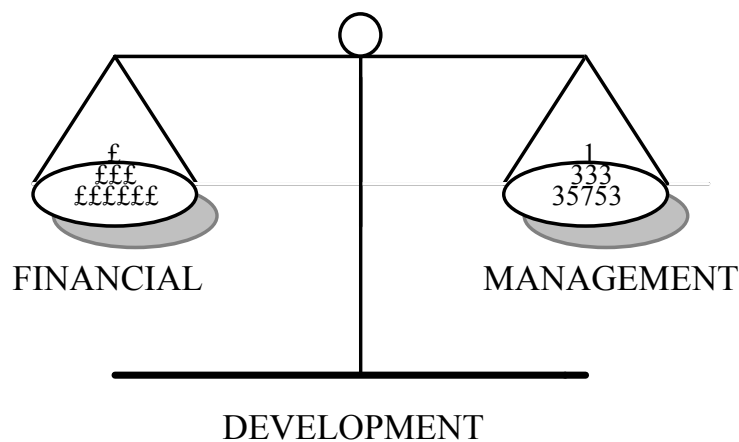


FINANCIAL MANAGEMENT DEVELOPMENT

CHARITY MANAGEMENT

NO 702

INTERNAL FINANCIAL STATEMENTS



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

FROM

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

CHARITY MANAGEMENT INTERNAL FINANCIAL STATEMENTS

OVERVIEW

Charities and other Not For Profit organisations require two sorts of financial information. Firstly there is management information which is designed for internal use to help make decisions, and secondly there is published information for external use to inform others of the Charity's activities. Since the purpose of these documents is different it is not unreasonable that their content, format and timing will be different. In essence the internal data will be designed to be timely and useful. The external data will have to conform to specific guidelines depending on the nature of the Charity. This paper will consider the data for internal use. Another paper will look at external published financial data.

This paper is intended as a guide for the lay person, not a blueprint for action. For fuller explanations, you are recommended to look at the papers in the section on Financial Accounting. As in other papers the word "Charity" is used to cover the whole range of Not For Profit organisations and "Trustees" used for those responsible for them. The paper on external reporting considers the different requirements for different types of legal entities.

CASHFLOW REPORTING IS VITAL

The first document any charity trustee or management team will want to see is the Cashflow Statement. This is very simple. It looks back over a period of time and shows:

		£
	Cash we had at the start of the period	x
Plus	Cash receipts (broken down into categories helpful to managers)	x
Less	Cash payments (broken down into categories helpful to managers)	(x)

Equals	Cash balance at the end	x
		==

Note that the cash balance at the end may not be the same as the figure on the Bank Statement as there may be cheques recorded in the books which have not yet been paid by the bank and/or monies received not yet paid into the bank. These differences should be identified on the Bank reconciliation, which the Trustees may not need to see but they do need to know it is being done.

This document is vital for proper control over one of the key charity assets CASH. Even the smallest charity will want to see this document on a regular basis. Larger charities may choose to have other documents which help to manage the charity and delegate control of the cash to management, but if they do so, they will need to be sure that there is a control mechanism to record the cash and reconcile it to whatever documents they do review. If the Trustees do not ensure there is enough cash the Charity may go bankrupt, or part company with the Trustees, die and pass on to a "Charity Heaven" run by the Charity Commissioners.

A good Trustee will want to know more than just the past cash inflows and outflows. The Bible says no one sets out to do something without planning the cost (Luke 14:28), or if they do they run the risk of looking foolish. Thus it makes sense to have a simple spreadsheet showing the expected monthly cashflows in and out and therefore the expected cash on hand/borrowing required. This concept is explored more fully in the paper on Charity Budgeting and Planning. Here it is sufficient to note that a key reporting document for all charities is the cashflow statement. It shows past activity to provide control and should include a forecast, based on the past plus specified reasons for any changes to help ensure that future plans are consistent with reality.

