stewardship
transforming generosity

What you can and can't do with your charity's money: Making sense of fund accounting

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Stewardship Briefing Paper

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table of contents

Page

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About Stewardship

Our vision

Our vision is for the world to encounter Jesus through the generosity of His church. We do this by:

- Making giving easy
- Inspiring greater generosity
- Strengthening Christian causes

Since 1906, Stewardship has been helping the Christian community in the UK to give and receive. We love making giving easy and help over 25,000 individuals to give around £60 million each year, to our database of over 19,000 charitable causes.

We are committed to strengthening Christian causes, by offering practical, tailored support to help Churches and Christian charities to transform the world.

And we inspire greater generosity from this community too, through our wealth of resources, courses and campaigns for individuals and churches alike, including the multiple award winning 40acts campaign and website.

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1 Introduction to fund accounting

What is it that makes charities different from businesses? Well there are a number of things; first and foremost, the purpose of a charity must fall within one of the 13 charitable purposes set out in legislation. Second, the governance structure is normally different with unpaid volunteer trustees taking overall responsibility for the charity. Then somewhere way down the list of differences comes fund accounting; a concept unique to charities.

The concept of fund accounting applies to all charities; regardless of size, regardless of legal status and regardless of whether the charity produces accruals accounts or not. In their publication "Charity finances: trustee essentials[1]" the Charity Commission makes it clear that trustees should understand their finances and must know what funds are restricted and how those funds can be used.

However, other than this, and a small amount of guidance contained in CC19 which deals with charity reserves, the Charity Commission does not offer much guidance to church treasurers and trustees when it comes to understanding and accounting for different funds. So this paper aimed at churches will draw primarily on the 2015 Charity SORP which contains some helpful background information explaining fund accounting which in this instance applies to **all** charities.

The SORP sets out a useful summary of fund accounting. It explains that:

> Fund accounting distinguishes between two primary classes of fund:
>
> 1. Those that are unrestricted in their use, which can be spent for **any charitable purposes** of a charity and
>
> 2. Those that are restricted in use, which can only be lawfully used for a **specific charitable purpose**.

So, to be clear, unrestricted funds can be used in whatever way the church trustees decide, so long as the expenditure is for one of the charitable purposes of the church. However, trustees do not have the same level of freedom for restricted funds because these funds can only be used for the purpose for which they were given. This purpose still has to be a charitable, but now it is specific.

The SORP goes on to say that "the proper administration of individual charitable funds is essential if charity trustees are not to act in breach of trust".

Figure 1 (see next page) sets out the various types of funds available to charities. At the highest level, funds are distinguished between restricted and unrestricted with their broad uses as explained above. There are further levels of sub-division which fall under each of these main headings and the rest of this paper unpacks the different types of funds and how they might be used.

[1] https://www.gov.uk/government/publications/managing-charity-assets-and-resources-cc25/managing-charity-assets-and-resources

