SORP Committee

Minutes of the SORP Committee Meeting of 12 October 2011
(Approved at the November 2011 SORP Committee Meeting)

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Present:

Laura Anderson, Joint Chair of the SORP Committee
Sam Younger, Joint Chair of the SORP Committee
Peter Gotham
John Graham
Pesh Framjee
Keith Hickey
Noel Hyndman
Ray Jones
Lynne Robb
Carol Rudge
Kate Sayer
Paul Spokes

In attendance:

Nigel Davies, Secretary to the SORP Committee
Frances McCandless, Chief Executive, Charity Commission Northern Ireland (observer member)
Jane Hobson, Head of Policy, Charity Commission (for items 1 to 5)
Joanna Spencer, Accounting Standards Board (observer member)
Claire Stewart, Senior Accountant, Office of the Scottish Charity Regulator

Invited speaker:

Paul Pacter, Board Member, International Accounting Standards Board (for item 5 on the agenda)

Apologies:

Debra Allcock-Tyler
Tidi Diyan
Tris Lumley
Catriona Scrimgeour

Item 1: Opening remarks and declarations of interest

1.1 Laura Anderson opened the meeting by introducing Jane Hobson and Claire Stewart who were attending the meeting to learn more about the work of the Committee. 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 8 September 2011 were considered and were approved.

2.2 Laura Anderson reported that progress had been made on launching a 'micro-site' to host the completed SORP modules for Committee members to view. However due to technical problems with the site provider the issuing of registration details had been delayed. Registration details would be forwarded to Committee members in time for the November meeting.

2.3 The Secretariat noted that Caron Bradshaw, Chief Executive, Charity Finance Directors' Group (CFDG), would be joining the Committee as an observer member.

2.4 It was reported that a submission had been made to the Financial Reporting Review Panel on cutting clutter in annual reports and accounts. Two new current consultations were identified as having implications for the sector, namely the proposal for simplified financial reporting by micro entities and a review of the audit threshold for companies.

Item 3 Update from the ASB

3.1 Joanna Spencer noted that in the feedback received by the ASB on the draft Financial Reporting Standard for Public Benefit Entities (FRSPBE), the most contentious issue had been that of accounting for donated goods. The ASB Board were due to consider two papers on the draft FRSPBE at the 20 October 2011 meeting. The first paper concerns incoming resources from non-exchange transactions, including donated goods, and the nature of performance conditions that affect income recognition. The second paper addresses the initial and subsequent measurement of donated goods.

3.2 Regarding government grants, as an interim step, the ASB Board had directed staff to redraft this section to retain current practice based on SSAP4 'Accounting for Government Grants'. The issue would be reviewed in depth at a later date.

3.3 There was a possibility that the FRSPBE might be incorporated as sector specific paragraphs into the Financial Reporting Standard for Medium-sized Entities (FRSME). The Committee noted that if this was the case, it made it even more important for the SORP to provide a comprehensive solution that met the needs of both FRSME and FRSSE (Financial Reporting Standard for Smaller Entities) users. It was noted that almost 98% of registered charities in the UK would be eligible to use the FRSSE.

3.4 The ASB's expectation is that the hierarchy set out in the consultation whereby users of the FRSSE refer up to the FRSME where an issue is not dealt with in the FRSSE will mean that the SORP will have effect for FRSSE users.

3.5 It was very likely that the ASB would be consulting again on the FRSME due to the extensive changes being made to it and the fact that many entities that anticipated being tier 1 (full EU adopted International Reporting Standards, IFRS) had not considered the FRSME. That consultation might be held in early 2012.

Item 4: Impairment of assets module

4.1 Ray Jones introduced this paper. He noted that the draft module was completely new text. It took account of the detail provided in the FRSPBE and FRSME on impairment and so the module looks at the charity specific issues. The underlying concept is that assets are reported at their recoverable amount. He noted that the FRSSE as a simplified standard makes no specific reference to impairment but does require a fixed asset to be carried at no more than its recoverable amount.

4.2 When considering impairment, charities must consider the service potential of an asset and not simply the generation of cash-flows. More examples would help preparers to consider impairment and the content could be re-ordered to emphasise that if impairment was not indicated nothing more is done.

