# Review of public benefit SORP PAPER 3

## Summary of SORP Technical Working Group's conclusions

**Introduction**

**In February 2008 a PricewaterhouseCoopers' report, commissioned by the Accounting Standards Board, comparing public benefit entity SORPs was published. In April 2008 Andrew Lennard, wrote to Andrew Hind, Chair of the Charities SORP Committee, highlighting a number a number of areas where different accounting treatments are prescribed by the different public benefit entity SORPs. In particular, a request was made for the SORP Committee to review the issues identified and consider whether financial reporting would be improved if the Charities SORP adopted the treatment prescribed by another SORP.**

**Four specific issues were identified:**

- **Primary statements - where the Charity SORP adopts a Statement of Financial Activities as its primary performance statement;**
- **Capital grants and financing;**
- **Designated reserves; and**
- **Combinations - in particular merger accounting.**

**The SORP Committee, in its June 2008 meeting, delegated initial consideration of these issues together with multi-year funding arrangements and narrative reporting to Technical Working Groups which would commence their work in the late autumn of 2008.**

**The attached paper summarises the conclusions reached by these groups and the basis for the conclusions reached. These initial conclusions are tabled for consideration by the SORP Committee in conjunction with initial finding from the series of roundtable events.**

## Summary of SORP Technical Working Group's conclusions

### 1 Primary statements - Statement of Financial Activities

1.1 Accounting for restricted funds is based on trust law and provides information relevant to users' information needs. The SoFA reflects both the legal requirements and operational practices adopted by charities for the management of restricted funds.

1.2 The approach put forward within both the RSL and FHE SORPs was seen as reflecting the economic model operated within these sub-sectors, in particular, the lower incidence of funding restrictions being stipulated by donors. The approach adopted by the FHE SORP fails to give adequate recognition to restricted funding and by taking endowment receipts to a separate Statement of Recognised Gains and Losses creates particular issues in relation to the clear identification of movements in endowment funds.

1.3 It was noted that initial findings from roundtable events also give a strong indication that information about restricted funds being presented on the face of the SoFA was helpful and should not be relegated to note disclosure. It was noted that working group considering designations had recommended that movements in designated funds should not be shown on the face of the SoFA.

1.4 The impact of the columnar approach on complexity was also considered. The basic approach put forward by the SORP does not add unnecessarily to complexity but it was recognised that some charities add further columns to identify particular operational activities or to provide other information that is considered relevant to stakeholders needs. One approach would be to the use of an additional operating statement or note where charities wanted to provide further segmented information about particular activities.

1.5 The retention of a columnar approach within the performance statements of charities was therefore strongly supported and seen as vital to proper stewardship reporting and enabling users to understand the restrictions placed on funding received.

1.6 The issue of commercial sensitivity was raised. This was seen as a particular issue for single activity charities where aggregation did not prevent the identification of margins or costs on a particular contract. A review of particular SORP disclosure requirements might help identify particular disclosures that were causing particular concerns and enable a more informed assessment of their relevance for accountability and the competition issues they raise. It was noted that abbreviated accounts which small private companies can file as their public records meant that a fully level playing field could not be achieved without a negation of the wider accountability needs of charities. It was also noted that Freedom of Information requests are now being used to obtain background information on existing contract to assist in tendering on the renewal of contracts and that information obtained in this way could often be obtained irrespective of accounting disclosures.

1.7 No significant inconsistencies with FRS 3 were identified - indeed the key elements of an income and expenditure account and a STRGL could be identified with a SoFA. It was also noted that there were indications that a combined statement was likely to be possible within the framework of international standards.

1.8 The issue of where within the SoFA investment gains should be reported was considered. The key issue here was a desired not to split realised and unrealised gains within a statement. In particular it was noted that the amount of realised gains reported was simply a factor of revaluation policies. For example, policies of continual revaluation resulted in nil reporting of realised gains. Moreover, the need to identify realised gains to establish distributable reserves was unnecessary in the context of charities as they are prohibited from making distributions to shareholders. It was however recognised that the recognition of investment gains in the income section of the SoFA would have advantages where expenditure was funded from investment gains or where total return investment policies were adopted.

