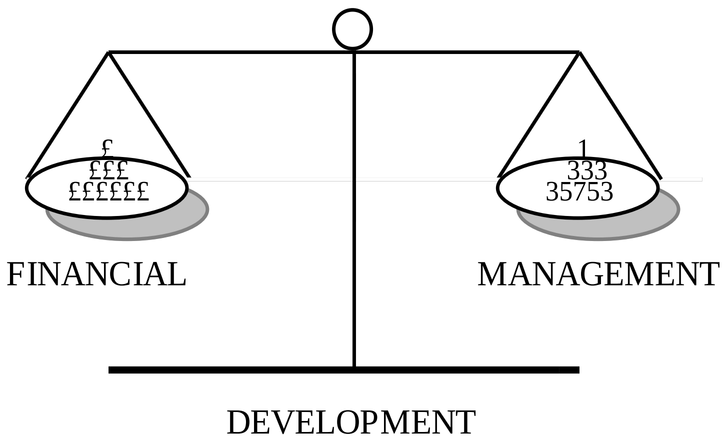
FINANCIAL MANAGEMENT DEVELOPMENT

CHARITY MANAGEMENT

NO 703

EXTERNAL FINANCIAL STATEMENTS



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

FROM

www.FinancialManagementDevelopment.com

This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

CHARITY MANAGEMENT
EXTERNAL FINANCIAL STATEMENTS

OVERVIEW

Charities and other Not For Profit organisations require two sorts of financial information. Firstly there is management information which is designed for internal use to help make decisions, and secondly there is published information for external use to inform others of the Charity's activities. Since the purpose of these documents is different it is not unreasonable that their content, format and timing will be different. In essence the internal data will be designed to be timely and useful. The external data will have to conform to specific guidelines depending on the nature of the Charity. This paper will consider the data for external use. Another paper will look at internal financial data for management.

This paper is intended as a guide for the lay person, not a blueprint for action. For fuller explanations, you are recommended to look at the papers in the section on Financial Accounting. In these papers the word "Charity" is used to cover the whole range of Not For Profit organisations and "Trustees" used for those responsible for them. In this paper it is important to consider the different requirements for different types of legal entities.

WHAT IS THE LEGAL NATURE OF THE CHARITY?

This is a key question. The main types of Not For Profit organisations are:
Trusts
Grant Funded Bodies
Unincorporated Associations
Corporations - set up by Government or under various Acts
- Companies (Normally Companies Limited by Guarantee)

For Grant Funded Bodies it would be normal to ask the Funding provider what they want. There is a similar situation with Corporations set up by Government. Trusts and Unincorporated Associations may have their reporting requirements set out in their governing instrument (Trust Deed or Constitution). Companies have to comply with the reporting Requirements of the Companies Act. These may add to the rules shown here.

For UK Charities Registered with the Charity Commissioners there is a requirement to produce Published Accounts in accordance with a document published in 2000 (revised 2005) "Accounting and Reporting by Charities" often called SORP. This basically sets out what you have to produce "except where a more specialised SORP applies" e.g. for Higher Education Institutions. Unless you want to spend much time and money arguing with Auditors and Lawyers it is best to follow the content of the SORP. It is fairly easy to read and useful as a reference document. It can be obtained from the Charity Commissioners website: www.charity-commission.gov.uk. The rest of this paper will seek to explain in layman's terms what the SORP asks Trustees to produce. It is therefore simplified and those wanting detailed information or advice are advised to seek it. This paper is intended to help them ask better quality questions of their advisor.

YOU CANNOT IGNORE THE SORP

Numbers quoted are references to the paragraphs in the SORP.
Paragraph 25 states "The charity's trustees are jointly responsible for the preparation of the Annual Report and Accounts......" Thus the next time you are asked to approve the Accounts you need to exercise reasonable care. It is no good saying "I don't understand the note about Deferred Capital Grants, but I am sure someone around the table does."

The Key Documents are set out in Paragraph 30. They are:

The Annual Report
The Statement of Financial Activities (effectively the Income and Expenditure Account)
The Balance Sheet
The Cashflow Statement
The Notes

We will look at the outline contents of each of these, with the emphasis on explaining the financial aspects, what they mean and why they are included.

