SORP Committee

Minutes of the SORP Committee Meeting of 10 March 2011
(For adoption at the April 2011 SORP Committee Meeting)

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Present:

Debra Allcock-Tyler
Laura Anderson, Joint Chair of the SORP Committee
Peter Gotham
Pesh Framjee
Keith Hickey
Noel Hyndman
Frances McCandless, Chief Executive, Charity Commission Northern Ireland (observer member)
Ray Jones
Carol Rudge
Kate Sayer
Catriona Scrimgeour
Paul Spokes
Sam Younger, Joint Chair of the SORP Committee

In attendance:

Nigel Davies, Secretary to the SORP Committee
Janet Slade, Charity Commission
Joanna Spencer, Accounting Standards Board

Apologies:

Tidi Diyan
John Graham
Chris Harris
Tris Lumley
Lynne Robb

Item 1: Opening remarks and declarations of interest

1.1 Sam Younger opened the meeting and noted that it was his first since being confirmed as Joint Chair by the ASB. He noted the importance of the SORP to the sector and also to the work of the Charity Commission. In taking forward its work, he emphasised that the Committee should take full account of the wider public interest and the need for accessibility and transparency of information.

1.2 Laura Anderson, Joint Chair, then invited any declarations of interest to be declared. None were noted.

Item 2: Approval of the minutes and matters arising

2.1 The minutes of the meeting of the 7 February 2011 were considered and were approved.

Items 3 Update on the ASB proposals and plans for the future of UK GAAP

3.1 Joanna Spencer updated the Committee on progress on the development of the Public Benefit Entity Standard (FRSPBE). The standard was likely to be released for comment next week on the ASB's website and issued later in print.

3.2 She advised that the ASB Board had made two changes to the draft. The section on heritage assets was to be an addition to the Financial Reporting Standard for Medium-sized Entities (FRSME). Secondly in respect of concessionary loans the option to value these at fair value had been added.

3.3 The FRSPBE consultation will be open until 31 July 2011 and overlaps therefore for a short period with the consultation on the future of UK Generally Accepted Accounting Practice (UK GAAP) which closes on 30 April.

3.4 The Committee noted that:
The UK GAAP and FRSPBE consultations were agenda items for the April meeting.

Items 4: SORP Research Study

4.1 The Committee welcomed Janet Slade to the meeting. She noted that the research study had involved reviewing 536 sets of accounts for the use of natural categories and the accounting policies for: valuation of buildings, capitalisation of borrowing costs, legacies, multi-year commitments and multi-year income receivable.

4.2 She noted that the random selection was made from registered non-company charities required to prepare accruals accounts, incomes exceeding £250,000 and from registered company charities. It was a stratified sample covering all sizes of charity but which took account of the cut off for the Financial Reporting Standard for Smaller-sized Entities (FRSSE) of £6.5m income. The Committee was invited to review the findings for each of the 6 topics in turn.

4.3 The SORP permits those charities below the statutory audit threshold to report income and expenditure on an alternative basis to activities using such other categories as best suited the charity's circumstances. Of those eligible, the study found that 12% of charities (1 in 8) opted for natural categories and reported by type or nature of income and expense.

4.4 In discussion the Committee noted the increasing interest of funders in outputs, outcomes and impact which was better served by activity reporting. However where there was only one activity undertaken by a smaller charity the use of natural categories would still work well and meet funder's needs. Also natural categories were easier for trustees to understand and meant that the statutory accounts were more comparable to the management accounting information used by trustees in year.

4.5 Referring to table 1 of the appendix to paper 2, it was noted that of those charities with buildings up to a third (1 in 3) adopted a policy of valuation for all or part of the functional property held. However historic cost remained the predominant accounting policy.

4.6 In discussion it was noted that the impact of the draft FRSME's prohibition of valuation of property would depend upon the flexibility of the banks regarding covenants. Since loan funding was an increasing feature of the sector, the inability to revalue was of concern. The impact would be even greater for registered social landlords (RSLs) and higher and further education. Revaluation was also valuable in identifying through depreciation charges the true economic cost of assets being used, and it had implications for grants and funding which are based on costs incurred.

4.7 The survey found that 7% (1 in 14) of charities had an accountancy policy to capitalise borrowing costs on the acquisition of a fixed asset. All 7 registered social landlord (RSLs) charities had a very full explanation of their policy. The draft FRSME requires all borrowing costs to be treated as an expense.