4.3 Consideration should also be given to assets held for service potential which also generate cash-flows. Additional cross referencing for the treatment of goodwill would be helpful. It was noted that the FRSPBE concluded for property held for social benefits that cash flows were not the predominant factor in deciding if an asset was an investment property, instead reference is made to the primary provision for which the asset is held.

4.4 Depreciated Replacement Cost (DRC) was only one approach to measuring service potential. It was noted that the International Public Sector Accounting Standards Board (ISPASB) had developed three variations on DRC. Insurance valuations might provide a cheaper solution for providing a valuation for buildings if adjusted for the cost of demolition and site clearance. However if a replica is required, as opposed to replacing service potential, the insurance valuation may be insufficient. Also land values would often be greater than the building value.

4.5 Value in use did not imply that an asset must be used every day. Some assets might only be used periodically, for example at religious festivals or services. Other assets might be subject to seasonal use, such as school buildings. Often the key issue is whether the activity for which the asset is used is discontinued altogether or the asset is partly or wholly unavailable for its intended use.

4.6 There should be a greater explanation of the implications of restricted covenants that would apply on disposal and which would affect the market value (fair value) and other restrictions that may affect value in use. It was agreed that the reversal of impairment is effectively negative depreciation and not other income; however the cap on reversal should be noted.

4.7 The Committee agreed that:

- **The module as drafted is common to both FRSME and FRSSE users and a separate module is not required for FRSSE users.**
- **There should be greater cross referencing to help users of the SORP know when to refer to the FRSME for advice or more information.**
- **The content be re-ordered with section 4 coming after the initial introduction and definition.**
- **Additional content be added to reflect the measurement of value in use for assets held which have both service potential and generate cash-flows.**

Item 5: Presentation from Paul Pacter on the International Accounting Standards Board's (IASB) agenda consultation 2011

5.1 Mr Pacter began by sharing his previous experience as Deputy Director of Research at the USA Financial Accounting Standards Board (FASB). He noted that FASB's remit includes not-for profit entities and the body of US standards contained specific standards for not-for profits. He noted that a medical or educational institution could be for-profit, not-for profit or government. Therefore many issues were common to all sectors. However not-for profits in the USA were not required by law to prepare general purpose financial statements but produced simplified statements in support of tax returns.

5.2 However the development of international accounting standards (IFRS) retains an exclusively commercial focus. He noted the growing adoption of IFRS across global commerce. However currently there was no international standard setter for not-for-profits. Also no trustee of the IASB Foundation comes from a not-for profit accounting background. Not-for profits in a sense had fallen through the cracks as IASB focussed on for-profit commerce and the International Public Sector Accounting Standards Board (IPSASB) focused on government accounting.

5.3 The development of the IFRS for small and medium-sized entities (SMEs) had recognised a demand internationally for a simplified framework for SMEs. In the USA SMEs were not required to produce general purpose financial statements but produced simplified statements in support of tax returns. If they chose to report under US Generally Accepted Accounting Practice (US GAAP) then they reported in the same way as listed companies with few dispensations. In the USA there were 28m SMEs and only 25,000 publicly accountable entities.

5.4 The work on IFRS for SMEs began in 2004 and it resulted in the publication, after consultation, in 2009 of a self contained standard of 230 pages. The implementation of the standard is supported by comprehensive training modules, tutorials and questions and answers which are all freely available via the IASB web site. Implementation is overseen by the SME Implementation Group (SMEIG) which Paul chairs.

5.5 In developing the IFRS for SMEs, two issues were uppermost. Who uses the general purpose financial statements? What is the cost- benefit trade off involved in the accounting? Users were banks and lenders, family shareholders and creditors. Their interest was would the loan be repaid with interest, is the business making a return, and would their invoice be paid. Cash-flow was therefore important and that is why all SMEs are required to produce a cash-flow statement. Since between 40% and 80% of businesses in countries in the EU have loans the assertion that there is no external interest in SMEs and so no need to produce general purpose financial statements is unsupportable.

5.6 The IASB agenda consultation is out for public comment. There are a number of non-negotiable elements relating to the existing major projects in hand, for example leases accounting and revenue recognition and the scheduled implementation reviews for IFRS3 (business combinations) and IFRS8 (segmental reporting). Otherwise the agenda can be shaped.

