SORP Committee

Minutes of the SORP Committee Meeting of 8 September 2011
(Approved at the October 2011 SORP Committee Meeting)

Contact: Nigel Davies, Secretary to the SORP Committee
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Present:

Laura Anderson, Joint Chair of the SORP Committee
Debra Allcock-Tyler
Tidi Diyan
Peter Gotham
John Graham
Pesh Framjee
Chris Harris
Keith Hickey
Noel Hyndman
Ray Jones
Carol Rudge
Kate Sayer
Catriona Scrimgeour
Paul Spokes

In attendance:

Nigel Davies, Secretary to the SORP Committee

Apologies:

Frances McCandless, Chief Executive, Charity Commission Northern Ireland (observer member)
Tris Lumley
Lynne Robb
Joanna Spencer, Accounting Standards Board (observer member)
Sam Younger, Joint Chair of the SORP Committee

Item 1: Opening remarks and declarations of interest

1.1 Laura Anderson opened the meeting by thanking Pesh Framjee and Crowe Clark Whitehill for hosting the meeting. She invited any declarations of interest to be declared. No declarations of interest were noted.

Item 2: Approval of the minutes and matters arising

2.1 The minutes of the meeting of the 28 July 2011 were considered and were approved.

2.2 Laura Anderson noted that a 'micro-site' to host the finished SORP text for Committee members to view has been progressed. The Information Technology Team at the Office of the Scottish Charity Regulator (OSCR) has registered a members' only service. Sign on details would be forwarded to Committee members in time for the October meeting.

2.3 The Secretariat noted that Mr Paul Pacter, Board Member, International Accounting Standards Board (IASB) would be attending the October Committee meeting to discuss the IASB's work and agenda.

Item 3 Update from the ASB

3.1 There was no update from the Accounting Standards Board (ASB). In giving her apologies, Joanna Spencer had advised that the ASB Board would be shortly considering the feedback from the Financial Reporting Standard for Public Benefit Entities (FRSPBE) consultation exercise (also known as Financial Reporting Exposure Draft 45, FRED 45).

Item 4 Control in the context of charities: subsidiaries, joint venture entities, and associates

4.1 Nigel Davies introduced this paper. He noted that commercially based international accounting standards (IFRS) and UK Generally Accepted Accounting Practice (GAAP) were in agreement that control 'is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'. The purpose of consolidated financial statements is to present the parent and subsidiary as a single economic entity. He cited the work of the International Public Sector Accounting Standards Board (IPSASB) which distinguished two elements to control: the power element and the benefit element.

4.2 In identifying the power element, he noted that in the absence of equity the focus would need to be on voting rights. He noted that IPSASB considered that, in the public sector context, the benefit element would be demonstrated by the ability of one entity to direct the activities of another to further its own aims. Arguably this was the same situation for charities as charities do not remit dividends to a parent entity.

4.3 The Committee noted that when identifying whether the power element exists, reference should also be made to any agreement or formal arrangement. There were instances where a non-governmental organisation (NGO), as a condition of funding, put in place a funding agreement giving it the ability to direct the activities of the recipient. However, simply being the main or sole funder was an insufficient test of control as charities might on occasion have a single grant maker or public body as its sole or main funder and in the absence of that body exercising the power of control through voting rights or the terms of an agreement then control is not demonstrated for accounting purposes. Where the parent entity exercises control through the terms of an agreement, the charity subsidiary is analogous to a special purpose entity.

4.4 The power of the trustees of one charity to direct another charity did not mean that trustees of the subsidiary were acting in breach of charity law. Just as company directors must act in the interests of the company, so trustees must act in the interests of their charity. However UK company law recognised this by using the term dominant influence to describe the nature of control being exercised. The directors of the subsidiary still act lawfully but are directed by, or act also to further the interests of, the parent. In the for-profit context this situation would be demonstrated by the subsidiary generating income, profits and dividends for the parent. In the charity context, benefit is achieved through the undertaking of charitable activities which are of benefit to both parent and charitable subsidiary. The charitable purposes of the parent charity must be furthered so that it benefits from the activities undertaken by the subsidiary for the benefit element of control to be met.

4.5 The Committee considered whether the existence of common trustees in two or more charities would be sufficient to demonstrate control and agreed that this was insufficient. Where there are common trustees, the power element must still be demonstrated by one or more entities being control by another and with the benefit element being present. For example, the parent must benefit from a degree of shared aims or charitable activities which contribute to its own charitable purposes.

