2. Fund accounting

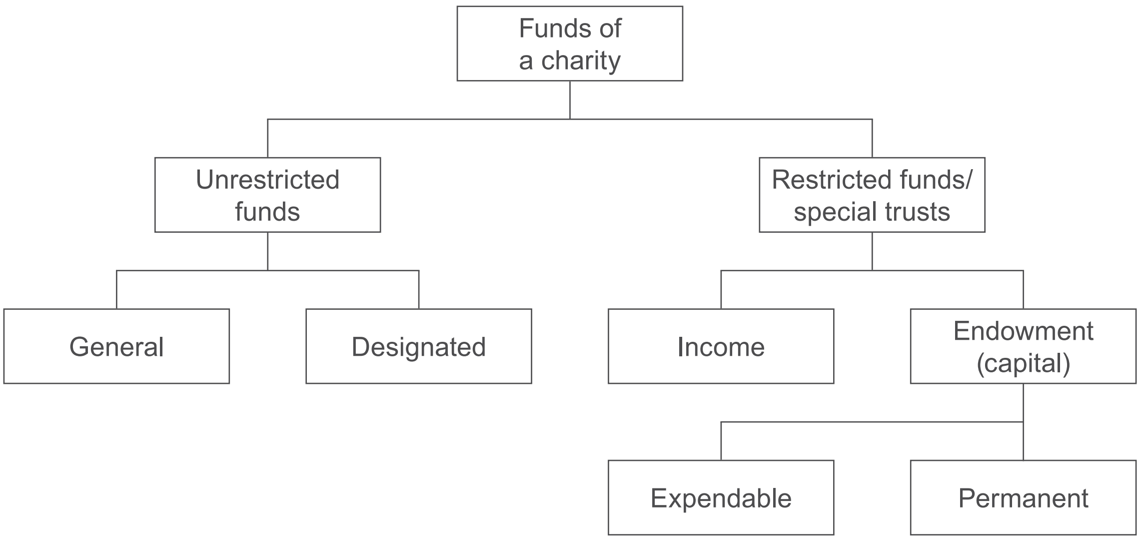
Introduction

2.1. Accounting for the particular charitable funds held by a charity is a key feature of charity accounting. Each class of fund has unique characteristics in trust law. Fund accounting distinguishes between two primary classes of fund: those that are unrestricted in their use, which can be spent for any charitable purposes of a charity, and those that are restricted in use, which can only be lawfully used for a specific charitable purpose.

2.2. The proper administration of individual charitable funds is essential if charity trustees are not to act in breach of trust.

2.3. Restricted funds (also known as special trusts in England and Wales) are further analysed between restricted income funds and endowment funds (also known as capital funds). Figure 1 sets out these classes of fund diagrammatically. This differentiation of funds is an essential feature in the presentation of a charity's statement of financial activities (SoFA) and balance sheet.

Figure 1: The classes of charitable funds



2.4. FRS 102 does not deal with fund accounting by charities and therefore this module reflects the requirements of charity law and current accounting practice which charities adopting this SORP must follow. This module sets out:

- general principles of fund accounting;
- transfers between funds; and
- fund disclosures in the notes to the accounts.

General principles of fund accounting

2.5. A prerequisite of fund accounting is an understanding of the different classes of funds a charity may hold on trust. A charity may hold both unrestricted and restricted funds. Income generated by the investment of a particular fund's assets accrues to that fund unless the terms of the initial gift provide otherwise, for example in the case of permanent endowment. Similarly, any Gift Aid amount recovered on a donation forms part of that gift and is an addition to the same fund as the initial donation unless the donor or the terms of the appeal have specified otherwise.

Unrestricted funds

2.6. Unrestricted funds are spent or applied at the discretion of the trustees to further any of the charity's purposes. Unrestricted funds can be used to supplement expenditure made from restricted funds. For example, a restricted grant may have provided part of the funding needed for a specific project. In this case unrestricted funds may be used to meet any funding shortfall for that project.

2.7. Trustees may choose during the reporting period to set aside a part of the unrestricted funds to be used for a particular future project or commitment. By earmarking funds in this way, the trustees set up a designated fund that remains part of the unrestricted funds of the charity. This is because the designation has an administrative purpose only and does not legally restrict the trustees' discretion in how to apply the unrestricted funds that they have earmarked. Identifying designated funds may be helpful when explaining the charity's reserve policy and the level of reserves it holds.

Restricted funds

2.8. Funds held on specific trusts under charity law are classed as restricted funds. The specific trusts may be declared by the donor when making the gift or may result from the terms of an appeal for funds. The specific trusts establish the purpose for which a charity can lawfully use the restricted funds. It is possible that a charity may have several individual restricted funds, each for a particular purpose of the charity.