1.9 The terminology used to describe the analysis categories within the SoFA were regarded as unhelpful and should be reconsidered. A further issued related to the categories themselves and in particular whether the distinction between voluntary income and income generated from charitable activities was meaningful or understood. A view existed that the linkages provided between income generating activities and related costs often suggested a relationship that was not as precise as suggested by the analysis headings. It would be helpful to look again at the various methodologies that have been used or could be used to provide an analysis of income. This paper should consider an approach that identified the nature of the funder, for example, government funding, foundations and individuals etc. It was noted that information about who funded a charity was often considered important by the funders themselves.

1.10 The possibility of a broader restructuring of the SoFA was considered, for example, starting with expenditure and then presenting income as a funding stream below. Although there might be merit in such an approach conceptually, the group was mindful that initial roundtable feedback did not appear to support radical changes to the SoFA. Moreover, this approach would take us further away from the more conventional income and expenditure approach known to be favoured by some. For these reason no major structural changes to the SoFA are supported by the group.

1.11 The disclosure of Support Costs and their detailed allocation to objectives or activities was seen as unhelpful. The costs identified as support costs were often a factor of underlying accounting systems. The view was that users would prefer to seen activity costs identified with an indication of the key cost components of an activity eg. Staff, property and other costs provided.

1.12 A further suggestion that charities should be encouraged to provide trend analysis, was supported. This might help counter concerns that reporting focuses too much on a single period. Such information could be provided within the Annual Report where it is relevant to the understanding of an activity or the direction of travel taken by a charity.

1.13 The use of natural classification headings should not be seen as free-form. It should continue to be presented as an option for those charities below the charity audit threshold. The group recognised that the use of natural classification can disadvantage a charity where funders require reports are on an activity basis.

### 1.14 Conclusions

- The retention of a SoFA and its columnar approach is supported.
- An operational statement should be allowed where charities wish to present further segmented information on their activities.
- The SORP's disclosures should be reviewed to ensure an appropriate balance is achieved between accountability and commercial sensitivities relating to information required.
- There is no significant inconsistency between the SoFA and requirements of FRS 3.
- Further consideration should be given by the SORP Committee as to where investments gains are to be disclosed within the SoFA.
- The terminology used to describe SoFA categories should be simplified and better reflect the nature of income or costs the analysis category sought to capture.
- A separate paper should be prepared setting out methodologies and analysis categories that could be used to identify and present categories of income.
- No major structural changes to the SoFA are supported.
- Support costs should be dropped from accounting notes. Instead details of key cost components of an objective/activity should be reported.
- Trend information should be allowed with the Annual Report.
- The SoFA should continue to allow charities below the charities, audit threshold to present information using the natural classification system.

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**2 Capital Grants**

2.1 The different approaches to capital grants adopted by the four public benefits SORP's reflect the business models under which these sub-sectors operate. Charities do not operate on a 'subsidy model' rather they seek funding for the objectives they seek to carry forward.

2.2 Income recognition and presentation within charity accounts is determined by both the restrictions on the use of funding and the conditions that determine entitlement. Capital grants are only recognised when conditions relating to the grant are met and are presented as a restricted fund until relevant restrictions/ trusts relating to the grant are met or 'extinguished'.

2.3 The identification of capital grants as a restricted fund ensures such income is differentiated from contractual or unrestricted income.

2.4 Restrictions as to future use of an asset are recognised through fund accounting (restricted income, ongoing restriction or endowment). Funders and charities do not generally perceive a capital grant as a long term subsidy of revenue costs associated with an asset but rather focus on any restrictions over the future use of the asset.

2.5 Restrictions as to future use of asset do not affect recognition but will result in ongoing recognition as a restricted fund.

2.6 The nature of ongoing restrictions should be explained in notes that help the reader of accounts understand what the balance on the restricted fund represents.

2.7 SSAP 4 creates issues for readers of accounts in understanding the nature of the liability created by income deferral.

2.8 If funding conditions created a 'performance related grant' dependent, for example, on the stages of a construction project then such conditions would be relevant to initial recognition of the grant.

2.9 It is important to have internal consistency between accounting for donations to fund a capital project (eg. an appeal) and grant funding for the whole or part of a capital project.

**2.10 Conclusion:**

- Within the context of the SoFA and fund accounting, the Charity SORP's approach to the recognition of capital grants provides the most appropriate accounting treatment reflecting the legal framework and business model within which charities operate.

- Only if the SoFA was to be replaced by a single column 'income and expenditure' account model might the balance of the argument support a 'matching approach'.

