

SORP **made simple**

Introduction 3

1 Fund accounting 4

2 The format and content of charity accounts 6

3 Trustees' Annual Report 7

4 Statement of financial activities 10

5 Incoming resources 13

6 Resources expended 16

7 Charity balance sheets 18

Further information 20

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Sayer Vincent only works with charities and not-for-profit organisations. We have built up a wealth of sector experience as business consultants in the voluntary sector over the last 25 years. Working with a diverse portfolio of charities, we deliver rapid insights into your issues and problems and help you to find effective solutions to them.

Our work focuses on making charities more effective through improved infrastructure, reporting and governance. We help charities with mergers, systems implementations and training. Charities appoint us as consultants, internal auditors or external auditors. Sayer Vincent also undertakes practical research to enhance the efficiency and effectiveness of not-for-profit organisations, for example through IS Benchlearning and the Adaptive Performance Management Forum.

For more information, go to www.sayervincent.co.uk

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Introduction

This guide is designed for people who may be new to the charity sector or otherwise need to understand charity accounts.

Charities have to prepare accounts in accordance with the Statement of Recommended Practice ('SORP'). The most recent version of this was issued in March 2005, known as SORP 2005, with an updated edition issued in July 2008. Note that charities registered in Scotland, Northern Ireland and the Republic of Ireland follow the SORP, but also have to follow local legislation. SORP does not apply to charities preparing receipts and payments accounts, a choice available to those with annual income below £250,000.

How are charity accounts different to commercial accounts?

The SORP tries to get away from the concept of profit as the measure of success or failure. 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. For example, incoming resources will include new endowments received by the charity, even though these are new capital to the charity. Donated assets and services are also brought into a SoFA, whereas commercial profit and loss accounts would not include them.

1 Fund accounting

One of main differences to commercial accounts is the format of charity accounts showing that all incoming and outgoing resources, assets and liabilities belong to a fund in the charity's accounts. It is necessary to track funds through the accounts, so that one knows the amounts received, expended and balances on each type of fund.



The different types of funds are:

- **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. These may be cash or other assets.
- **Expendable endowment funds** are donations that have been given to a charity to be held as capital, where the trustees do have a discretionary power to use the funds as income.
- **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, grants or donations. 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.

Reserves

The term 'reserves' describes that part of a charity's funds that is freely available. The term therefore normally excludes endowments and restricted funds, and also any part of unrestricted funds not readily available for spending, e.g. fixed assets.

Reserves are held for the following purposes:

- To protect the continuity of the charity's work in the event of a shortfall in income
- To protect the charity's funds from loss in value e.g. market investments
- To provide the capital needed to finance expansion of the charity
- To provide the funds needed to replace assets

In essence charities should retain reserves to manage continuity and to minimise the risk that charitable programmes will be jeopardised because of a fall in income.

Trustees need to form a policy on the level of reserves they need to manage the identified risks. This is usually expressed as a number of months of regular running costs and may be stated as a range. Separate guides in this series explain how to develop a reserves policy and how to undertake a risk assessment for your charity.

2 The format and content of charity accounts

A full set of charity accounts will consist of:

- Trustees' Annual Report
- Statement of Financial Activities (SoFA)
- Balance Sheet
- Notes to the Accounts
- Auditor's Report or Independent Examiner's Report

Larger or more complex charities may additionally produce a consolidated Statement of Financial Activities, a Summary Income and Expenditure account and a Cashflow Statement. Small charities taking advantage of exemptions may produce a simpler form of accounts – receipts and payments account and a statement of assets and liabilities. Helpful guidance on accounts for smaller charities is provided by the Charity Commission on their website.

3 Trustees' Annual Report

The trustees' annual report following the guidelines of SORP 2005 will also be enough for the directors' report under the Companies Acts. The requirements of the SORP 2005 are summarised below:

Reference and administrative details

This section needs to include:

- Name of the charity, the charity number, company number if registered and address of the principal office.
- Trustees during the period of the report up to the date the report was approved.

Additional information required for charities above the audit threshold:

- Senior staff to whom day-to-day management of the charity is delegated.
- Names and addresses of advisors such as bankers, solicitors, auditors and investment managers.

Structure, governance and management

This section should explain how the charity is constituted, its organisational structure and how the charity's decision-making processes operate. All charities should report:

- The constitution e.g. trust, company limited by guarantee, unincorporated association etc.
- How trustees are recruited and appointed and whether they receive any benefits.

