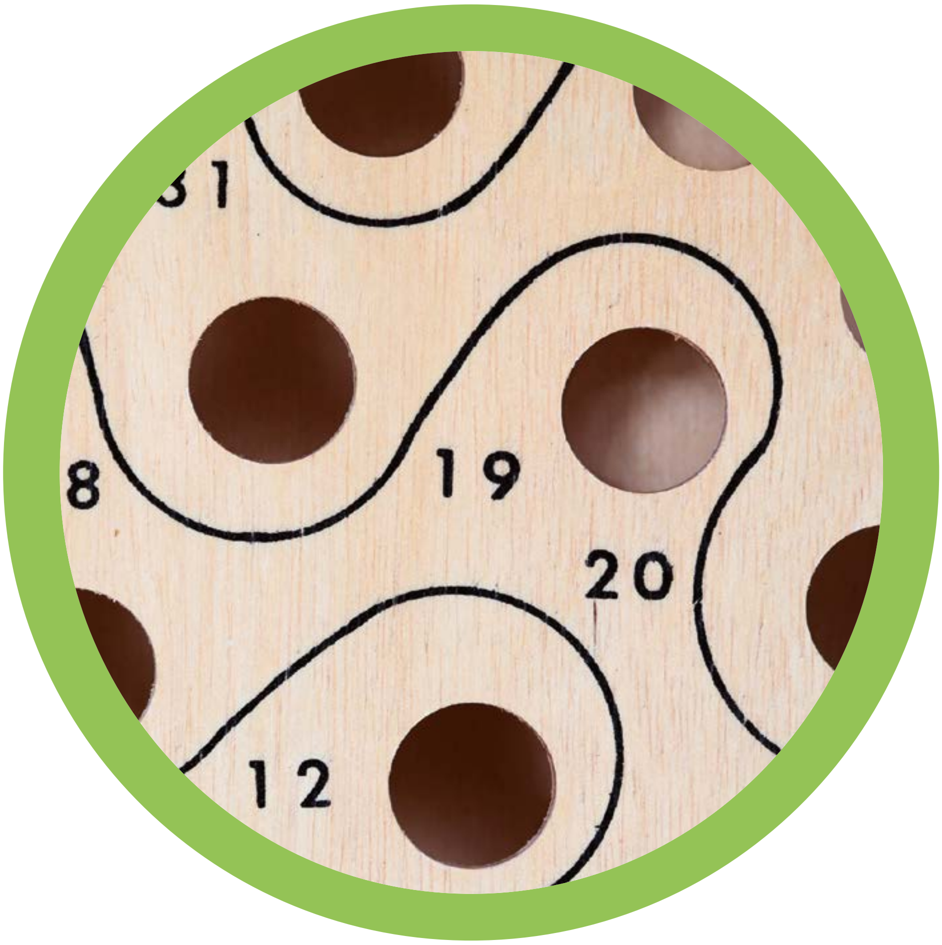
Reading charity accounts

made simple



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Introduction

Charities have to prepare their accounts in accordance with a guide called the Statement of Recommended Practice (SORP), which in turn is based on the Financial Reporting Standard 102. These guidance principles were updated in 2015 and must be adopted in order to fulfil the trustees' responsibilities to prepare accounts that show a true and fair view.

This guide aims to make reading a set of charity accounts simple for those new to the charity sector. Most of the basic accounting principles apply, but they have to be adapted to fit the non-commercial nature of some charity transactions.

The guide covers fund accounting, different types of charity and what to consider when reading a charity's accounts and assessing a charity's performance. Terms in bold in the text are explained in the glossary at the back, along with some other common terminology for financial statements.

Further information is referenced in the final section.

How are charity accounts different to commercial accounts?

The profit concept is not appropriate to charities, as charity law requires them to use all funds to further the charitable objects. The profit and loss account (income and expenditure account) is therefore replaced by a statement of financial activities (SoFA). The SoFA brings together all the resources available to the charity and shows how these have been used to fulfil the charity's objectives. Incoming resources will include new endowments received by the charity, donated assets and donated services. Volunteer services are excluded from the incoming resources, although charities should explain how the charity benefits from volunteer support.

