SORP JOINT CHARITIES SORP MAKING BODY

CHARITY COMMISSION

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Your Ref:
Our Ref: nkd/SORP 2012

Date: 13 November 2012

Dear Michelle,

Comprehensive Review of the IFRS for SMEs

The Charity Commission for England and Wales and the Office of the Scottish Charity Regulator are established by law as the regulators and registrars of charities in England and Wales and Scotland respectively. UK charities represent the larger part of the not-for-profit sector in the UK. The Charity Commission and the Office of the Scottish Charity Regulator also act together as the joint SORP-making body for UK charities and our response to your discussion paper is made in that capacity.

The Charities SORP is an interpretation of UK Generally Accepted Accounting Practice for charities and in developing the SORP we are advised by a SORP committee constituted of sector finance directors, practitioners and lay members. Your discussion paper 'Comprehensive Review of the IFRS for SMEs' was considered, with interest, by our SORP Committee at a recent meeting. Our response, which supports your initiative, incorporates the views and advice we have received from that Committee.

We note that question S3 considers the use of the IFRS for SMEs by not-for-profit entities. Rather than scope out the use of the IFRS for SMEs by not-for profit entities we recommend that the IASB adapt the IFRS for SMEs for the specific not-for-profit issues. This is the model successfully used in the UK. Our response to question S20 identifies those issues that need to be considered.

A formal prohibition on the use of IFRS for SMEs might also be taken to imply that the use of full IFRS is more appropriate for charities. However, the application of full IFRS would create a level of complexity ill-suited to the vast majority of charities and the information needs of their stakeholders. Almost 99% of registered UK charities have an income of £6.5m or less.

Question S3 specifically considers whether not-for-profits meet the definition of 'publicly accountable' and are therefore ineligible to use the IFRS for SMEs. It is true that charities hold funds in a fiduciary capacity on charitable trusts but we would consider that this falls outside of the capital market focus of 'public accountability' intended by IFRS which was not developed with charities in mind.

We do have some concerns about the extent of disclosure required in the notes to the financial statements and we believe the review is an opportunity to simplify reporting and cut clutter by reducing the number of detailed disclosures required.

In closing, we recommend that the IASB, in conjunction with the not-for-profit sector, develop an international accounting standard for not-for-profit entities. There is an existing accounting literature including Canada, New Zealand, UK, and USA which would assist in that endeavour. The use of the existing IFRS for SMEs by not-for-profits is arguably evidence supporting the need for an international standard designed for not-for-profits.

Our comments on the specific issues raised by your consultation are set out in the annex to this letter. If you wish to discuss further how IFRS for SMEs might be expanded to address the reporting needs of not-for-profit entities please contact Nigel Davies, Charities SORP Secretariat.

Yours sincerely,

Sam Younger
Joint Chair of Charities SORP Committee
Chief Executive, Charity Commission

Laura Anderson
Joint Chair of Charities SORP Committee
Head of Inquiry & Investigation, OSCR

Annex to UK Charities SORP- making body response to the Comprehensive review of the IFRS for SMEs

Response to the consultation questions:

Question S1: Use by publicly traded entities (Section 1)

On balance, we favour **option B** where each jurisdiction being allowed to decide whether entities which have debt or equity instruments traded in a public market should be permitted to use the IFRS for SMEs.

Question S2: Use by financial institutions (Section 1)

On balance we favour **option B** with each jurisdiction being allowed to decide whether any financial institutions and other entities that hold assets for a broad group of outsiders, as one of their primary businesses, should be permitted to use the IFRS for SMEs.

Alternatively, we would welcome an amendment to Section 1 that gives effect to the guidance provided by the SME Implementation Group that 'if an entity holds and manages financial resources for only a few investors, or only for investors that are not considered to be outsiders (for example, the investors all participate in the investment decisions), then this would not constitute a broad group of outsiders'.

Were the IFRS for SMEs amended for use by not-for-profit entities, it would be also appropriate to exclude from the definition of financial institutions:

- Those common investment pools created by charities under common trusteeship which manage their investment funds on a pooled basis; and
- Closed investment pools which are limited to only a selected group of charities by virtue of their governing document and which are therefore closed to other charities and investors.

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Question S3: Clarification of use by not-for-profit entities (Section 1)

Pragmatically we would prefer **option A**. In our view the public accountability of soliciting and accepting contributions or donations is not the same as market accountability to global capital markets which is envisaged by full IFRS.

The information needs of those who donate to charities and other not-for-profit entities are different to the needs of investors in capital markets. Moreover, charities and other not-for-profit entities are often small and the compliance cost of full IFRS makes the adoption of full IFRS impractical. In the absence of an international standard for not-for-profits it would be helpful if the IFRS for SMEs could be used and adapted in those countries which have no not-for-profit accounting standard.