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**3 Use of Designations**

3.1 An explanation of designations should primarily form part of a charities reserves policy.

3.2 Designations should not be presented as part of income or expenditure within the SoFA or presented in the balance sheet as a liability.

3.3 The identification of designations for future projects or expenditure can create a presumption that expenditure was committed which may not be the case.

3.4 Concerns existed that designations were being used as 'window dressing' although it was accepted these concerns were based on anecdotal evidence rather than empirical evidence.

3.5 Designations did have value in helping the reader of accounts understand that certain tangible fixed assets were utilised for the provision of charitable services/activities.

3.6 The usefulness of this information to users of accounts, primarily funders, is particularly important.

**3.7 The majority view**

- Designations should be limited to identify assets used for provision of charitable services/activity.
- The determination of this issue should however give very high weighting to the views of funders.

**3.8 The minority view**

- There was no legal impediment or prohibition in standards that prevented the reporting of designations.
- Commercial companies were not prohibited from use of designations - so a prohibition for charities would be inequitable.
- If there was 'window dressing' then SORP rules could be tightened.
- Decision should be informed by research on use/abuse of designations.

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**4 Combinations**

4.1 Consolidation of subsidiaries was relevant to charity accounting notwithstanding the absence of traded debt and equity. Further consideration of the threshold at which consolidation was required was desirable as part of the post implementation review of the Charities Act 2006.

4.2 The recognition given with the Interpretation for Public Benefit Entities of Statement of Principles that mergers do arise was welcomed. Ideally this accounting treatment should be preserved (if compatible with the standards framework on which SORP is based). The SORP should identify the criteria that can be used to differentiate mergers from acquisitions.

4.3 SORP should continue to provide recommendations on accounting for associates and joint ventures. Equity accounting was favoured in both cases. The criteria by which significant influenced was assessed in the case of an associate charity required particular consideration - the criteria put forward in IPSAS 7 provided some ideas but may not work unless adapted for charities. A particular issue was Board representation by charity funders.

4.4 SORP needs to address accounting requirements where a subsidiary is acquired or disposed of in a financial year. In particular, any goodwill on the acquisition of a charitable subsidiary should be recognised as a gain. The transfer of trusteeship of an endowment or restricted fund should similarly be recognised as a gain. (Different accounting treatment for the transfer of endowments and restricted funds was not supported).

4.5 The next SORP should clarify the accounting responsibilities of corporate trustees. Some still assume that corporate trustee should prepare consolidated accounts to include the charities where they act as corporate trustee.

4.6 Moves within government accounting to assume charity trusteeship should create a presumption for consolidation was a concern. There should be no automatic assumption that trustees exercise control to obtain economic benefit for an appointing entity. The nature of trusteeship needs to be understood and the next SORP should set out criteria by which control can be assessed in the context of a charitable subsidiary. Power of appointment and a general concurrence of purpose should not be taken as meeting the 'benefit test' inherent in consolidation. There needs to be evidence that trusteeship is used to create a 'managed' benefit for the parent entity before consolidation criteria are considered met. Consideration should also be given to whether charitable trusts created a 'long term restriction' which would prohibit consolidation of a charity by a non-charitable parent.

4.7 A number of minor points should also be considered in drafting including:

- Differentiating between branches and subsidiaries.

- Drafting in paragraph 383 of the SORP should be reviewed as paragraph 383(b) repeats earlier text.

- Paragraph 397 of the SORP needs greater clarity as to the presentation of parent entity SoFA/results.

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- Paragraph 405 of the SORP needs greater clarity as to expectations in relation to the presentation of segmented information.

- Requirements for intermediate subsidiaries should be addressed.

### 4.8 Conclusion

- The next SORP primarily needed to address the criteria by which control is assessed in the context of a charity. It should also provide further guidance on accounting treatments resulting from mergers or acquisitions within the financial year.

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### 5 Multi-Year Funding Arrangements

5.1 It was agreed that deferring the recognition of grant liabilities to match with future income streams that will fund future grant payment has no basis in accounting principles. Such an approach would result in liabilities only being recognised when funds exist to meet a liability - a result that is clearly erroneous.

