

Annex: Proposed changes to FRS 102 and the future arrangements for non-profit accounting and reporting

Introduction

Within each section are a series of proposals. Each proposal starts with the change sought, followed by the rationale and evidence base for change and concludes with a view on the impact of making the proposed change. The term non-profits is used for not-for-profit organisations including charities. The research evidence presented is solely charity related. All additions to the existing text are shown as underlined text and deletions are shown with strikethrough

Section 1 Changes with respect to application of section 1A of FRS102

1.1 Modifying section 1A in its application to eligible charities

Proposal:

Section 1A of FRS 102 paragraph 1A.6 be amended as shown and an additional paragraph inserted

- Paragraph 1A.6 be amended as shown and an additional paragraph inserted: A small entity that is not a PBE may need to provide disclosures in addition to those set out in this section in order to comply with the requirement of paragraph 1A.5 (see also paragraphs 1A.16 and 1A.17).
- PBE 1A.6A Entities that are PBEs that prepare their accounts in accordance with a SORP shall provide such additional disclosures as may be required by that SORP.

Section 1A of FRS 102 paragraph 1A.17 be amended as shown

- Paragraph 1A.17 be amended as shown: A small entity is required to comply with the disclosure requirements of Section 3 (to the extent set out in paragraph 1A.7) and Sections 8 to 35 of this FRS. However, because those disclosures are usually considered relevant to giving a true and fair view, a small entity that is not a PBE is encouraged to consider and provide any of those disclosures that are relevant to material transactions, other events or conditions of the small entity in order to meet the requirement set out in paragraphs 1A.5 and 1A.16 and in the case of a PBE a small entity shall meet the requirement set out in paragraphs 1A.5 and 1A.6A.

Rationale: Section 1A was developed in response to an EU Accounting Directive and the withdrawal of the Financial Reporting Standard for Smaller Entities (FRSSE). In a for-profit company it is read in the context of the option to submit 'abridged accounts'; if a UK company meets two qualifying criteria (turnover is no more than £10.2 million, balance sheet total is no more than £5.1 million, and/ or average number of employees is no more than 50) then it need not file full accounts if its members agree. An abridged profit and loss account discloses less information, for example opening with gross profit rather than disclosing turnover and cost of sales. An abridged balance sheet does not require notes showing how the main headings are made up, although it does show movements on each type of fixed asset in total.

References to disclosing more than what is required by section 1A therefore have no effect if the relevant components of the accounts are not prepared for the public record. Currently there is no comparable legal filing framework for charities.

The proposed change seeks to differentiate the application of section 1A differently between for-profit companies that enjoy exemptions to aspects of accounts preparation under the smaller company reporting framework and charities which do not have this option.

The proposed changes facilitate disclosures that are better targeted at both the user and preparer with a proportionate basis for accounts preparation providing the information the user requires and the simplification offered by section 1A accompanied by those charity specific additional disclosures required by the charities SORP. It offers a more tailored approach for smaller charities than FRS 102 alone. Unlike other PBEs SORPs that cater for what would be 'medium' or 'large' companies, over 99% of registered charities would be classed as 'small' in company law terms. Having the latitude to simplify disclosure requirements would facilitate the development of tiered reporting requirements based on a charity meeting certain criteria and thereby remove clutter and focus reporting on the needs of the user of charity accounts.

Evidence: A variety of sources, where public domain a link is referenced to the SORP site, where cited for the first time:

- Presentation by the combined engagement strands of 17 November calling for: 'Consideration of smaller charities and how the framework can be more flexible or simplified' <https://www.charitySORP.org/media/649817/sorp-engagement-strand-update-revised.pdf>
- Minutes of 14 December meeting: 'Consideration should be made of 'what is in the gift of the SORP'. The framework in which the SORP operates and its scope would need to be examined. How far would the committee be able to push the boundaries and requirements? For example, looking at micro reporting for smaller charities. Should reference be made to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland, Section 1A 'Micro reporting'? Should the SORP committee review the reporting framework for the SORP' https://www.charitySORP.org/media/649855/minutes_141220.pdf

Impact: The consistent feedback from all the stakeholder strands and of the advisory SORP Committee is that the extensive disclosure requirements of FRS 102 coupled with those charity specific requirements found in the Charities SORP require too much of both the reader of smaller charity reports and accounts. A simplified approach offers scope to remove clutter, in particular for-profit orientated disclosures, and better focus charity specific disclosures on the context in which smaller charities operate and so better meets the needs of the user of the report and accounts.

