Accounting terms for charities

Firstly, you need to understand what sort of accounts you should be preparing, either:

- the receipts and payments or cash basis
- the accruals basis

(The Charity Commission has lots of up to date information about this to help you).

Cash-basis accounting

Date	Description	Ref	Income	Expenses	Bank Balance	
1-Apr	Balance b/f				200.00	R
4-Apr	Folders and pens	1		15.00	185.00	R
15-Apr	Sale: Ms E Dey	2	54		239.00	R
18-Apr	Sale: Mr B Paul	3	30		269.00	R
19-Apr	Drawings	4		10.00	259.00	R
21-Apr	Envelopes & Stamps	5		20.00	239.00	R
24-Apr	Web host fees	6		40.00	199.00	R
27-Apr	Simply Chairs: Chair	7		127.00	72.00	
29-Apr	Sale: Mr S. Sen	8	30		102.00	R
30-Apr	Bank Fee	9		2.50	99.50	R
30-Apr	Sale: Mr B. Roy	10	54.0		153.50	
	Totals		168.0	214.50	153.50	C/F

Cash accounting is where transactions are 'recognised' only when cash changes hands. This is also called a "receipts and payments" form of accounting. The advantage over accrual-basis accounting is its simplicity. Non-company charities with gross income of less than £250,000 are entitled to prepare their accounts on this basis.

Accrual-basis accounting

Debit (DR)	Advertising Expenses		Credit (CR)
Bank	**7,500**	**Accrued Expense (Reversal)**	**1,325**
		(Release of accrual from last year)	
Accrued Expense	**1,000**		
(Accrual for invoice received after the year end)		**Statement of Profit/Loss**	**7,175**
		(SPL) *(Balancing figure)*	
	8,500		**8,500**

Debit (DR)	Accrued Expenses		Credit (CR)
Advertising Expenses	**1,325**	**Advertising Expenses**	**1,325**
(Release of last year's accrual)		*(Last year's accrual)*	
		Advertising Expenses	**1,000**
		(This year's accrual)	
Balance c/d	**1,000**		
	2,325		**2,325**

This is a form of accounting where transactions are recorded when they occur, notwithstanding when the related cash exchanges hands. E.g., a charity is normally invoiced in arrears for a consultant's fees. The consultant has done some work in a given accounting period, but at the end of that period, no invoice had been received. The estimated cost that relates to those services is an accrual.

What is financial reporting?

Financial reporting is the disclosure of financial results and related information both to management and external stakeholders, i.e., funders, members, users, and beneficiaries about how you are performing.

Financial reports or management accounts are usually issued on a quarterly and/or an annual basis and include the following:

- Balance Sheet or Statement of Financial Position - usually the end of a fiscal quarter or year.
- Income Statement or Profit and Loss Report – reports on income, expenses, and profits over a period of time, such as a fiscal quarter or year. This includes sales and the various expenses incurred during the stated period.
- Cash Flow Statement – reports on cash flow activities, including its operating, investing, and financing activities.

Dependent on the size of your organisation this may be a simple version of just one of the above or all three.

Balance sheet

A snapshot of an organisation's finances on a given date. For charities, this includes the value of its "assets," "liabilities," and "reserves" as at that date (see below for more on these terms).

Statement of Financial Activities

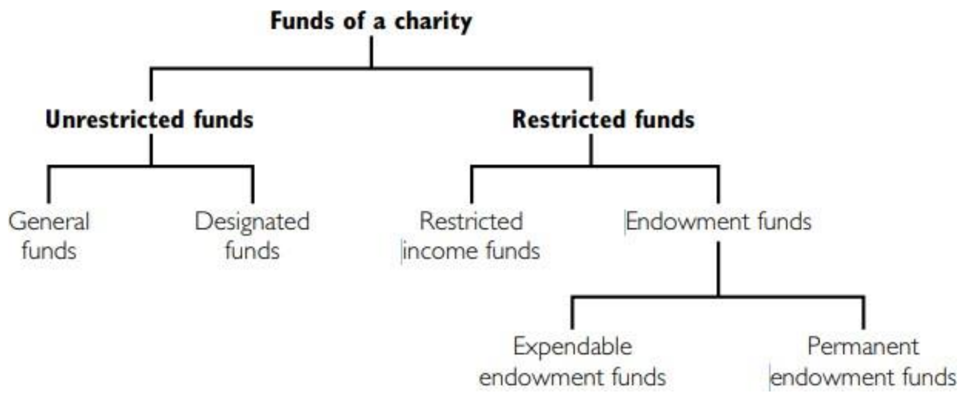
This is a summary of a charity's financial performance over a given period. This includes its income and expenditure for that period, as well as a summary of movement in reserves. For certain organisations, it is also called an Income & Expenditure Account (or Profit and Loss Account for profit-making organisations).