THE ANNUAL REPORT (Paragraph 36)

"The Trustees' Annual Report should be a coherent document that meets the requirements of law and regulation and provides a fair review of the charity's structure, aims, objectives, activities and performance. Good reporting will explain what the charity is trying to do and how it is going about it. It will assist the user of accounts in addressing the progress made by the charity against its objectives for the year and in understanding its plans for the future. Good reporting will also explain the charity's governance and management structure and enable the reader to understand how the numerical part of the accounts relates to the organisational structure and activities of the charity."

Whilst there are some specific items which have to be included, like review of risks, this is one of the clearest and most sensible instructions that I have seen written. Your task as a Trustee is to look at the report for your charity before you approve it and see if a reasonable person would agree with you that it does what the paragraph above asks.

THE STATEMENT OF FINANCIAL ACTIVITIES (SOFA)

The Statement of Financial Activities (SOFA) is effectively the income and expenditure account. Whereas small charities may be allowed to present a simple statement of receipts and payments (effectively just an analysis of cash received and paid out), most charities are expected to present accounts based on accruals accounting principles. Thus income is shown when it is earned rather than when it is received and expenditure is shown when the cost is incurred rather than when it is paid. For an explanation of why a simple cash account is misleading see the paper on Internal Financial Statements. The analysis required in the SOFA is set out in the SORP and it is normal to have separate columns for any funds which are restricted for specific purposes e.g. grants with specific conditions as to how they are spent. It is also usual to show the comparative figures for the previous year.

The key Headings are:

INCOMING RESOURCES

Donations	-	including legacies and similar receipts
Incoming resources	-	from charitable activities e.g. fees or grants
	-	from activities to generate funds e.g. from shops or events

RESOURCES EXPENDED

Cost of Generating Funds		e.g. fundraising costs, shop costs, publicity etc.
Charitable expenditure	-	grants made to others
	-	in performing charitable works caring, education etc.
	-	support costs for the first two
	-	charity management costs

The net of the total of these two is the Net Incoming (or Outgoing) Resources. Adjustments are then required for any movements between separate funds held by the charity e.g. a charge paid by the general fund on behalf of a restricted fund needs to be recharged to the correct fund. There is then a line for any changes in asset values other than through the income and expenditure account. This is where any revaluation or devaluation of investments held by the charity would be shown.

This leads to a figure for the Net Movement in Funds, which is added to the fund brought forward to give the total value of each Fund at the year end. This of course should agree to the total of the funds shown in the Balance Sheet.

THE BALANCE SHEET

The Balance Sheet shows:

What the Charity Owns	Assets	(Buildings, Debtors Cash etc.)
Less: What the Charity Owes	Liabilities	(Creditors, Accruals, Provisions etc.)
Equals: What the Charity is Worth	Reserves	(The net uncommitted funds)

The SORP is fairly prescriptive about the contents of the Balance Sheet:

FIXED ASSETS	Intangible Assets (Rights, Patents etc.)
	Tangible Assets (Land, Buildings, Equipment, Vehicles etc.)
	Inalienable and Historic Assets (Churches, Monuments etc.)
	Investments (Held for long term income)
CURRENT ASSETS	Stocks and work in progress
	Debtors (monies owed to the charity including prepayments)
	Investments (held for short term income)
	Cash at bank and in hand
LIABILITIES	These should be split into those due over and under 1 year.
	Creditors (unpaid invoices)
	Accruals (provisions for costs incurred not yet invoiced)
	Provisions (for future costs e.g. pensions or taxation)
FUNDS	Split into Unrestricted and Restricted Funds

THE CASHFLOW STATEMENT

The Cashflow Statement is one of the most important internal reporting documents. In external published accounts it is frequently incomprehensible. Its layout is as set out in Financial Reporting Statement 1 (FRS1). Fortunately it is not obligatory for "Smaller Entities" defined as those with less than two of: Turnover (i.e. sales or income) of £5,600,000; Gross Assets (before deducting liabilities) of £2,800,000; 50 Employees. However as smaller charities are encouraged to produce a cashflow statement and inflation will erode these limits, a brief explanation may be helpful.

