

## Expenditure Classification and the Charities SORP - Discussion Briefing

Prepared by: CIPFA and Reviewed by the Charities SORP-making body, August 2021

### Purpose of the briefing paper

To assist the engagement strands and the Charities SORP Committee in their reflections on the current approach to expenditure classification within the SORP and to undertake a problem-solving exercise to identify:

- how charity expenditure should be classified, and
- a preferred option with a recommendation as to what the changes to the SORP should be, if any.

While efforts have been made to keep overlap to a minimum, there is some unavoidable overlap between this briefing paper and the briefing paper on support costs. Both briefing papers will be sent to working groups and engagement strands at the same time. Working groups and engagement strands should note that there is no expectation for them to duplicate effort. Where it is unclear whether a comment should be made in response to this briefing paper or in response to the briefing on support costs, working groups and engagement strands are encouraged to make the comment only once in response to the briefing paper they feel is most appropriate. The Secretariat will be mindful of this issue in analysing feedback once comments have been received.

### Reflection - what does the SORP say about expenditure classification?

The SORP requires larger charities to report on an activity basis. Further details on requirements for smaller charities with respect to expenditure are as follows (please note, SORP requirements not related to expenditure have been removed from the below extracts):

- 4.22. *The analysis of income and expenditure by activity is encouraged for all charities preparing accruals accounts. However, smaller charities are not required to report their income and expenditure on an activity basis and may adopt an alternative approach to their analysis.*
- 4.23. *This analysis may be based on the nature of the income and expenditure. For example, expenditure could be analysed by salary-related costs, premises-related*

*costs, interest expenses, transport costs and grants made. Alternatively, the headings used by the charity to record expenditure in its own accounting records could be used.*

- 4.24. *Where an alternative approach to analysis is adopted, this SORP requires that charities must disclose in their SoFA:*
- total expenditure of the charity*
  - a relevant analysis of the components of expenditure*
  - net income/(expenditure)*
- 4.25. *If a material component of income or expenditure is not presented on the face of the SoFA, the nature and amount of the item must be disclosed in the notes to the accounts.*
- 4.26. *Charities preparing their accounts using a natural or alternative basis of analysis must also provide those disclosures required by other modules relevant to the charity. For example, a charity must disclose any remuneration, benefits or expenses paid to trustees and any related party transactions.*

Where charities report on an activity basis, the following requirements are relevant to expenditure:

- 4.27. *This SORP requires that larger charities and those smaller charities opting to report on an activity basis must classify their income and expenditure by activity.*
- 4.28. *... Expenditure must be analysed by the nature of the activities undertaken.*
- 4.29. *Where relevant to the understanding of material activities, the expenditure analysis headings should enable the user of the accounts to understand the relationship with income derived from the activity. For example:*
- a charity selling donated goods through a shop could use the description 'Shops' within row A3 ('Income from other trading activities') and row B1 ('Expenditure on raising funds');*
  - a charity running a care home could use the description 'Residential care fees' within row A2 ('Income from charitable activities') and 'Residential care costs' in row B2 ('Expenditure on charitable activities');*
  - an arts charity providing a mix of paid-for and free services could use the description 'Admission fees for galleries and exhibitions' within row A2 ('Income from charitable activities') and use the heading 'Operation of art gallery and touring exhibitions to schools and community' in row B2 ('Expenditure on charitable activities'); and*
  - an endowed grant-making charity mainly making grants to advance education could use the description 'Investment income' within row A4 ('Investment income') and 'Grants to education and research institutions, student bursaries and other grants' in row B2 ('Expenditure on charitable activities').*

4.30. *In most cases, it will be clear which activity generated the income or expenditure. Expenditure shared between two or more activities should be apportioned between them on a reasonable, justifiable and consistent basis (see the SORP module 'Allocating costs by activity in the statement of financial activities').*

Paragraph 4.7 sets out the line headings to be used in the SoFA when reporting by activity as follows:

- *B1 Expenditure on raising funds;*
- *B2 Expenditure on charitable activities;*
- *B3 Other expenditure;*
- *B4 Gains/(losses) on investments.*

Further, an analysis of expenditure must be included in the notes to the accounts (see SORP paragraph 4.57).

Detailed descriptions of the above expenditure line items as set out in the SORP are provided in Appendix 1 to this briefing paper.

Charities that report on an activity basis are required by the SORP to apply Module 8 (Allocating costs by activity in the statement of financial activities). Module 8 contains the relevant provisions of the current Charities SORP (FRS 102) for expenditure classification.

FRS 102 does not address how to present a SoFA on an activity basis or the allocation of costs to activities in that statement.