However our preferred approach is for a standard to be developed to address the sector specific issues that are arise in charity and not-for-profit accounting. Both IFRS and the IFRS for SMEs were developed explicitly for 'the general purpose financial statements and other financial reporting of profit-orientated entities'. It follows that the application of these standards to not-for-profit entities and their unique transactions has not been considered in the development. Please refer to our answer to question S20 for more information as to how the IFRS for SMEs could be adapted for use by not-for-profit entities.

S4 Consideration of recent changes to the consolidation guidance in full IFRSs (Section 9)

Provided it does not place undue cost or disclosure burdens on preparers, the alignment of the IFRS for SMEs with IFRS envisaged in **option C** is desirable.

The context in IFRS 10 is of an investor effectively having control and exercising control through an agent and that agent directs the investee. However, in the not-for-profit sector, agency arrangements have a different character. In the charity context, an agent may hold and distribute funds and in acting on the instructions of the principal it distributes the assets. The agent as an entity is not controlled by the principal as the principal only has control over those funds administered on its behalf by the agent.

The agent excludes those assets and associated liabilities it administers on behalf of the principal from its own financial statements because it does not have operating control over them. The agent only recognises any income due to it and expenses chargeable to it as a result of its own operations.

Agency arrangements are not uncommon in the charity sector and the recognition that an agency arrangement does not automatically give rise to control would be an important clarification.

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S5 Use of recognition and measurement provisions in full IFRSs for financial instruments (Section 11)

In the context of the UK, it is anticipated that IFRS 9 will be available under GAAP and **option B** would provide flexibility for entities to report either under sections 11 and 12 of the IFRS for SMEs or IFRS 9 as best suits their circumstances.

The adoption of IFRS 9 would be appropriate where private financial institutions or charitable common investment funds are able to use the IFRS for SMEs.

S6 Guidance on fair value measurement for financial and non-financial items (Section 11 and other sections)

We support **option A**. IFRS 13 - Fair value measurement - is a standard designed to fit within the suite of IFRSs used by large companies which are active in global capital markets. The IFRS for SMEs is intended for smaller enterprises and therefore we favour maintaining the simpler approach provided in Sections 11 and 12 of the IFRS for SMEs.

In the context of charities the concept of 'highest and best use of non-financial assets' may not apply as charity law restrictions on the use of an asset may preclude any alternate 'highest and best use'. Also not-for-profits do not necessarily hold non-financial assets to generate cash flows and assets may be used exclusively to further charitable activities that are not cash generating. Examples include habitat preservation and the provision of homeless shelters.

S7 Positioning of fair value guidance in the Standard (Section 11)

We favour **option A**. The fair value guidance is appropriately located in section 11 as it is primarily relevant in the context of basic financial instruments. The positioning of the guidance here enables the reader to appreciate its application.

Were IFRS for SMEs extended to apply to not-for-profits then there may be occasions where the existing approaches to fair value may need to be modified, for example when valuing donated goods and services.

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S8 Consideration of recent changes to accounting for joint ventures in full IFRSs (Section 15)

In the context of potentially adapting the IFRS for SMEs for not-for-profit entities we favour **option A** as this retains current practice.

Section 15 distinguishes jointly controlled operations, jointly controlled assets and jointly controlled entities. In the not-for-profit context the dropping of the requirement for a separate legal entity as an essential characteristic of a joint venture may have unintended consequences due to the absence of equity interest.

A different approach is necessary because the trustees of a charity joint venture and the trustees of the venturer charities which subscribe to that joint venture charity all hold funds on trust on behalf of beneficiaries and not as owners or investors. The 'arrangement' of itself has no assets as these are held on trust. This is unlike a for-profit joint venture which has its own corporate assets from which it pays dividends to the venturer equity holders.

IFRS 11 sets out two categories: joint arrangement and joint venture and (paragraph B14) notes that to be a joint venture each participating entity must have 'rights to the net assets of the arrangement'. Whilst this definition might be workable for for-profit entities with shareholdings in the joint venture entity, charities seldom have share equity in issue.

In such instances the basis for assessing the share of each venturer in the joint venture charity is likely to be based on the specified portion of net income remitted to each charity venturer or proportion of activities undertaken by the entity which furthers the purposes of each charity venturer or in proportion to voting power. However IFRS 11 rules out these measurement approaches for joint ventures. Indeed a strict application of IFRS 11 might effectively prevent most, if not all charity, joint ventures being classed as joint ventures.

S9 Revaluation of property, plant and equipment (Section 17)

We favour **option B** and would encourage the IASB to revise the IFRS for SMEs to permit an entity to choose, for each major class of PPE, whether to apply the cost-depreciation-impairment model or the revaluation model.

The revaluation model is not complex and is a well understood. It provides a relevant option, particularly when an entity uses existing PPE as security for loan finance. For many smaller entities and most charities, the cost model meets their needs and that is why a choice should be kept available.

S10 Capitalisation of development costs (Section 18)

No comment.

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S11 Amortisation period for goodwill and other intangible assets (Section 18)

No comment.