Profit and Loss

The profit and loss statements contain summarised information about revenue and expenses. These statements can be generated on a weekly, monthly, quarterly, or annual basis. Remember if you are a trustee to ask for financial information in a way that you can understand and ask questions.

How your funds are organised

A fund is essentially a pot of money or resources held for specific purposes.



Unrestricted funds

This is income that has no external conditions or expectations on the charity in its use. The charity has discretion as to how the funds will be applied to achieve its objectives. It is common for these reserves to be referred to as “General funds.”

Designated reserves

Designated reserves are a portion of unrestricted reserves that the charity has earmarked for specific purposes. The difference between designated reserves and restricted reserves is that for designated reserves, the purpose requirement is internally imposed, while for restricted reserves it is externally imposed either explicitly or as an expectation on the charity by external stakeholders.

A charity can have many different types of designated reserves:

Fixed asset fund

This represents the proportion of a charity's reserves that is tied up in fixed assets – it means that it would be difficult to turn those reserves into cash.

Development fund

Trustees may choose to set aside some funds for expected future costs of exploring new projects or services.

Free reserves

The balance of unrestricted funds, after designated reserves have been deducted.

Restricted income

A charity's income is said to be restricted if: either the donor has stated that the income should be used for a specific purpose or in a certain way; or the charity has created an expectation that the money will be used for a specific purpose or in a certain way during the application process. Any unused restricted income after all related costs have been charged is carried forward in a restricted reserve.

Endowment funds

These are a special type of restricted funds, often in the form of "permanent endowment funds," which comprise of a restricted capital fund usually for generating future income for the charity e.g., through interest, rental income, or dividends. Usually, the endowment fund itself cannot be spent, except with approval from the Charity Commission. The income generated is itself unrestricted usually and mixing it together with the endowment fund can be misleading as this would give the impression that it is also "locked in."

Useful terms when applying for grants:

Direct costs

These are costs that can be directly attributable to a given activity, so they increase or reduce in line with activity levels. Examples include printing training materials for a training project; the salary of those employees who are specifically hired for and whose time is dedicated to the specific project; the purchase cost of items for distribution to beneficiaries; etc.

Indirect costs

These are costs that cannot be directly attributable to a specific project and are needed for the general administration of the organisation. They are sometimes also called support costs, shared costs, or overheads. Examples include office rent, administration, staff salaries, office supplies, etc. This expense is often distributed among projects based on a formula.

Grants

Contributed assets given by an individual or another organisation with no reciprocal receipt of services or goods. Sometimes grants are given with a legal restriction imposed upon their use.

In-kind contribution

A contribution made of goods or services rather than cash.

Internal controls

The system of practices, procedures and policies intended to safeguard the assets of the organisation from fraud or error and ensure accurate recordkeeping.

Management and general expenses

Expenses that are used for the purpose of planning and managing the organisation as a whole rather than for projects or fundraising. Expenses may include all or part of the cost of the senior management team, finance, human resources, and general promotion and communications.

Preparing your Annual Report and Accounts Charity SORP

A SORP is a Statement of Recommended Practice. The SORP provides a comprehensive framework of recommended practice for charity accounting and reporting. It provides a mechanism enabling charities to meet the legal requirement for their accounts to give a true and fair view and provides consistency in the sector's interpretation of accounting standards. The SORP also provides recommendations for annual reporting that are relevant to sector and stakeholders' needs and are in line with wider developments in reporting.