Just these few examples demonstrate how it can be very difficult to monetise all charity transactions. By their very nature, charity transactions are often non-commercial and non-reciprocal. The charity SORP seeks to provide guidance on how to handle such transactions so that charity accounts show a true and fair view of the charity's financial position.

Charities can only be registered if they have a charitable purpose and if they can demonstrate that they will provide benefit to the public.

Fund accounting

One of the main fundamental principles underlying the format of charity accounts is fund accounting, which requires all incoming and outgoing resources, assets and liabilities to belong to a fund. It is necessary to track income and expenditure on each fund in the accounts, so the amounts received, expended, and the balances on each fund are visible. The different types of funds are:

Restricted

- Endowment (permanent or expendable)
- Restricted income funds

Unrestricted

- General funds
- Designated funds

Permanent endowment funds are donations that have been given to a charity to be held as capital with no power to convert the funds to income. Funds may be cash or other assets but should be invested to maintain the capital value and earn income. The income earned is available for use on the charity's objects as unrestricted income unless the terms of the endowment specify otherwise.

Expendable endowment funds are donations that have been given to a charity to be held as capital, but where the trustees do have a discretionary power to use the funds as income. The terms of the endowment may specify what is permitted.

Restricted funds are funds subject to special trusts specified by the donor. This might be because it was a public appeal for a specific purpose, or grants or donations given for specific activities. It may also include land, buildings or other assets donated to a charity. The trustees will be in breach of trust if they use restricted income other than for the specified purpose. Unless specified, interest or other investment income on a restricted fund will be added to the fund. Significant restricted funds have to be separately disclosed in the notes to the accounts.

Unrestricted funds are funds available for the purposes of the charity, to be spent as the trustees see fit.

Designated funds are unrestricted funds that have been earmarked for a particular purpose by the trustees. The notes to the accounts should explain the purpose of designated funds.

General funds are unrestricted funds which have not been earmarked and may be used generally to further the charity's objects.

When you are reviewing a set of charity accounts, you will usually be presented with a columnar format in the statement of financial activities (replacing the profit and loss account) showing the income and expenditure belonging to each fund. The income for endowment and restricted funds can only be used for the purposes for which it was given. It is normal for restricted funds to show a balance of net incoming resources which is being taken into the subsequent financial year. This is not a surplus as it is only funds being held by the charity. If the charity is no longer able to use those funds for the purpose for which they were given, then the charity must offer the funders back to the donor.

If the column for unrestricted funds is showing net incoming resources, then this is a surplus, but the funds may only be spent on the charity's purpose. And in some years, this may be a deficit as the charity may using funds retained from an earlier year.

What sort of charity?

Charity status is a broad category rather than a type of business. You can compare the performance of similar charities, such as housing associations, but it is difficult to compare the accounts of a university to a hospice. So to understand a set of charity accounts you need to understand the type of charity first. Some common charity business models are described below:

Donation model

Charities appeal for donations and legacies, and once received they decide how to spend them. A variant on this model is the appeal for donations for a particular purpose – the charity knows what it will spend the funds on in advance. In both cases, the charity will build up cash reserves during the time it is accumulating enough funds, then spend more than its annual income, possibly on a major capital asset. Let's bring this to life with an example.

A hospice needs to build an extension so it launches an appeal to supporters. It takes two years to attract sufficient donations to give the trustees confidence to sign a building contract. During those two years, they are receiving more income and adding the income to reserves. In subsequent years, they are spending cash to invest in capital assets. So looking at any one year's financial results may give a misleading impression.

In this model, charities frequently receive donations as restricted funds, which can only be spent on the purpose for which the funds were given.

Endowment model

The endowment model is commonly used for grant-making trusts. The initial funds may come from a legacy or a gift from a founder. Less commonly, a charity may build up an endowment fund from an appeal.

Typically, an endowed charity will invest the funds and use the income to spend on the charitable purposes. If this is by grant-making, the administration costs of the charity will be limited to the costs of managing the grant-making process, supporting the board's meetings and compliance activity such as audit.