Section 2 Taking a new approach to the financial statements

2.1 Departing from company law based custom and practice in the presentation of the performance statement

Proposal: Section 5 of FRS 102 be amended with an additional paragraph inserted:

- PBE 5.5C An entity which is a PBE may reorder the line items within the income statement and amend the descriptions in paragraph 5B where the applicable SORP permits or otherwise requires.

Rationale: The first SORP in 1988 and subsequent SORPs have been framed in the context of the custom and practice of company law reporting that underpins UK-Irish GAAP. The focus on turnover, gross profit and net, and distributable, profit is understandable in the context of for-profits investors will need to understand the actual and potential capability of the company to generate private benefit to providers of risk capital. Due to the very nature of PBEs being for public benefit as opposed to private benefit an alternate approach could better suit PBEs where evidence shows that readers are interested in how the money was spent rather than how it was raised. Having the flexibility to reframe reporting for charities may better address user needs.

Evidence:

- Presentation by the combined engagement strands of 17 November 2020 calling for: ' Need to revisit certain issues to check that the technical solution is the right one and/or whether to allow other options' and the notes for that meeting also refer to: 'Whether an upside-down SOFA starting with how the resources were spent and then considering how the charities raised those resources should be considered if it would better communicate the messages to the users of the accounts'
https://www.charitySORP.org/media/649836/summary_points_171120.pdf

Impact: An alternate approach currently under consideration for charities is for the Statement of Financial Activities to open with expenditure analysing how the money was spent with the lower half of the statement explaining how that expenditure was funded and closing with the movement in fund balances. The change proposed would provide scope to permit this alternate presentation.

2.2 Permitting SORPs to specify the use of comparatives for SORP specific reporting requirements for small entities (FRS 102 section 1A)

Proposal: Section 1A of FRS 102 paragraph 1A.10 be amended as shown and an additional paragraph be added:

- Paragraph 1.A10 In accordance with paragraph 3.14 a small entity that is not a PBE shall present comparative information in respect of the preceding period for all amounts presented in the current period's financial statements, except when this FRS permits or requires otherwise.
- PBE 1A.10A : In accordance with paragraph 3.14 a small entity that is a PBE shall present comparative information in respect of the preceding period for all amounts presented in the current period's financial statements, except when this FRS permits or, in the case of PBEs that prepare their accounts in accordance with a SORP, where that SORP permits.

Rationale: Prior to the Charities SORP (FRS 102) custom and practice was that elements of the charity specific requirements found in the SORP, in terms of fund accounting, had no comparatives provided. In the development of the Charities SORP (FRS 102) the FRC identified that strict adherence to the standard required these comparatives. The evidence from users and preparers is that the provision of these additional comparatives has not proved informative or useful to decision-making by users of the accounts and instead has proven to be a source of clutter.

The FRC has previously considered this point, see Part B of the basis for conclusions, paragraph B3.2 and concluded that: 'Comparatives are intended to provide useful information to users, and FRS 102 only provides an exemption from comparatives in limited circumstances reflecting historical company law exemptions. Therefore, in accordance with paragraph 3.14, comparatives should be provided for disclosures required by SORPs'. The evidence since gathered has demonstrated that the premise that in the case of the charity specific disclosures required by the SORP that the obligation to provide these additional comparatives gave useful information to users was without foundation. The proposed change reinstates the prior position and recognises that for SORP specific items, the SORP development process is a better arbiter of what is useful to users than the application of a rule without distinction regarding entity type and/or user benefit.

Evidence:

- Paper from users of accounts perspective from the engagement strands (16 February 2021 meeting) includes the finding: 'Remove requirements for comparatives for every item and therefore cut clutter'
https://www.charitySORP.org/media/649882/160221_paper3.pdf
- Paper from the preparer of accounts perspective (23 February 2021 meeting) includes the finding: ' Comparative requirement: Presentation of comparatives causes clutter in the accounts and difficulty for some charities...'

Impact: Having the latitude to determine in which circumstances comparatives are required for charity specific disclosures will further facilitate simplification and the development of tiered reporting with fewer disclosures and analysis required of less complex charities. This will help users discern information relevant to their decision-making and reduce the demands placed on preparers and independent examiners of charity accounts.

