

# **SORP 2005**

## **charity accounts**

### **an overview of what has changed**

January 2007

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# 1 Introduction

The content and format of church and charity accounts is governed by law and the Charities' Statement of Recommended Practice: Charity Accounting and Reporting (SORP). Despite the title, SORP has the force of law for all but smaller charities that prepare accounts on the receipts and payments basis. Charities preparing accounts on the accruals basis must follow SORP although there are considerable relaxations for charities that are not subject to statutory audit.

A new and revised SORP was published in 2005 and applies to accounting periods beginning on or after 1<sup>st</sup> April 2005. For many charities, the first period that the revised SORP will apply to will therefore be the year ended 31 December 2006

SORP has long since ceased to function purely as an accounting standard. But SORP 2005 is even more of a manual of charity accounting than earlier versions. As a result, it has become a very detailed and lengthy document.

This Paper gives an overview of selected topics covering some of the **more significant changes** in requirements from previous versions of the Charity SORP. Because of its technical nature, readers are encouraged to skip over the specialised sections to the extent that they do not apply in their own charity situation.

Our Briefing Paper "SORP 2005 charity accounts: a detailed guide" is available to those who wish to examine SORP 2005 principles in greater depth.

## 2 Receipts and Payments (R&P) Accounts

SORP 2005 does not deal with R&P accounts at all. The inclusion of guidance in previous SORPs has been recognised as giving rise to confusion.

Charities with gross income under £100,000 can generally prepare simplified accounts that do not have to comply with much of the accounting and reporting regulations. The Charity Commission and the Office of the Scottish Charity Regulator have produced guidance outside of the context of SORP for these statements of accounts. (See CC16: "Receipts and Payments Accounts Pack", available from the publications section of the Charity Commission website: [www.charity-commission.gov.uk](http://www.charity-commission.gov.uk)).

## 3 Trustees' Report

The trustee report requirements have been entirely recast by SORP 2005. New disclosure requirements include:

### 3.1 Reference and Administrative details section

Disclosure of the name of the Chief Executive or other senior staff members to whom day to day management is delegated by the trustees.<sup>(\*)</sup>

### 3.2 Structure, Governance and Management section

This new section will deal with disclosures on:

- Methods adopted for recruitment and appointment of trustees;
- Policies and procedures for induction and training of trustees;<sup>(\*)</sup>
- Organisational structure, clearly showing which decisions are taken by trustees and those delegated to staff;<sup>(\*)</sup>

- Wider networks the charity is part of, where this impacts on operating policies adopted by the charity; <sup>(\*)</sup>
- Risk management, which now refers to management rather than mitigation of risk.<sup>(\*)</sup>

### 3.3 Objectives and Activities

The disclosure requirements under this heading are re-worded to emphasise the setting of short term objectives, strategies etc. together with an explanation of the difference that the charity seeks to make through its activities.

### 3.4 Achievements and Performance

This section should now give:

- A fair review of activities and performance against set objectives (qualitative and quantitative information);
- Comment on factors affecting achievement of objectives;

But with more limited disclosures for charities below the audit threshold.

### 3.5 Financial Review

This is largely as before but will include details of principal funding sources including borrowings and how expenditure has supported key objectives of the charity.

### 3.6 Future Plans

- 3.6.1 Disclosure of plans for the future will now include aims and key objectives set and activities planned to achieve them.<sup>(\*)</sup>
- 3.6.2 The Charity Commission intends there to be a clear link between achievements in the Trustees' Report and the related income and expenditure streams in the Statement of Financial Activities (SoFA).
- 3.6.3 The changes to the trustees' report are broadly welcome. Although we are a little sceptical about the 'public demand' for this kind of reporting, the discipline of preparing these reports will focus trustees' minds on what matters – such as setting objectives, achieving outcomes, managing risk etc.
- 3.6.4 Where the accounts do have a sufficiently wide circulation, the trustees' report is a key 'shop window' providing the opportunity to 'sell' the charity to those that provide funds now or in the future.

