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**Charity Accounting and Reporting:
Big Challenges and Big Changes**

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Charity Accounting and Reporting: Big Challenges and Big Changes

by

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A big sector

The charity sector is significant socially and economically. The activities of charities, including such well-known names as Cancer Research and the Royal Society for the Protection of Birds in the UK, and Trócaire and Focus Ireland in the Republic of Ireland (RoI), are pervasive and often highly visible. The sector represents the sphere of social activity undertaken by organisations that are non-profit and non-governmental. It is quite different from either the private or the public sectors in terms of its orientation and motivation, the nature of its activities, its resource availability and the manner of its contribution to the public good. Regardless of their size, charities play a vital role in society, often serving and helping those who are most disadvantaged or marginalised. In both the UK and RoI, an organisation is considered to be a charity if its purposes are deemed to be ‘charitable’ and it fulfils a ‘public benefit’ (with the law in each jurisdiction specifying how such factors are determined). In terms of economic activity, the sector is large:

- in the UK there are over 200,000 registered charities with an estimated total annual income approaching £80 billion; and
- in RoI, where it is more difficult to get accurate estimates of numbers and economic significance (partly because of a regulatory framework more in its infancy), it is estimated that there are over 8,000 charities, which are a subset of a larger not-for-profit (NFP) sector of 12,000 organisations with an annual income of approximately €6 billion (approximately £5 billion).

Big challenges: scandal, trust and funding crises

It is a sector where trust and confidence by the general public (and society at large) are crucial as a basis for ensuring its health and growth. Scandals, however isolated, have the potential to inflict considerable damage. For example, in the UK in 2015, there was the collapse of Kids Company amid allegations of financial mismanagement; and the much-publicised suicide of the 92 year-old poppy seller Olive Cooke (believed to have received almost 3,000 charity mailings in a single year). Similarly, in RoI, the Irish Hospice Foundation, for example, claimed that scandals in 2013 and 2014, involving the now reconstituted Central Remedial Clinic and Rehab, resulted in a 50 per cent drop in donations to the hospice’s annual Christmas appeal.

In addition, it is a sector that is changing, or perhaps, more correctly, it is a sector that is being changed by the external challenges that it faces. Pressures on funding and demands on services have intensified. These, often triggered by the recent financial crisis and subsequent programmes of austerity with respect to public spending, have created a ‘perfect storm’ for charities, whereby they try to do more with less. Such has necessitated, among other things, major adjustments in strategies for seeking and using precious funds, although the ethical stance of a few charities in this regard has not always been viewed as of the highest standard (in particular, see Andrew Hind’s 2017 article in *Public Money & Management*, ‘Fundraising in UK charities: stepping back

from the abyss' – Andrew was the first chief executive of the Charity Commission in England and Wales). Furthermore, expansion of the charity sector has frequently been openly endorsed (and funded) by governments, sometimes based on policy objectives related to a perceived 'appropriate' balance of government and non-government activities. This has occasionally increased the risk of inappropriate interference and steering by government, with potential negative consequences to a range of stakeholders, including the public.

Need for better accountability and better reporting

Given the growth in size and reach of the sector, the need for it to operate transparently and discharge accountability has been widely articulated. Indeed, under the 2006 Charities Act, the Charity Commission in England and Wales has been charged with the responsibility to: enhance charitable accountability; increase public trust and confidence; and promote the effective use of charitable funds. In Scotland and Northern Ireland, major recent changes in the regulatory environment have emphasised similar themes. In RoI, the Department of Justice, Law Reform and Equality is responsible for charity regulation. While the Charities Regulatory Authority (CRA) was established in October 2014, elements of the RoI Charities Act 2009 are still awaiting legislative commencement and, at the time of writing (June 2017), the task of creating a register and implementing a robust system of regulation and oversight is still in its infancy.

The strength of the charity sector comes from the value society places on the social capital that it generates. A key argument is that good regulation underpins good accountability, good accountability supports the building of trust, and trust is essential to ensure the continuing health of the sector (including its ability to access funding). Conversely, poor regulation undermines accountability, undermined accountability damages trust, and damaged trust weakens the sector (and makes it more difficult to access funding). Therefore, good accountability is vital. Accountability can be viewed as being related to the requirement to be answerable for one's conduct and responsibilities; a concept that comes more into focus when faced with a changing and dynamic external environment (influenced by, for example, funding pressures and high-profile scandals). While accountability is wider than accounting (no matter how widely we define accounting), good accounting and reporting are key aspects of a good system of accountability.