THE CASHFLOW STATEMENT IS NOT ENOUGH

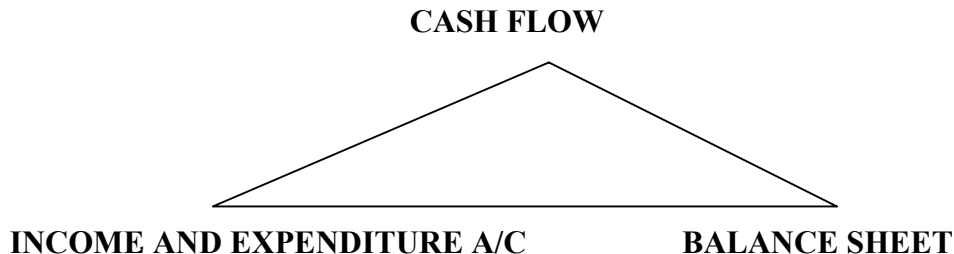
One problem with looking at cash is that it can be misleading. Cash is not the same as income or expenditure. Sometimes charities receive money for doing things. In a sense they hold the money on trust until they have done them. Thus if a University receives £120 in September to teach a student for a year, it will only have fully earned that money at the end of the year. During the year it will have to decide how much of the money it has earned (and can therefore release as income) and how much it has yet to earn (and therefore it should treat as still being owed). It can make life very simple e.g. release £10 per month for twelve months; or very complicated e.g. release a percentage based on the percentage of the total contact time delivered by the tutor to each student to date divided by the total contact time anticipated for the whole course.

Whatever method is agreed upon for the release of such income, it should be simple to understand, capable of being calculated fairly easily and broadly allocate the income to match the timing of the costs incurred in delivery of the service. Accountants call this an application of the accruals concept. I call it ACS (Applied Common Sense). If you do not understand how the main income streams are being received and earned then you are not really managing the Charity.

There is a similar problem with cash outflows. Some may be large payments in advance e.g. annual insurance premiums. Whilst the cashflow will show all the money paid in one month, the true position is better served by showing one twelfth of the total being consumed each month. The remainder can be treated as a prepayment, which slowly reduces as the year progresses. This problem is even worse with some items that last longer than a year e.g. a photocopier that costs £3,600 and will last 3 years. It would be silly to say "We have had a bad month because we bought a photocopier." even if in cash terms it is true. It is much better to say "We have invested £3,600 in a photocopier that will last 3 years so each month we use it we will show a decrease in its value of £100, and we will hold the balance as an asset until 36 months time." Accountants call this process "capitalising the expenditure" i.e. putting the cost on the Balance Sheet not the Income and Expenditure Account; and they call the recognition of the cost "depreciation".

It should be clear by now why organisations - whether working for profit or not - need an Income and Expenditure account and a Balance Sheet as well as a Cash Flow Statement. For a very simple organisation, Cash Flow Statements are sufficient, but for complex activities, you need a fuller analysis and you must understand how they are made up.

The three statements fit together and interrelate with each other like lines to form a triangle:



Cash Flow shows the raw movement of cash. The Income and Expenditure Account shows how much is earned or consumed this period. The Balance Sheet collects the unused bits which have yet to be released in the form of Assets yet to be fully used (Fixed Assets e.g. Buildings or Equipment; or Current Assets e.g. stocks of goods or prepayments) and Liabilities yet to be paid for (payments received for services yet to be delivered e.g. grants not yet earned; or services used but not yet paid for e.g. electricity bills not yet received).

The whole process of double entry bookkeeping is wonderful for its symmetry (if you like that sort of thing). Having considered Cash Flow we can look at the other two documents.

INCOME AND EXPENDITURE ACCOUNT

The Income and Expenditure Account is essentially similar to the Profit and Loss Account produced by commercial organisations. It just has a different name because the emphasis is different. To add to the confusion the Statement of Recommended Accounting Practice (SORP) issued in October 2000 introduced a new document "The Statement of Financial Activities" (SOFA). Fortunately that is a document for external use and we are concentrating on internal reporting documents in this paper.

For Internal Management purposes the Trustees will want to see the income streams and expenditure streams broken down into the main headings. Internal accounts are entirely discretionary and their only purpose is to help managers manage, so you do not have to have the same layout as the published data. However it does help if the categories are broadly similar. A reasonable approach is to ask for information on a monthly or quarterly basis compared to budget and to last year. Headings could be:

I&E A/C FOR.....	This month			Year to date		
	Actual	Budget	Last Year	Actual	Budget	Last Year
		Variance	Variance		Variance	Variance
	£000	£000	£000	£000	£000	£000

With lines for:
 Donations and Income Earned etc.
 less: Expenditure etc.
 Equals Net Income

It is than helpful to have an analysis month by month. A good approach is to start with the twelve month analysis of the Budget and then substitute the Actual results as they are incurred. The total column then becomes the revised forecast i.e. actual to date plus budget to the end of the year. Revise the forecast if the budget is obviously wrong. Do not get obsessed with accuracy. What is needed are simple documents showing the results to help identify problems, or opportunities and help make decisions. The report should fit on one page (which helps concentrate the mind when deciding on what level of detail is appropriate).

