

Number crunching

Pesh Framjee reports on the impact of the Statement of Recommended Practice (SORP)



The charity sector, with income estimated as being in excess of £20bn, is an important part of the UK economy, so it is not surprising that charity accountability is moving centre stage. This year sees important new initiatives and developments aimed at shaping how charities identify, record and report on what matters. The government in its response to a Cabinet Office report on the charity and non-profit sector focused on the Statement of Recommended Practice (SORP) on accounting and reporting by charities as being the vehicle to improve the quality of reporting. As part of the process the Charity Commission's SORP Review Committee has reviewed SORP – the new SORP 2005 is available on the Charity Commission's website – see <http://www.charitycommission.gov.uk/investigations/sorp>.

Other useful publications available on the website include:

- The changes between SORP 2000 and SORP 2005. This is a short document

outlining the changes made by SORP 2005.

- Tracked change copy of SORP 2005. This document gives the full text of SORP 2005 and shows which parts of the text were included in SORP 2000 and which parts are new.
- Frequently asked questions and answers about SORP.

Comparability

There are far too many commentators who believe that it is possible to compare one charity with another simply by looking at accounts and measuring the ubiquitous cost ratios. The SORP clarifies that: "Charities are highly disparate in character, so any comparison of the financial information they produce should be undertaken with care, even if the charities involved seem to be similar." It goes on to dispel other myths: "The balance sheet is not necessarily a measure of the wealth of the charity"; and "The Statement of Financial Activities provides information as to how a charity receives and applies its resources to meet its objec-

tives. It is not intended to demonstrate a charity's efficiency."

Do charities have to follow SORP?

Some believe that the SORP is only a recommendation that can be ignored. This is far from the case. SORP is enshrined in accounting standards and also the law. Financial reporting standards (FRSs) are applicable to all financial statements that are intended to give a true and fair view. FRS 18 on accounting policies explains that the relevant SORP should be followed where one exists.

SORP explains: "SORP is compatible with the requirements of the law. The SORP clarifies how charity accounting is affected by legal requirements, including aspects of trust law. It provides the charity sector with an interpretation of accounting standards and principles and clarifies the accounting treatment for sector-specific transactions. In so doing, applying the SORP enables the preparers of charity accounts to meet their legal or other reporting duties for their accounts to give a true and fair view." Table 1 in the SORP provides a useful summary of the legislative framework that underpins the SORP.

Trustees' annual report

SORP recognises that there is much more to good reporting than providing historical information relating to pounds and pence and, as such, much focus is on qualitative narrative reporting as well as quantitative financial information. Importantly, there is renewed emphasis on the need to link objectives, activities, achievements, and performance narrative with the financial statements.

And there is much emphasis in the new SORP on an expanded Trustees Annual Report.

The Trustees' Report should include information on:



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SORP

SORP is mandatory for accounting periods beginning on or after 1 April 2005 (early adoption is encouraged) and it has been informed by:

■ The Accounting Standards Board's (ASB's) discussion paper: *Statement of Principles for Financial reporting – Proposed interpretation for Public Benefit entities*. This publication has informed the thinking on income and expenditure recognition.

See <http://www.frc.org.uk/asb/technical/projects/project0017.html>

■ The influential Charity Finance Directors' Group's (CFDG) authoritative report *Inputs Matter* which focused on fundraising costs, accounting practice in relation to support management and administration costs and the value of volunteers.

See http://www.cfdg.org.uk/cfdg/includes/download-files/Policy_CFDG_Inputs_Matter.pdf

- Details of the charity, its trustees and advisers.
- Structure, governance and management.
- Objectives and activities.
- Achievements and performance.
- Financial review.
- Plans for future periods.

Many charities present much of the performance information through innovative reporting formats to answer the last question. These 'impact reports' highlight:

- a) what the charity set out to achieve;
- b) what it has achieved; and
- c) what it has yet to do.

Setting this out in this way is a fairly intuitive way of reporting. The reality is that most of what it has achieved is inevitably about outputs and outcomes, because impacts require much more careful consideration and longer time frames. The key benefit is that these reports provide greater emphasis on outputs and outcomes and less emphasis on inputs, and at the same time allow better linkages to be made between spend, resource shortages and activity levels.

Income recognition

Contrary to popular misconception much of the income of charities does not come from traditional philanthropic donors but is earned by providing much needed services for a fee. In some cases the income is by way of grant and in other cases it is the result of a contract and SORP introduces the concept of a

'performance-related grant'. This is where the terms of the grant require the performance of a specified service and where the grant is conditional on specified outputs and deliverables. In such cases the income should only be recognised when the charity has 'performed' and earned entitlement to the income.