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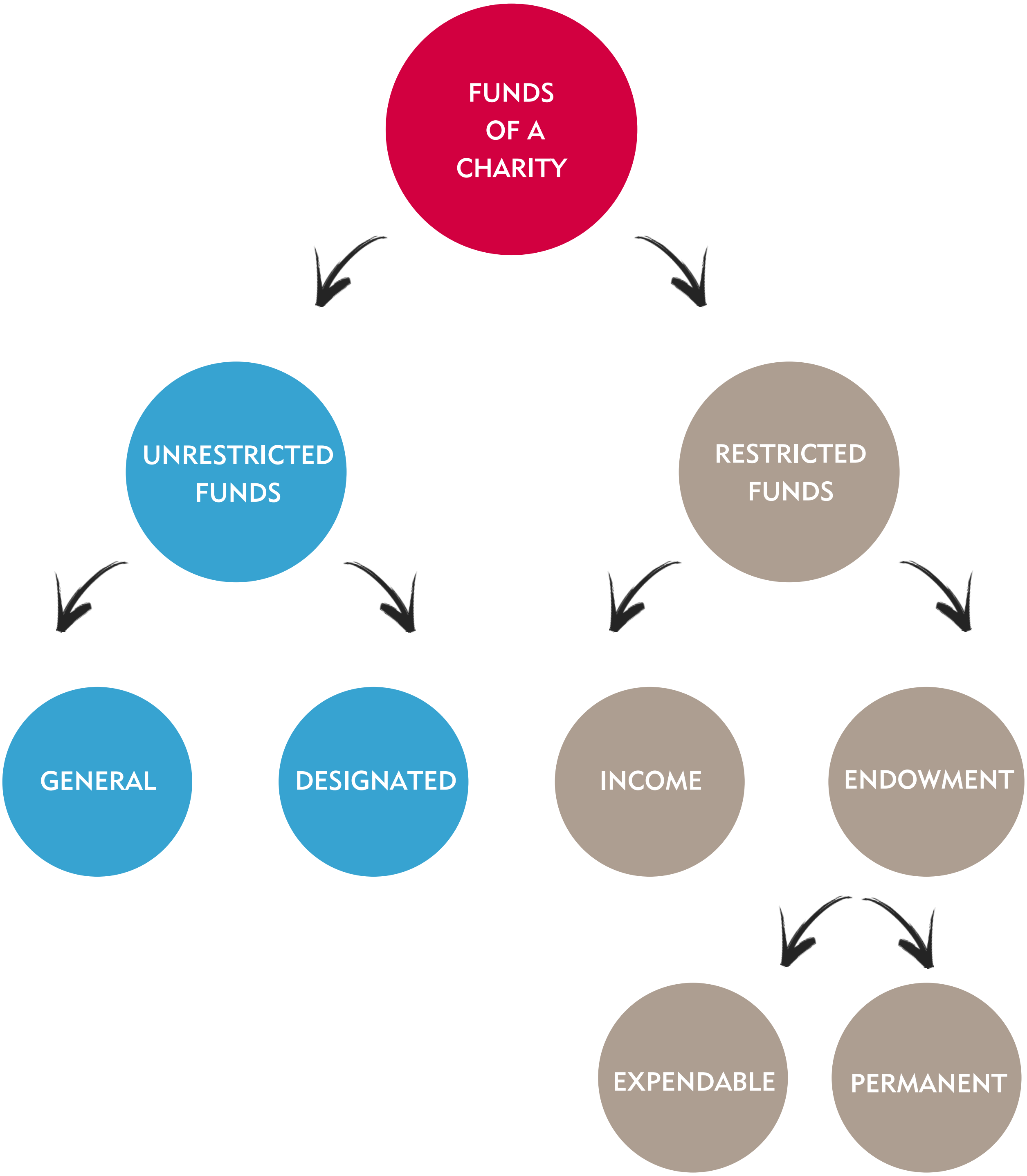
Figure 1:
Types of funds available to charities



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2 Unrestricted funds

General

Unrestricted general funds can be spent at the discretion of the trustees to further any charitable purpose of the charity. This means that these funds can be spent in their own right, or can be added to a restricted fund which does not have enough money to cover its expenditure. For most churches general offerings and donations would normally fall into this category, as would contractual income streams including, for example, rental income from church premises.

General funds are available to be used to pay for the activities of the church. These would include paying the staff, renting the church manse or being used as grants to support other individuals and organisations which are carrying out work which meets the charitable purposes of the church. They can be used for any charitable purpose within the church.

Normally, a church's reserves will be held as part of general unrestricted funds.

Designated

Designated funds are still unrestricted, but have been set aside by the trustees; 'earmarked' for a particular future project or commitment e.g. sound equipment upgrade. The designation is for administrative purposes only and carries no legal authority. So in the same way that the trustees designate funds they are also able to remove that designation without needing permission from anyone else.

One of the main advantages of designating funds is that everyone becomes aware of the reason why the funds are being held, and they are not considered to be available for general purposes. If we do have funds which are known to have been set aside for the sound equipment, they are less likely to be used for general purposes. Everyone knows what they are going to be used for and that spending this money on something else may mean that the sound equipment can't be easily replaced. However, in a situation where the church is in need of finances for general purposes, the trustees may decide to remove the designation and so free those funds up completely.