The conventional view of accounting is that it is a purposive activity, directed towards a specified end, which is the meeting of users' (or stakeholders') information needs. While accepting that accountability is more than accounting, focusing on the information needs of users seems clearly linked with ideas relating to accountability. In considering accountability, two key questions emerge: to whom is a charity accountable? and what form should that account take? It can be argued that donors (or funders) are a primary upward stakeholder group to whom an account is owed (they provide funding to a charity and often receive no direct economic benefit in return). Without their support charities cannot function and charitable activity will cease. In terms of the form of the account, while financial accountability (through audited financial statements) may be important (to indicate, for example: that the money raised has been used for the appropriate purposes; that the charity has 'lived within its means'; and the level of resources available to the charity for future service provision), such accounts are likely only to be of secondary importance. Other wider information, particularly relating to performance, is probably paramount in discharging accountability to donors; and this will require the telling of 'the story' of the charity in a way that is truthful, consequential and engages with donors. With donors, good accounting and reporting are likely to be central to the discharge of accountability.

A sector in crisis

The framework for charity accounting and reporting in the 1970s and 1980s was extremely weak. In the UK and RoI regulation was not robust; only England and Wales had such a functionary and it focussed little on accounting and reporting. Charity law was diverse and it had little to say about charity accounting. While charities were often under an obligation to keep proper books of account and to prepare financial statements, frequently such statements did not have to show a 'true and fair view' and were not required to be audited. In practice, the detailed application of accounting standards was commonly ignored (even when charities were incorporated as limited companies) by both preparers and auditors of financial statements. Overall, there was little pressure to improve charity reporting from legislation, accounting standards or an effective regulatory body, and wider reporting (such as that relating to governance and performance) was rarely on the agenda.

A major input to the highlighting of the questionable state of accounting and reporting at this time was pioneering research conducted by Peter Bird and Peter Morgan-Jones (*Financial Reporting by Charities*, 1981). This revealed a sector where non-compliance with accounting standards was prevalent, archaic accounting treatments were used and wide disparity in accounting practices between charities was observed. Stark examples of these failings were given, often strongly contrary to the relevant accounting standards or normal practice, and frequently with the effect of understating surpluses and assets, or overstating losses and liabilities. Examples of such practices included:

- Recording legacy income (in full or partially) to capital rather than income. The majority of charities that received legacies (that is, most charities in the survey), either credited them directly to capital, or split the credit between revenue and capital (often through the use of a 'legacy equalisation account').
- Immediate expensing of fixed asset purchases (rather than capitalising and depreciating such assets over their useful life). Indeed, in a small number of cases, even freehold property was written off on acquisition.
- Creating provisions for future expenses which were charged to the income statement to reduce the surplus / increase the deficit of the period (contrary to the rules on provisioning).

This perceived bias towards treatments which made charities seem more in need of funds, led Bird and Morgan-Jones to suggest that (p.196): 'Management is fearful that, if they report truly and fairly, its fundraising activities will be adversely affected, and therefore ways and means are found for tucking away revenue and charging expenses which would not be tolerated in business accounts.' Moreover, they concluded that this situation was tolerated, and indeed perpetuated, because there was no effective monitoring of the public accountability of charities.

The SORP: a vehicle for accountability and trust

The Bird and Morgan-Jones' research was widely regarded as a 'wake-up call' for the charity sector and a trigger for what was to come. Since the early 1980s, considerable efforts have been made to improve the quality and consistency of charity accounting and reporting. A vital aspect of this has been the development (in 1988), and periodic 'refreshing' (in 1995, 2000, 2005 and, most recently, in 2014), of a Statement of Recommended Practice (SORP). The latest Charity SORP (*Accounting and Reporting by Charities: the FRS 102 SORP*) is effective for accounting periods beginning on or after 1 January 2015.

SORPs are recommendations on accounting practice for specialised industries or sectors; they do not replace other legal and regulatory requirements, rather they supplement and interpret such requirements. The first SORP (SORP 1988) focussed on addressing financial reporting

deficiencies which had been identified in the Bird and Morgan-Jones research, often closely following that report's recommendations and interpreting existing UK reporting standards. In the majority of cases it clarified best practice – for example: legacies should be recognised immediately as income, and donated assets should be included as incoming resources at a reasonable estimate of their value to the charity.

Over time, through its various iterations, the SORP has changed almost beyond recognition. The SORP consists of a mix of financial statement and trustees' annual report (TAR) requirements, with the latter focus on the disclosure of non-financial information (including information relating to performance and governance). As outlined in the Figure 'Evolution of Charity Statement of Recommended Practice' below, over time the SORP has:

- become an 'Accounting and Reporting' SORP rather than purely an 'Accounting' SORP (reflecting a much greater emphasis on the TAR);
- become mandatory for large UK charities, and best practice for RoI charities (with the possibility that it will also become mandatory for large RoI charities in the not-too-distant future);
- required charity accounts to provide an appropriate and relevant 'financial account' that is very different from commercial accounts, for example with a Statement of Financial Activities (SOFA) (with its columnar format separately showing income and expenses related to restricted and unrestricted funds) replacing a traditional for-profit income and expenditure statement;
- increasingly emphasised the importance of the 'performance account' (relating to the telling of a charity's story) of a charity; and
- significantly reduced the discretion of the preparing accountant (for example, investments are now required to be shown on the balance sheet at market value, whereas the initial 1988 SORP allowed preparers a variety of valuation bases).

