2. Fund accounting

Introduction

2.1. The reporting tiers applied for module 2 are as specified in the table below.

Table 2.1A: Tiered reporting for module 2

All tiers	The requirements of this module apply fully to all charities.

What is fund accounting?

2.2. Accounting for the particular classes of 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:

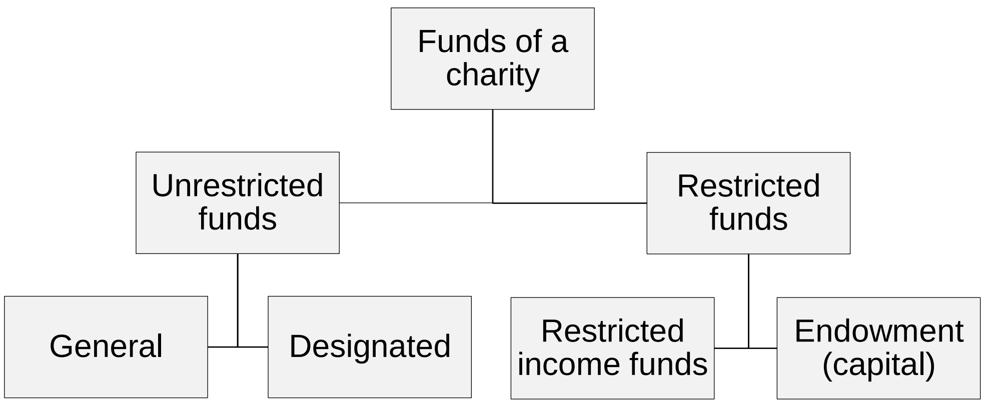
- those that are **unrestricted** in their use, which can be spent for any charitable purposes of a charity
- those that are **restricted** in their use

2.3. The proper management and administration of individual restricted funds is essential and failure in this respect can result in charity trustees acting in breach of trust.

2.4. Restricted funds are further analysed between restricted income funds and **endowment funds** (also known as capital funds). In England and Wales, restricted funds that must be lawfully used for a specific charitable purpose are known as special trusts.

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



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

- General principles of fund accounting
- How to account for tangible fixed assets funded through an appeal, grant or donation
- Transfers between funds
- Fund disclosures in the notes to the accounts

General principles of fund accounting

2.6. 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 endowment, the income generated from the fund must be spent in accordance with the terms of that trust which may be for the charity's general purposes or for a narrower purpose (see paragraph 2.28). 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

2.7. Unrestricted funds do not have any restrictions or conditions on their use and can be spent or applied at the discretion of the trustees to further any of the charity's purposes. Unrestricted funds can be used to supplement expenses 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.

2.8. Trustees may choose to set aside a part of the charity's unrestricted funds to be used for a particular future project or commitment. In this way, the trustees set up a **designated fund**, which remains part of the unrestricted funds of the charity. The designation does not create any legal restrictions. This means that the trustees can exercise their discretion in how to apply the designated fund and can change what the funds are designated for. Trustees can decide to remove the designation at a later date. Identifying the nature and amount of designated funds is necessary when considering and explaining the charity's reserves policy and the level of reserves it holds.

Restricted funds

2.9. Funds held for specific charitable purposes under charity law are classed as restricted funds (also known as special trusts in England and Wales). Special trusts may be restricted income funds or may be endowed. Restricted funds also include endowment funds generating income for a charity’s general purposes.

2.10. Restricted funds can be established in a range of ways. For example, the restricted fund may be declared by the donor when making the gift or may result from the terms of an appeal for funds. It is common for a charity to have a number of individual restricted funds, each for a particular purpose of the charity.

2.11. 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 such cases, the funds are held as part of the charity’s 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 (see paragraph 2.8).

2.12. Some trustees have the power to declare trusts over unrestricted funds. Where a charity’s governing document sets out such a power and the trustees use it, the assets affected will form part of the charity’s restricted funds. The trustees’ discretion to apply that fund will then be legally restricted.

2.13. Restricted income funds are to be spent or applied within a reasonable or specified 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).

2.14. Charities must separately identify each restricted fund and maintain the accounting records to show:

- the income received and expenses incurred on the specific purposes for each restricted fund
- the assets and liabilities separately for each restricted fund

2.15. Expenses charged to a restricted fund relate to the activities undertaken to further the specific charitable purposes the fund was established to support. These expenses include both direct expenses and support costs associated with the activities undertaken to further the specific charitable purposes of the restricted fund(s). In addition to a reasonable allocation of support costs, any other costs associated with raising, investing and managing the restricted funds should normally be charged to the fund to which the cost relates.