The downside of having a number of designated funds is that the church needs to keep track of income and expenditure for each fund. That can be time consuming and, depending upon which accounting package you use, not very straight forward. We cover that aspect more in the "accounting for funds" section a little later in this paper.

Although designated funds should be separately identified, this does not mean that they have to be held in a separate bank account. In some cases where the amount is large, or perhaps represents the church's reserves, a church may choose to hold them separately, but they are not required to do so.

Where trustees choose to designate funds or to remove a prior designation, we suggest that the matter is discussed at a trustees meeting and decisions are formally recorded in the minutes. If there is a conflict of interest in that discussion, this should be noted and the conflicted trustee should play no part in the discussion or the decision.

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3 Restricted funds

Restricted funds are completely different. Restricted funds refer to funds held under 'specific trusts'; in lay mans' terms that is held for a specific charitable purpose. The restriction carries the weight of the law and so restricted funds can only be lawfully spent on the specific charitable purpose for which they were provided. As with designated funds, there is no requirement for restricted funds to be held in a separate bank account, although in practice we do tend to see this happen a little more often.

The restricted purpose may be declared by the donor when making a gift e.g. a donation intended for a specific overseas mission, or to help pay a particular employee of the charity. A restriction may originate from the terms of a financial appeal e.g. raising funds for a new building or building refurbishment.

Appeals can be particularly problematical if they are not handled properly and we would always suggest that the purpose of any appeal is not defined too narrowly as this can lead to cash being tied up in a restricted fund not available for any other use. Please see our briefing paper on financial appeals at stewardship.org.uk/resources for some tips on how to handle an appeal and avoid getting into an unwanted situation.

As a general rule, without different instructions from the donor, any income tax recoverable under Gift Aid carries the same restriction as the donation itself and therefore becomes part of the restricted fund. Where restricted funds have been used to buy a fixed asset, the terms of the gift are important when trying to decide whether the asset itself is restricted. If the terms of the restriction are met when buying the asset then the asset can be used on an unrestricted basis for any charitable purpose. In other circumstances the terms may require the charity to hold on to the asset for a specific purpose. The circumstances which apply in each case are what is important.

Restricted funds are then further subdivided into income funds and endowment funds.

Income

Restricted income funds are to be spent within a reasonable period from their receipt to further the specific charitable purpose for which they were given. There is no definition of reasonable period but although it does not mean immediately, it also does not mean that they should be held for longer than is necessary. In some cases e.g. a building project, restricted funds may be held for a number of years whilst additional funds are sought to reach the necessary amount to undertake the project, in others where funds are perhaps given to support an overseas mission, these should generally be passed on in good time unless for good reason.

A charity may have any number of restricted income funds each for a different purpose and we have seen some churches with 20 or more! As with designated funds, the more restricted funds a charity has, the more difficult it is to keep track of them all. However, as the restriction carries the weight of the law, unlike for designated funds, the trustees cannot simply remove the restriction. Normally, restricted funds can only be used for purposes other than the restricted purpose with the express consent of the donor which is not always easy to get particularly with the passage of time.

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Endowment

Restricted endowment funds require charities under trust law to invest the assets of an endowment, or retain them for the charity's use rather than to spend them.

A gift of endowment, in cases where there is no power to convert the capital into income, is known as a permanent endowment fund and must normally be held indefinitely. Where the trustees have the power to convert endowment funds into income, such funds are known as expendable endowments.

As these are the least common type of funds, we cover them more fully in the appendix.

4 Transfers between funds

It is possible to transfer money between funds and there are various reasons why you might want to do this. Of the examples provided in the Charity SORP the one that is most often seen in churches is a transfer from an unrestricted fund to finance a deficit on a restricted fund. The Charity SORP (2.26) includes other examples. Transfers can be made between or from restricted funds in certain limited cases.

For example, where it can be demonstrated that expenditure from a general fund has been used for a restricted purpose, the restricted fund may be able to 'reimburse' the general fund for that expenditure. This is only possible in cases where the restricted fund has a sufficient balance available at the time of the payment and not in cases where restricted funds are received after the event. Suffice to say that transferring between or from unrestricted funds is far easier than transferring between or from restricted funds.