Charities above the audit threshold additionally report:

- The policies and procedures adopted for the induction and training of trustees.
- The organisational structure of the charity and how decisions are made. For example, which types of decisions are taken by the charity trustees and those which are delegated to staff.
- Where the charity is part of a wider network (for example charities affiliated within an umbrella group) then the relationship involved should also be explained where this impacts on the operating policies adopted by the charity.
- The relationships between the charity and related parties, including its subsidiaries and with any other charities and organisations with which it co-operates.
- A statement should be provided confirming that the major risks to which the charity is exposed, as identified by the trustees, have been reviewed and systems or procedures have been established to manage those risks. Note that larger charitable companies need to go

further to comply with company legislation in this respect and provide more information on the major risks and uncertainties facing the charity.

Objectives and activities

The report should explain what the charity's objects are and what it does in order to achieve them. All charities have to state the objects of the charity as set out in its governing document. From 2009 onwards, charities also have to explain the public benefits that arise from the charitable aims and the steps taken by the charity to ensure that the benefits from its activities continue to relate to the aims of the charity. Trustees also need to confirm that they have referred to the Charity Commission's guidance on public benefit when reviewing the charity's aims and objectives and planning future activities.

Charities above the audit threshold additionally report:

- Charity's aims and mission.
- Main objectives for the year.
- Strategies to achieve those objectives.
- Details of significant activities such as main programmes, projects, or services provided, that contribute to the achievement of the objectives.
- Grantmaking policies where this is a significant activity.
- Information about the role and contribution of volunteers, such as the activities that volunteers help provide, quantify the contribution in terms of hours or staff equivalents, and an indicative value of this contribution.

Achievements and performance

All charities have to provide a summary of the main achievements of the charity during the year. Trustees also have to describe how the benefits provided by the charity are for the benefit of the public or a section of the public. Explain access or restrictions to access as necessary.

Charities above the audit threshold should provide a review of its performance against set objectives, giving both qualitative and quantitative information such as indicators, milestones and benchmarks against which the achievement is assessed by the charity. In particular, the report should contain:

A review of charitable activities undertaken to explain performance.

- Comment on fundraising performance.
- Details of the performance of investment compared to the policy.
- Comment on those factors affecting performance.

Financial review

The report should contain a review of the financial position of the charity and the main financial management policies adopted in the year, including:

- Reserves policy stating the level of reserves held and why they are held. This should include designated funds and the likely timing of future expenditure from those funds.
- If there are funds in deficit, then the reasons for the deficit and plans to eliminate the deficit.

Charities above the audit threshold should additionally report:

- Principal funding sources and how expenditure in the year has supported the key objectives of the charity.
- The investment policy and objectives, including any social, environmental or ethical policies.

Plans for the future

Only charities above the audit threshold need to provide information under this section. They need to describe the charity's plans for the future including the aims and key objectives it has set for future periods together with details of any activities planned to achieve them.

Funds held as custodian trustee

If a charity holds funds as a custodian trustee, then further details are needed as follows:

- Description of the assets which they hold in this capacity.
- The name and objects of the charity (or charities) on whose behalf the assets are held and how this activity falls within their own objects.
- Details of the arrangements for safe custody and segregation of such assets from the charity's own assets.

4 Statement of financial activities

The SoFA should be prepared using a columnar format where the charity has more than one type of fund – incoming resources and resources expended should be separated between restricted and unrestricted funds, and endowment funds where they have them.

The SoFA shows the ‘net incoming resources’ instead of surplus or profit – these are resources that are carried forward and have to be spent to further the charity’s objects in future accounting periods. Where these net incoming resources relate to restricted funds, then the purpose for their application has been established by the donor.

The SoFA is split into the following sections, which are subdivided by different headings and subheadings:

Incoming resources

Incoming resources from generated funds

Voluntary income	Donations, grants given with no expectation of a service in return; legacies.
Activities for generating funds: <i>Sub-headings for actual activity income</i>	Various fundraising activities such as events, charity shops, catalogues, sales of merchandise. Can include non-charitable trading.
Investment income	Dividends Bank interest e.g. on deposit accounts

Incoming resources from charitable activities

<i>Sub-headings for actual activity income</i>	Grants and fees received on the understanding or contractual terms that it will be used to undertake activities to further charity’s objects. Can include charitable trading. Use appropriate headings for charity’s particular activities – e.g. residential care fees.
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Other incoming resources

Use only where income falls outside the normal charity activities e.g. profit on disposal of a fixed asset.