2.3 Permitting SORPs to specify the use of comparatives for SORP specific reporting requirements for those charities not classed as small entities (FRS 102 section 1A)

Proposal: Section 3 of FRS 102 paragraph 3.14 be amended as shown and an additional paragraph be added:

- Paragraph 3.14 For those entities that are not PBEs, except when this FRS permits or requires otherwise, an entity shall present comparative information in respect of the preceding period for all amounts presented in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.
- PBE 3.14A For those entities that are PBEs which prepare their accounts in accordance with a SORP, except when this FRS permits or requires otherwise, or in the case of SORP specific statements or disclosures that the SORP permits or requires otherwise, an entity shall present comparative information in respect of the preceding period for all amounts presented in the current period's financial statements. An entity shall include comparative information for narrative and descriptive information when it is relevant to an understanding of the current period's financial statements.

Rationale: Prior to the Charities SORP (FRS 102) custom and practice was that elements of the charity specific requirements found in the SORP, in terms of fund accounting, had no comparatives provided. In development of the Charities SORP (FRS 102) the FRC identified that strict adherence to the standard required these comparatives. The evidence from users and preparers is that the providing of these additional comparatives has not proved informative or useful to decision-making by users of the accounts and have instead proven to be a source of clutter.

The FRC has previously considered this point, see Part B of the basis for conclusions, paragraph B3.2 and concluded that: ‘Comparatives are intended to provide useful information to users, and FRS 102 only provides an exemption from comparatives in limited circumstances reflecting historical company law exemptions. Therefore, in accordance with paragraph 3.14, comparatives should be provided for disclosures required by SORPs’. The evidence since gathered has demonstrated that the premise that in the case of the charity specific disclosures required by the SORP that the obligation to provide these additional comparatives gave useful information to users was without foundation. The proposed change reinstates the prior position and recognises that for SORP specific items, the SORP development process is a better arbiter of what is useful to users than the application of a rule.

Evidence:

- Notes of the meeting of 17 November 2020 and the finding of the funders’ strand that: ‘Duplication of the prior year SOFA is simply not useful’ and from a preparers’ perspective (23 November 2020): ‘Comparative requirement: Presentation of comparatives causes clutter in the accounts and difficulty for some charities...’ and paper (23 February 2021 meeting) noted that ‘The requirement for comparative information on all amounts presented in the financial statements is considered inflexible, onerous and unnecessary. Previous SORPs did not require this in all cases for charity specific items’.

Impact: Having the latitude to determine in which circumstances comparatives are required for charity specific disclosures will further facilitate simplification with disclosures and analysis focussed on the users of the accounts who will more easily discern information relevant to their decision-making and reduce the potential for clutter in charity accounts.

Section 3 Simplification and revisiting required disclosures

3.1 Orientating disclosures to the capabilities of the reader/ user of the accounts

Proposal: Paragraph 2.4 of section 2 be amended as shown:

- Paragraph 2.4 The information provided in financial statements should be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. ~~However, the need for understandability does not allow relevant information to be omitted on the grounds that it may be too difficult for some users to understand.~~

Rationale: Paragraph 2.5 provides that 'Information has the quality of relevance when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations'; therefore, given the skill level already anticipated, knowingly requiring disclosures that are only comprehensible to those expert in accounting is frustrating to the majority of users as it represents information that cannot be understood and is therefore detrimental to their decision-making by reducing their confidence in using the accounts and also in giving rise to clutter.

Evidence:

- Minutes of 14 December 2020: 'Accessibility – in producing the next SORP the committee needs to be aware of where value is added to the reporting process in terms of providing information that is accessible and meaningful to the reader as opposed existing information or possible changes where it does not'.

Impact: By limiting disclosures to those that can be understood by the able (as already defined) user of the accounts, the information provided will be effective for decision-making by the majority of users. In our view, requiring information to be included that is only understood by a very expert audience at best creates uninformative clutter for the majority of able users of the accounts and may even alienate them by undermining their confidence in reviewing the accounts and in their view of the usefulness of accounts for decision-making. Having a user focussed requirement will permit a specific simplification sought in respect of pension disclosures (see below).