5 Accounting for funds

Prior year comparatives

For those churches which are preparing their accounts on an accruals basis, the charity SORP requires prior year comparatives for each type of fund. These can be shown on the face of the SoFA, or by way of the notes. Whilst obtaining the necessary figures is not difficult, sometimes being able to present so many figures clearly is not always so easy.

Some churches with fewer funds types have tended to include all comparatives on the SoFA. On the other hand, those churches which have endowment funds as well as other restricted funds have often opted to show the comparatives by way of a note to the accounts, perhaps switching to a landscape layout for that page. Either approach is perfectly acceptable.

Keeping track

As we have already mentioned, one of the problems for churches which have a large number of funds (designated or restricted) is keeping track of the income and expenditure which relates to each one of them. The year-end accounts will include a note setting out the opening balance, inflows and outflows, and transfers for each individual designated and restricted fund, and in the case of restricted funds should also include narrative setting out the nature of the restriction.

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Accounting software designed primarily for the charity sector normally includes functionality that makes fund accounting easier. More commercially oriented software does not handle fund accounting so well (if at all) and can cause a real headache to trustees and treasurers, especially for those charities operating with many different funds.

So, before the trustees place too many designations of unrestricted funds, or agree to accept too many different types of restricted income funds they need to be aware of the accounting issues, and have in place systems and procedures which ensure that income and expenditure relating to each fund is properly identified and captured.

Remember, trustees are not obliged to accept every restricted donation offered to them.

6 Charity SORP

Module 2 of the 2015 Charity SORP, sets out in some detail the characteristics and regulations which apply to the different types of fund. We suggest this module is essential reading for all church treasurers regardless of whether your charity produces accruals accounts or not. The 'fund principles' set out in the SORP apply in all cases and to all charities.

7 Conclusion

Fund accounting is a concept unique to charities. It is not straightforward and particularly for the lay-man can take time to understand and come to grips with. Many of our consultants have been in more than one charity trustees meeting trying to explain why restricted funds can't be used to pay a shortfall in this month's wage bill.

The most important aspects for trustees are;

- To be clear why a certain fund may carry a restriction or a designation;
- To identify and to account for each fund correctly.

Although this sounds simple, in practice it is not always the case and so we would ask trustees to think before taking on funds unnecessarily.

8 Contact us

For further help or information, please contact us on 020 8502 5600 or email enquiries@stewardship.org.uk. You can also visit our website at stewardship.org.uk.

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Appendix 1

As set out in the main text of this paper, endowment funds fall into two categories, expendable and permanent. Although expendable endowments are very rare, we have seen none in practice, we cover both types of fund below.

The charity has a responsibility to invest the endowment funds and any income produced from this investment must be spent on furthering its charitable purposes. Once again depending upon the terms of the endowment, this income can be either unrestricted or restricted. A church may have several endowments each of which may be treated differently.

Expendable endowments

A gift of expendable endowment is one where the trustees have the power to convert part or all of it into income. On first glance, expendable endowment funds might look a lot like restricted income funds. However, where restricted income funds need to be used within a reasonable timeframe, there is no requirement for trustees to actually spend or apply expendable endowment funds until such time as the trustees decide to do so. Once that decision is made by the trustees, the relevant funds are either unrestricted or restricted depending upon the terms of the gift.

Permanent endowment

Permanent endowments that we come across most often take the form of land and buildings. Although less common amongst churches, financial investments are another form of permanent endowment. However, permanence in this context does not mean that the same assets, the same buildings or the same investments, have to be held for ever. Financial assets can be sold and reinvested in other financial products, capital assets can be sold and the proceeds used to buy similar assets. This is a common occurrence in the case of church properties where the church sells an endowment fund building but reinvests in a different church property.

Endowment assets are no different from other assets and may be capable of depreciation or impairment. It may also be the case that improvements and extensions to a permanent endowment property will then themselves be treated as if they were part of the endowment asset.

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