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Does Your Finance Function Allow for Effective Financial Reporting – SORP Compliance

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Internal reporting versus Charity SORP compliance and why it is important to understand the differences

Charities need to manage their finances so they can keep abreast of their on-going financial position. This means producing timely, accurate and understandable financial information. However, charities also need to prepare annual statutory accounts which are compliant with charity law. In particular, this means complying with the Statement of Recommended Practice for Charities (Charity SORP). These two objectives can sometimes be at odds with each other:

Let's consider a charity which delivers services that are funded through a blend of contracts and grants. To comply with the Charity SORP, the accounts need to recognise income from service contracts to the extent that the service had been delivered, whereas grant income would generally be recognised at the point that the grant was receivable. Producing internal management accounts which adhere to these contrasting income recognition rules could be confusing to lay users and it is therefore not surprising that because of complexities such as this, some charities choose to prepare internal financial information on a different basis to the Charity SORP.

Non-compliance with the Charity SORP is not always deliberate. One common issue we encounter as auditors is charities who do not adequately monitor the balances of restricted and unrestricted funds during the year. This situation is potentially very worrying. A charity's fund position can have an enormous impact on its financial health. A charity may have a strong balance sheet and be creating surpluses, but if those surpluses are restricted for a very specific purpose, the charity could easily find itself with an inability to pay for core running costs and find itself technically insolvent. Understanding the fund position often requires additional work and sometimes involves making high level judgements. It is not surprising some charities struggle to find the resource and expertise to undertake this very important exercise regularly.

Why does it matter if our finance function does not comply with SORP?

Although sometimes charities choose not to adopt all of the policies of Charity SORP when preparing internal management information, it is still important that charities periodically review the position and monitor the extent that their internal financial reporting differs from the SORP.

Charities often use their statutory accounts as a fundraising tool, or send them to existing funders as part of a monitoring process. It is therefore essential that the charity understands whether the statutory accounts will differ significantly from the message being communicated to funders during the year or during the application process. Funders may perceive a radical change in the results as a lack of financial control and it is therefore helpful to proactively communicate differences at the soonest opportunity.

It is also good from a housekeeping perspective to understand the level of work needed to bring the financial records into a SORP compliant format. The work could be time consuming or require third party input, which could easily delay the production of the statutory accounts or incur additional professional fees.

Applying some of the requirements of SORP to internal reporting can have very real benefits to understanding the day to day financial position of the organisation.

We have already provided one example of how understanding a charity's fund position can aid day-to-day financial management. However, there are many other aspects of SORP reporting which are geared to help charities better understand their position. Exploring these differences periodically may help to improve the quality of the internal information produced by a charity.

It is also commonplace for charities to appraise the effectiveness of the internal systems by considering the level of adjustments that emerge as part of the annual audit. It is important to understand whether these differences are the result of deliberately adopting differing accounting policies or whether they are due to inherent weaknesses in the accounting systems.

A new reporting standard

2016 was a year that many organisations began to wrestle with a new reporting standard. The Charity SORP was updated to reflect the wider changes to the UK accounting regime, in particular the adoption of Financial Reporting Standard 102 (FRS102). Although some smaller entities have temporarily dodged some of the changes by adopting the Financial Reporting Standard for Smaller Entities (FRSSE), the FRSSE cannot be used for periods beginning on or after 1 January 2016 and all charities will need to adopt the provisions of SORP FRS102 in due course.

These new reporting standards are likely to have exacerbated the position and it is possible that the differences between internal management accounts and the SORP may have increased. For example, the FRS102 SORP makes it clear that charities should be including an accrual for the value of untaken staff holidays. Charities that have a holiday year which does not coincide with the financial year can easily see this balance being significant. The calculation of the accrual is potentially time intensive and it is not something we have traditionally seen charities incorporate into their internal financial systems. Charities need to ask themselves if this is something their internal financial function needs to start monitoring.

Another example is that income recognition criteria have changed, meaning that income can be accrued when receipt is probable rather than virtually certain. This is particularly relevant for income streams such as legacies, where notification of the legacy could be sufficient to include the income. Potentially, finance teams may need to look more carefully at setting up legacy registers or reviewing correspondence to ensure their systems are compliant with SORP. If not, the statutory accounts may end up showing significantly different results once the auditor has reviewed the position.

These and other changes in the SORP mean that it is a good time to review your finance function for SORP compliance.

Checklist for the month

- **Speak to your auditor:** They will have a unique perspective on the extent your financial systems adhere to the Charity SORP and because they work with similar organisations they may be able to advise pragmatic ways of bringing the systems in line.
- **Understand the differences:** There are situations where it may be beneficial to have differences between the statutory accounts and the numbers reported internally. If it is decided that internal information should deviate from SORP policies, the decisions should be recorded and made collectively.
- **Understand the work involved:** Although it may be attractive to have fully SORP compliant reporting throughout the year, it may not be practical with the resources available. Some numbers may require third party input which could incur additional cost.
- **Consider if other stake holders need to be informed:** If there are other users of your internal financial information who may be confused by differences between statutory and management accounts, consider proactively discussing differences with them.
- **Regularly review the position:** Consider revisiting the position in regular intervals (perhaps annually). This will keep new Trustees abreast and ensure that the internal information adapts to the changing needs of the organisation.

Where can I get more information?

- **Keeping account:** A Guide to Charity Financial Analysis (New Philanthropy Capital)
- **Charity SORP (FRS102)**
- **CC15b:** Charity reporting and accounting: the essentials
- **CC19:** Charity Reserves

If you have any questions arising from this article or would like to speak to a member of our team about how we can help. Please get in touch with your local MHA member firm.