5.2 The group noted that some charities maintain that accounting principles are impacting on operational grant making policies and inhibiting the award of multi-year funding due to a reluctance to book the resulting liability. The claim is made that this has the potential to inhibit much needed work, for example medical research. The group questioned this claim and whether it would be a prudent policy to award a grant payable over 3 to 5 years without any assessment of the progress of the project taking place. Moreover, it was considered important that accounting treatment reflected the operational reality. In the unlikely event that a grant was awarded payable over 5 years without any review clause then quite simply in the absence of performance terms the full liability should be recognised.

5.3 It was pointed out that review of grants needed to have substance - in effect it would be improper to simply use a review clause to limit liability recognition where there was every intention to make payments irrespective of progress.

5.4 Where multi-period liabilities arise then consideration needs to be given to explaining any resulting deficits rather than looking for a basis to avoid the recognition of a liability

5.5 It was suggested that widening the definition of performance related grants might enable more funding charities to recognise liabilities as project objectives were delivered. The definition was considered and the view was taken that any broadening of the definition was problematic as the key feature of entitlement based on output required by the funder remained key to the concept.

5.6 The idea that all grants are quasi exchange arrangements was also considered. The concept that in making an award the donor achieves its objectives may be of philosophical interest but would be difficult to apply in practice. There was no support for developing ideas surrounding this concept further.

5.7 The possibility of moving towards a more legally based definition of an unavoidable liability was also considered. Under such an approach a liability would be recognised to the extent the recipient had an enforceable right under promissory estoppel (reflecting money spent and committed by the recipient in relation to promised funding). Again, this approach was not favoured by the group, partly due to the complexity of establishing the level of funds spent or committed by a recipient and partly due to the possibility of recipients simply initially claiming that all promised funding was committed.

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### 5.8 Conclusions

- The group's conclusion was that the approach for grant liability recognition currently based around FRS 12 remained appropriate and best reflected the nature of the funding provided.

- The group understood that initial analysis of roundtable questionnaires indicated dissatisfaction with the current approach to grant liability recognition and it was noted that if the current approach was maintained then an explanation of why other approaches had been rejected would be needed.

- The group concurred that the same principles should be applied to a promise of services formally communicated to a recipient, for example, to provide free care to an individual. However, where services were provided on an exchange basis this would over-ride the FRS 12 principles.

- The issues surrounding recognition of incoming grants was also touched on. It was agreed that income recognition will not necessarily be a mirror image of the accounting position of the funder. The criteria of entitlement, certainty and measurability give rise to a number of approaches in practice. No firm conclusions were reached as to the direction a future SORP might take on this issue and the group concluded that this issue might be best address initially through the development of information sheet guidance.

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### 6 Narrative reporting

6.1 The role of the annual report in complementing and explaining the accompanying accounts was recognised and there was a consensus that a future SORP should continue to provide recommendations for annual reporting.

6.2 There was less support for a move to full operating and financial review. Larger charities that choose to move in that direction may do so but there should be no requirement in SORP to do.

6.3 Larger company charities are already required to meet the requirements for a business review and this should be addressed in SORP where such reporting is required by the law.

6.4 It was agreed that SORP needed to address public benefit reporting requirements but it was suggested that an annual report cannot do the work of the Commission in this area.

6.5 Concerns were raised about the level of information required in areas such as plans, activities and achievements and that this put charities at a completive disadvantage. This view was not wholly shared by the group. In particular, it was suggested that the listed companies report on these issues and indeed often in more detail. Again, this view was questioned within the group. Again, there was little consensus about the need to develop the reporting of performance and a questioning of concept that good reporting could enable charities to compete on results.

6.6 The reluctance to report on difficult circumstances or where projects have not succeeded was discussed. The potential impact on sector practice was noted in that practices can continue if weakness or failures do not feed through to future plans and strategy.

6.7 Issues were raised as to the value added by disclosures such a recruitment and training, risk management, strategies, outside factors impacting on the charity. Again, no consensus was reached on these issues.

**6.8 Conclusions**

- The role of the annual report in complementing and explaining the accompanying accounts was recognised and there was a consensus that a future SORP should continue to provide recommendations for annual reporting.

- No consensus was reached at this meeting in terms of a clear recommendation to the SORP Committee as to content of the report and its emphasis on objectives, activities and performance. It was agreed that an issue as wide-ranging as annual reporting needed to be initially discussed in the wider forum of the SORP Committee.

**Accountancy Policy Team**
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