SORP Committee

Minutes of the SORP Committee Meeting of 13 May 2011
(Approved at the June 2011 SORP Committee Meeting)

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Present:

Laura Anderson, Joint Chair of the SORP Committee
Tidi Diyan
Peter Gotham
John Graham
Pesh Framjee
Chris Harris
Keith Hickey
Noel Hyndman
Carol Rudge
Kate Sayer
Paul Spokes
Sam Younger, Joint Chair of the SORP Committee

In attendance:

Nigel Davies, Secretary to the SORP Committee
Joanna Spencer, Accounting Standards Board

Apologies:

Debra Allcock-Tyler
Frances McCandless, Chief Executive, Charity Commission Northern Ireland (observer member)
Ray Jones
Tris Lumley
Lynne Robb
Catriona Scrimgeour

Item 1: Opening remarks and declarations of interest

1.1 Laura Anderson opened the meeting and invited any declarations of interest to be declared. None were noted.

Item 2: Approval of the minutes and matters arising

2.1 The minutes of the meeting of the 5 April 2011 were considered and were approved.

2.2 In connection with minute 2.2 it was noted that when reviewing the SoFA module some thought needs to be given to ensuring consistency in the application of the headings. Experience had shown that income was not being consistently classified using the existing headings.

2.3 The submissions to the consultation on FRED 43 and FRED 44 were noted. The joint chair noted that the submission from OSCR identified points relevant to Scottish and cross border charities and was made in support of the submission by the joint SORP making body.

2.4 It was noted that the revised draft response to FRED 45, the Financial Reporting Standard for Public Benefit Entities (FRSPBE) would be circulated for review by e-mail. The submission deadline being 31 July.

Item 3 Update from the ASB

3.1 Joanna Spencer gave a verbal update on the consultation on FRED 43 and 44. She noted that there had been 274 responses with over 100 submitted by the social housing sector. Following this, she anticipated a discussion with the social housing sector would take place.

3.2 It was noted that whilst few individual charities had submitted a response, sector umbrella bodies such as CFDG had submitted detailed responses on behalf of the sector.

Item 4 Expenditure recognition module

4.1 Nigel Davies introduced this paper. He noted that the Financial Reporting Standard for Smaller Sized Entities (FRSSE) had little to say on expenditure recognition. The module was based therefore on the draft Financial Reporting Standard for Medium-sized Entities (FRSME). Additional sections had been added including accounting for onerous contracts, employee benefits and the effect of fraud, theft and loss of assets. It was agreed that each question posed in the supporting paper would be discussed in turn.

4.2 The change in the recognition criteria from the requirement that expenditure is recognised when it is certain to when it is probable that there will be a transfer of resources was noted.

4.3 The Committee discussed the retention of the current SORP’s approach to booking a liability where a clause in the grant agreement provides for non-payment in the event of a lack of funds. It was noted that these clauses were common but had no real bearing since the grant makers were unlikely to make an offer knowing they were not expecting to honour it. The impact of non-payment would be damaging to their reputation and the future effectiveness of their grant making. It was therefore probable that payment would be made. Probable strengthened the case for accrual as it looked through the eyes of the grant maker whereas the current approach considered the intentions and expectations of the recipient.

4.4 It was noted that the comment in the guidance section 6A.2 of the draft Financial Reporting Standard for Public Benefit Entities (FRSPBE) was not part of the standard. The SORP’s approach was consistent with the text of the draft Standard. In the event that future income proved an issue the adjustment to the grant paid or payable is made at the time circumstances change. Grant makers manage this risk through their reserves or expendable endowment.

4.5 The outcome of the SORP research in 2008-09 was reviewed in particular the consensus that ‘matching’ as an accounting principle should be reintroduced if at all possible. A typical comment quoted in the research was: ‘The matching principle was thrown out when the SORP came in. I want it back.’ It was noted that the presence of and fulfilment of performance conditions were more important to recognition and for identifying work in progress than the timing of payments.

4.6 It was noted that the draft FRSME did require any linked reimbursement to be shown as a separate asset, it did not preclude netting off the reimbursement against the provision in the SoFA. In the context of charities the statement that reimbursement cannot exceed the provision should be dropped.

4.7 The Committee considered the proposal to require provision for onerous contracts in recognition of the growing funding of the sector via contracts. It was noted that the existing UK GAAP contained a number of helpful examples which could be adapted to provide more guidance for charities on this issue.

4.8 The sector could and did supplement contracts with its own resources where contracted activities were undertaken to further a charity’s objects. Since profit is not the motive, the commercial criteria needed to be interpreted because trustees of a charity may legitimately decide undertake an activity at less than full cost recovery to further their objects and so a loss is not in fact incurred. However where the actual costs of fulfilment exceed the planned costs of fulfilment the excess of resources required does reflect an onerous contract situation. An example common to the sector was a vacated property subject to a lease. It was noted that the US Standard Setter FASB had produced helpful guidance in this area too and that this situation did not apply to executory contracts for example situations of future performance. An onerous contract situation may also arise if there is no ongoing benefit from undertaking the activity.