The SORP also specifies the following,

- 8.2. *The SoFA must distinguish between expenditure incurred on charitable activities which contribute to furthering the charity's aims and purposes, and those undertaken to raise funds. Further analysis of significant activities included within these broad categories must be provided either on the face of the SoFA or in the notes to the accounts.*
- 8.3. *The activity analysis must be on a full cost basis. Full cost is made up of the total of the direct costs and shared costs, including support costs, involved in undertaking each reported activity.*

General principles for reporting activities are also prescribed by the SORP as follows:

- 8.4. *A charity's SoFA or related notes should provide an analysis of a charity's significant activities in a way that is relevant to both the charity and the users of its accounts.*

- 8.5. *Significant activities are those which, due to their scale or importance, are key to the charity in meeting its aims and objectives. The analysis of activities should provide an understanding of how a charity raises its funds and uses them to further its purposes. For example, charitable activities may be analysed according to services provided, projects or programmes undertaken, or by the particular aims or objectives taken forward.*
- 8.6. *The activities reported should also be consistent with the significant activities noted in the trustees' annual report. The narrative provided by the trustees' annual report should help the user of the accounts to understand the nature of those significant activities and what has been achieved as a result of the expenditure incurred on them.*

The SORP specifies the methods for the allocation of costs to activities:

- 8.8. *To ensure that the accounts present the costs of activities fairly, charities should ensure that the method(s) of cost allocation adopted are reasonable and consistently applied. In attributing costs to activities, the following principles must be applied:*
- *Direct costs attributable to a single activity must be allocated directly to that activity (for example the salary cost of someone solely employed on a particular activity or the cost of running a vehicle used wholly for a particular activity).*
  - *Shared costs which contribute directly to more than one activity must be apportioned between those activities (for example the cost of a staff member whose time is divided between a fundraising activity and working on a charitable project).*
  - *Support costs which are not attributable to a single activity must also be apportioned between the activities being supported.*
- 8.9. *The method(s) of apportionment adopted by a charity should be reasonable and be consistent between reporting periods unless circumstances change. Charities should also balance the benefits of greater accuracy with the costs involved when selecting methods of apportioning costs. Examples of bases for apportionment that may be applied include:*
- *usage of a resource or activity in terms of time taken, capacity used, requests made or other measure;*
  - *per capita, based on the number of people employed within an activity;*
  - *floor area occupied by an activity; or*
  - *time, where staff duties span more than one activity.*

The requirements for accounting for costs shared between fundraising and charitable activities are as follows:

8.10. *Information about the aims, objectives and projects of a charity is frequently provided in the context of mail shots, websites, public fundraising collections and telephone fundraising. In determining whether costs are shared, a distinction should be drawn between:*

- *publicity or information costs involved in raising the profile of the charity which is associated with fundraising; and*
- *educational publicity or information to further the charity's aims and objectives.*

8.11. *For publicity or information to be regarded as charitable expenditure, it must be provided for an educational purpose. In the context of a fundraising activity, in order to achieve an educational purpose the information supplied must fulfil the following educational criteria:*

- *be targeted at beneficiaries or others who can use the information to further the charity's purposes;*
- *be information on which the recipient can act in an informed manner to further the charity's purposes; and*
- *be related to other educational activities or objectives undertaken by the charity.*

8.12. *For example, a health education charity might target high-risk beneficiary groups or medical professionals when distributing its fundraising material and, as part of the same mailing, also supply information on health risks and symptom recognition. The health information supplied would be charitable expenditure because it is targeted at beneficiaries or others who could act on the information and has been distributed by the charity as part of its health education activity. The shared cost of producing and distributing the information should therefore be fairly apportioned between the fundraising and charitable activities. If the educational criteria had not been met then all relevant costs would be attributed to fundraising activities.*

Disclosures (within the notes to the accounts) has been the topic of a separate briefing paper and was discussed by the Charities SORP committee on 4th August 2021. At that meeting, there was tentative support for further consideration of how disclosures could be simplified and reduced on a module-by-module basis. Consideration may need to be given to the disclosure requirements with respect to expenditure classification:

8.13. *This SORP requires that charities reporting on an activity basis must disclose:*

- *details of the accounting policy adopted for the apportionment of costs between activities and any estimation technique(s) used to calculate their apportionment;*
- *the total amount of support costs incurred in the reporting period;*

- an analysis of material items or categories of expenditure included within support costs, with the total amount of governance costs incurred separately identified ... ; and
- the amount of support costs apportioned to each of the charity's significant activities as disclosed in the SoFA or in the notes to the accounts.

*Analysis of expenditure in the notes to the accounts*

4.57. This SORP requires that the notes to the accounts must provide a relevant analysis of the activities included within each expenditure heading provided on the face of the SoFA. The analysis provided should aggregate the cost of similar activities and provide the user of the accounts with an understanding of the charity's main activities.