4.6 It was noted that in Scotland an entity could not be a charity if it was subject to ministerial control. Also, it was noted that in England and Wales, 'local authority controlled companies' were identified where a local authority had a majority shareholding or appoints/ removes the majority of directors or has majority voting power (Local Government and Housing Act 1989). Influence is assumed to exist if more than 19% of voting rights are held by the local authority.

4.7 When considering the benefit element, the Committee considered that there need only be a concurrence of aims and of beneficiary class. There was no requirement for identical charitable aims or for the parent's aims to be wider than the subsidiary. However, entirely dissimilar aims would mean that the benefit element was not present and so control could not exist even if the power element was present. To establish benefit, the extent of the concurrence of aims would need to be considered since consolidated financial statements need to present a true and fair view of the parent and subsidiary as a single economic entity.

4.8 Joint venture charities, unlike commercial for-profit entities, have no share capital by which each venturer's equity share can be calculated. In the case of charities, the simple division of the results and net assets of joint venture by the number partners would provide a reasonable basis to identify each partner's interest if the joint venture agreement was silent about respective interests and there was no other evidence that established an alternate basis for consolidation. However, initial reference should be to any agreement or other evidence, for example the extent of any initial or ongoing financial contributions.

4.9 A charity may be the associate of another where significant influence exists and neither a subsidiary nor joint venture relationship exists. However, it may be problematic to simply ascribe an equity interest based simply on the voting rights of appointed trustees. The Committee found the existing discussion in SORP 2005 on establishing if an associate interest exists very helpful and it should be retained. However, the Committee were not convinced that a simple disclosure of an associate

relationship was sufficient in the absence of an equity interest. There was a need to consider other evidence, such as the terms of a funding agreement to determine whether consolidation should be based on the proportion of voting rights held by the parent charity or its appointed trustees. To avoid recalculation of equity interest based on vagaries of trustee turnover, the proportion of voting rights held should be determined by reference to the governing document.

4.10 Simple collaborations or assistance involving the provision of expertise. advice or support to another charity through the provision of a trustee does not create an associate interest. The Committee noted that in commerce a parent entity invests in an associate to earn a financial return and influences the associate in order to vary that return. There still needed to be the exercise of influence over the financial and operating policies of a charity for an associate relationship to exist in the context of a charity and, in addition, the benefit element must also be present in terms of a concurrence of aims and beneficiaries. A donor charity providing funding is not exercising influence unless it also exercises voting rights and uses those rights to actively influence the way in which the charity operates in order to further its own aims.

4.11 Supporters of a charity may on occasion invest in the trading subsidiary of a charity. The investors may not be seeking a return and the investment primarily supports the fundraising activities of the charity. In such cases, when considering the minority interests, it is important to consider substance over form. If the minority shareholders are not receiving a return because they have waived their rights to a dividend or accept that profits are donated to the parent charity then a minority interest need not be recognised on consolidation. If the minority shareholders in a subsidiary entity participate in its profits then such a minority interest is measured on the basis of their equity interest in the subsidiary.

4.12 The Committee agreed that:

- **Where a charity has the majority of the voting power in a non-charitable subsidiary then that entity is a subsidiary.**
- **Control of one charity by another charity can be demonstrated by reference to: sole trusteeship, appointing the majority of trustees, an agreement or formal arrangement, and clause in a governing document or legislative provision.**
- **Simply having trustees in common was insufficient to demonstrate the power element of control is present.**
- **The funding of one charity by another is insufficient on its own to demonstrate that the power element is present.**
- **The IPSASB approach to defining control by reference to a power element and benefit element is a helpful way of identifying whether control is present in practice.**
- **In the absence of equity and the ability to distribute profit, charities need to look to an alternative indicator of benefit to establish whether control is present.**
- **A concurrence of aims is sufficient to demonstrate the benefit element is present provided there is also a concurrence of beneficiary class. To benefit from the activities of a subsidiary charity, the aims of the parent charity need not be identical to or indeed wider than the**

subsidiary but there must be a degree of overlapping aims, aims in common or sharing of aims between parent and subsidiary.