4.8 In discussion it was noted that RSLs routinely build or acquire property whereas many charities have one-off acquisitions where they would capitalise borrowing costs. It did not follow that the impact on the sector would be small from losing this option. Also with the concept of localism and the transfer of assets out of the public sector, there were likely to be more situations where charities would need this option.

4.9 The study found a wide variation in the wording of the accounting policy for legacies and a wide variation in practice with a lack of clarity as to the recognition point used in accruing legacy income.

4.10 In discussion it was agreed that the wording of the SORP did appear to permit variation in practice but the situation of charities receiving millions of pounds of legacies did differ in scale and complexity from that facing smaller charities receiving legacies infrequently. However although a degree of flexibility can be justified, the range of variation found was too great.

4.11 The Committee noted that the legal position in Scotland differed from England and Wales with a 6 month period before confirmation of estate could be made. In England and Wales although probate did provide a degree of certainty it was not necessarily confirmation that funds were available, particularly in the case of residuary estates. Also appeals and contested wills were additional factors. The key was a consistent interpretation of the tests for recognising income.

4.12 The study found that there was divergent practice on the accounting treatment for multi-year grant commitments. Grant makers seldom disclosed unaccrued commitments.

4.13 In discussion it was noted that the SORP roundtables and the results of the research indicated a preference for matching. However accounting standards had moved away from matching as a practice. Grant makers often made grants subject to the availability of funds and to conditions being met. It was noted that the constructive obligation is not just in the eye only of the grant maker but also in that of the recipient. The proviso that a grant is subject to funding being available was less relevant because grant makers face a risk to their reputation if they default on a commitment and if their practice is always to fund once approval is given it is not a real constraint in any case. The accounting should follow sound principles and not be swayed by management issues as to how grant makers operated their grant making programmes.

4.14 The final area reviewed by the study was the accounting for multi-year income. Again some charities had adopted a matching approach which is not permitted by the SORP. Also wide variation in accounting for life memberships was noted.

4.15 In discussion the Committee noted that a time of austerity there was a concern that public sector bodies would renege on multi-year grant commitments making income more unpredictable. The approach to income recognition is necessarily more conservative than the recognition of liabilities. In law once work is undertaken in good faith a liability arises for the costs incurred under promissory estoppel.

4.16 The Committee concluded that:

The option for smaller charities to use natural rather than activity based categories should be retained and the option should be made more visible so that trustees knew it was there.
The option to revalue property is needed.
The option to capitalise borrowing costs is needed.
There is a need for greater clarity in the SORP about legacy recognition to facilitate a greater degree of consistency in accounting treatment.
Further guidance should be given on accruing multi-year commitments to facilitate grater consistency in sector practice.
Disclosure is needed for multi-year commitments that have been made but which fall short of a liability.

Item 5: Statement of Financial Activities Module - FRSSE

5.1 Ray Jones introduced the discussion on the Statement of Financial Activities (SoFA) based on the existing UK GAAP FRSSE. He then led the Committee through the questions posed in the paper.

5.2 The Committee noted that terminology aside, the classification of some items was ambiguous with two very different approaches possible for the classification of grant income either as voluntary income or income in furtherance of the charity’s activities. With the growth in public sector funding and the use of performance related grants and service level agreements the scope for inconsistency had increased. There was also a growing interest in the extent of State funding of the sector and there was a debate as to whether state funding could ever be considered voluntary income. Also there was some confusion between conditions relating to performance and restricted funds. This situation was not helped by the terminology used in the SoFA in SORP 2005.

5.3 Where charities deliver services, donors who give to support the charity have an interest in how the charity is being financed so that they can take informed decisions. Charities may choose to supplement State funding to deliver higher quality outcomes. There is a need for comparability and consistency in income classification to assist donors. SORP 2005 had taken an activity based approach to help donors and the public understand how sources of finance related to the charity's activities and costs. Knowing the extent of State or contract funding helps donors understand the financial stability of a charity and the choices trustees were making in developing the charity's activities.

5.4 The Committee noted the tension between a growing involvement in contracting with a desire to reduce disclosure to protect commercially sensitive information and the ethos of charities to be transparent and accountable to donors and the public. This could be a very acute tension, especially for charities with few activities where the income and cost profiles were more readily discerned from the financial statements. On balance if the sector was to retain its distinctiveness and the confidence of donors and the public the maintenance of transparency and the sector's independence was essential. This was the case even if it may on occasion disadvantage charities in the bidding process. SORP has a key role in this process by providing a benchmark for transparency in the interests of donors and the public.

