SORP Committee

Minutes of the SORP Committee Meeting of 12 December 2012
(approved at the 7 February 2013 SORP Committee Meeting)

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Present:

Laura Anderson, Joint Chair of the SORP Committee
Debra Allcock- Tyler
Peter Gotham
Keith Hickey
Noel Hyndman
Ray Jones
Tris Lumley (for agenda items 1, 2, 3 and 5)
Carol Rudge
Kate Sayer
Sam Younger, Joint Chair of the SORP Committee

In attendance:

Caron Bradshaw (observer member)
Nigel Davies, Secretary to the SORP Committee
Jane Hobson, Charity Commission (for agenda items 1, 2, 3 and 5)
Joanna Spencer, Accounting Standards Board (observer member)

Apologies:

Tidi Diyan
Pesh Framjee
John Graham
Frances McCandless (observer member)
Lynne Robb
Catriona Scrimgeour
Paul Spokes

Item 1: Opening remarks and declarations of interest

1.1 Laura Anderson opened the meeting by recording the Committee's thanks to Grant Thornton for hosting the meeting. She welcomed Jane Hobson as an observer at the meeting and then invited any declarations of interest. No declarations of interest were noted.

1.2 It was agreed that in order to facilitate business that the Committee would discuss paper 4 before considering paper 3.

Item 2: Approval of the minutes and matters arising

2.1 The minutes of the meeting of the 8 November 2012 were considered. The Committee noted that the sector had been grappling with how to treat grants from statutory funders for many years. The boundary between ‘contract’ and ‘voluntary’ income had become blurred. The new approach to the classification of income would mean that a grant for a specific activity, a performance related grant for agreed volumes of goods and services and money received from a contracted activity would all fall within the new earned income heading.

2.2 The minutes were approved subject to the following changes:

- That the conclusions concerning the SoFA, minute 3.13, were ‘tentative conclusions’.
- That the Committee wished to consider the SoFA again in the context of the SoFA module as a whole to ensure that the new format is a meaningful analysis and presentation of a charity’s income and activities.
- That the typographical error in the first bullet point of minute 3.13 be corrected with the word ‘differentiation’ replaced by ‘differentiate’.

2.3 Nigel Davies noted that the SORP making body’s submissions to the International Accounting Standard Board’s (IASB) consultation on the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) and the Financial Reporting Council’s (FRC) consultation on changes to Financial Reporting Exposure Draft 48 (FRED 48) were included in the Committee papers.

2.4 Nigel Davies advised that the plain English review of the draft SORP was now underway and was planned to conclude by mid January. The plain English draft would be the main agenda item for the Committee’s first meeting of 2013.

2.5 Nigel Davies advised the Committee that he understood that the Chief Executives of the CCAB accountancy bodies had shown an interest in authorising research into the need for an international not-for-profit accounting standard. The Committee noted that Charity Finance Group and MHA MacIntyre Hudson were actively engaging in the debate about taking forward a not-for-profit accounting standard.

Item 3: Programme related investment and social investment

3.1 Ray Jones introduced this item by referring to Paper 2. He noted that the Committee had previously considered the module on programme related and mixed motive investments and agreed the approach to accounting disclosures, classification and impairment. Since the Committee last considered the topic, together with Keith Hickey he had met Claire Brown, Finance Director, Esmee Fairbairn Foundation to discuss their accounting treatment of social investment. He had also reviewed the accounts of several foundations active in social investment and acted on Lord Hodgsons’ recommendation that the SORP Committee consider the approach taken by the private equity industry to valuing investments.

3.2 He noted that the area of social investment was in its infancy. The approach Esmee Fairbairn took was consistent with current standards and valued programme related investments, unquoted equity and similar investments at cost less any provision for diminution in value (impairment).

3.3 The approach taken by private equity, the ‘international private equity and venture capital valuation guide’, was to apply standards and it offered guidance on the use of valuation techniques where fair value could not be measured reliably by reference to market transactions. These valuation techniques included multiples of earnings, discounted cash flows, proportion of net assets or the use of industry benchmarks. However for recently acquired investments in start up companies or companies in an early stage of development such approaches may not be reliable and cost may often give a good indication of fair value.