Statutory audit versus independent examination

A statutory audit is a rigorous review of an organisation's financial statements under the Charities Act 2011 and Companies Act 2006. The auditor will form a 'positive' opinion on whether or not the financial statements show a true and fair view of the organisation's finances. Charities require an audit if their gross income is above £500,000 or if their gross assets are above £3.26m and their gross income is above £250,000. An independent examination on the other hand provides "negative" assurance that "no evidence was found of a lack of accounting records; nor of the accounts failing to comply with the records; nor of accounts failing to comply with the Charities Act; nor are there other matters that need to be disclosed."

An independent examination therefore usually requires less rigorous testing than an audit (and can be significantly cheaper for charities). All charities whose gross income is above £25,000 a year require an independent examination of their accounts. If the charity's income is above £250,000 (but below the audit threshold), the independent examination must be completed by a qualified accountant.

Assets

An asset is something of value that an organisation owns. Some assets can be owned over the long term (usually more than 1 year), and these are called fixed assets. E.g., property, equipment, vehicles, etc. Other assets can only be owned for a short term (usually less than 1 year), and these are called current assets. In accounting for charities, current assets will normally refer to either cash or something that can be converted into cash within short time e.g., amounts owed to the charity.

Liabilities

A liability is something of value that an organisation owes. There can be long-term liabilities i.e., repayable in more than 1 year e.g., loans and mortgages or short term i.e., repayable in less than 1 year e.g. amounts owed to suppliers.

Accruals accounting: Income

In accruals accounting therefore, income refers to any amounts that the charity has become entitled to, whether actually received or not. For example, a small charity with a 31 December year-end receives confirmation of a grant funding to cover costs for quarter 4 to December, but money does not actually get transferred until early January. This amount would be included in the income for the year under accruals accounting (but not under cash accounting).

Accruals accounting: Expenditure

In accruals accounting, expenditure is reported when there is a commitment by the organisation to incur the cost. For example, if a charity with a year end of 31 December has a staff Christmas dinner at a rented space, but the invoice is only received in January and the payment is made soon after. The cost of renting the space is included in the year of the Christmas dinner, even if the payment is made the following year.

Accruals accounting: Surplus versus deficit

The difference between income and expenditure in any given financial period is a surplus if income is higher than expenditure, and a deficit if income is lower than expenditure. A charity's total reserves will increase or reduce over time by the amount of surplus or deficit in each financial period.

Accrued income

Amounts which an organisation becomes entitled to in one period, but payment had not been received at the end of that financial period, and no invoice had been issued.

Prepayments

Payments made in one accounting period, but the goods or services will only be received in future periods. E.g., An organisation whose year-end is 31 December pays for hall hire in December, to use the hall in May the following year. Prepayments are current assets.

Debtors

Amounts owed to the organisation. This is a general term that can also include prepayments and accrued income. A more specific term is trade debtors, which refers to amounts owed to the organisation and for which an invoice has been issued.

Deferred income

This is income that has been received (or has been invoiced) in one financial period but relates to future financial periods. For example, an organisation with a financial year end of 31 December may receive a grant in November, to support activities that will be carried out from January to December the following year. This amount is 'deferred' to the following period, as that is when the organisation would "earn" it.

Creditors

Amounts owed by the organisation. This is a more general term which sometimes also includes accruals. A more specific term trade creditors is used to refer to amounts owed to suppliers for which invoices have been received by the organisation.

Liquidity

This is a term used to refer to the measure of an organisation's accessibility to cash and whether this is sufficient to cover its short-term obligations. It is about how quickly the organisation can increase its cash in order to meet its immediate obligations. We would say that an organisation has liquidity problems if it is unable to meet its immediate obligations (which is possible even if the charity may not be running a deficit on its Income Statement).

Allocation versus apportionment of support costs

Support costs are normally allocated or apportioned to projects following agreed cost allocation principles.