This clarification is driven by Application Note G to FRS5 on revenue recognition, which came into force for accounting periods ending on or after 23 December 2003. The Application Note refers to the right to consideration and it is important to appreciate that, in this context, this right is the direct reflection of contractual performance and is not affected by arrangements that may or not exist for stage payments or invoicing. In particular, with contracts that span the accounting reference date, the revenue recognised must reflect the proportion of work completed, rather than costs incurred or an agreed invoicing or funding timetable. This will be relevant for many charities and will require rethinking on the way that earned income is recorded in the Statement of Financial Activities.

The practice adopted by some charities of simply recording expenditure incurred and income received and not recognising 'earned' income, which meets the income recognition criteria can lead to a distortion of the reported activities. This means that the charity must have systems to record and monitor the work actually completed. It will also be necessary to take credit for ascertainable incoming resources and the cost of any resources expended while contracts are in progress.

Recognition of liabilities

SORP echoes FRS12 and emphasises that there may be an accounting liability, although there is no legal liability. SORP explains that liabilities may arise from a constructive or a legal obligation. A constructive obligation arises where events have created a valid expectation in other parties that the charity will discharge its obligations. The issue is relevant to multi-year grants and the principle is that, if the substance of the arrangement is that the charity has committed itself to making a multi-year payment, it should recognise the full liability.

Fundraising costs

Many that are responsible for the financial reporting of non-profit organisations have complained that statutory accounts suffer because income is often recognised in a different period from related expenditure. For example, new donor acquisition costs may be incurred in year one, but the real benefits of this investment in fundraising will come in later years. SORP recommends better disclosure of such information through more relevant analysis of the key components of fundraising expenditure, highlighting any exceptional costs.

A number of charity accountants and auditors are often confused about the appropriate treatment for joint costs. For example, mailings, websites and other published material may serve a dual purpose of generating income and also informing and educating in a way that furthers the objectives of the charity. The former would lead to fundraising expenditure and the latter to charitable expenditure. Useful guidelines explain that to be treated as charitable expenditure, the information supplied should be targeted at those who can use the information to further the charity's objectives. Where the information is targeted at potential donors, the expenditure should be treated as fundraising costs.

Examples of information provided to further charitable objectives include:

- A campaigning charity has a website that informs the public about what it is trying to achieve and provides information that can be used for advocacy and lobbying.
- A conservation charity has information that explains the rules about animal products and what holiday makers should not purchase when overseas.
- A medical charity provides information about the ailment and best practice guidelines on prevention, cure, medication, life style etc.

Governance costs

Recognising that a charity's overhead and management costs are generally incurred to raise funds or to apply them on charitable endeavour, SORP has dispensed with the headings of support costs and management and administration. This should also facilitate the general thrust that charities should aim for full cost recovery in funding arrangements. Support costs should be dis-

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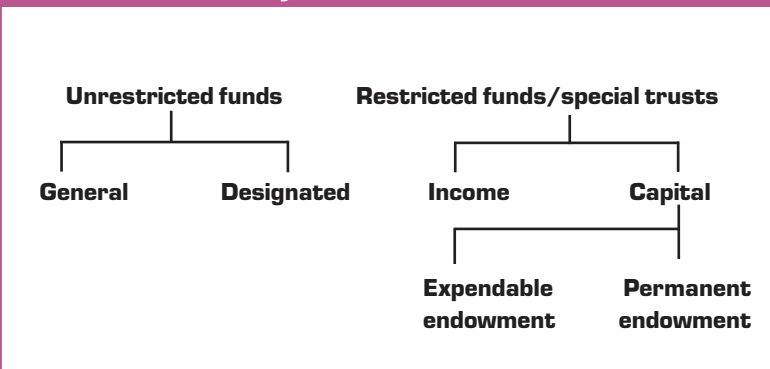
closed by way of note to the accounts with disclosure of the basis and method of cost allocation. A new category of 'governance costs' has been introduced to cover costs relating to the general running of the charity as opposed to the direct management functions inherent in generating funds, service delivery and programme or project work. These costs relate to the governance infrastructure that allows a charity to operate and to generate the information required for public accountability.

Fund accounting

It is important to appreciate that the principles of fund accounting are fundamental to trust law and are not simply the requirements of the SORP. Due to the constraints of trust law and the important matter of donor-imposed restrictions, it is vital that users of the accounts can see what the increase or decrease in net resources represents.

Many charities receive significant amounts of resources where the appli-

Funds of a charity



cation is restricted and these restrictions often affect types and levels of services. Consequently, information about the change in the nature of net assets is vitally useful in assessing a charity's ability to respond to short-term needs or higher levels of service. Therefore, the recommendations are that the resources of a charity should be grouped according to the restrictions on their use as depicted in the table above.

Appendix 3 to the SORP provides useful guidance on fund accounting.

Other areas covered

SORP also addresses new developments and includes guidance on accounting for programme-related investments and total return investment policies. There is also updated guidance on the application of financial reporting standards and a detailed section on implementing FRS17: retirements benefits.

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