Contract model

Charities delivering services of many types are run as charitable businesses, employing staff and owning or leasing property. The funding for the operational costs typically comes from fees, rents and contracts. Sometimes, charities will subsidise services with donations.

Such charities are likely to have low margins, only just covering their costs with the funding. They have to bid for contracts and are often competing with commercially run companies.

Fee and contract income will usually be unrestricted as it is not received under trust law. It can be difficult to distinguish a grant from a contract, so refer to *Grants and contracts made simple* on the Sayer Vincent website.

Retail activities

Charities undertake fundraising through various retail activities, including high street shops and selling donated goods though online auction websites. Typically, a charity shop will sell donated goods and some bought-in goods such as Christmas cards. Although the business model relies on volunteers and donated goods, the charity often has to pay for the premises and some staff such as managers. It incurs costs to collect goods and manage aspects such as health and safety. The margins look low compared to other forms of fundraising, but the profit on the trading provides an important source of income. The accounts correctly show the gross income from the trade, together with the cost of sales under fundraising costs, so you can calculate the profit.

Charities have been able to increase the return on their retail activities by claiming Gift Aid on the value of donations. This is administratively cumbersome and detailed rules set by HMRC must be followed. See the Sayer Vincent guide *Charity shops made simple*.

Membership organisation

Membership organisations that are registered charities provide benefit to the public, rather than private benefit. Members have a shared interest in the purpose of the charity and pay subscriptions to fund the work of the charity. Often these charities have more expensive governance structures because they seek to involve members.

Non-departmental public body

Some charitable organisations receive core funding from the government known as grant-in-aid. Although they are independent bodies with their own board, they are accountable to a government department for the expenditure of the grant and their accounts are laid before Parliament. Their accounts may follow government accounting rules rather than the charity SORP.

Specialist bodies

Housing associations or registered social landlords and higher education institutions have their own SORPs because of the specialist nature of their activities.

Reading charity accounts

There is no equivalent to *earnings per share* for charities. In fact, judging charities on their financial performance is missing the main point. Charities are not owned by anyone and do not aim to provide a financial return to shareholders. You need to find out what the main purpose of the charity is and then how it delivers its strategy to achieve that purpose.

Trustees' annual report

The charity should provide information on its achievements in its annual report so that readers can understand its performance. The trustees' annual report provided with the charity's accounts should explain significant financial transactions during the year and explain the salient features of the accounts. From reading the report, you should learn what type of charity it is, how it is funded, what its key policies are such as reserves, investment and grant-making. And it should explain how it manages risk. From 2016, charities will also have to explain what it considers to be its major risks and how it manages them.

The best charity annual reports explain the difference the charity has made. Most use a combination of case studies and output statistics. The charity SORP requires you to state your charity's purpose (what is the problem you are trying to solve), how you think you can solve it (what do you do), how successful you have been (providing some evidence such as numbers helped). This can also be summarised as aims, activities, achievements and impact. You can then go on to explain the lessons you have learned and set out your future plans.

The charity SORP does expect the trustees' annual report to explain the numbers. The words and numbers should link and should make sense to a reader.

Performance on fundraising

Charities undertake a wide range of activities to raise funds for their cause. Some forms of fundraising require significant investment, some have high costs, some are higher risk than others. Consequently, there is no single performance indicator.

Many readers of charity accounts will look at the formula of fundraising cost over total income to measure the fundraising return. This would be misleading because some forms of income will probably not have required any fundraising input. So you could omit this income and just compare the cost of fundraising to the funds raised. This is a more appropriate cost/income ratio at least, but the following needs to be borne in mind:

- The fundraising costs reported in the financial statements are likely to be generating income in the following financial year or years – you are not matching income to the relevant costs. This may not matter too much for a mature charity, but it will make a difference for a young charity or one that is embarking on new fundraising and so in the investment phase.
- Income from legacies will fluctuate from year to year, but this has nothing to do with fundraising performance.
- Different forms of fundraising have different margins. For example, charity shops may have relatively small margins, but income is steady and unrestricted. Major donations might represent a much

greater return, but they are unpredictable and often restricted. In order to assess the fundraising performance of a charity you need to understand more about the fundraising mix.