Resources expended

Costs of generating funds

<i>Sub-headings for actual fundraising activities</i>	Sub-headings may include ‘costs for generating voluntary income’, ‘fundraising trading’, and ‘investment management costs’, if these costs are significant.
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Charitable activities

<i>Sub-headings for actual activity income</i>	These should correspond to the income headings under charitable activities.
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Governance costs	These should include only the costs of governance arrangements. Normally these will be internal and external audit, cost of trustee meetings and preparing statutory accounts. They can also include an apportionment of shared and indirect costs.
Other resources expended	Use only where expenditure falls outside the normal charity activities.
Transfers	Used when capital funds are released to an income fund from expendable endowment, or when unrestricted funds need to be used to fund shortfall of restricted funds, etc.
Other recognised gains and losses <i>Subheadings for different types of gains and losses</i>	These may include revaluation gains on fixed assets, gains and losses on investments, and actuarial gains and losses.
Reconciliation of funds	The result for the year will be added onto the reserves brought forward from last year. The total will then agree to the balance sheet.

Example statement of financial activities

	Endowment £'000	Restricted £'000	Unrestricted £'000	This year Total £'000	Last year Total £'000
Incoming resources					
<i>Incoming resources from generated funds</i>					
Voluntary income	253	27	15	295	57
Investment income	-	-	25	25	13
<i>Incoming resources from charitable activities</i>					
Childcare grants	-	257	50	307	295
Parenting classes	-	-	245	245	239
Total incoming resources	253	284	335	872	604
Resources expended					
<i>Costs of generating funds</i>					
Fundraising and publicity	-	-	21	21	29
<i>Charitable activities</i>					
Childcare work	-	279	51	330	316
Parenting classes	-	-	226	226	209
Governance costs	-	-	36	36	35
Total resources expended	0	279	334	613	589
Net incoming resources	253	5	1	259	15
Unrealised gains on investment assets	30	-	-	30	22
Net movement in funds	283	5	1	289	37
Reconciliation of funds					
Total funds brought forward	250	30	73	353	316
Total funds carried forward	533	35	74	642	353

5 Incoming resources

There are specific items in charities which you will not often see in commercial entities and the treatment of which may differ from normal accounting practices.

Legacies

These are included in the incoming resources on the SoFA when they fulfil the criteria of entitlement, measurement and certainty. Legacy administration can be slow and so even when probate has been granted, there may still be questions over the charity's entitlement. It may not be clear which charity was intended as the recipient or there may be a dispute with the relatives. Frequently, charities are entitled to a residual legacy, such as 'the remainder of my estate'. This can make it difficult to measure the value the legacy until all assets have been sold and debts paid. It is not always certain that there will be anything left to pass to the charity and the timing is very uncertain until the administration is close to an end. Consequently, most charities will only bring legacies into income when they receive notification that a sum will be paid, or when instalments are received in the case of a large legacy.

Gifts in kind

Charities sometimes receive assets as donations, rather than cash. The value placed on gifts in kind included in the SoFA should be the estimated value to the charity of the gift received. Current value to the recipient charity will usually be the price that it estimates it would have to pay in the open market for an equivalent item. Where gifts in kind are recognised, an equivalent amount should be included as expenditure under the appropriate heading in the SoFA. Gifts in kind can take several forms:

- **Buildings and major equipment donated for the charity's own use** – these are tangible fixed assets and need to be shown as an addition to fixed assets and depreciated in the same way as assets bought by the charity. As well as recognising the asset, the charity would recognise the same amount as an incoming resource in the SoFA in the same accounting period. This would usually form part of the restricted funds of the charity and the depreciation would be charged against the fund.
- **Equipment or supplies for the charity's own use** – smaller items of equipment or supplies to be used in operational activities. For example, a company may donate food normally sold in its stores, but which is just past its 'sell by' date to a charity helping homeless people.

- **Goods donated to charity shops or similar** – account only for the cash received once the goods have been sold.
- **Goods for distribution** – such as overseas development charities receiving donated goods which they then distribute to people overseas. Include the donated goods under incoming resources as donations and the same amount under the relevant expenditure category. Both entries should be in the financial year in which the goods are distributed, avoiding the need to recognise stock in the balance sheet.