3.4 The Committee considered the nature of social investments and noted the diversity of arrangements ranging from a simple loan to quasi equity and income sharing agreements. The Committee debated whether the ability to recoup the capital was an indicator of whether it was an investment or a form of grant. The Committee noted that if the social investment is producing a revenue stream then it has value whether or not the capital is recouped. This is the case because social investment is generating a blended return of a financial yield and a social purpose that furthered a charity’s aims. In the case of a quasi equity investment in a charity, that charity cannot be sold like a for-profit start up company to recoup the capital invested.

3.5 A social investment has to generate a financial return and/or be recoverable otherwise it is impaired in financial terms. To do anything else would leave non-performing assets on the balance sheet which would be misleading since these assets would not be generating a return and could not be realised. The Committee considered that the approach taken to impairment would depend upon the character of the social investment. A charity that invests directly in a mixed purpose property to be used partly to generate a commercial rent and partly for a charitable activity would consider impairment in relation to both purposes. Financial impairment would be indicated to the extent that the expected yield (or recoverability) was not occurring as anticipated and the assessment whether that non-performance was transitory or not. When the expected level of charitable activity was not being achieved then the asset may need to be reclassified as a financial investment if the asset no longer contributed to the achievement of the charity’s purposes.

3.6 The approach taken by the draft module was to use fair value where practicable but otherwise to value at cost less impairment. The Committee noted the spectrum of valuation techniques; the SORP could not be expected to review every one but it might sign-post preparers to them. Similarly the developing language and typology of social investment meant that the SORP could not consider each specific investment type but should instead set out the broad principles to consider.

3.8 The Committee noted that the terminology used by intermediaries often concealed quite straight forward investment products or revenue streams. There seemed to be a lot of marketing around the subject with many terms ill defined by current participants. The SORP’s role is not to be a guide to social investments. However there were instances of very complex arrangements where the participants are the investor, an intermediary managing the investment, an impartial assessor of the outcomes of the investment, the party responsible for repaying the capital invested and a charity undertaking the investment funded activity. The SORP needed to provide guidance to both the charity recipient and charity investor.

3.9 The key for the general reader of the accounts is to know what a charity owes, what it owns, what it does and what it has earned. The place for explaining the investment approach is the trustees' annual report. The categories of investment are disclosed either separately on the face of the balance sheet, or as an analysis in the notes to the accounts depending upon their materiality and nature.

3.10 The treatment of ethical investment in the module was considered. It was noted that this approach to investment is more about investment selection than the type of investment (share, loan or other asset) held. The module mentions ethical investment policies simply to confirm that these are financial investments not a separate asset class. The investment policies adopted should be explained in the trustees' annual report.

3.11 The Committee concluded that:

- **The module should be re-titled as the investment categories dealt with in the module are broader than programme related investments.**
- **The module should set the context for the typology of social investment with an emphasis on understanding the substance of the investment.**
- **The module should signpost recipients to the balance sheet or income recognition modules depending upon the substance of the arrangement.**
- **The module should look at the principles that underpin social investment to provide a framework for preparers who can then look at the detail of each agreement or investment and identify how to treat it.**
- **The module should encourage valuation at cost less impairment where it is impractical to identify fair value.**

Item 5: Impact/ performance reporting in the annual report

5.1 Ray Jones noted that the Committee had considered the trustees' annual report on three previous occasions. At the October 2012 meeting the Committee, after reflecting on the latest research on aspects of current public interest in charity reporting, had requested that the topic of performance and impact reporting be revisited in the context of the ACEVO/ NCVO/ Charity Finance Group/ New Philanthropy Capital report 'the principles of good impact reporting' (the principles).

5.2 He noted that there was already a good fit between the current SORP and the principles and paper 4 looked at each of the six areas covered in the principles and advised how these were addressed in the annual report module. The draft module sought to encourage good practice rather than make it mandatory.

5.3 The Committee discussed how the annual report was an opportunity for a charity to tell its story. This should be emphasised in the module. The annual report and accounts go together as a whole and neither is sufficient on its own to communicate a rounded picture of the charity and its achievements to both potential and current funders, donors and supporters. A charity needs to explain its situation in the context of its journey.

5.4 Care must be taken to identify what smaller charities and larger charities must report, as opposed to best practice which they could follow. The Committee considered using a matrix or grid style of layout to set out the SORP's recommendations. Whichever style is adopted smaller charities should be able to identify their requirements without having to read unnecessary text. Perhaps this could be achieved by stating the requirements placed on small charities first in a single section. The preparer needs to see the module as a framework for good reporting, rather than as a set of rules, each of which must be followed.