Many charities will not undertake any fundraising, but will bid for contracts or receive significant grant funding for their activities.

Administration costs

Often administration costs are seen as 'bad' costs, but if a charity is to use its resources well, understand its performance, pay the wages of its staff etc. – it is going to have to spend money on administration. A well-run charity will do many of these things efficiently and so will not waste resources. Just because a charity spends very little on its administration, that does not necessarily mean that it is well run. In fact, the opposite is more likely to be the case. Without good administration, it is more likely that resources are wasted on activities that do not generate good results. Unless the charity is gathering evidence of what works and studying it, it will not know where to put its resources.

If you look for 'administration costs' in a set of charity accounts, you won't find them. The administration costs of a charity are divided between support costs and governance costs. The support costs are the indirect costs of an activity or project – they are a necessary part of the operation, such as the rent for a youth club or paying the wages. Governance costs are the statutory costs of running the organisation and include the costs of trustee meetings (if any), audit and legal advice.

Executive pay

Charities have to disclose information about the numbers of staff paid at a rate greater than £60,000 in the reporting period (excluding employer pension contributions but including any other benefits). This will be detailed in a note to the accounts. From 2016, charities will additionally have to disclose the aggregate pay of their "key management personnel" or senior management team in a note to the accounts and provide a narrative explanation in the trustees' report of the remuneration policy.

Reserves

The unspent unrestricted funds of a charity are its reserves. Some charities do not need reserves – for example, endowed charities that distribute grants from the income earned. But many charities will have committed expenditure and need to hold reserves as a contingency fund. Most charitable businesses need some working capital.

Many charities express their reserves policy as the number of days that the amount held in reserves would fund. So a charity with annual running costs of £365,000 might state that it holds £90,000 in reserve to provide three months cover. It is not possible to judge whether this is appropriate or not unless the charity also explains the nature of the risks it faces and whether three months is sufficient cover. The reserves policy should explain why the charity needs to hold reserves, describe the level of reserves required, state the actual level of reserves held and explain any variation between the target and actual reserves.

Designated funds are part of the unrestricted reserves that have been put aside for a particular purpose. Notes to the accounts should explain the purpose of designated funds.

Pension funds

Just as any commercial entity, charities that have previously set up defined benefit pension schemes now find that these schemes are in deficit. Many charities have admitted body status to local authority or other government sponsored pension schemes, and so have little control over how these are performing financially. Under financial reporting standards, participant entities in defined benefit schemes have to bring their share of the assets or liabilities of the scheme onto their balance sheet. Significant pension deficits will make the balance sheet look as if the organisation is in poor financial health, whereas in practice pension fund deficits are not of the same order as loans or actual liabilities. A pension fund deficit is a long-term position which may change if the contribution rate is increased, investments perform better or any of the other assumptions such as retirement age of the members of the scheme change. A pension fund deficit is an actuarial estimate, not an actual liability. While it should not be totally discounted, it is more important to understand what the contribution rate to the pension scheme will be in the coming years, as this will have an immediate budgetary effect.

Volunteers

The value of volunteers as a resource to the charity is not included in the incoming resources, but should be estimated in the trustees' annual report. The report should explain how the charity uses the services of volunteers and provide an indication of the extent of volunteering such as the number of volunteers, the roles they perform, the number of hours or days and the value of their time.

This is important information as the charity can only achieve its outputs with this additional input.

Property and other assets

As for other entities, charities have to state their assets in the balance sheet at fair value. However, property acquired for use by the charity in delivering its objects may be stated at the original cost and depreciated. The depreciated cost figure known as the net book value does not represent the market value of that property, but is a statement of the previous investment.

Assessing charity performance

Reading a set of charity accounts may prompt more questions rather than leading to simple assessment of performance according to some financial metrics. Some of the relevant questions about a charity's financial health and performance follow:

Does the charity have a diverse range of income sources?

A charity that is highly dependent on one source is vulnerable and would need large reserves to cover that risk.

Does the charity hold large reserves?

