

Feedback from Engagement Strands and Working Groups on Expenditure Classification

Engagement Strand: Professional and Technical Group A
A. Options Considered by the Engagement Strand
Option 1: Keep fundraising costs as a separate item. However, remove investment management expenses from fundraising costs as they sometimes distort the true picture.
B. Conclusions
Option 1: Remove investment management costs from fundraising costs. PTA put this option forward as a recommendation, noting that one member felt that putting investment management costs on the face of the SOFA could be considered as a backward step and would increase clutter in the primary statements. This recommendation would require an amendment to paragraph 4.45 of the SORP, which lists the costs included in expenditure on raising funds.
C. Other comments
<ul style="list-style-type: none"> • The expenditure disclosure notes required under the current SORP were thought to be too complex, especially after taking comparative figures into account. This makes it difficult for preparers of accounts and is not necessarily helpful to users of accounts. • It is unhelpful to refer to any activity as non-charitable. If there needs to be a distinction, then direct and indirect charitable costs would be more useful. • The flexibility in the SORP to expand the analysis on the face of the SOFA (paragraph 4.51) is seen as useful and should be retained in a revised SORP. • Losses due to fraud could be described as “other”. The Engagement Strand noted the flexibility to include an additional sub-heading where an amount is material. • It would be preferable not to clutter the face of the SOFA with extra detail but rather include any detail in the notes to the accounts.

Engagement Strand: Trustees
A. Options Considered by the Engagement Strand
Option 1 – to re-commit to the recommendations made by the Engagement Strand at the end of phase one. Specific recommendations relevant to expenditure classification include: <ul style="list-style-type: none"> • the use of Plain English accompanied by an additional ‘think non-financial expert first’ approach. • provision of a comprehensive glossary (reflecting terms and definitions used by the regulators) and full indexation to assist cross-referencing. Having clearer definitions, used consistently within the SORP, would be of benefit to the issue of expenditure classifications. • make it easier to identify within the SORP whether a provision of the SORP is a legal or regulatory requirement and what is recommended practice, citing sources where relevant, and • reduce the length and complexity of the financial notes by better use of referencing, signposting, cross-referencing and hyperlinking.

Option 2: Permit the wider use of 'natural classifications'. Greater efforts should be used to educate trustees that an alternative approach to expenditure classifications might be the use of 'natural classifications'. Increased awareness is likely to result in more charities adopting the natural classification approach where permitted. This might also improve consistency within a charity between operational and statutory information.

It was noted that retaining activity-based classifications did provide for some form of comparative data between charities, however, the Engagement Strand expressed the view that given the diversity of the sector such comparisons are always going to be challenging.

The Secretariat notes that smaller charities are already permitted to use natural classification in expense analysis.

B. Conclusions

Option 1: The Trustees Engagement Strand supported this option, specifically recommending the following:

- resources should be provided for trustees to assess and apportion costs in a more consistent manner, with suggestions as to which KPIs to adopt
- worked examples and case studies should be produced to help steer trustees through the process. This information should already be available from professional bodies and other financial experts
- encourage trustees to review their governing documents when looking at cost allocation to ensure their stated funded activities mirror their charitable purposes; and
- ensure the revised SORP has a clear glossary of terms and definitions which are used consistently within the framework, in any supporting resources and charity registers (and other regulatory communications).

Option 2: The Engagement Strand recommended that small charities should be permitted the option to adopt the 'natural classification' approach. This option should be recommended in the first instance to support "think small first".

The Engagement Strand expressed a preference for natural classification remaining optional, allowing smaller charities to retain analysis by activity if they wish. In addition to the option, trustees should be required to explain why a particular approach was taken. This could help trustees to question the guidance from professional advisers, and thereby improve understanding.

Other conclusions and recommendations:

- The term 'natural classification' is less meaningful to non-financial trustees and that the use of the term 'nature of expenditure' is more useful.
- There is a need to move discussions about overheads and administrative costs away from binary suggestions of 'good' and 'bad' expenditure of charitable funds. Such costs are part of running a charity well and in line with legal and regulatory requirements. The regulators and the SORP making machinery are perfectly placed to lead and/or shape a campaign to educate the users of accounts that there is no such thing as 'good' or 'bad' expenditure in charities.

C. Other Comments

- Some smaller charities who analyse expenses by activity may find it difficult to apportion costs without using an external adviser. The knowledge and expertise may not be available 'in-house' to inform the best approach.