5.5 The Committee debated the extent to which the report is a marketing tool. Although any communication issued by a charity potentially affects how the charity is viewed and seen, the report needs to focus on the charity's goals and how far it has achieved them, the challenges and difficulties faced and the extent to which these were overcome. The report is not marketing literature but does provide opportunities for a charity to explain what it does and achieves. The SORP is an opportunity to shape reporting behaviour and it needs to encourage high quality and balanced reporting.

5.6 The discipline of annual reports helps trustees stock take on what their charity is there for and the extent to which it is achieving its mission. However although the trustees need to be involved with the report process, they may often rely on others to draft the report.

5.7 It was agreed that the discussion of a charity's solvency is best placed in the annual report module as drafted and should not be relegated to the accounting policies note. The inclusion of this text was in response to the FRC report 'going concern and liquidity risk: guidance for directors of UK companies 2009'. This was useful guidance and put the reserves policy section of the report in context. Many successful charities have no reserves and operate effectively based on loan or bank borrowing and so it is important that the reader understands the charity's approach to managing solvency and its finances.

5.8 The Committee considered the topic of reserves. Whilst there might be an argument to require a detailed calculation of the reserves figure in the notes to the accounts, this would be subject to audit against the standard of 'true and fair'. The Committee noted the flexibility in the SORP definition of reserves and the need for preparers and trustees to exercise judgement. On balance an explanation in the annual report, which auditors check for consistency with the accounts, remains the better solution. For those charities where it is not possible to identify how the reserves are calculated, the reader can draw their own conclusions.

5.9 The Committee debated the degree to which the SORP should define what is meant by 'impact' reporting. The Committee noted that the terms used to identify the difference a charity makes have moved from 'results' to 'outcomes' to 'impact' but in practice the terminology remains ill defined. There is a spectrum of impact ranging from outputs, outcomes and the wider effects of a charity's work. The important message is that charities should communicate the difference they are making through their reporting rather simply describing the activities undertaken.

5.10 The Committee concluded that:

- **The module should clarify that whilst it is the duty of trustees to ensure that there is an annual report and that the trustees must be involved and approve that annual report, this did not necessarily mean that they had to write it.**
- **The phrase 'the accounts of the charity cannot alone easily portray what the charity has done' should be changed to reflect the message that it is the accounts and report taken together that tell the charity's story.**
- **For clarity the requirements of smaller charities should be shown in a single presentation.**
- **The module should emphasise the need for a charity to tell its story effectively and in a balanced way.**
- **The disclosure of reserves should require that the figure given for reserves, if any, is explained. The module should note that the trustees might have decided that a reserves policy is not necessary in which case the trustees should disclose this fact and their reasons behind their decision.**
- **Restricted funds or a subsidiary in deficit are to be taken in the context of materiality to the charity as a whole.**
- **In considering 'impact' the text contained all the necessary guidance but it should be formulated in a way that encourages charity's to identify the difference they are making with a necessary minimum of terms used.**

Item 4: Reduced disclosure Framework

4.1 Nigel Davies referred to paper 3 and the noted that the new Generally Accepted Accounting Practice (GAAP) is based on three new standards and the existing Financial Reporting Standard for Smaller Entities (FRSSE). The FRSSE is a standard developed with small for-profit companies in mind. By size, over 99% of registered charities would be able to opt to prepare their accounts under this standard. The SORP was being developed to support the FRSSE option for eligible charities.

4.2 The FRC had also decided that it would be proportionate for those for-profit companies not required by listing rules to adopt IFRS to benefit from further simplifications. Standard FRS 101, the reduced disclosure framework, simplified reporting for parent entities and subsidiaries reporting under IFRS. It was noted that both company law and charity law prevented charities adopting IFRS and so FRS 101 would not apply to them.

4.3 The FRC had also developed a reduced disclosure framework for parent entities and their subsidiaries reporting under the new standard FRS 102, the Financial Reporting Standard, applicable in the UK and Republic of Ireland. The SORP was being developed to support the application of FRS 102 by charities and so the Committee needed to decide if the reduced disclosure framework should be available to parent charities and their subsidiaries.

4.4 Particular attention was drawn to two of the six simplifications offered by the reduced disclosure framework - the cash-flow statement and related party disclosures.

