How trustees can get to grips with charity accounts

Many trustees will be expert in accounting, but will still find charity accounts a bit of a mystery. Other trustees will not have much financial training but they are equally responsible for the financial governance of the charity. So how to make sense of charity accounts?

Charities are different

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.

The charity should provide information on its achievements in its annual report so that readers can understand its performance. 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. Since 2016, charities have had to explain what it considers to be its major risks and how it manages them.

5 ways charity accounts differ from company accounts:

- The audit threshold is lower it's £1million of income for a charity, £10.2million for companies
- Statement of Financial Activities replaces the Profit and Loss Account
- Your SOFA will have columns for restricted and unrestricted income and expenditure plus a total and comparatives
- Relative to a company of a similar size accounts disclosures are far more detailed
- Don't just focus on the result for the year as you might in a for-profit company – the funds available at the end of the year for the charity to operate in future are key

Regulatory framework

Charities must prepare their accounts in compliance with the charity Statement of Recommended Practice (SORP). Despite the name, it is not optional.

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.

Fundraising performance

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 would 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.

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

Don't charities spend too much on 'admin'?

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. If 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. You will have to look in the notes to the accounts to find the analysis of these costs.

Charity executives' pay is transparent

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. Charities 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.

What about 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.

Should I be worried about pension fund deficits?

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.

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.

Comparing charities

It is difficult to compare charities unless they have similar operating and funding models. One charity may receive large block grants and another has to raise all their funds from the public, so you should expect the costs and financial profile to be different. Hopefully the trustees' annual report will provide a useful narrative to give you a proper insight into the charity's health and performance.

Example statement of financial activities under FRS 102 SORP

	Endowment £ '000	Restricted £ '000	Unrestricted £ '000	This year total £ '000	Last year total £ '000
Income and endowments					
Donations and legacies	253	27	15	295	57
Investment income	–	–	25	25	13
Income from charitable activities					
Childcare grants	–	257	50	307	295
Parenting classes	–	–	245	245	239
Total income and endowments	253	284	335	872	604
Expenditure					
Expenditure on raising funds					
Fundraising and publicity	–	–	21	21	29
Expenditure on charitable activities					
Childcare work	–	279	51	330	316
Parenting classes	–	–	226	226	209
Other expenditure	–	–	36	36	35
Total expenditure	-	279	334	613	589
Net income/(expenditure) before gains and losses on investments	253	5	1	259	15
Net gains/(losses) on investments	11	–	–	11	12
Net income/(expenditure) for the year	264	5	1	270	15
Net gains / (losses) on the revaluation of fixed assets	19	–	–	19	10
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