S12 Consideration of changes to accounting for business combinations in full IFRSs (Section 19)

In the context of adapting the IFRS for SMEs for use by not-for-profit entities at a future date, we favour **option C**. In the case of not-for-profit entities, we have significant concerns that the use of the acquisition accounting method will not give a 'true and fair view' of entity combinations in all cases.

Charities may combine to further shared purposes in the interests of their beneficiaries, and a genuine merger of interests can occur. Similarly, two or more charities may have trustees in common and, whilst trust law requires the trustees to administer each distinct charity in line with its specific trusts, the trustees report on a combined basis for stewardship purposes on all the resources they manage with the restricted nature of the distinct funds identified in the financial statements and relevant notes. This situation is analogous to combined financial statements (Section 9 of the IFRS for SMEs).

Charities do not remit profits to investors as dividends. The residual interest of a charity is held on trust for the purposes of the charity and its beneficiaries. Whilst trusteeship can change through the merger of two distinct charities or the appointment of new trustees, there is no equity to be bought and sold. Trusteeship cannot be traded in the way acquisition accounting suggests.

We recognise that there are instances where one charity may agree to take over the undertakings of another and in those limited circumstances a variation on acquisition accounting is appropriate whereby a net gain or loss is taken through the performance statement to reflect the net assets/liabilities assumed.

S13 Presentation of share subscriptions receivable (Section 22)

No comment.

S14 Capitalisation of borrowing costs on qualifying assets (Section 25)

We would prefer entities having the option to capitalise borrowing costs directly attributable to the acquisition or production of a qualifying asset and so favour **option C**. When charities construct assets and the benefits flow over a number of years to beneficiaries, the attribution through depreciation of the capitalised borrowing costs over the life of the asset more fairly reflects the service potential delivered by the asset. However making such an approach mandatory would be disproportionate.

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S15 Presentation of actuarial gains or losses (Section 28)

On balance we recommend **option B** as we would prefer to see all actuarial gains and losses recognised in other comprehensive income. This would help users identify and understand such gains and losses and also remove a source of volatility within the profit and loss section of the performance statement.

S16 Approach for accounting for deferred income taxes (Section 29)

No comment.

S17 Consideration of IAS 12 exemptions from recognising deferred taxes and other differences under IAS 12 (Section 29)

No comment.

S18 Rebuttable presumption that investment property at fair value is recovered through sale (Section 29)

No comment.

S19 Inclusion of additional topics in the IFRS for SMEs

No comment.

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S20 Opportunity to add your own specific issues

Were the IFRS for SMEs to be extended to not-for-profits, including charities, we strongly recommend that the following issues are addressed:

- The recognition of assets and liabilities (and gains and losses) arising from non-exchange transactions as this is a predominant feature of charities' activities.
- Charities also enter into obligations that are of a non-exchange nature and whilst not enforceable under contract they may still result in an unavoidable outflow of resources (a constructive obligation).
- Fund accounting for charities to distinguish in the financial statements between those funds held on trust that are unrestricted and available for any purpose from other funds which are held on restricted trusts.
- The legal restriction on the use of resources held by charities is a significant constraint on their use that needs to be addressed through presentation and disclosure
- Assets (both tangible and investment assets) that are held for purposes other than for making a profit or for cash generation. Alternate approaches are needed to recognition and impairment reflecting the assessment of their service potential.
- Measurement of assets is not limited to historic cost, current cost, realisable value and present value but extends to service potential and includes the use of depreciated replacement cost where these measures provide a faithful representation.
- Fair value, historic cost or depreciated replacement cost all are potential problematic when used for the measure of assets with cultural, social or heritage qualities e.g. ancient places of worship, castles, or protected habitats.
- The concept of control may need further consideration as the ability of a parent entity to benefit will be limited by the purposes for which a charity's funds may be used.
- Acquisition accounting will not always reflect the substance of a combination when charities come under common control or merge to take forward a shared purpose.
- When applying acquisition accounting to charities the recognition of a gain or loss is faithful representation whereas goodwill or negative goodwill which implies an adjustment to profit is not applicable.

G1 How should the IASB deal with such minor improvements, where the IFRS for SMEs is based on old wording from full IFRS?

No comment.

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G2 Do you believe that the current, limited programme for developing Q&As should continue after this comprehensive review is completed?

No comment.

G3 Should the Q&As be incorporated into the IFRS for SMEs?

Option C is preferred. To the extent that Q&As usefully clarify the text of the standard, there may be merit in incorporating the explanation into the standard.

G4 Do you have any comments on the IFRS for SMEs training material available on the link above?

Yes, the SORP Secretariat has made reference to that material and anticipates it will be useful to those charities following the new UK-Irish GAAP which is based, in part, on IFRS for SMEs.

G5 Are there any additional issues you would like to bring to the IASB's attention relating to the IFRS for SMEs?

No comment.

G6 Use of IFRs for SMEs in your jurisdiction

The IFRS for SMEs is not a part of UK-Irish GAAP, however this standard does form the basis of the new Financial Reporting Standards that will apply for accounting periods commencing on or after 1 January 2015.