2.9. In certain circumstances the donor may express a form of non-binding preference as to the use of the funds, which falls short of imposing a restriction in trust law. In which case the charity will include the funds as part of its unrestricted funds. To respect these non-binding donor wishes, trustees may decide to designate those funds to reflect the purposes which the donor had in mind.

2.10. Some trustees have the power to declare special trusts over unrestricted funds. Where such a power is available to the trustees and they use it, the assets affected will form part of the restricted funds as a special trust. The trustees' discretion to apply that fund will then be legally restricted.

2.11. Restricted funds fall into one of two sub-classes: restricted income funds or endowment funds. Restricted income funds are to be spent or applied within a reasonable period from their receipt to further a specific purpose of the charity, which is to further one or more but not all of the charity's charitable purposes. Alternatively the restricted fund may be an endowment. Trust law requires a charity to invest the assets of an endowment, or retain them for the charity's use in furtherance of its charitable purposes, rather than apply or spend them as income (see 'Endowment funds' below).

2.12. When a tangible fixed asset is funded through an appeal or by way of a grant or donation, the accounting treatment of the asset acquired will depend on the circumstances of each case. In deciding whether the asset is categorised as restricted or unrestricted, trustees should consider whether the terms of the gift:

- require the charity to hold the tangible fixed asset acquired on an on-going basis for a specific purpose; or
- are met once the specified asset is acquired, so allowing the charity to use the asset acquired on an unrestricted basis for any charitable purpose.

2.13. In some circumstances the trustees may be able to settle a tangible fixed asset on trust for a specific purpose implied by the appeal, provided this is consistent with the charity's governing instrument. Where this happens, the trustees' decision is legally binding and the asset is an addition to the restricted funds.

2.14. In maintaining the accounting records, charities must separately identify each restricted fund and the income received and expenditure made from each restricted fund.

2.15. Costs charged to a restricted fund relate to the activities undertaken to further the specific charitable purposes the fund was established to support. These costs include both direct and support costs associated with the activities undertaken by the restricted fund(s). In addition to a reasonable allocation of support costs, other costs associated with raising, investing and managing the restricted funds should normally be charged to the fund to which the cost relates. Expenditure attributable to a restricted fund may still be charged to it even if there is an insufficient balance on that fund at the time. However, expenditure should only be charged to a restricted fund in deficit when there is a realistic expectation that future income will be received to cover the shortfall, for example when a decision has been made to invite donations to that restricted fund.

Endowment funds

2.16. A gift of endowment, where there is no power to convert the capital into income, is known as a permanent endowment fund. A permanent endowment fund must normally be held indefinitely. Where trustees have the power to convert endowment funds into income, such funds are known as expendable endowments. A gift of expendable endowment provides the trustees with a power to convert all or part of it into income.

2.17. Expendable endowment is distinguishable from income funds in that there is no actual requirement to spend or apply the capital unless, or until, the trustees decide to spend it. If the trustees exercise the power to spend or apply the capital of the expendable endowment, the relevant funds become unrestricted funds or restricted income funds depending on whether the terms of the gift permit expenditure for any of the charity's purposes, or only for specific purposes.

2.18. The income generated from endowment funds held for investment must be spent on furthering its charitable purposes unless the charity exercises a power of accumulation or a charity in England and Wales has invested the endowment on a total return basis (see the SORP module 'Total return (investments)') under the provisions of section 104A of the Charities Act 2011 as amended by the Trust (Capital and Income) Act 2013 or an Order of the Charity Commission made under section 105 of the Charities Act 2011. If there is no restriction as to the use of the income, the income is an addition to unrestricted funds. It is possible that a charity may have several endowment funds; the income from each endowment being restricted to a particular purpose.

2.19. The concept of permanence does not mean that a charity must keep holding the assets in the endowment funds in the form that they were initially given. The investments or property held within an endowment fund can be changed. For example, a charity could sell a particular equity investment and reinvest the proceeds in a different financial asset, or it might use the proceeds from the sale of endowed freehold land and buildings to purchase a new freehold property which will then form part of the endowment.

2.20. In some cases the permanent endowment's trusts will require the retention of a specific asset for the charity's own use, for example a building. It follows that an endowed asset may be capable of depreciation or impairment. Trustees that use income funds to build, erect, extend or improve a building on land which is an endowment asset should note that the default position is that the value of the enhancement to the asset will form part of the endowment in the absence of evidence to the contrary.