3.2 Focussing defined benefit pension scheme disclosures on relevant information for charities

Proposal: Section 28 of FRS 102 paragraph 28.41 be amended as shown and an additional paragraph be added:

Paragraph 28.41 An entity that is not a PBE shall disclose the following information about defined benefit plans (except for any multi-employer defined benefit plans that are accounted for as a defined contribution plan in accordance with paragraphs 28.11 and 28.11A, for which the disclosures in paragraphs 28.40 and 28.40A apply instead). If an entity has more than one defined benefit plan, these disclosures may be made in aggregate, separately for each plan, or in such groupings as are considered to be the most useful:

PBE 28.41A An entity that is a PBE shall disclose the following information about defined benefit plans (except for any multi-employer defined benefit plans that are accounted for as a defined contribution plan in accordance with paragraphs 28.11 and 28.11A, for which the disclosures in paragraphs 28.40 and 28.40A apply instead). If an entity has more than one defined benefit plan, these disclosures may be made in aggregate, separately for each plan, or in such groupings as are considered to be the most useful:

(a) A general description of the type of plan, including funding policy. This includes the amount and timing of the future payments to be made by the entity under any agreement with the defined benefit plan to fund a deficit (such as a schedule of contributions).

(b) [The date of the most recent comprehensive actuarial valuation and, if it was not as of the reporting date, a description of the adjustments that were made to measure the defined benefit obligation at the reporting date.

(c) A reconciliation of opening and closing balances for each of the following: (i) the defined benefit obligation; (ii) the fair value of plan assets; and (iii) any reimbursement right recognised as an asset. (f) Each of the reconciliations in paragraph 28.41(d) shall show each of the following, if applicable: (i) the change in the defined benefit liability arising from employee service rendered during the reporting period in profit or loss; (ii) interest income or expense; (iii) remeasurement of the defined benefit liability, showing separately actuarial gains and losses and the return on plan assets less amounts included in (ii) above; and (iv) plan introductions, changes, curtailments and settlements.

(e) The total cost relating to defined benefit plans for the period, disclosing separately the amounts: (i) recognised in profit or loss as an expense; and (ii) included in the cost of an asset.

(f) A statement confirming that the disclosures of balances, reconciliations and cost have been prepared in accordance with the professional advice of a qualified actuary and give particulars of the date of that advice, the name, employing firm (if any) and address of the actuary.

Rationale: The evidence provided demonstrates that the disclosures of other details, including actuarial assumptions, is not proving useful to even expert users of charity accounts and is instead a source of uninformative clutter. The proposed approach seeks to retain those disclosures found useful supplemented by an assurance that the statements have involved a qualified actuary in their preparation.

Evidence:

- Notes of the meeting of 17 November 2020 refer to: 'Funders read the notes, which can be highly technical including numerous pages of unhelpful technical notes, for example, pensions reporting runs to many pages of unhelpful technical data. The simple fact needed is the appropriate liability and where this is included in the financial statements' and 'The proposal for decluttering, for example the pensions note, is important but this must be balanced with the need for robust financial reporting'

Impact: The proposed approach will reduce clutter and ensure that the information found useful to decision-making is retained.

Section 4. Developing a new approach for the UK and Ireland- a not-for-profit conceptual framework and accounting standard

Proposal: The view of the SORP-making body, supported by recommendations from its advisory SORP Committee, is that the FRC consult on developing a conceptual framework for not-for-profits and the development of a dedicated financial reporting standard.

The way in which for-profit accounting has developed, including alignment with the IFRS for SMEs has, in our view, led to developments in measurement, presentation and disclosure unsuitable for the readers and users of charity accounts. Although the initial adaptation of for-profit accounting standards in the late 1980s transformed charity accounting, the UK and Ireland charity sector has since matured and there is now a need for a solution wholly developed with not-for-profits at its core.

Just as with the initial 1988 SORP developed by the Accounting Standards Council was itself a major innovation, the inclusion of PBE paragraphs in an accounting standard was also a global leading innovation by the FRC. In view of global developments we now commend the FRC to take the next logical step.