Figure: Evolution of Charity Statement of Recommended Practice

Accounting by Charities (SORP 1988)	→	Accounting and Reporting by Charities (FRS 102 SORP)
Recommended practice	→	Mandatory for large UK charities (best practice for RoI charities)
Commercial basis	→	Charity-specific basis (although aligned with FRS 102)
Financial reporting focus	→	Increased performance reporting focus (including encouragement for impact / outcome information)
High degree of preparer discretion	→	Reduced preparer discretion

In particular, over time, recommendations on performance and governance reporting (arguably having greater importance to many charity stakeholders than traditional financial statements) have been progressively added to the SORP. The evolving SORP has increasingly required more disclosure on the administration, governance and management of the charity. For example, the current SORP requires disclosure in the TAR of, among other things: the charity’s objectives and activities, and the strategies for achieving the objectives; qualitative and quantitative information about achievements and performance; and information to allow readers to understand the role and contribution of volunteers.

Specific changes in the 2014 FRS 102 Charity SORP

The latest SORP introduced a number of changes to both interpret FRS 102 and to connect to wider issues of particular relevance to the charity context. This was facilitated on the basis of widespread stakeholder engagement designed to make the SORP a sharper and more relevant document that steered the sector in terms of achieving better accountability and greater legitimacy. While some of these changes related to all charities required to produce accruals accounts, others only applied to ‘larger’ charities (defined by the SORP as those requiring an audit, or, if in a jurisdiction with no charity law audit requirement, to those charities with gross incomes of over £500,000 in the UK or €500,000 in RoI). The key changes introduced by FRS 102 Charity SORP are outlined below.

With respect to the financial statements, and in particular to the SOFA

- The heading of ‘governance costs’ is dropped altogether, with these costs now being included in expenditure on ‘charitable activities’ (for those charities reporting on an activity basis, governance costs are now a separate component of support costs).
- Changes in the value of financial instruments measured at fair value are now taken through profit and loss, with gains and losses on investments now shown before striking a total for ‘net income/ expenditure’ (specifically required to align the SORP with FRS 102).
- Income is to be recognised when its receipt is ‘probable’, whereas the equivalent criterion previously was ‘virtually certain’ (again, specifically required to align the SORP with FRS 102).

With respect to the TAR

- There is encouragement to report on impacts (considered as the ultimate expression of the performance of a charity), with impact viewed in terms of the long-term effect of a charity's activities on both individual beneficiaries and at a societal level (this is a term not used in previous SORPs).
- A previous, more general, statement concerning risk management made by larger charities is amended, and instead larger charities are required to provide a description of the principal risks and uncertainties facing the charity, together with a summary of their plans and strategies for managing those risks.
- The charity must explain its policy for holding reserves and state the amounts of those reserves and why they are held (if trustees have decided that holding reserves is unnecessary, the report must disclose this fact and provide reasons).
- Larger charities must disclose their arrangements for setting the pay and remuneration of the charity's key management personnel and any benchmarks, parameters or criteria used in doing this.

The call for change

In the charity sector over the past 30 years, accounting and reporting have been shaped by a series of Charity SORPs which have been developed to encourage high-quality reporting practices. Over time this has increasingly implied a significant engagement with a range of stakeholders (including many members of the accounting profession) and has focussed on making the charity sector more transparent, more accountable and more legitimate (thereby reducing the potential for damaging scandals). At the same time, the regulatory regime in the UK (where the SORP is mandatory for large charities) and in the RoI (where the SORP is best practice) has been strengthened (or developed) to buttress such goals. In particular, in RoI, it would seem that the adoption of the SORP as a compulsory benchmark for accounting and reporting by charities has much merit. Indeed, even if legislative enforcement is not present, there seem good reasons why individual charities should embrace and apply the extant SORP. These aligned processes of required reporting and better regulation have the potential to reduce information asymmetry between charities, their funders and society at large, and, as a result, increase confidence in, and support of, the very valuable work that charities do

The mobilisation of stakeholder views and stakeholder forces in both the development and promotion of the SORP (and the establishment of robust regulatory regimes) has the capability to strengthen the sector. Given this, the contribution that the accounting profession has made (and can make) to support charities, and to facilitate the health and growth of the sector, is considerable. Accounting and reporting by charities is not, and should not, be the same as accounting and reporting by commercial organisations; charities do not have the same focus as commercial organisations, their performance cannot be measured in the same way and the information needs of their stakeholders are very different. Thus, a considered, appropriate and creative framework to steer and support charity accounting and reporting (and the periodic renewal of it to reflect the ever-changing context in which charities operate) can provide the basis for a more legitimate, better managed, more accountable and healthier charity sector in the UK and RoI. This is the objective of the journey that is reflected in the evolving Charity SORP, and is likely to be consistent with the goals of all those with a heart for the varied, valuable and socially-desirable activities engaged in by charities; and it is an objective which seems highly laudable by the authors of this article.