5.7 Although not-for profits was not identified as a specific work stream in the agenda consultation itself, submissions could be made regarding the place of the proposed phase G project on adapting the conceptual framework for not-for profit entities. There was much still to do on the conceptual framework and Paul anticipated that presentation and disclosure were likely to be very high priorities in the next stage of its development. He also noted the report from the Institute of Chartered Accountants of Scotland and the New Zealand Accounting Standards Board which advocated a major simplification of disclosures under full IFRS. He thought that work on Phase G would be several years away.

5.8 The review of the IFRS for SMEs is a separate work stream. The IASB has said that it would be reviewed every 3 years to see if change was necessary. Given developments in IFRS it would be premature to initiate the review until the major standards projects were completed. Paul suggested that mid 2012 at the earliest was the likely timing for starting that review. If changes are needed, an exposure draft would then follow, perhaps in 2013 and if this time-line was followed the final revised IFRS for SMEs would be issued late 2013 or early 2014. This time-line was illustrative and reference should be made to the IASB web site for developments and announcements.

5.9 The IFRS for SMEs is framed around businesses with 50 employees or less and of the UK’s 4.7m businesses 99% meet that definition. Publicly accountable for-profit entities are required to report under full IFRS. In thinking about public accountability, not-for profits do not meet the IASB definition and so could use the IFRS for SMEs. Although not-for profits could follow IFRS, if following IFRS whilst it is acceptable to develop new accounting treatments for areas not covered by IFRS or where IFRS provides no treatment, it is unacceptable to change or adapt IFRS prescribed accounting treatments.

5.10 There are a number of areas where IFRS does not consider issues affecting not-for profit entities, for example: revenue recognition of gifts and donations, whether services provided by not-for-profits in collaboration with other entities should be consolidated or not by the funder, and the impairment of monuments and similar assets such as art collections.

5.11 In discussion with the Committee it was noted that:

- The not-for profit constituency might not be engaging with the IASB as it assumed that the IASB agenda was not for them. There had to be doubt that international not-for profit non-governmental organisations had appreciated how they could influence the development of the IASB agenda and the development of IFRS for not-for profit.
- IAS20 (government grants) allowed a considerable diversity of practice. The IFRS for SMEs had settled on recognising government grants when receivable once any performance conditions have been met. This approach was compatible with the existing UK SORP for charities.
- IAS18 (revenue) is contract based and does not recognise accounting for grants and gifts.
- Although constructive obligations are considered in IFRS, in particular IAS37, the treatment of promises is not developed in IFRS. However IFRS does require bonuses to be accrued where custom and practice is that they be awarded and the damage to reputation is a factor in identifying a constructive obligation. Also the direction of travel in leases was to include a right of use as an asset. Executory contracts are not recognised. The recognition of income from contracts reflects the fulfilment of each party's contractual obligations and performance under the contract.
- In some countries not-for profits were treated as a subset of government accounting and so followed IPSASB standards rather than IFRS.
- Some international not-for-profits had adopted IFRS and where IFRS was silent developed their own accounting solutions. Paul agreed that provided this was made clear and that no changes were made to IFRS specified treatments then these entities could assert that they complied with IFRS.
- Fund accounting and the distinction between restricted and unrestricted funds is an area which is essential to charity accounting but not considered anywhere in IFRS. There was a danger international not-for-profits could claim compliance with IFRS but still produce misleading accounts which did not deal with fundamental issues like fund accounting.
- There are only a few areas unique to not-for profit accounting and so the potential was there for IFRS to be extended to not-for profit if these specific areas were dealt with.

Item 6: Consolidated financial statements module

6.1 Nigel Davies introduced this paper. He noted the work of the Committee at its September meeting considering the nature of control and how that was demonstrated in the case of charitable subsidiaries and joint ventures.

6.2 The draft module followed the IPSASB model of control and identifies a ‘power element’ and a ‘benefit element’; both elements must be present for control to exist. He noted that IFRS10 referred to power and benefit and the ability to exercise power to vary the benefit received. The Committee noted that FRS5 made reference to quasi subsidiaries and in the context of IFRS, reference is made to special purpose entities. For clarity, specific consideration should be given to these issues in the module.