Decisions have to be made regarding the application of accounting policies. These may require thought e.g. Legacy income will be brought into the books when the money is received, and not when it is notified; Stationery stock will be written off when bought, or counted each month end to calculate usage; pension costs will be accrued for each month; 10% of rent arrears will be assumed to be irrecoverable etc. Discussion of these points should not be left to the accountants. It is important that all Trustees understand the basis of the data they receive.

BALANCE SHEET

Many organisational managers do not ask for a regular Balance Sheet. Many organisations are so inefficiently run that they cease to survive. There is a correlation between these two statements. Without a Balance Sheet showing Assets and Liabilities, it is not possible to assess the true status of the organisation. In some organisations it may be sufficient to look at only some aspects of the Balance Sheet e.g. Stock, Debtors, Cash and Creditors; on the grounds that the other areas: Fixed Assets and Reserves etc. do not change much. To do so is a short cut and may be dangerous. It must be clearly stated that this is internal management information. It does not have to have the same degree of accuracy as the Published Financial Accounts. I am not saying that a full stocktake and valuation should be carried out each month, nor need there be a full review of prepayments and accruals. An educated guess or a comment "assumed the same as last month" may be sufficient. It is better be approximately right than precisely wrong.

For full details on the contents of a Balance Sheet, see the paper in the Basic Accounting section of Financial Accounting. For an explanation of why it balances see the paper on Financial Accounts. In simple terms it is a document showing:

What the Charity Owns Assets (Buildings, Stocks Debtors Cash etc.)

Less:

What the Charity Owes Liabilities (Creditors, Accruals, Provisions etc.)

Equals:

What the Charity is Worth Reserves (The net uncommitted funds)

Note:

The movement on Reserves will normally be the figure at the bottom of the Income and Expenditure Account unless there are revaluations of assets.

Reserves are not "Cash in Bank" unless the only asset is cash and there are no liabilities.

For reporting purposes the layout should be simple and needs few lines. In order to help understanding it can be helpful to show this month, last month and the change.

Balance Sheet as at	This Month	Last Month	Movement
	£000	£000	£000
Fixed Assets	x	y	x-y
Stocks	x	y	x-y
Debtors	x	y	x-y
Prepayments	x	y	x-y
Cash	x	y	x-y
Creditors	(x)	(y)	x-y
Accruals	(x)	(y)	x-y
Provisions	(x)	(y)	x-y
Reserves	x	x	I&E

A COMMENTARY IS VITAL

A set of management accounts without a commentary is useless. It is vital that this is written by someone who knows what has happened. The approach should be "explain the month's results using numbers as appropriate." A good Trustee Board will provide feedback on the data they receive - too much, too little, too detailed etc.

OTHER FINANCIAL AND NON FINANCIAL DATA

It is important that each charity considers what other information it needs to monitor and plan its activities. Some will be financial e.g. Donations per collecting box, shop sales per day, cost per room, salary per head etc. Some will not be financial, but will have financial implications e.g. room occupancy, average length of stay, visits per volunteer. Such information varies and frequently charity associations publish average statistics based on returns by individual charities, which can be used as a benchmark. The creation of the appropriate Key Performance Indicators and their monitoring is an important part of the Trustee role. Time spent gaining agreement on these, their basis and the format of the reporting documents can save hours of time spent looking at useless data, and prevent recriminations over "who should have been checking what".

The easiest way of identifying these sorts of indicators is to brainstorm what are the key activities, assets, incomes and costs and then try to find ratios to link them. Beware of relying on any one ratio too heavily. It is easy to reduce cast per bed by not having any patients; or to increase income per collector by getting rid of all but the best collector.

For many ratios it may be easiest to present the information in the form of graphs (use rolling twelve month graphs as they iron out seasonal fluctuations.) or pie charts. With the ready availability of spreadsheets there is no excuse for not presenting timely, useful relevant management information in an intelligible, digestible format.

DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development.

He has worked as a Financial Controller and Company Secretary in the Finance Industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over thirty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP) and post course reinforcement workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material, he has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants and the need for taxation awareness training for general managers. He is also an active promoter of the need for the demonstration of the benefit of Christian values in the workplace, as a founder member of the Christian Institute of Training and Development.

He is married with one grown up daughter and his outside interests include being a Trustee of Crew Trust (Catholic Charismatic Renewal in England and Wales), a Trustee of the Sion Community for Evangelisation, The Treasurer of the Hospice of St. Francis (Berkhamsted), a Governor at Dunstable College and a member of the Catholic Evangelisation Services Team (producing video series on the love of God for His people expressed through His Church) and the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared with all (Matthew 10:8).