Charities applying FRS 102 have to produce a cash flow statement and this would be a new reporting requirement for charities with an income of less than £6.5m adopting this standard. One of the simplifications of the reduced disclosure framework is that a charity would not be required to prepare a cash flow if the charity was a subsidiary and group accounts were also prepared. FRSSE users are not required to prepare a cash flow statement.

4.5 For-profit entities are not required by section 33 of FRS 102 to make detailed disclosure of individual directors' remuneration. Section 33 simply requires the total key management personnel compensation to be disclosed but this requirement is dropped as one of the simplifications to the accounts of parent and subsidiary entities. By analogy this would imply that trustee remuneration and trustee employment remuneration would not be disclosed if the reduced disclosure framework is adopted.

4.6 In discussion, the Committee noted that stakeholders would want to know about what each charity, whether a parent charity or a subsidiary charity, had done with their money. Charity reporting involved a higher degree of transparency because the funds are held on trust and it would be highly undesirable for trustee remuneration and employments to only be disclosed by some but not all charities under the SORP. The Committee noted that the main simplification to preparers was not having to produce a cash flow statement. However, this statement would not be required if the charity was eligible for, and opted to, prepare accounts under the FRSSE.

4.7 The Committee concluded that:

- **The option of the reduced disclosure framework should not be available to charities preparing their accounts under FRS 102 due to the loss of transparency in the disclosure of related party transactions.**

Item 6: SSAP 4 and grant income recognition

6.1 Nigel Davies introduced this topic by referring to the SORP 2008-09 research findings that identified significant support for the matching concept when recognising income. Although the findings were that opinion was evenly divided over the matching of income from a capital grant with the economic life of the asset, there was a majority view in favour of matching revenue grants; this would treat the income as a form of flexible subsidy which is drawn down and recognised as income only as related expenditure was incurred, rather than recognised with the charity's entitlement to that income.

6.2 Accounting standards, since the 1980s, had moved away from the concept of matching to recognition based on a transaction creating an asset or liability which in turn gives rise to income or expenditure. Although FRS 102 retained the option of matching, referred to as the 'accrual model', the concepts and principles set out in section 2 of FRS 102 were unambiguously against matching. The choice before the Committee was whether to permit the use of the accrual model when accounting for income from government grants.

6.3 The Committee noted that SORP 2005 was consistent with the 'performance model' whereby income is only deferred to the extent that performance conditions have not been met. Those charities reporting under the FRSSE are required to retain their current accounting policies and this meant that FRSSE users would be unable to adopt the ‘accrual model’ even if the option was open to charities applying FRS 102. In its previous submission to the FRC, the Committee had opposed the retention of the ‘accrual model’ because it is inconsistent with accounting principles.

6.4 The Committee considered that the role of the SoFA is to identify the change in the level of funds held in the year. If a charity is entitled to a resource then this is reflected in an increase in fund balances. The SoFA is not simply a profit and loss statement but is designed to show the resources that have become available to a charity in a reporting period and how they have been used. Moreover, the SORP’s approach to income recognition has been in place since SORP 2000 and charities have adapted to the current approach by using the trustees’ annual report or the notes to the accounts to explain the effect of capital grants and material revenue grants on the charity’s financial position.

6.5 The Committee also agreed that the use of the accrual model would introduce inconsistency both between accounts prepared under FRSSE and FRS 102 and also between charities accounting for the same transaction in different ways depending on whether or not the funding was provided by government. This would introduce a new anomaly whereby income from an appeal to fund a fixed asset would be recognised on entitlement (probably receipt) but a government grant for the acquisition of the same fixed asset might be deferred and only recognised as income over the economic life of the building.

6.6 The Committee concluded that:

- **The option of using the accrual model to recognise income from government grants should not be permitted.**

Item 7: Update from the FRC

7.1 Joanna Spencer advised that the FRC had received a lot of comment on its proposals to amend FRED 48, particularly with regard to recognising a liability where there are arrangements for an entity to make scheduled additional payments to clear a pension liability.

7.2 The intention remains, if at all possible, to publish the settled FRS 102 at the end of January. However FRS 102 was to be amended for IFRS 9, financial instruments, in due course.

Item 8: Any other business

8.1 The Committee enquired as to when the contract to publish the new SORP was to be let. Nigel Davies advised that the process of awarding the permission to print the new SORP would not be begun until the SORP Exposure Draft was published.

8.2 There being no other business the meeting closed