- Guidance, suggested KPIs, case studies and worked examples would be helpful in establishing some broad principles to expenditure allocation and apportionment when spreading the costs across different activities.
- Grant funding may not cover overheads. Grant funders may therefore need to be persuaded that their grants should allow for a proportion of overheads (or support costs) without which the charity may be unable to operate. It might be better to be up front with these costs to demonstrate that well-led and managed organisations require robust and effective administrative and managerial support.
- Different grant providers may adopt a different approach to cost allocation which can result in a charity spending valuable time and resources meeting the needs of funders rather than concentrating on delivering charitable objects.
- The Engagement Strand supports a reduction in the length and complexity of the notes to the accounts, therefore if it is agreed that additional information on expenditure classifications is added into the financial notes, it should only be done with a significant reduction in the overall size of those notes from current practices.

Engagement Strand: **Professional and Technical Group B**

A. Options Considered by the Engagement Strand

Option 1: Change the wording of SORP paragraph 4.22 – at present the wording has led users of the Charities SORP to understand that that the activity basis is the default approach to reporting expenditure for smaller charities. A change in wording is likely to lead to an increase in charities using natural classifications.

Option 2: Clarify that it is acceptable to report a single charitable activity if the charity only has one type of charitable activity. Some charities in this position believe they should break down expenditure on this charitable activity further. This makes a ‘mini-industry’ of activity reporting, and it is not necessary. It is the view of the Engagement Strand that this issue is indicative of a wider issue that the material within the SORP which is designed to help charities identify material activities isn’t working well and further guidance within the SORP could help to improve this.

Option 3: Introduce alternative terminology to replace the term ‘expenditure on charitable activities’. This term gives the impression that expenditure in other categories is ‘non-charitable expenditure’. Use of the term ‘expenditure on charitable activities’ creates competition between charities regarding their percentage spend on ‘charitable activities’. Further, the term ‘expenditure on charitable activities’ excludes costs that are essential for the charity to operate well and are ‘charitable expenditure’ in a broader ‘true’ sense, including governance costs and support costs. ‘Non-charitable’ expenses could include:

- Losses due to fraud
- Ex gratia payments
- Any damages payable following a court judgement

However, the Engagement Strand acknowledges that studies indicate the public want to know that charities fundraise efficiently and therefore to understand what percentage of donations is spent directly on the charity’s purposes. Having to present this information also encourages charities not to overspend on fundraising.

B. Conclusions

Option 1: The Engagement Strand recommends that the wording of paragraph 4.22 is amended and more detailed guidance is included with the next edition of the Charities SORP on how smaller charities can apply natural classifications. PTB reiterated that their suggestion has been to classify charities with income of up to £1m as “smaller”, therefore their recommendation about natural classifications is intended to apply to charities with income of up to £1m.

Option 2: The Engagement Strand recommends that the SORP should make it clear that it is acceptable for a charity to assess that it has one charitable activity and therefore only have one line to report under the heading ‘expenditure on charitable activities’. Further guidance is needed within the SORP to assist charities identify material activities. This is to give confidence to charities not to unnecessarily sub-divide material activities.

Option 3: Introduce alternative terminology to replace the term ‘expenditure on charitable activities’. No agreement was reached on this option.

C. Other Comments

- Guidance on applying natural classifications could include examples of broad expenditure categories charities can use, for example:
 - Salaries and wages
 - Support costs
 - Governance costs
 - Investing activities
 - Disposal of assets
- To support a stronger link between the TAR and the accounts, the classification and presentation of cost information could be aligned to the charity’s cost centres for budgeting and management reporting purposes. This would reflect how a charity is governed and managed. Noted that there is nothing in the current SORP to prohibit this approach.
- Suggestions for alternative terms for expenditure on charitable activities were made, and included:
 - Operational costs.
 - Direct charitable expenditure (which would reduce the type of costs currently included within ‘expenditure on charitable activities’, a principle which could be extended to fundraising costs.)
 - Delivery of services to beneficiaries.
 - Remove the term ‘charitable activities’ altogether; it is not necessary to highlight charitable activities as these are charity financial statements. Instead, require charities to report non-charitable expenditure separately when incurred.
- The classification of expenditure incurred in trading subsidiaries should be considered as part of discussions on expenditure classification.
- Many costs which do not fall neatly into one category and, in classifying expenses by activity, charities have to apply judgement as to how they apportion cost between the main categories of expenditure. Cost allocation is very subjective. Clarification and guidance would help and potentially make financial statements more comparable. However, no formal recommendations are being made on the allocation of costs on an activity basis in this report as the topic is to be covered separately from the classification of expenditure.
- If there are to be changes in the round to the description and/or classification of items of expenditure it may be necessary for the Charities SORP to clarify whether non-charitable expenditure should be treated as extraordinary. In particular, the Engagement Strand discussed whether fraud should be considered extraordinary, concluding that it should not

- A member of the Engagement Strand questioned why the SORP requires such detailed analysis of expenditure over and above that of normal companies and the purpose that this serves. As this analysis is complex and time consuming, the cost of producing financial statements may outweigh the benefits.