4.9 The new section on employee benefits should be retained but the text on holiday pay dropped as reassurance for non-accrual is not required because this is rarely material anyway.

4.10 The additional section on fraud and theft was helpful in identifying where the loss should be shown. Whether it was retail ‘shrinkage’ in charity shops or losses from overseas activity, the sector did face this issue as a result of undertaking its work. The recent IPSOS MORI poll conducted in 2010 for the Charity Commission had shown considerable public interest in what had happened to donor’s money and so losses due to material fraud may have an even greater impact on public confidence if found out through other avenues than disclosure by the charity. After debate it was agreed that the disclosure of material losses due to fraud or theft or other loss would be of interest to donors and financial supporters but the trustees should have the choice as to how and where to make this disclosure.

4.11 The Committee agreed that:

- **The recognition criteria can apply to all charities. The recognition criterion be entitled ‘certainty’ should be renamed ‘likelihood’. The same expression ‘likelihood’ should be used in the income recognition and donated goods and services modules.**

- **It was agreed that discounting of liabilities is only required where the liability is material and due for settlement in more than 12 months time. The module should also note that whenever a liability such as a loan is repayable on demand it should be classed as a current liability and not discounted.**
- **The response to the FRED 45 should also note that the guidance in paragraph 6A.2 was inconsistent with the draft standard because the practice in grant making is once an unconditional grant offer is made it is not realistic to withdraw from it and settlement is probable.**
- **The response to the FRED 45 should also that the guidance given in 6A.1 is misleading. It is the nature of public benefit entities that many obligations are not contractual but constructive. The statement made that 'entities rarely make irrevocable commitments without requiring future performance' is a misleading generalisation that should be dropped.**
- **The Secretariat to check that netting off in the performance statement of a provision and a reimbursement is not prohibited in the FRSME or for tier 1. If not, both the income and expenditure models should recognise that this is permitted.**
- **The section onerous contracts be modified to note the additional factor that charity's can undertake activities to further their objects at below full cost. Also some sector specific examples should be added.**
- **The section on fraud and theft be simplified to focus on the accounting and the related disclosure whilst a must, should permit disclosure in either the notes to the accounts or the Trustees' Annual Report.**

Item 5: Donated goods and services module

5.1 Nigel Davies introduced this draft module. He noted that the recognition criteria were common to income recognition but there was additional guidance based on FRED 45 to do with measurement. He noted that CFDG had produced a document 'Inputs Matter' in 2004 which advocated the valuation of all volunteers. However he noted that the findings of the SORP research conducted in 2008-09 was unanimously opposed to the valuation of 'general volunteers'. Instead the contribution of such volunteers should be acknowledged in the Trustees' Annual Report. It was agreed that each question posed in the supporting paper would be discussed in turn.

5.2 In discussing measurement, the Committee noted the ASB's assumption set out in paragraph 34 of section IV of FRED 45 that: 'In many cases, an entity would be able to sell a donated asset and, if appropriate, purchase a cheaper asset with the equivalent service potential.' This justification was used as the basis for preferring open market value, as fair value instead of the value the charity would have willingly paid to acquire the service potential to used, was not valid. From experience, a charity may not be able to sub lease gifted leases on premises or sell pro bono legal advice provided by top law firms.

5.3 Also for reasons of practicality and donor relationships, gifted goods of a higher specification than required would be retained and used rather than sold with lower specification items acquired using the proceeds. For example in responding to disaster relief donated tents of a higher specification would be used given the need and urgency of the situation. The response to FRED 45 should reflect this situation.

5.4 The section on donated goods retained for the charity's own use could helpfully be split into two sections to clearly differentiate the accounting treatment for goods donated for distribution and their treatment as stock (inventory) and goods retained as non-current assets. A strict interpretation of stock being valued at the lower of cost or net realisable value would often lead in practice to a nil valuation because the acquisition cost is nil but the stock does have a service potential in use for the charity so value to the charity, which is the approach taken by SORP 2005, is a better solution.

5.5 Goods donated for resale was framed based on FRED 45. The Committee noted that the theory of recognising goods where received or receivable was sound but the practice was potentially an onerous burden, of little practical value to the reader of the financial statements and speculative in measurement.

5.6 The Committee considered the mixed approach to valuation offered in the module. The emphasis on practicality and of selectively valuing material or specific categories of items would be a source of inconsistency on the balance sheet. In theory valuation could be undertaken at any stage with options including: simple valuation of bags based on an average value, valuation of sorted rags and items, valuation based on displayed items and ticket price less the cost of sales or valuation based on proceeds of sale sheet. However it was noted that this was also the situation with heritage assets.