Donated services

Donated services should be included in the SoFA in a similar way to donated goods, by including the value of the gift under donations and the relevant cost heading. Donated services should be included in the SoFA where the benefit to the charity is quantifiable and measurable and should be valued at the value to the charity. Volunteer time is not recognised in charity accounts, although it should be recognised in the trustees' annual report.

6 Resources expended

The categories of expenditure are:

- **Costs of generating funds**
Sub-divided into categories to match incoming resources
- **Charitable activities**
Sub-divided into a number of different categories to reflect charity activities
- **Governance costs**

Costs of generating funds

These are the costs which are associated with generating incoming resources from all sources other than from undertaking charitable activities. The main components of costs within this category are:

- costs of generating voluntary income
- costs of fundraising trading, including cost of goods sold and other associated costs
- costs of managing investments for both income generation and capital maintenance
- any other costs of generating funds.

The costs of generating funds should **not** include:

- costs associated with delivering or supporting the provision of goods and services in the furtherance of the charity's objects; nor
- the costs of negotiating the terms of a contract or performance-related grant relating to the provision of such services.

Fundraising trading costs which comprise the costs of trading to raise funds including the cost of goods sold and any other costs associated with a trading operation.

Fundraising costs should not be netted off against income. Where a branch or a subsidiary company is used to undertake some of the charity's fundraising activities, the costs of those activities would have to be included under the costs of generating funds in the consolidated SoFA.

Investment management fees are included under the costs of generating funds.

Charitable activities

This heading covers all expenditure directly relating to the objects of the charity. It should include grants payable and the direct cost of supporting charitable activities and projects (e.g. salaries, office,

communications and other costs identifiable as an integral part of the cost of carrying out those charitable activities or projects), as well as depreciation of fixed assets where used wholly or mainly for charitable activities. The charity should describe the main charitable activities and attribute expenditure to them to give an indication of the way resources are expended. This should mirror the activities shown under the incoming resources categories as far as possible. A note to the accounts will give further analysis of the expenditure. Expenditure on activities should include an appropriate proportion of support costs.

Support costs

In undertaking any activity there may be support costs incurred that, whilst necessary to deliver an activity, do not themselves produce or constitute the output of the charitable activity. Similarly, costs will be incurred in supporting income generation activities such as fundraising, and in supporting the governance of the charity. Support costs include the central or regional office functions such as general management, payroll administration, budgeting and accounting, information technology, human resources, and financing.

Support costs do not, in themselves, constitute an activity, instead they enable output-creating activities to be undertaken. Support costs are therefore allocated to the relevant activity cost category they support. This enables the total cost of an activity to be disclosed in the SoFA. Support costs will not appear as a heading in the SoFA.

The notes to the accounts should provide details of the total support costs incurred and of material items or categories of expenditure included within support costs. Where support costs are material, an explanation should be provided in the notes of how these costs have been allocated to each of the activity cost categories disclosed in the SoFA or the supporting notes to the accounts. The explanation may include percentages or amounts allocated, details of the methods of apportionment used or a table showing the detailed allocations.

Governance costs

These are the costs associated with the governance arrangements of the charity which relate to the general running of the charity as opposed to those costs associated with fundraising or charitable activity. The costs will normally include internal and external audit, legal advice for trustees and costs associated with constitutional and statutory requirements e.g. the cost of trustee meetings and preparing statutory accounts. Included within this category are any costs associated with the strategic as opposed to day to day management of the charity's activities. It will also include an appropriate proportion of overhead costs.

Allocation of costs

A reliable approach to cost allocation should be adopted, but a charity should also consider the materiality of the amounts involved and the cost benefit advantages of the approach in that greater accuracy may on occasions only be achievable at a high incremental cost.

In attributing costs between activity categories, the following principles should be applied:

- Where appropriate, expenditure should be allocated directly to an activity cost category.
- Items of expenditure which contribute directly to the output of more than one activity cost category, for example, the cost of a staff member whose time is divided between a fundraising activity and working on a charitable project, should be apportioned on a reasonable, justifiable and consistent basis.
- Depreciation, amortisation, impairment or losses on disposal of fixed assets should be allocated in accordance with the same principles.
- Support costs may not be attributable to single activity, but rather provide the organisational infrastructure that enables output-producing activities to take place. Such costs should therefore also be apportioned on a reasonable, justifiable and consistent basis to the activity cost categories being supported.

There are a number of bases for apportionment that may be applied.