Engagement Strand: Large Charities
A. Options Considered by the Engagement Strand
<p>Option 1: Extend the option to use natural classifications to more charities within the tiered reporting decisions/discussions e.g. those charities with income up to £/€1m. Many organisations in this category do not have professional accounting staff and rely on advisers for expenditure classification which dilutes trustee understanding and ownership of the accounting process. Activity-based classifications are also likely to be disproportionate in effort and benefit to users in a smaller charity context.</p>
B. Conclusions
<p>Option 1: Extension of natural classifications as an option to charities with income up to £/€1m was recommended.</p> <p>Other conclusions: It was recognised that for the accounts preparer, expenditure classification can take up a lot of time and require re-organisation of systems and approaches used in preparing management accounts, plus significant judgements in allocating costs. However, it was felt there was unlikely to be a more practical alternative.</p>
C. Other Comments
<ul style="list-style-type: none"> • In trading subsidiary companies there is an issue with unpicking things. Allocations are subjective, therefore allocating expenditure involves a lot of work and time. • It was questioned whether cost allocation give users of SORP accounts a greater understanding or make the accounts more complicated. • Greater prescription would not be beneficial. Engagement Strand members did not want to make anything more complex or to break what's in place now. • Noted that the more often you do something the easier it gets so, within charities, consistency can emerge even if judgements are required.

Engagement Strand: Academics and regulators and proxies for the public interest
A. Options Considered by the Engagement Strand
<p>Option 1: Extend the usage of natural classifications.</p> <p>A regulator argued against this, as it would make it more difficult for the reader of the accounts to see what proportion of expenditure has been spent on charitable activities. Further, optionality was seen as increasing confusion for both the reader and the preparer. A member of the Engagement Strand noted there is a tension between simplifying things for smaller charities and providing helpful information within the accounts. The activity basis is needed to get consistent data for charities and a global view of what is happening. Alternative bases and optionality do not necessarily make accounts preparation easier for smaller charities – it is possible that more</p>

guidance is a better solution. Comparisons are difficult without the activity basis being used. A regulator noted a preference for the activity basis, including a suggestion that this should be a requirement for charities with income between £250k-£500k, because it helps donors to see what difference their donation is making.

However, this was not a consensus view in the Engagement Strand. A member of the Engagement Strand noted a slight preference towards natural classifications rather than the activity basis as the activity basis is not currently done well and many accounts reviewed by the regulator are a hybrid of the natural and activity bases. The natural classification option therefore requires more prominence in the SORP. Further, another member of the Engagement Strand questioned the comparability of accounting information produced on the activity basis. There was reference to an 'aura of comparability' and this being an idea but not reality.

Option 2: No substantive change required.

A proxy for the public interest member did not see expenditure classification as high priority for the current review of the SORP. The proxy for the public interest member noted that while the guidance could be simplified and made more accessible to the lay reader, the already SORP offers sensible parameters to guide judgment.

B. Conclusions

No conclusions were reached, but several issues were discussed as outlined above and below.

C. Other Comments

- A funding regulator member noted that the prominence of fundraising costs is helpful for their levy calculation.
- Many charities are used to the activity basis, but it would be wise to future-proof it. New events/campaigns are becoming more common as is service delivery within fundraising activity. There is also a big shift towards online fundraising activity (e.g. lotteries) and the traditional forms of fundraising that are referred to in the SORP are out of date.
- The fundraising regulator uses breakdowns of costs when assessing complaints about the efficiency of charity fundraising.
- Where a regulator makes data about charities available to the public, it needs to be reliable. This is only possible if that data can be drawn from accounts, preferably that have been independently verified by audit or examination. Any extension to the use of natural classifications (e.g. permitting charities with income up to £1m to use natural classifications) would be detrimental to this work.
- In the experience of one of the regulators, the lack of a clear framework for accounting with 'natural' categories contributes to confusion and inconsistency. More guidance will be needed in the SORP if natural classifications are retained.
- The lack of consistency one regulator sees in accounts suggests that charities may just need clearer and simpler guidance on preparing their accounts.
- Activity-based allocation of costs should help trustees with management accounting and should inform planning and decision making.
- A regulator suggested consideration should be given to adding more detail on the face of the SoFA (clearer and more intuitive sub-categories for expenses with matching income categories); one option might be a reversion to the categories in SORP 2005, which was more granular in its categories.

- A regulator recommended drawing together the relevant information and guidance on activity-based accounting into a single SORP module to make it easier to follow.