Rationale: The following issues are highlighted as illustrative of the wider problem now posed in continuing with the current approach and should not be taken as exhaustive:

- Use of discounted cash flow to impute the financing component of transactions- this requirement first came into the SORP with SORP 2005 (paragraph 323) in the context of provisions settled 'over several years' but alignment with IFRS for SMEs (see FRS 102 section 11 paragraph 11.13) has made it more pervasive in its application. Arguably distinguishing an intrinsic financing component of a transaction may well assist potential investors better appreciate the return offered as opposed to the returns received by other providers of capital, fulfil aspects of for-profit company reporting requirements, and allow a theoretical appreciation of different elements of cash-flows but since charities are not privately owned and operate for the public benefit such considerations are simply irrelevant. The mooted extension of this approach for the accounting for operating leases poses a further concern. Arguably of far more relevance is the total value of cashflows as an indicator of financial stability, with items such as the formal structure of actual debt, the extent of secured debt, total value and timing of settlement of liabilities, loans advanced or credit facilities taken up.
- The classification of financial instruments- perhaps reflecting innovations in for-profit commerce and commercial credit operations the classification of financial instruments is complex. For example, the definition of a basic financial instrument runs to 5 paragraphs and 10 worked examples. It is likely even the experienced practitioner may find this approach challenging but to the user of charity accounts in our view this presentational approach is potentially mystifying.

- Focus on capital market reporting of cash flows and debt- without consideration of its relevance for charities, a requirement for a statement of changes in net debt (section 7 paragraph 7.22) has been introduced. This was added to a presentation already wholly focussed on capital market considerations for example investing activities involving equity or debt instruments and loans to third parties and a dedicated section on financing transactions. A charity centred approach might instead consider cash flows from charitable activities and cash flows from fundraising and non-charitable trading as more meaningful to the user of the accounts.
- Growth in disclosures- understandably with a framework developed with capital markets in mind disclosures of transactions have become extensive. In particular goodwill, financial instruments, hedge accounting, and intangible assets. Although these topics may have an application, in our view, were the user of the accounts of the not-for-profit sector in mind then the content and extent of such disclosures would very well take a different approach.

Evidence: The Central Council of Accounting Bodies (CCAB) commissioned academic research to consider international financial reporting for the not-for-profit sector. This report, published in 2014, was a comprehensive international study. Its findings included four options to address the reporting needs of the sector with 'a formal international standard appears to command a good deal of interest' (72% of respondents supported this proposal) in contrast to the existing approach where 'many respondents seemed resigned to the problems of existing frameworks'.

In terms of the Charities SORP development process the adaptations noted in previous sections of this annex point to the shortcomings in the current approach. The SORP-making body published an overview of the distinctive features of charity reporting in 2009: <https://www.charitySORP.org/media/88724/ap3141209.pdf> noting many features that need consideration.

The recent IFR4NPO project which is looking to develop guidance for non-profits provides further evidence of the mismatch between solutions based on IFRS and the reporting needs for non-profits: <https://www.humentum.org/blog-news/press-releases/humentum-and-cipfa-develop-international-financial-reporting-standards-non>

A variety of sources favour a new approach; where public domain a link is referenced to the SORP site (unless already referenced elsewhere):

- Presentation by the combined engagement strands of 17 November 2020 calling for: 'Need to reform standards to better recognise the charity sector's reporting realities' and calls for: 'disclosures and decluttering – FRS 102, Companies Act, other legislative requirements mean there is a lot in the accounts that is not due to the SORP prescriptions. Some of these disclosures are considered not to add value but they add length and time to prepare them'.
- Minutes of 14 December 2020 meeting: 'The importance of reflecting the values of the charities sector in the SORP, rather than the business sector' https://www.charitySORP.org/media/649855/minutes_141220.pdf

- Paper 3 to 16 February 2021 meeting from a user of accounts perspective notes: 'One suggestion is that it would be more meaningful if it reported cashflows by different categories of fund (unrestricted, restricted and endowment). Consideration of how to improve the information contained in the statement and the accompanying notes may be worthwhile as might the criteria for preparing a cash flow statement since the complexity and not just its size could be a factor in determining whether a statement of cashflows should be prepared'.

Impact: Although it is possible to continue to adapt for-profit accounting and reporting we anticipate that further developments with capital markets in mind will undoubtedly increase the number of disclosure and reporting requirements burdensome to the sector with little, if any, discernible benefit to the users or readers of the report and accounts. Having a well-developed conceptual framework and not-for-profit accounting standard will provide a solution developed with the user and reader of the reports and accounts in mind which is technically sound as a basis for prepare 'true and fair' accounts and comprehensive in its treatment of the distinctive characteristics of not-for-profits, including charities.