Examples include:

- Usage – e.g. on the same basis as expenditure incurred directly in undertaking an activity.
- Per capita – i.e. on the number of people employed within an activity.
- On the basis of floor area occupied by an activity.
- On the basis of time (e.g. where staff duties are multi-activity).

The bases for apportionment adopted by a charity should be appropriate to the cost concerned and to the charity's particular circumstances and applied consistently.

The accounting policy notes should explain the policy adopted for the apportionment of costs between activities and any estimation technique(s) used to calculate their apportionment.

7 Charity balance sheets

Normal rules apply for most balance sheet items, e.g. buildings used for the charity's work and equipment are fixed assets on the balance sheet and depreciated. There are a few areas where the charity treatment of balance sheet items is different.

Heritage assets

Heritage assets are assets of historical, artistic or scientific importance that are held to advance the preservation, conservation and educational objectives of charities and through public access contribute to the nation's culture and education either at a national or local level. Such assets are central to the achievement of the purposes of such charities and include the land, buildings, structures, collections, exhibits or artefacts that are preserved or conserved and are central to the educational objectives of such charities.

Newly purchased heritage assets should be initially measured and recognised at their cost. Where heritage assets were acquired in the past, it may be difficult or costly to attribute a cost or value to them. In such cases these assets may be excluded from the balance sheet if reliable cost information is not available and conventional valuation approaches lack sufficient reliability. For example, it may be difficult to attribute a value to donated assets or unique assets.

Information on heritage assets should always be given in the notes to the accounts. The notes should contain an analysis or narrative that enables the user to appreciate the age, scale and nature of the heritage assets held and the use made of them. In addition, the notes should show one of the following:

- Details of the cost (or value) of additions and disposals of heritage assets during the year.
- A brief description of the nature of the assets acquired or disposed of, together with the sales proceeds of any disposals.

Investments

Investment assets (including stocks, shares, investment properties and cash held for investment purposes) are a separate category within fixed assets. Investments should be shown at their market value at the balance sheet date, with changes in value being shown in the 'gains and losses on investment assets' section of the SoFA.

For investment property, the trustees may use any reasonable approach to market valuations. For example, they may obtain a professional valuation or they may value the property themselves, particularly if

they have relevant expertise on the trustee board. However, a fresh valuation is required every five years as a minimum, although trustees should still be prepared to change the valuation if there is evidence to suggest that the value has changed significantly. Note that investment property is not depreciated.

Grant commitments

Normal rules apply to recognising liabilities where a charity makes a legally binding commitment to fund the work of other organisations. However, grants are often not documented in formal legal agreements as they are freely given with the timing and amount at the discretion of the grant-maker. Consequently a constructive obligation may arise rather than a legal obligation. In these circumstances, the grant award should be recognised as a liability on the awarding charity's balance sheet. A constructive obligation arises where there is a specific commitment to provide grant funding and this fact is communicated directly to the grant recipient. If, however, an irrevocable commitment has not been made, then the liability would not be shown on the balance sheet, but should be explained in a note to the accounts. For example, the grant-making charity may specify that certain conditions have to be met before further instalments of the grant will be made.

Further information

Statement of Recommended Practice: Reporting and Accounting by Charities

Published by the Charity Commission – latest edition July 2008
www.charitycommission.gov.uk

In addition to the SORP, the Charity Commission produces guidance on accounting and audit requirements for different size charities, along with the up to date work of the SORP Committee. Similar guidance is also available on the Office of the Scottish Charity Regulator (OSCR)
www.oscr.org.uk

A Practical Guide to Financial Management for Charities

By Kate Sayer
Published by the Directory of Social Change

SORP Made Simpler

Published by the Association of Charitable Foundations
SORP guidance specifically for grant makers.

Grants and Contracts Made Simple

Another publication in this series accessible from the Sayer Vincent website.
www.sayervincent.co.uk

Charities Aid Foundation website – www.cafonline.org.uk

CAF runs online accounts awards with ICAEW. These awards are given to charities who publish Trustees' Annual Reports and accounting online. They aim to award best practice in financial accounting, raise the standard of web-based Annual Reports and encourage more charities to display their financial information online. CAF website gives results, feedback from judges and links to winners' websites.

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.

Other guides in the series

Risk assessment made simple

Reserves policies made simple

Trading issues made simple

Subsidiaries made simple

VAT made simple

Grants and contracts made simple

Pricing made simple

Gift aid made simple

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