Support costs are allocated to a project if the project caused the overhead cost to be incurred – e.g., if the charity has to expand its premises in order to accommodate a new project. Allocable support costs are akin to direct costs. However, we can only allocate support costs in this way if the amount can be reasonably known.

Support costs are apportioned if they cannot be specifically identifiable to a specific project. These are therefore apportioned on a reasonable basis to the organisation's projects or "cost centres." Reasonable bases of apportionment include staff time, floor space, and proportion of geographical coverage.

Natural classification versus functional analysis

Charities which are subject to audit by law are required to follow the functional analysis of expenditure. Smaller charities which are below the threshold can follow a natural classification.

Natural classification

This is where income and expenditure are described according to their natural name without categorisations. For example, costs such as rent, travel and subsistence, salaries and wages, telephone, etc. would be shown in the Statement of Financial Activities (or in a Note to the Accounts) with these natural names.

Functional analysis

This is where income and expenditure are analysed according to their functional headings. These are:

- Incoming resources - from generated funds (including voluntary income, income from activities for generating funds, and investment income)
- Incoming resources from charitable activities
- Other incoming resources

Resources expended

Costs of generating funds (including costs of generating voluntary income, fundraising trading: costs of goods sold and other costs, and investment management costs).

- Charitable activities costs
- Governance costs
- Other resources expended

Fixed costs

These are costs which remain the same notwithstanding the level of the Charity's activities. For example, a homelessness charity that provides a sleepover service in the winter days may pay the same amount for rent on each night notwithstanding the number of service users that actually stay. Rent is a fixed cost in this case.

Variable costs

These are costs which will reduce or increase depending on the level of activity. e.g. the costs of buying volunteers' lunch for a series of campaign activities will depend on the number of events held and number of volunteers for each event. In this case, these are variable costs.

Reserves

A charity's reserves is the accumulation of its surpluses and deficits over its life. There are two broad categories of charity reserves: restricted and unrestricted reserves.

(Take a look at Sayer Vincent's helpful diagram on page 14 Reserves policies made simple).

Reserves versus cash balances

A charity's reserves do not normally equal its "cash reserves" i.e., the total amount held in cash and bank accounts. This is because there are non-cash items that are included in reserves but not in cash reserves. In general, a small charity's reserves comprise:

- Bank and cash balances
- Add net book value of fixed assets (see above)
- Add other amounts receivable (see above)
- Less amounts payable (see above)

Restricted reserves

This is the excess of accumulated restricted income over restricted expenditure. These are sometimes also called restricted funds.

Restricted funds versus deferred income

Deferred income is about income that the charity has received or invoiced but has not yet "earned" i.e., the timing of the related activities is in future periods. Restricted reserves on the other hand represent the excess of income over expenditure on restricted reserves i.e., it is about the purpose of the income or the manner in which it should be spent, rather than the timing of use.

Other useful terms

Capital campaign: A fundraising effort with a specific purpose and goals that is above and beyond the ongoing fundraising. The purpose of the campaign is usually for a building project, special programme, endowment, or reserves.

Capital expenditure: Payment of money to acquire fixed assets, such as a building or equipment.

Capitalising an asset: Recording the cost of land, a building or equipment as fixed assets rather than as an expense when purchased.

Cash flow: The movement of cash into and out of an organisation; or the difference between cash receipts and cash disbursements during a period of time.

Cash flow projection: A management tool used to predict incoming and outgoing cash during a specified period of time. Used to anticipate and plan for times of low and high cash balances.

Change in net assets: The net results of total income minus total expenses for a period of time, which may be Positive or Negative. Also referred to as surplus or Deficit.

Chart of accounts: A list of all accounts used in the accounting system, including assets, liabilities, income, and expenses.

Contribution: A donation, gift or transfer of cash or other assets.

Deferred revenue: Income for which payment has been received before it has been earned. It is reflected as a liability on the Balance Sheet until it is earned and can be recognised as income in a future accounting period.

Depreciation: The recognition, by recording an expense, of the decrease in value of a fixed asset over its expected physical or economic life.

General ledger: Accounting system tool for recording all transactions.