5.5 Terminology for public funding via grants is a problem. The Committee debated the terms core grants, grant in aid, grant for core costs and reflected on whether they are distinct from performance related grants that were not voluntary income. None of these terms were completely satisfactory particularly given the pseudo contractual terminology often used in making these grants.

5.6 In considering whether support costs should be disclosed or fully absorbed without separate disclosure, the Committee reflected on the reasons why SORP 2005 opted to disclose support costs. There was genuine public interest in what might be termed central core costs, management and administration, governance or overhead costs. At the SORP roundtables funders had shown interest in having access to this information. The Committee noted that in developing SORP 2005 it was public interest which led to the disclosure rather than just simply requiring their full absorption into activities reported in the SoFA.

5.7 The Committee noted that however defined there was a great degree of judgement in identifying these costs and then apportioning or allocating them across activities. In smaller charities with few staff, individuals often took on a variety of roles and so the allocations could be rather subjective and vary greatly from year to year. Comparability between years for an individual charity was problematic and comparisons between charities difficult and arguably unreliable. If disclosure of support costs were to be retained, then charities should be required to disclose such costs whether located out in the field or in a headquarters facility so as to facilitate greater consistency. If disclosure is needed the Committee noted that the activity based approach was better than a single line in the SoFA because it related the support costs to the activities undertaken.

5.8 On reflection the terminology introduced by SORP 2005 for the SoFA had not worked. The draft SoFA proposed new terms that might be better understood by donors and the public and facilitate the more consistent categorisation of income. It was noted that fundraising by way of trading would be perceived differently by the public from fundraising events such as concerts or gala diners.

5.9 The SORP roundtables had fed back that a simplification of the SoFA and a reduction in the amount of information contained may help understanding. The Committee considered whether a single column analogous to an Income and Expenditure Statement would be an improvement with restricted funds only shown on the face of the balance sheet and in the notes to the financial statements. This was rejected as there was widespread interest in the distinction between restricted and unrestricted funds and this distinction assists trustees in managing their charity effectively.

5.10 The Committee did agree that a two column SoFA with endowment treated by way of an extra row or rows in a section of the SoFA analogous to a Statement of Recognised Gains and Losses (UK GAAP) or other comprehensive income (IFRS) did have merit. It would be a simplification by dropping the third column which for many endowed charities was either not material or subject to infrequent transactions.

5.11 An area of continuing departure with UK GAAP was the SORP's treatment of recognised and unrecognised gains and losses on investments. Whereas the SORP combined them, the FRSSE required their separate disclosure with recognised gains and losses treated in the income section of the SoFA. This was now further complicated by the FRSME which did combine them and would include them in the income section. The only exception being gains and losses relating to endowment funds.

5.12 The Committee agreed that:

The option for smaller charities to prepare a SoFA on a natural basis should be retained.
The requirement for an activity based approach over the audit threshold should be retained.
The next draft of the SoFA should consider how comparability in the analysis of income can be maintained given the switch in funding of charitable activities from grants to contracts.
The next draft of the SoFA should aim to have simpler and clearer definitions for income distinguishing between income that is given, income from non-charitable trading and fundraising, income earned from contracts and forms of executory contracts and investment income.
For transparency a total for income from public and state sector funding should be given in the notes to the SoFA.
Support costs should be analysed separately and disclosed but a future consultation question should be put to see whether the sector supports this approach or would prefer simple absorption of support costs without separate disclosure.
Governance costs are often not material and should be reported as a component of support costs.

Committee members will e-mail suggestions on how to improve the terminology used in the SoFA to ensure it is more intuitive and clearer.
A single column SoFA was not practicable given the need to distinguish restricted from unrestricted funds. However an alternative presentation of the SoFA based on a two columnar approach should be considered. A two column approach would require further consideration particularly in relation to how gains released to income would be presented.

Item 6: Statement of Financial Activities Module - FRSME

6.1 Ray Jones introduced this paper noting that the FRSME permits a single statement approach based on the IFRS Statement of Comprehensive Income. Although considerable flexibility is given, the FRSME does require the separate disclosure of financing costs. Also the income from discontinued activities is shown net of expenses as a single entry. Items in the other comprehensive income section were investments in foreign non-charitable subsidiaries, actuarial gains and losses and unrealised hedging gains or losses. However there was an option to reclassify actuarial gains and losses to the income section (the equivalent of profit and loss). Also gains on property revaluation are show under other comprehensive income.