Engagement Strand: Smaller Charities and Independent Examiners
A. Options Considered by the Engagement Strand
<p>Option 1: Increase the visibility of natural classifications and increase the number of charities that this option is available for.</p> <p>The Engagement Strand noted the benefits of high-quality activity-based information, however, added that to achieve this standard can be cost prohibitive, particularly for smaller charities.</p> <p>Members of the Engagement Strand regularly see accounts which appear to be fully compliant in terms of adopting activity based classification but the underlying reality is that all expenditure is simply classified as ‘charitable’ and then a natural classification is provided in the notes, with no separation into different charitable activities even where these are actually undertaken. Members of the Engagement Strand also see accounts prepared where the analysis of expenditure is the bare minimum therefore a charity using natural classification is likely to be providing more detail for the reader.</p> <p>The natural classification format may be more accessible to a wider variety of users of accounts in terms of reducing the need for additional notes to explain figures and methods of calculation to a minimum. The difficulty of understanding activity based accounts may make them less transparent.</p>
B. Conclusions
<p>Option 1: Increase the visibility of natural classifications and increase the number of charities that this option is available for.</p> <p>The Engagement Strand recommended this option.</p>
C. Other Comments
n/a

Engagement Strand: Major Funders & Donors and Government & Public Bodies
A. Options Considered by the Engagement Strand
<p>Option 1: Include more expenditure classifications on the SoFA. The Engagement Strand thought this would be more user-friendly. The additional classifications should be more ‘natural’ classifications which would help the reader understand the expenditure more clearly, without constant reference to the notes. The Engagement Strand thought this would be more user friendly as information several pages into the notes may not be read by the lay-person who may not get that far into the accounts.</p> <p>Some analysis could still be incorporated within other existing notes. If the SoFA was prepared using ‘natural classifications’ and gave the total cost of salaries paid out, the salaries note could then be expanded to include an analysis between fundraising, service delivery, admin etc. That</p>

would be more helpful to the reader as the reader would need to undertake less navigation of the notes.

Option 2: Move away from the split between charitable expenditure and other expenditure. This option is intended to address the perception of 'bad' expenditure.

Option 3: Increase the visibility of the natural classifications option for smaller charities through an education piece and, if the next SORP is written with three tiers, consider mandating activity basis reporting to charities who fall in the highest tier only. Natural classifications were seen as offering a clearer way for the charity to 'tell its story'.

B. Conclusions

Option 1: Increase the categories lines of expenditure on the face of the SoFA.

The Engagement Strand recommended this option.

Option 2: To reduce the perception of some expenditure as "bad", the Engagement Strand recommended an education programme to be led by the Charity Commission.

Option 3: Increase the visibility of the natural classifications option for smaller charities and consider mandating activity basis reporting to charities who fall in the highest tier only.

The Engagement Strand recommended this option.

Other conclusions and recommendations: The Engagement Strand would add the extra heading as in SORP 2015 of Other Expenditure, as this can be used to record losses due to fraud or misappropriation which do not sit well elsewhere.

C. Other Comments

The Engagement Strand was of the view that:

- Consideration should be given to an educational piece of work by the Charity Commission to ensure the public understands that all charities have administrative costs.
- One of the major problems with subjective analysis of expenditure is that there are differing motivational issues arising in charities. It is difficult to legislate for subjectivity.
- Para 8.9 of the SORP gives guidance/suggestions as to which methods of apportionment might be adopted, but rarely do accounts state which method has been adopted. Unless all charities within the same sector have adopted the same method, comparisons are meaningless.
- The Engagement Strand looked back at the wording in SORP 2000 and felt that the expenditure classifications included therein provided greater clarity.

Working Group A

- Natural classification is seen as easier for smaller charities but is not signposted early enough in the SORP. This option should be at the front of the SORP/more prominent. There is possibly also an education need. Opportunities should be taken to highlight the ability of the relevant small charities of using the receipts and payments approach.

- Activity based classification is good when it's done well, but that isn't always the case.
 - This comment is relevant to all charities, not just smaller charities.
- For smaller charities, the choice of natural classifications versus activity-based reporting may be driven by accounting software or the charity's external accountants.
- There was general (but not unanimous) agreement that natural classifications should remain optional, not mandatory, for smaller charities (up to e.g. £1m income).
 - Some smaller charities may keep detailed accounting records e.g. for funding purposes, and may therefore prefer to use the activity basis.
 - The general preference would not be to mandate activity based reporting for all charities. It can be more complex and if a charity only has one activity, disclosure notes effectively apply natural classifications.
 - It was noted that choice does not always simplify matters.
 - However, it was also noted that activity based reporting can better link to the trustees' annual report.
- It was noted that natural classifications can highlight certain expenses that may be thought of as "bad" and that wouldn't be so obvious if apportioned to an activity.
- A fair share of governance costs and support costs is not yet included in line B1 on the SoFA (Expenditure on raising funds); a member of the Working Group argued that this should be included.

Working Group B

There is no need to change existing SORP classifications or requirements.

The group included one recommendation to clarify the use of the "Other costs" category and to explain that the use of this classification is the exception and not the rule.