6.3 The text on minority interests was appropriate. For example ‘spin out’ companies in the Higher Education sector often had an employee minority interest. When dealing with acquisitions and disposals of non-charitable trading activities the flexibility of the FRSME on writing off goodwill was noted. The 5 year time scale was a presumption and not a cap.

6.4 Whilst the Committee were content with the section on mergers, it was noted that this text could not be finalised until the FRSPBE was published. Also the SORP may have to identify what is meant by the criterion: ‘there is no significant change to the class of beneficiaries of the combining entities or the benefits provided as a result of the combination’. Examples may be needed to illustrate what would be a merger and what would not be a merger.

6.5 In practice, whilst the new merged entity would combine the existing activities of the parties, very often the merged entity would undertake additional activities not previously carried out by any of the parties to the merger. Also the merger may allow activities to be undertaken in a different way rather than simply replicating the services already provided. The synergies and efficiencies a merger brings mean doing existing activities differently and potentially engaging in new activities that the parties to the merger could not have carried through out alone.

6.6 The Committee discussed the great variation in group structures and how they were formed. De-mergers also take place and similarly part disposals and discontinued operations happen.

6.7 Regarding associates and joint ventures, the presentation in the Statement of Financial Activities (SoFA) should be revisited once the FRSME and FRSSE SoFA formats have been settled. For charitable associates, a line for income and a line for expenditure may be a better solution than a single net figure.

6.8 In the light of the debate on 'cutting clutter' at the previous Committee meeting each disclosure should be checked against the standard to see if it is required. To clarify the materiality issue, text should be added to advise that immaterial associates and joint ventures may be recognised as investments rather than treated as consolidation adjustments. Subject to the threshold on group accounting in charity law similar considerations apply to immaterial trading subsidiaries. The existing SORP text from paragraph 403 should be amended to avoid excessive disclosure of immaterial subsidiaries.

6.9 The Committee agreed that:

- **The reference to 'owns half or less of the voting power' should be changed to 'directly or indirectly controls half or less of the voting power'**
- **Text is added to deal with special purpose entities (quasi subsidiaries) setting out factors for identifying them and confirmation of the accounting treatment to be followed.**
- **Flag up to preparers the need to consider whether there is a contingent liability arising from a minority interest.**
- **Delete the term 'bargain purchase' from the section on acquisitions and replace with 'purchase'.**
- **A reference to the accounting following the transfer of assets and liabilities on incorporation is needed.**
- **The heading 'changes in the trusteeship of charitable funds' should be changed to include acquisition and disposal of a charitable subsidiary to avoid confusion.**
- **Delete the reference to governing document in the section on associates.**
- **The reference to two or more charities should be changed to two or more parties as a social enterprise might be a venture partner.**
- **Text be added to advise that immaterial associates and joint ventures can be treated as an investment rather than a consolidation adjustment.**
- **The disclosures be checked against the FRSME to identify any items that could be dropped.**

Item 7: Is a FRSSE consolidated financial statements module needed?

7.1 The Committee agreed that in the light of time pressures comments on the proposal that only additional FRSSE specific text be added to the module on consolidated financial statements be taken by e-mail. Responses to the Secretariat should be made before the next meeting.

Item 8: Transition to new reporting framework module

8.1 Ray Jones introduced this paper. He noted that the FRSME included a comprehensive section on the transition to the FRSME on its first adoption. Changes in measurement and recognition of assets and liabilities might arise on transition. Given the widespread use of the FRSSE, the guidance would need to be available for as long as the non-IFRS version of the FRSSE remains in use.

8.2 He noted that the transition meant that for the year preceding implementation, the SoFA and balance sheet would need restating to present comparative figures . This meant that the opening balance sheets and supporting trial balances would need to be prepared on a FRSME basis. A reconciliation is also need to be provided reconciling the funds and net movement in funds of a charity with those previously disclosed under UK GAAP prepared accounts.

8.3 The Committee noted that with the text of the FRSPBE being incorporated into the FRSME that those charities using the FRSSE would have to refer to the FRSME for charity specific requirements. This will make the role of the SORP more important if charities using the FRSSE were to avoid making frequent reference to the FRSME.

8.4 The Committee agreed that:

- **Although some sector specific guidance was needed on the transition, it should not be in a SORP module. Instead an Information Sheet or similar accompanying guidance should be prepared.**

Item 9: Any other business

9.1 There being no other business the meeting closed.