6.2 The Committee noted that in the context of charities discontinued activities did not mean a change in geographical activity for example in disaster relief. This differed from commerce where activities are developed around particular markets or production locations.

6.3 The Committee concluded that:

The categorisation used in the SoFA should be consistent between FRSSE and FRSME presentations and so the treatment of gains and losses on income funds should follow the requirements of the FRSME.
There is a difficulty in achieving a consistent approach between the FRSSE and FRSME in the treatment of unrealised gains.
The treatment of Endowment should be consistent with the FRSSE and should be show in the other comprehensive income section if a two columnar approach is adopted.

Item 7: Activity Costing module

7.1 Nigel Davies introduced this paper and noted that the Committee had decided earlier in the meeting that there would be a consultation question as to whether the disclosure of support costs would be required. The design of the module had taken account of the existing guidance in SORP 2005 and the requirements of IFRS 8 Operating Segments. He also noted that the module would need to be reviewed once the format of the SoFA had been agreed to ensure it was consistent with it and also with the description of activities set out in the Trustees’ Annual Report module. He led the Committee through the questions posed in the paper.

7.2 The Committee considered whether the existing guidance in the SORP about distinguishing fundraising related communications and information related to the charity's activities should be retained or removed to reduce the length of the text. The Committee noted hat this text had been added to deal with practices originating in the USA where charities had concealed the true costs of fundraising by attributing it to charitable activities by including some superficial additional information in the mailings. Given public interest in fundraising this section should be retained.

7.3 The Committee concluded that:

> **The reference to up to 10 activities should be dropped in favour of allocating support costs across the material activities reported in the SoFA.**
> **The introduction should be changed to emphasise the logical flow of defining the activities reported in the SoFA, identifying support costs and then allocating those support cost across the activities reported in the SoFA.**

Item 8: Total Return module

8.1 Nigel Davies introduced this paper and noted that this may be a module only applicable to charities in England and Wales with permanent endowment. It did not apply in Scotland and may not apply in the Republic of Ireland or Northern Ireland. The module set out the accounting treatment to be followed where a charity obtained a power of total return from the Charity Commission. This was unaffected by the Perpetuities and Accumulations Act 2009 by virtue of section 14(2) which provides for the limit on accumulations not to apply where the provision is made by the Charity Commission. The mooted Trust Capital and Income Bill would provide a general power to undertake total return without Charity Commission approval being required.

8.2 The Committee concluded that:

> **The accounting treatment set should be compatible with the SoFA format once the SoFA modules are completed.**

Item 9: Statement of Cash Flows module

9.1 Nigel Davies introduced this paper and noted that unlike UK GAAP FRS1 there was no opt out of preparing a Statement of Cash Flows under the FRSME. The module had been written with the preparers of smaller charities in mind who may never have been required to prepare a Statement of Cash Flows before.

9.2 In discussion the Committee agreed the approach taken was helpful but to avoid the module being viewed as a checklist the examples given of the three types of cash flow from operations, investing and financing should have the caveat added that they are not exhaustive.

9.3 The Committee considered the proposal to treat cash flows from programme related investments as relating to operations. Since the main focus of programme related investments is not a financial return and there may be no return at all the recommended approach was supported.

9.4 The Committee considered the treatment of endowment and the options of showing in a multi column statement, to show it in operations or to show it in financing. On balance, given that endowment is treated as capital in trust law and initially invested, the Committee decided that it was more analogous to long term financing such as loans or equity.

9.5 The Committee concluded that:

> **That cash flows from programme related investments show under operations.**
> **That cash flows from endowment show under cash flows from financing activities.**

Item 10: Events after the end of the reporting period module

10.1 Nigel Davies introduced this paper and noted that SORP 2005 had treated this item in an appendix but the FRSME and FRSSE treated it as a separate section. The treatments in the FRSME and FRSSE were comparable.

10.2 The Committee concluded that:

> **More of the examples given should be charity specific to assist preparers identify adjusting and non-adjusting events.**

Item 11: Dates for Committee meetings

11.1 Additional meetings have been scheduled for July, September, October, November and December.

Item 12: Any other business

12.1 There being no other business the meeting closed.