In essence it starts with the line from the Income and Expenditure Account headed "Net incoming/(outgoing) resources before revaluations and investment asset disposals" which everyone knows is not the same as cash; and then adjusts for all the reasons why to arrive at a movement for cash. A good Trustee will review the statement for obvious errors but only the financially astute would expect to understand why it is in that format. The only consolation is that the same standard applies for Companies and very few Company Directors understand why either.

Much of the detail will be relegated to notes but the layout will probably be:

Cashflow from Operating Activities The Net Income and Expenditure figure (plus depreciation and adjustments for debtor, stock and creditor movements)	**x**
Returns on investments and Servicing of Finance Interest Paid or Received	**x**
Investing Activities Purchases and sales of Fixed Assets	**x**
Financing Activities Borrowings	**x**
	--
Balancing to **-Increase in cash/cash equivalents**	**x**
	=

THE NOTES

The notes to the accounts are there to shed light on the detail of the numbers in the three main statements. However the first note is usually a statement of the Accounting Policies used. Since these are often difficult areas for Charities it is worthwhile reviewing what they say to ensure you agree with them. The Published Financial Statements are expected to give "A True and Fair view of the charity's state of affairs and its activities" and the Audit Report should say something on those lines. When considering accounting policies or levels of disclosure the best guide is to ask yourself "What gives the fairest view to someone not connected with the charity for that particular item?" The accounting policy merely says what you have done. On that point it is worthwhile remembering that one of the purposes of having an Auditor is for them to hear your view and then decide if they agree. It is worthwhile asking them what they think, as it may save you reinventing a policy that someone else has already decided on.

SOME DIFFICULT AREAS

Set out below are comments on some of the common problem areas. They are not from the SORP although some are drawn from the recommendations contained therein.

Income Recognition

Trustees will want to set sensible policies for the recognition of income and state these in the accounts. Legacies: included when notified, or when the cash is received? Grants: if received for the provision of a service which spans the year end, how is the receipt allocated across the two years? Subscriptions: Are annual subscriptions taken to income when received or spread over twelve months to give a liability at the year end?

Donated Assets, Goods and Services

Donated assets are normally brought in at a valuation e.g. a gift of a new photocopier is recognised as a donation at the list price and the asset is recognised and depreciated over its life. The problem is not normally the policy but how to work out the value especially for something that is not new. Donated goods e.g. for sale in charity shops are often ignored until sold when the proceeds are then brought in as a donation. Donated services are often ignored e.g. few charities attempt to value their volunteers' time and show it in the accounts. Normally these are only included if there is a specific cost to the donor e.g. an accounting firm lending a staff member to help but not charging for their services could be treated as a donation of the salary cost.

Fixed Asset Valuations and Depreciation

Fixed Assets are items owned by the charity for use over the long term. If they decline in value over time e.g. a photocopier lasts 3 years, then a charge for depreciation should be shown in the Income and Expense Account and the value in the Balance sheet will reflect this. In some cases fixed assets can be revalued. Where the original cost is unknown and/or valuation is difficult e.g. Stonehenge, there needs to be some sensible discussion on what to include in the accounts. The lives used for depreciation should be stated.

Capital or Revenue

The accounting definition of Capital spending is very broad "The bringing into existence of an asset for the future benefit of the trade." Treating an item as capital involves taking the cost to the Balance Sheet rather than against income. There it may be depreciated. All organisations have problems deciding on the dividing line between capital and revenue. Broadly spending should be treated as revenue, i.e. a cost to be charged against income unless it is big (say over £500 to avoid capitalising pencils); lasts more than one year and will bring future benefit. It helps if it is tangible. Spending £1,000 on a new logo might be treated as capital but most charities would write it off, whereas spending £1,000 on software to produce accounts for the next three years is probable capital.

Reserves Policy

Not unreasonably the SORP requires charities to state their reserves policy. Otherwise the financial position would not be obvious to the reader of the accounts. There is a clear distinction between restricted funds (reserves arising where money has been received for a specified purpose but not yet expended) and reserves set up as designated reserves e.g. to fund the purchase of an asset or a project. The former are legally unable to be used for anything other than the restricted purpose, a designated fund has an administrative purpose only and does not affect the Trustees' legal right to apply the fund.

Whatever policy you decide - state it clearly.

Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:
FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