## 4 General Principles

SORP is clear that International Accounting standards are not considered appropriate for charities. Charitable companies cannot use IAS's.

## 5 Statement of Financial Activities ('SoFA')

- 5.1 The structure and headings on the face of the SoFA have been changed with the following objectives:
- To provide a clear distinction between incoming resources derived from activities *to generate funds* on the one hand, and income received from the *charitable activities* themselves on the other.
  - To facilitate disclosure of costs based on activity undertaken.
  - To link incoming resources to costs, and activities / outcomes to expenditure.

<sup>(\*)</sup> These disclosures will not be mandatory for charities that are below the audit threshold although they are specifically encouraged as a matter of good practice.

5.2 Unless your charity's accounts are distributed beyond trustees, management, bankers, auditors/ examiners and the like, there seems little point in committing huge effort and resources to clever analysis of income and expenditure to functional (rather than natural) classifications. The important matter is to have a justifiable and consistent basis year on year. Simplicity is probably the byword here.

5.3 It is however useful to focus on the benefits or otherwise of fundraising expenditure and the public are rightly concerned to see that this is kept in proportion.

The attempt to correlate income to expenditure is clearly of interest to service delivery charities but may be difficult to apply in churches, and other charities that rely on funding from various sources 'to make things happen'

## 6 New headings on the face of the SoFA

To achieve the above objectives the following structure is proposed:

Incoming resources:

- Incoming resources from generated funds
- Voluntary income
- Incoming resources from charitable activities

Resources expended:

- Costs of generating voluntary income
- Fundraising trading (costs of goods sold etc.)
- Investment management costs
- Other costs of generating funds
- Charitable activities (rather than expenditure)
- Governance costs (rather than management and administration)

Other gains / losses:

- Holding gains / losses
- Actuarial gains / losses on defined benefit pension schemes

The resources expended section has been reorganised to facilitate disclosure of costs based on activity taken.

## 7 'Support Costs' and 'Management & Administration' costs

7.1 Another widely misunderstood area of SORP has been the distinction between '*support costs*' and '*management and administration*' costs. SORP 2005 makes two fundamental changes to address this:

7.1.1 First, '*support costs*' are more clearly defined and will no longer appear as a separate category on the face of the SoFA. Instead, these costs are to be allocated to the relevant activities within "Costs of Generating Funds" or "Charitable Activities". They should then be disclosed in the notes to the accounts, together with the basis of allocation to the relevant activities.

7.1.2 Second, '*management and administration*' costs are re-titled '*Governance costs*' to make their original intention clearer. The new term is much more narrowly defined

7.2 **Support Costs** are those costs that whilst necessary to deliver an activity, do not themselves produce or constitute the output of charitable activity. Also included is cost incurred in *supporting* income generation and governance. Examples are: central or regional office functions such as general management, payroll administration, budgeting and accounting, IT, human resources and financing.

7.3 **Governance Costs** are defined as costs relating to the general running of the charity as an entity as opposed to the direct management functions inherent in generating funds, service delivery and programme or project related work.

These are costs that allow the charity to operate and to generate the information required for public accountability. They therefore will include audit / examination costs, legal advice to trustees, costs associated with constitutional and statutory obligations, trustees' meeting costs and preparation of statutory accounts. It will include strategic as opposed to day to day management costs.

Governance costs will also include a share of overheads / support costs.

A clear analysis of all the main items of governance costs should be included in the notes to the accounts.

7.4 The re-titling of management and administration costs as 'governance costs' is a very welcome clarification which should promote a greater degree of consistency between charities in this particular aspect of cost allocation.

## 8 SoFA Cost Allocations

Advice is given on the means of apportioning costs that contribute to more than one activity. Support costs would be a typical example of costs needing to be apportioned in this way.

Another example concerns the distinction between expenditure incurred on publicity or information that raises the profile of the charity (which is essentially fundraising) and publicity or information provided in an educational manner in furtherance of the charity's objects.