5.7 The impact on unpaid volunteers could not be overstated, especially for those charities with several shops. The impact o retaining and recruiting volunteers, the complexity of maintaining stock records and the practicality of training volunteers were significant hurdles.

5.8 Also audit standards would require auditors to be present at stock takes where the item is material to the accounts and so the ASB's requirement would be a significant cost to audited charities. However it was acknowledged that for specialised outlets stock could be valued and similarly larger charities do run the shops on a very professional basis where bought in stock for sale is readily valued.

5.9 The Committee considered the valuation of general volunteers. The valuation of volunteers offering professional services and the non-valuation of general volunteers was another example of a mixed approach based on practicality and cost and undue effort. It was noted that the charity V had developed more sophisticated modelling techniques for valuing volunteers based upon the role they undertook. However to require valuation would be an onerous reporting burden for charities and the SORP research had shown no support for this. On reflection there should be no requirement to value. Those charities that wished to value could always provide an indicative valuation for information.

5.10 The Committee concluded that:

- **The criterion on entitlement should make reference to unconditional right to the donated goods, facilities or service. The recommendations on stock valuation were unnecessary and should be deleted.**
- **The response to the FRED 45 should also note that where a charity cannot reasonably sell the donated good or service due to a constraint or the need to maintain donor relationships, then the fair value should be that which the charity would have paid to acquire the donated goods or service based upon the actual requirement of the charity**
- **Separate sections are needed for goods donated for distribution and non-current assets.**
- **For goods for distribution the valuation of stock distributed should be that which was originally recognised. This would retain the approach of SORP 2005 where a donated item shown in income has a corresponding charge show in charitable expenditure.**
- **The response to the FRED 45 should note that the consideration of valuation of goods for resale should have a strong caveat that the requirement to value upon receipt or when receivable should involve no undue cost or effort.**
- **The module cannot be finalised until the final FRSPBE has been settled and so the module should be resubmitted for Committee consideration at a later date.**

Item 6: Branches, linked charities and joint arrangements

6.1 Nigel Davies introduced this paper and noted that the underlying approach proposed was changed from SORP 2005. In revisiting branches he noted that the underlying nature of a branch is that it is a part of, and not separate from, the charity. Also in cases of insolvency of non-company charities trustees could not access funds held in a separate linked charity for general creditors of the reporting charity itself whereas they can access all funds held with the reporting charity to pay creditors. The draft proposed that separate incorporated charities cannot be branches.

6.2 However he noted that in e-correspondence the point had been made that the draft had not fully considered the nature of special trusts in England and Wales. Special trusts may or may not be separate funds that are registered or registerable as unincorporated charities.

6.3 The Committee noted that the regulatory requirements of overseas jurisdictions may require the separate registration of a branch and require that branch to have a local Board or Management Committee, however such arrangements do not mean that they are effectively autonomous and independent. Substance over legal form was an important consideration in identifying a branch situation.

6.4 The Committee noted that HMRC guidance on VAT included some useful indicators of when a branch existed. When considering joint venture entities the guidance issued by US standard setter FASB will be a useful reference source.

6.5 The Committee agreed that:

- **Separate incorporated charities cannot be treated as branches or accounted for in a manner analogous to branches.**
- **The definition of branches be modified to note that incorporated entities cannot be branches whereas in many cases the existence of local boards or management arrangement s are still effectively branches.**
- **A separate section for special trusts should be added that explains that the accounting treatment is analogous to that of branches.**
- **The treatment of joint ventures arrangements which are not joint venture entities is correctly considered as analogous to branches.**

Item 7: Retirement Benefits Module

7.1 Nigel Davies introduced the module. He noted that given the introduction of a form of compulsory pension saving from 2012 on a phased basis, this would be a core module. He noted that the treatment of pensions in the FRSSE was based on FRS17 which was itself consistent with IAS 19 whereas the FRSME was based on a simplified IAS 19. This meant that whilst the analysis of cost components was identical, the disclosure requirements and the valuation requirements were much greater for users of the FRSSE than the FRSME.

7.2 The module was based upon the requirements set out in the FRSME with the additional requirements of the FRSSE for defined benefit pensions in particular were noted where appropriate.

7.3 In discussion it was noted that pension scheme disclosures were very lengthy and that to avoid disproportionate lengthy notes and complexity, where two or more defined benefit pension schemes were in operation these disclosures could usefully be made on a combined basis provided such an approach was not inconsistent with the FRSME and IAS 19.

7.4 The Committee concluded that:

- **The draft module could usefully add the accounting recommendations which permitted combining defined benefit pension scheme disclosures that are permitted by FRS17 if these are not inconsistent with IAS19.**

Item 8: Any other business

8.1 There being no other business the meeting closed.