Charities receive funds in order to spend them on the purpose for which they were established. The policy should set out why the charity holds reserves and should set out how it plans to use amounts held in excess of that.

Does the charity explain its fundraising performance?

The best indicator is the return on investment on a particular project or activity. This may be over a number of years rather than the annual performance in a set of accounts.

Does the charity explain its impact?

Most charities can explain their outputs even if only by describing the activities they spend their funds on. Some reports will go further and give details of the number of people helped with each service or other measures of reach. Impact is not simply about numbers however, and you need to know whether the intervention achieved the objective and was effective. Some charities publish separate impact reports and commission independent evaluations of their work.

Assessing financial health

Charities need to hold enough unrestricted funds in reserves in order to cover their financial risks. In company law, a company is no longer a going concern if it cannot pay its debts as they fall due. For charities, this is complicated by the existence of restricted funds, which cannot be included in the funds available to pay general debts. A charity could hold significant amounts of cash in the bank, but if this is all from restricted funds, then it is not available for general spending.

Conclusion

The purpose of charity accounts is to provide a stewardship report of the funds entrusted to them. To quote *SORP 2015*:

"The objective of the trustees' annual report (the report) and accounts is to provide information about a charity's financial performance and financial position that will be useful to a wide range of stakeholders in assessing the trustees' stewardship and management of charitable funds, and to assist the user of the accounts to make economic decisions in relation to the charity.

Although past, current and potential funders, donors and financial supporters of a charity are the primary audience for the financial information contained in a charity's report and accounts, the preparer should also be aware that interest in this information may also extend to a charity's service users and other beneficiaries.

The report and accounts should not be viewed simply as a statutory requirement or a technical exercise. The report and accounts, when read together, should help users of the information to understand what the charity is set up to do, the resources available to it, how these resources have been used and what has been achieved as a result of its activities."

Charities should strive to provide full and honest accounts of its activities to achieve its purpose. It is up to charities themselves to set out what they consider 'success' to be for their own charity, and then report how they measure up against that standard.

Readers of charity annual reports need to take the context into account and consider the performance of each charity on its merits, recognising that 'charity' is a broad umbrella term for a large number of different types of organisations and activities. Comparisons between charities need to undertaken with some care as you may be comparing apples and pears.

Glossary

Accruals basis	This is a method of accounting which adjusts the receipts and payments for amounts which should have been collected or paid before the end of the accounting period to arrive at the income and expenditure account.
Assets	Assets are the money, goods and property which an organisation possesses, including any legal rights it may have to receive money, goods, services and property from others.
Balance sheet	A summary of the assets and liabilities of an organisation at a particular date. Sometimes described as a ‘snapshot’ of the financial position of an organisation. It also describes the funds which are represented by the net assets.
Capital budget	This is the plan for large-scale expenditure on building or equipment, together with the plan for funding such purchases.
Capital	The capital of a charity is a restricted fund (or funds) which the trustees must retain for the benefit of the charity and not spend. A capital fund is known as an endowment fund.
Capitalisation	When property or equipment is purchased and treated as an asset on the balance sheet, it is said to be capitalised. This means that the cost is not treated as an operating cost and is not charged to the expense accounts.
Charitable activities	This comprises all expenditure relating to the objects of the charity. It includes grants payable, the cost of supporting charitable activities and governance of the charity.
Cost of generating funds	The costs of activities undertaken for a fundraising purpose.
Creditors	The amounts owed by an organisation to others – included in liabilities.
Debtors	The amounts owed to the organisation for goods or services supplied. ‘Aged debtors’ is a breakdown of the total owed to the organisation month by month.
Depreciation	An allowance for wear and tear made on long-lasting property and equipment. An amount charged annually as an expense to spread the cost of fixed assets over their useful economic life.
Designated funds	Designated funds are unrestricted funds which have been earmarked for a particular purpose by the trustees.
Endowment	An endowment is a special type of restricted fund which must be retained intact and not spent.
Expendable endowment	This is a type of endowment fund where trustees have the discretion to eventually convert the fund into expendable income.