2.16. Expenses 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, expenses 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, or when a transfer will be made to the restricted fund from the unrestricted funds in the event of a shortfall.

2.17. Restricted funds fall outside of the definition of reserves but the nature and amount of the restricted funds may impact on a charity’s reserve policy.

Endowment funds

2.18. Permanent Endowment - A permanent endowment will generally be indefinite but may be held until a specified event or date, at which point the restriction can cease. There are two types of permanent endowment:

- Investment permanent endowment is where the capital has an administrative restriction on its expenditure and is invested to generate income which must be used for the charity's general purposes or narrower purposes. The concept of permanence does not always 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 on trust for investment 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, which could be for example, an equity investment or land and buildings which will then form part of the endowment.
- Functional permanent endowment is land or other property such as an art collection which the trusts require to be used to carry out the general purposes of the charity or a specific purpose of the charity. The purposes of the fund must be amended before the trustees are permitted to hold or use the property in a different way including sale without replacement.

2.19. Expendable Endowment is the term used to describe a capital fund where the trustees have the power in the trusts to convert the capital funds into income.

2.20. 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 the terms of the trust.

2.21. It is possible that a charity may have a number of investment endowment funds; the income from each endowment being restricted to a particular purpose within the charity's general purposes.

2.22. 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.

2.23. Endowment funds fall outside of the definition of reserves but the nature and amount of the restricted funds may impact on a charity's reserve policy.

Accounting for expenses related to endowment

2.24. A charity cannot use the capital held on permanent endowment trusts 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 capital 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
- the loss of value due to depreciation or impairment of an endowed property

2.25. 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 funds

2.26. 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 on 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.

2.27. 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.

2.28. Trust law applies different rules to endowment funds. The income generated from endowment funds held for investment must be spent on furthering the specific purposes for which the funds are held (which may be the charity's general purposes or narrower 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. Charities applying the provisions of section 104A,104AA and 104B of the Charities Act 2011 in accordance with the Charities (Total Return) Regulations 2013 (as amended 2018 and 2023) should refer to SORP module 20, '*Total return (investments)*'.

2.29. If there is no restriction as to the use of the income, the income generated from the capital endowment investment is an addition to unrestricted funds.

2.30. Any gain or loss on investment is attributed to the capital. If a charity has several invested capital endowment funds, any gain or loss on investments must be allocated correctly to each individual fund.

Tangible fixed assets funded through an appeal, grant or donation

2.31. 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 appeal, grant or donation:

- require the charity to hold the tangible fixed asset acquired on an on-going basis for a specific purpose (narrower than the general purpose of the charity)
- 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. This would normally be presented as a transfer between funds (see 2.32 below)

Transfers between funds

2.32. 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, providing that unrestricted funds are available
- 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 specific purpose
- where restrictions on capital restricted funds have been lawfully released and transferred to unrestricted funds
- where the trustees have exercised a power to declare trusts over an unrestricted gift so that it is held for narrower purposes and/or the capital must be invested to generate income
- where the trustees have used powers in their governing document or statute to amend the purposes for which a restricted fund is held
- where charity law (such as the cy-près procedures in England and Wales) permits the purposes of restricted funds to be amended, for example the alternative use of the proceeds of a failed fundraising appeal, or the alternative use of excess of funds raised from an appeal

Fund disclosures in the notes to the accounts

2.33. 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.

2.34. 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 and endowment funds (both permanent and expendable). Table 2, 'Outline summary of fund movements' gives an example of how the movements in material funds may be shown.

2.35. 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
- details of the legal power(s) used to remove the capital restrictions on, or amend the purposes of, a restricted fund where there has been a transfer from restricted funds to unrestricted funds or use of restricted funds as part of unrestricted 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 20, '*Total return (investments)*')
- details of the planned use of any material designated funds, explaining the purpose of the designation and that the trustees can remove the designation. In deciding on the most suitable form of presentation, the charity should consider:
- the complexity of the fund structure
- the need for any separate fund statement(s) or note(s) to agree with the charity's SoFA and balance sheet for unrestricted funds, restricted income funds and endowment funds

Table 2: Outline summary of fund movements

Fund name	Fund balances brought forward	Income	Expenses	Transfers	Gains and (losses)	Fund balances carried forward
	£	£	£	£	£	£
Unrestricted funds						
Designated funds:						
Fund 1						
Fund 2						
Fund 3						
Total designated funds						
Total restricted fund						
Endowment funds:						
Fund 1						
Fund 2						
Fund 3						
Total endowment funds						
Total funds						