Tests are set out which will enable trustees to determine this question. Where the tests are satisfied, part of the cost can legitimately be allocated to 'Charitable Activities' rather than Costs of Generating Funds.

## 9 SoFA – Incoming resources: Other specialised points of interest

### 9.1 Timing of income recognition

The rules governing the timing of recognition of income within the SoFA has been entirely re-written. These rules govern, for example, whether grant income is included as income in the current year or deferred to a later year because of, for example, grant conditions.

There are some possibly surprising outcomes here. For example, an up front grant received to cover expenditure over a number of years will not necessarily mean that the grant should not all be recognised in the SoFA in year one notwithstanding that the performance of the activity funded may stretch over a number of years. Accountants may feel that this offends the 'matching' concept.

## 9.2 Funds received as agent

There is a good deal of confusion for the Christian charity sector caused by this concept. For example, a church's Christmas offering is to go to the local orphanage. Is this restricted income of the church or does the church simply act as agent in passing these funds from the donor to the orphanage? In one case, income is included in the SoFA; in the other it is not.

The answer is not simple and depends on a number of factors. SORP 2005 will not change anything significantly although reference to the test of whether the charity controls the use of the resources in question rather than owning the resources brings a modest degree of clarity.

This remains a difficult area for churches to interpret. The key issue is whether or not the trustees are exercising their discretion in handling the funds in question. Our Briefing Paper "When a charity's income is not it's income" presents a very full technical discussion on this topic.

SORP requires disclosure in the Notes to the Accounts of all movements on agency funds even if there is no year end balance. Aside from the difficult interpretational issues, this is a very important disclosure since agency funding can be an easy target for money launderers. Charities not yet cognisant of the Proceeds of Crime Act and money laundering in the context of charities should update themselves quickly.

## 10 SoFA – Resources Expended: Other specialised points of interest

### 10.1 Grants – Constructive obligations

10.1.1 This concerns the timing of the recognition of certain liabilities. The relevant section of SORP has been entirely rewritten in much clearer form. Constructive obligations are described as well as scenarios in multi-year grant funding and the accounting treatment arising for each.

10.1.2 These new provisions can give rise to some surprising results with undesirable, possibly unintended, outcomes, especially for churches. On this, readers may wish to refer to the separate Briefing Paper "Long term support of missionaries" for further related discussion on this topic.

### 10.2 Charitable activities

Besides a clearer definition of what constitutes charitable activities, SORP 2005 expects the costs of a specific service delivery to be linked in the notes to the accounts to any related contract income or restricted fund income for that activity.

The notes to the accounts should analyse the amount of expenditure on direct charitable activity, grant funding of third parties and support costs across each activity or programme undertaken by the charity.

### 10.3 Grants – disclosure

SORP 2005 continues the previous theme of expecting an analysis of grants made between those made to individuals and those made to institutions. However, SORP 2005 defines a grant to an 'individual' as one made for the direct benefit of the individual receiving it, for example to relieve financial hardship. All other grants are institutional. Therefore if a church provides financial support to a member on mission, if the support is used for ministry purposes rather than living costs or is provided to their mission agency on a common purse basis, the grant is likely to be an institutional rather than individual grant for disclosure purposes.

The general theme of grant disclosures is unchanged. However the specific requirement to disclose the largest 50 institutional grants is replaced by a more flexible approach. More detailed guidance is also given on the expected analysis, by charitable purpose, of the total number and total value of grants as between institutions and individuals.

## **11 Balance Sheet**

SORP 2005 encourages use of a columnar format to the Balance Sheet in much the same way as the SoFA. If this format is not used, the same information must be provided in the notes to the accounts. The column headings are:

- Unrestricted funds
- Restricted funds
- Endowment funds
- Total funds
- Prior year total

Otherwise, the balance sheet broadly follows the same format as previously with one or two new headings dealing with, for example, programme related investments and a pension reserve for pension assets / liabilities.