4.58. This SORP also requires that the analysis must give details of the support costs charged to an activity and the cost of grant funding to third parties that have been included within the cost of charitable activities. The total provided within the analysis must reconcile with the amounts presented within the relevant expenditure headings of the SoFA. This information may, for example, be presented in a tabular format (see Table 3).

**Table 3: Analysis of expenditure on charitable activities**

Activity or programme	Activities undertaken directly	Grant funding of activities	Support costs	Total
	£	£	£	£
Activity 1				
Activity 2				
Activity 3				
<b>Total</b>				

What is the reporting difference between 'all' and 'larger' charities?

As detailed above, smaller charities may opt to report their charity's expenditure in a different way, for example by the nature of expenditure rather than on an activity basis.

## Engagement strand feedback during the exploration stage

Initial topics and ideas under discussion by the SORP engagement strands as presented to the SORP Committee in November 2020 indicated that there is a need for greater clarity and flexibility

on categories of expenditure. This could help to better describe each charity's business and could include simplification of cost analysis in notes.

The Smaller Charities and Independent Examiners engagement strand highlighted that since trustees rely on their independent examiners when compiling the accounts, they are unaware of the options open to trustees e.g. natural classification. It would also be useful to have examples to show how the options might be used in practice.

#### Engagement strand feedback: User of the account's perspective

One point on expenditure classification was raised from the user of the accounts' perspective:

- Distinguishing expenditure as charitable and non-charitable is problematic as in normal circumstances all expenditure should be considered charitable (PTS(B))

#### Engagement strand feedback: Preparer of the account's perspective

Natural classifications were mentioned by two strands in relation to simplifying accounting requirements, either by increasing the number of charities able to use the concession or increasing the prominence of the concession (PTS(B), S&IE). If a 'think small first' approach is taken, the ability to use natural categories in the SoFA should be made prominent in the SORP. "This will make it more likely that smaller charities will be aware of this concession and will therefore use it." (PTS(B)). The option of using 'natural classifications' should be available to more charities, at least up to £1m (the audit threshold in England and Wales) (S&IE).

Noting that there is some overlap between this issue and the issue of support costs, PTS (B) advocated for changes to the classification of expenditure, specifically addressing the classification of some unavoidable costs as non-charitable. Further, PTS (B) identified that the distinction between expenditure on charitable and non-charitable activity is problematic as in normal circumstance all expenditure should be considered charitable, for example, investment management fees. A distinction will remain necessary, for example, to report losses due to fraud.

#### Relevant SORP research findings

Responses to the 2016 research exercise did include comments on expenditure classification. Due to the overlap between this topic and support costs and the need to avoid duplication, it is recommended that working groups and engagement strands consider the research findings as part of their work on support costs. Please see the briefing paper on support costs for the detailed research findings.

## What needs to be done now?

### Step 1- Making the case for change - a 'basis for conclusions'

There is a need to consider the reporting requirements for expenditure classifications. This need has been raised by engagement strands and agreed by the SORP Committee.

At this stage, there is a need to decide:

- i) whether any changes are required to expenditure classification requirements specified in the Charities SORP
- ii) what those changes might be to improve the understanding of the users of the accounts or to assist accounts preparers with the decisions and judgements required to report on charity expenditure
- iii) the reasons to support the changes.

Without a case for change, no change will be considered because its rationale cannot be explained to those affected.

### Step 2 - Advising the change required to the SORP

Having made the case for change, the detailed changes required to the SORP and/or FRS 102 need to be set out. Consideration should be given in as much detail as possible for the requirements regarding expenditure classification and what else the SORP should include about expenditure classification – for example, additional disclosure requirements. If no detail is given, the conclusion drawn is that the detail is left wholly to the discretion of the SORP Committee and SORP-making body.

#### **Undertaking an assessment of the impact (savings or costs on the preparer and benefits or disadvantages to the reader)**

The FRC will require an impact assessment but until the implications of change are worked through the SORP framework, the impact is unlikely to be clear and so this will be considered at the drafting stage of the process.

### Step 3 - Recommendation

The case made by each working group, engagement strand or combination of strands will inform the deliberations of the SORP Committee and so there needs to be a clear recommendation from the working groups and engagement strands to the SORP Committee.



Following evidence provided by the working groups and engagement strands the SORP Committee will have its own discussion about what needs to be done and taking the evidence and views from the process, the Committee will settle on a recommended approach for drafting the SORP based on the evidence presented.