- **When consolidating joint venture charities, reference should first be made to the agreement to identify if there is a basis for identifying each sponsor's interest. If the agreement is silent then a joint venture charity is consolidated on the basis of equal shares between each venturer unless there is evidence to the contrary which suggests an alternate basis for consolidation would provide a more 'true and fair' view.**
- **Where there is a minority interest in a subsidiary reference should be made to the substance of that interest. Where a minority interest is not recognised, a contingent liability should be recognised if on dissolution of the entity the minority interest is entitled to a share of the subsidiary's net assets.**
- **The existing SORP 2005 text in paragraphs 409 and 410 to be retained and in the absence of any evidence to the contrary, an associate charity should be consolidated on the basis of the proportion of voting rights exercised by the parent charity in accordance with the trustee body established in the governing document.**
- **Where an associate relationship exists but it cannot be measured reliably it would constitute a related party, whereas when a charity collaborates with another charity this is evidence of a connection but they are not related parties.**
- **Similarly a minority interest of one charity in another charity should be considered on the basis of substance over form. If a minority interest is recognised then its treatment in term of identifying that minority interest's share of performance and net assets is analogous to the approach taken for associate charities.**
- **To facilitate discussion, the Committee agreed that order of the remaining agenda items be changed.**

Item 6: Trustees' Annual Report: 'cutting the clutter'

6.1 In introducing the paper, Ray Jones noted that the Financial Reporting Council (FRC) were leading a discussion looking at how the perceived clutter in the annual report and accounts of many listed companies might be reduced. The annual reports and accounts of larger charities tended to be considerably shorter than those of listed companies probably because they were not subject to full IFRS disclosures and the Combined Code. However, there was no room for complacency as Trustees' Annual Reports and the financial statements and notes were growing in length.

6.2 The FRC had noted that there were a number of drivers that led to clutter:

- materiality in disclosures was overlooked;
- standing information which is unchanged from year to year; and
- behavioural factors including a slavish following of checklists and examples with a lack of consideration as to what matters to stakeholders.

6.3 The Committee noted the extensive SORP research work undertaken in 2008-09. Although annual reports and accounts (financial statements) were primarily focussed on external stakeholders, focussed reporting would also be of benefit to

trustees. The key question is identifying what information matters to stakeholders. The term materiality was so closely associated with financial values that a different term is needed for non-financial information and accounting disclosures where monetary value is only one consideration.

6.4 The Committee noted the excessive length of some accounting disclosures, for example pensions. The SORP is required to comply with UK Generally Accepted Accounting Practice (GAAP) and so there is limited scope for the SORP Committee to simplify reporting without intervention from the FRC and the Accounting Standards Board.

6.5 Although the new SORP should offer more help in identifying what matters or is material, the setting of particular benchmarks, for example like 1% , should be avoided as these may be misinterpreted as rigid rules by some auditors or practitioners. The provision of guidance might encourage trustees to focus on the important and to resist well intentioned but misguided pressure for non-material disclosures or superfluous detail in their reporting.

6.6 The Trustees' Annual Report should focus on what a charity exists to do, how it went about it and what it achieved. If a 'what's changed' approach to standing information is not permitted by company law, charity law and the relevant regulations then such information needs to appear later on in the report. Impact or outcomes should be the main focus. A guide might be 'no numbers without linked stories but no stories without linked numbers'. This approach would knit the report and financial statements together better.

6.7 The sector would benefit from good guidance to encourage better practice and best practice reporting pioneers who can encourage others. The SORP modules should link the 'must' statements as closely as possible to materiality and clearly distinguish voluntary best practice to help guard against checklist style approaches to using the new SORP.

6.7 The Committee noted that whilst the financial statements are important, the weight of disclosures and the requirements of accounting standards has meant that much of the Committee's time has been spent on the detail rather than considering the wider picture of what stakeholders actually want and how that can be better addressed by the financial statements and the notes. A classic example are pension disclosures that run for many pages providing great detail but which are of interest to very few readers. Excessive disclosure means that the detail detracts from reporting what is actually important to stakeholders.

6.8 The Committee agreed that:

- **The trustees' annual report module should emphasise that reporting on what matters is the key and that standing information should appear later on. The flexibility allowed in the format of the report should also be emphasised.**
- **The SORP modules should assist trustees in understanding what materiality means for financial and non-financial information.**
- **A response should be made to the FRC discussion document which notes that it is in the gift of the FRC to act on simpler disclosure by**

reviewing the draft Financial Reporting Standard for Medium-sized Entities (FRSME) and Financial Reporting Standard for Public Benefit Entities (FRSPBE).

- **The draft response to the FRC be circulated for comment by e-mail.**
- **To avoid confusion a single term for materiality should be adopted in the Trustees' Annual Report and used consistently throughout the text to convey the sense of what matters to stakeholders is what should be reported, and if it doesn't matter then don't report it.**
- **The draft accounting policies module should be reviewed for emphasis on materiality and re-circulated.**

Item 5: Accounting policies

5.1 The Committee agreed that in the light of the discussion on cutting clutter that the draft module be reviewed for its emphasis on materiality and circulated for comment by e-mail before the next meeting.

Item 7: Any other business

7.1 There being no other business the meeting closed.