## **12 Balance Sheet: Other specialised points of interest**

### **12.1 Negative fund balances**

Exceptionally, for example when expenditure is incurred in anticipation of receipt of restricted income (and in defined circumstances), a particular restricted fund may have a negative balance at the financial year end. This balance should NOT be netted off on the face of the balance sheet and therefore there may be both positive and negative balances on restricted funds.

### **12.2 Summarised financial statements v summary financial information**

SORP 2005 is more rigorous in distinguishing between summarised financial statements (SFS) and summary financial information (SFI). The former is a summary derived from the statutory accounts and purports to be a SoFA or Balance Sheet or summary thereof. The latter makes no reference to these primary statements and may be based on parts only of the financial statements or indeed use other information.

For charitable companies, section 240 Companies Act 1995 applies for both SFS and SFI and guidance is given to the application of this for charities.

SFS should be accompanied by the necessary statements signed by the trustees and auditor / examiner, as appropriate.

SFI should be accompanied by a prescribed statement signed by the trustees.

## **13 Analysis of Net Movement in Funds**

Paragraph 180 of SORP 2000 is completely revised to make it clear that the Analysis of Net Movement in Funds statement alone does not give an indicator of a charity's performance.

For example, a charity may invest heavily in fixed assets that are used to provide charitable services. But this investment will not of itself give rise to a change in the funds of the charity.

The cashflow statement (where prepared) can provide further valuable information in interpreting the Net Movement statement. Separate notes to the accounts may now include:

- Total net movements in funds for the year
- Net endowment receipts for the year
- Net expenditure on additions to functional fixed assets
- Net investment in 'programme related investments'

'Programme related investment' or 'social investment' is defined as investment made directly in the pursuit of the organisation's charitable purposes. Although they can generate some financial return, the primary purpose is not financial. Investments of this kind can include loans to individual beneficiaries in need or to other charities for example for regeneration projects.

### **13.1 Programme related investments**

Unlike other investment assets, programme related investments do not have to be shown at current market value. Instead they should be included at the amount invested less any impairments or amounts repaid. Impairments are charges to resources expended on charitable activities.

Further detailed disclosure is required in the notes to the accounts where material.

### **13.2 Share Capital**

SORP 2005 makes it clear that although share capital in a charity is likely to be immaterial and form part of the unrestricted funds of the charity, company law requires that it is shown separately on the face of the balance sheet. This is likely to apply only to charities constituted as an Industrial and Provident Society or a company with ordinary share capital but with a constitutional prohibition on shareholders benefiting from their shareholding.

### **13.3 Specialised Sections**

The remainder of SORP dealing with specialised situations now has its own guidance in relation to:

- Accounting for retirement benefits
- Accounting for Common Investment Funds

Large parts of the guidance on consolidation of subsidiary undertakings has been rewritten.

## **14 Conclusion**

SORP 2005 has become a very technical document. For charities that are obliged by law to follow its principles (whether by virtue of being a company limited by guarantee, an unincorporated trust with gross income of over £100,000 or through other reasons) are more likely than ever to need charity specialist advice.

Increasingly, the Charity Commission are regarding non-compliance with SORP as a risk factor that may lead to a 'Section 8 Inquiry'.

For charities that can legitimately avoid full compliance (for example an unincorporated trust that has gross income of less than £100,000) are best advised to do so. These charities should not inadvertently find themselves in the position of needing to comply (for example by preparing accruals accounts voluntarily or accepting a very modest grant on terms that require accruals accounts or audited accounts to be prepared).

## 15 Further help

Further help and assistance can be obtained from:

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e-mail: [enquiries@stewardship.org.uk](mailto:enquiries@stewardship.org.uk)

web: [www.stewardship.org.uk](http://www.stewardship.org.uk)

contacts: Stephen Mathews or Kevin Russell

Stewardship offers a Consultancy Helpline service which provides a package of support to ensure year-round assistance. For further information, visit [www.stewardship.org.uk/consultancy\\_helpline.htm](http://www.stewardship.org.uk/consultancy_helpline.htm) or telephone for an information sheet.