Financial reporting standard	This is a statement of required accounting practice for all company accounts and all accounts which purport to give a true and fair view. It is obligatory for all published accounts to comply with Financial Reporting Standards. They are issued by a committee of accounting bodies and cover a range of accounting topics, with updated versions issued regularly.
Financial statements	The accounts of an organisation including the notes to the accounts and any other statements which are required to be included.
Fixed assets	These are assets which continue to be of value to the organisation year after year and which the trustees hold on a long-term basis and therefore do not intend to dispose of in the short term.
General funds	These are unrestricted funds which have not been earmarked and may be used generally to further the charity's stated objects.
Impairment	This is the term used to describe a fall in value of an asset. An impairment review may be required for certain tangible fixed assets. This is usually when some major event has occurred which causes you to think that the previous values ascribed to the asset are no longer valid.
Incoming resources	All resources available to a charity, including incoming capital (endowment), restricted income, gifts in kind and intangible income.
Liabilities	Liabilities are the amounts owed by an organisation at the balance sheet date. The cost will have already have been incurred, but the bill not paid.
Net book value	The net book value is calculated for tangible fixed assets by taking the original cost or valuation amount and deducting the accumulated depreciation. The net book value is the amount at which tangible fixed assets are stated in the balance sheet.
Permanent endowment	This is a type of endowment fund where the trustees must retain the fund intact as capital and use the funds to generate income or hold the assets (depending on the terms of the trust). The trustees have no discretion to convert the endowment into expendable income.
Restricted fund	This is a fund subject to specific trusts within the objects of the charity (e.g. by a letter from the donor at the time of the gift, or by the terms of a public appeal). It may be a capital fund, which cannot be spent but must be retained for the benefit of the charity, or it may be an income fund, which must be spent on the specified purpose within a reasonable time.
Statement of financial activities (SoFA)	Financial statement introduced especially for charities in the SORP. Summarises all incoming resources and application of resources. Replaces the income and expenditure account as a primary financial statement, it goes further by bringing together all the transactions of a charity.

Statement of recommended practice (SORP)	Guidance on the appropriate treatment of items in the accounts of specialised bodies. Its title as a statement of 'recommended' practice does not mean it is optional; adoption is required to show a true and fair view.
Stock	The value of goods on hand at the balance sheet date will be included in stock under current assets.
Support costs	These are part of the direct charitable expenditure and may be the management of projects from a central office. They may include a fair proportion of central office running costs.
Tangible fixed assets	Long-term assets that have some substance, such as buildings and equipment.
Unrestricted funds	These are funds held for the general purposes of the charity, to be spent within the stated objects.

Further information

Financial reporting standard 102

www.frc.org.uk/Our-Work/Codes-Standards/Corporate-reporting/Standards-in-Issue.aspx

Statement of Recommended Practice for charities

www.charitysorp.org/

Sayer Vincent website

www.sayervincent.co.uk

SORP 2015 resources

www.sayervincent.co.uk/resources/sorp-2015/

Made simple guides covering a range of charity accounting and tax topics

www.sayervincent.co.uk/resources/made-simple-guides/

It ain't what you give, it's the way that you give it

Caroline Fiennes
Published by Giving Evidence, 2012

Talking about results

NPC team including Sarah Hedley and Tris Lumley, 2010

www.thinknpc.org/publications/talking-about-results/

Notes

Made simple guides

Made Simple guides are aimed at finance professionals and other managers working in charities. They cover technical areas such as tax and VAT treatments as well as information management areas and aim to provide practical guidance to busy managers and trustees in charities.

The content of guides is correct at the time of going to print, but inevitably legal changes, case law and new financial reporting standards will change. You are therefore advised to check any particular actions you plan to take with the appropriate authority before committing yourself.
No responsibility is accepted by the authors for reliance placed on the content of this guide.

Made to measure

Sayer Vincent is a firm of chartered accountants working solely with charities and social enterprises. Through tailored audit and advice services, we provide trustees and managers with the assurance that their charity is managing its resources effectively.

As well as being commercial accountants, Sayer Vincent people have an in-depth knowledge of the governance and management of charities and social enterprises. We can advise on a range of business activities to achieve the best financial outcomes, keeping in mind the context of your organisation's objectives.

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