## Detailed descriptions of expenditure line items per the SORP

### B: Expenditure

#### *B1: Expenditure on raising funds*

- 4.44. Expenditure on raising funds includes all expenditure incurred by a charity to raise funds for its charitable purposes. It includes the costs of all fundraising activities, events, noncharitable trading activities, and the sale of donated goods. However, any costs incurred in providing goods or services as a charitable activity must not be included in this heading, even if a charge is made for their provision.
- 4.45. Expenditure on raising funds includes those costs incurred in:
- seeking donations, grants and legacies;
  - operating membership schemes and social lotteries;
  - staging events, including the performance fees, licence fees and other related costs;
  - contracting with agents to raise funds on behalf of the charity;
  - operating charity shops selling donated and/or bought-in goods;
  - operating a trading company undertaking non-charitable trading activities;
  - advertising, marketing and direct mail materials, including publicity costs not associated with educational material designed wholly or mainly to further the charity's purposes; and
  - investment management costs.
- 4.46. Investment management costs include the costs of:
- portfolio management;
  - obtaining investment advice;
  - administration of the investments;
  - costs of licensing intellectual property; and
  - rent collection, property repairs and maintenance charges.
- 4.47. Where investment management costs are material, these costs should be presented as a separate heading on the face of the SoFA or in the notes to the accounts.
- 4.48. Costs associated with acquiring and disposing of investments would normally form part of the acquisition cost of the investment or reduce the return on disposals. These costs are therefore not part of investment management costs. Where investment managers deduct management fees from investment income, the charity should report the gross investment income before fees and report the management fees charged in this cost category. However, charities are not expected to prorate

investment management fees charged to a collective investment scheme to identify the notional cost attributable to its own holding in the scheme.

- 4.49. Investment management costs associated with endowment fund investments should generally be charged to the endowment fund in the SoFA. Further guidance on the charging of investment management costs to endowment funds is provided in the SORP module 'Fund accounting'.
- 4.50. Fundraising costs may be incurred in starting up a new source of future income such as legacies, or in developing a supporter database. In most cases these start-up costs should not be carried forward as prepayments or deferred expenditure. Instead, such costs are charged to the SoFA as incurred. Data capture costs of an internally developed database must not be capitalised. The costs of a database that has been purchased or donated to the charity can be capitalised where it is probable that it will generate economic benefits, for example in generating income, and the resulting database has a readily ascertainable cost or value.
- 4.51. Charities may choose to expand the analysis provided within this heading for example by identifying separately 'Expenditure on raising donations and legacies' (A1), 'Expenditure on other trading activities' (A3) and 'Investment management costs' (A4) either in the SoFA or by way of an explanatory note.

#### *B2: Expenditure on charitable activities*

- 4.52. Expenditure on charitable activities includes all costs incurred by a charity in undertaking activities that further its charitable aims for the benefit of its beneficiaries, including those support costs and costs relating to the governance of the charity apportioned to charitable activities. Costs involved in negotiating contracts or grants that require the charity to provide specific charitable services should also be regarded as part of the cost of carrying out that activity.
- 4.53. Additional sub-headings should be added to the analysis of charitable activities to identify the significant charitable activities undertaken which have been reviewed in the trustees' annual report. The sub-headings used should reflect the nature of the activity undertaken.
- 4.54. On occasions, a subsidiary entity may undertake activities specifically to further the purposes of a parent charity rather than as a fundraising activity. Expenditure incurred by a subsidiary on activities that fall within the parent charity's purposes should be analysed as charitable activity when consolidated accounts are prepared
- 4.55. Charities may carry out their activities through a combination of direct service provision and the grant funding of third parties to undertake work that contributes to the charity's aims or programme of work. The cost of charitable activities presented in the SoFA includes the costs of both direct service provision and the payment of

grants. Charities making grants must refer to the SORP module 'Presentation and disclosure of grant-making activities', which sets out the particular disclosures required for grant-making in the notes to the accounts.

*B3: Other expenditure*

- 4.56. Other expenditure includes all expenditure that is neither related to raising funds for the charity nor part of its expenditure on charitable activities. Where an amount is material or its presentation on the face of the SoFA is necessary for an understanding of a charity's financial performance, an additional sub-heading should be used.

*B4: Gains/(losses) on investment assets*

- 4.59. This heading is used to record any realised and unrealised gains or losses on investment assets and investment properties, including those gains or losses arising from their revaluation in the reporting period.

**Abbreviations - Engagement Strands**

<b>Engagement Strand</b>	<b>Abbreviation</b>
Smaller charities and independent examiners	S&IE
Larger charities	L
Charity trustees	T
Academics and regulators and proxies for public interest	A&R&PPI
Professional, audit and technical strand A	PTS(A)
Professional, audit and technical strand B	PTS(B)
Major funders, donors and government and public bodies	MFDGPB