Accounting for expenses related to endowment

2.21. A charity cannot use permanent endowment as if it were income, for example to make payments or grants to third parties. Trust law only permits expenses to be charged to permanent endowment when incurred in the administration or protection of the investments or property of the endowment, for example:

- fees incurred in managing the investment of the endowment;
- the costs of valuation fees and expenses incurred in connection with the sale of endowed land;
- the cost of improvements to land held as an endowment investment; or
- the loss of value due to depreciation or impairment of an endowed property.

2.22. If the endowment has insufficient funds to meet the expenses that can be charged to it, or the terms of the trust of the endowed gift prohibit the charging of expenses, then the expenses must be charged to income funds. Other expenses must normally be charged to income funds.

Accounting for the investment return on income and endowment funds

2.23. The return on investment is made up of the income derived from the investment (interest, dividends, royalties or rents) and any gain or loss in the market value of the investment. If a charity sells an investment, a gain or loss on the carrying amount of the asset is realised upon its disposal. Where a charity retains an investment, an unrealised gain or loss on the carrying amount of the investment may arise at the balance sheet date.

2.24. For unrestricted funds and restricted income funds, trust law requires both the income and any investment gain or loss to be allocated to the fund holding the investment. Where the charity has a number of individual restricted income funds, any investment income and gain or loss on investments must be allocated to the individual restricted funds holding the investment.

2.25. Trust law applies different rules to endowment funds. In the case of endowment, trustees cannot add the income from investments to the endowment capital except where they have a power to invest on a total return basis (see the SORP module 'Total return (investments)') or exercise a power of accumulation. Instead, the income from the investment is allocated to either unrestricted funds or a restricted income fund depending on the terms of the gift. However, any gain or loss on investment is attributed to the endowment capital. If a charity has several invested endowments, any gain or loss on investments must be allocated correctly to each individual endowment.

Transfers between funds

2.26. The transfer line in the SoFA is used to record transfers between funds. The total transfers recorded between classes of fund in the reporting period must always net to nil. A transfer may be made for several reasons, including:

- to transfer assets from unrestricted funds to finance a deficit on a restricted fund;
- to transfer the value of tangible fixed assets from restricted to unrestricted funds when the asset has been purchased from a restricted fund donation but is held for a general and not a restricted purpose;
- where restricted funds have been lawfully released and transferred to unrestricted funds;
- where the trustees have exercised a power to declare a special trust over a gift initially recognised as unrestricted; or
- where charity law permits the proceeds of restricted funds to be spent for an alternative purpose (such as the cy-près procedures in England and Wales), for example the alternative use of the proceeds of a failed appeal, or the alternative use of excess of funds raised from an appeal.

Fund disclosures in the notes to the accounts

2.27. For the proper administration of charitable funds, the accounting records of a charity must identify the transactions for each of the funds held. This SORP requires that items recorded in the SoFA must be analysed between unrestricted funds, restricted income funds and endowment funds. The information for endowment funds provided in the SoFA should combine the presentation of permanent and expendable endowment.

2.28. This SORP requires that the notes to the accounts must provide information on material individual fund balances, movements in the reporting period and the purposes for which the funds are held. The notes must differentiate unrestricted funds (both general and designated), restricted income funds, permanently endowed funds and expendable endowments. Table 1, 'Outline summary of fund movements' gives an example of how the movements in material funds may be shown.

2.29. In particular, this SORP requires that notes to the accounts must disclose:

- a summary of the assets and liabilities of each category of fund of the charity, if not provided by presenting this information in a columnar balance sheet;
- details of the purposes and trust law restrictions imposed on each material individual fund;
- details of the movements on material individual funds in the reporting period, reconciling the opening and closing fund balance (small funds with similar purposes may be aggregated);
- details of the reasons for any material transfers between different classes of funds;
- where endowment has been converted to income, details of the amount(s) converted and the legal power for its conversion;
- where the trustees have a power to invest permanent endowment on a total return basis, the details of the movements in the value of unapplied total return for the reporting period (refer to the SORP module 'Total return (investments)'); and
- details of the planned use of any material designated funds, explaining the purpose of the designation.

2.30. In deciding on the most suitable form of presentation, the charity should consider:

- the complexity of the fund structure; and
- the need for any separate fund statement(s) or note(s) to agree with the charity's SoFA and balance sheet.

Table 1: Outline summary of fund movements

Fund name	Fund balances brought forward	Income	Expenditure	Transfers	Gains and losses	Fund balances carried forward
	£	£	£	£	£	£
Fund 1						
Fund 2						
Fund 3						
Other funds						
Total funds						