What are the distinctive features of accounting and reporting by charities?

1 What are the main distinctive features of charities?

1.1 The March 2008 meeting of the SORP Committee agreed that as the data gathering stage of the research programme draws to a close it would be valuable to revisit what the fundamental distinctive features of charity reporting and accounting are.

1.2 From the roundtables there are some emerging features that stakeholders consider important which are unlike commerce or government. Since the research will be evaluated by Queen's University, Belfast in the autumn and so the emerging themes are best viewed as provisional.

1.3 The ASB CAPE Committee has already considered what some of the distinctive accounting features might be at its meeting of 12 May 2009 and an initial set of issues is indentified in appendix 1.

1.4 A consideration of why charities differ in their reporting and accounting requirements would be timely as internationals standards develop and ASB deliberations about the future of UK GAAP.

2 What might the distinctive features be?

2.1 Charitable trusts – fund accounting. The SORP articulates the different funds in appendix 3 'The Funds of a Charity'. All funds held by a charity, which are gifted or received to further its charitable purposes, are held on trust and can only be used for a charitable purpose. Even where variations to trusts are permitted, the funds or assets remain impressed with charitable trust and cannot be diverted lawfully to another non-charitable use or to a charitable use outside of the trusts on which the assets are held. This contrasts with other forms of not-for profit such as Government accounting which is based on a statutory non-charitable basis where funds are used for the lawful purpose established by statute.

2.2 Not for private benefit – no owner interest. At the point that money is gifted it cases to be the property of the giver and is impressed with charitable trusts. The charity itself has no owners since private benefit, except where it is incidental or a by-product of the charity's work or is otherwise specifically authorised, is not permitted. A charity pays no dividends or profit shares to non-charitable owners. Ultimately the funds of a Government are owned by the citizens of that country but no such ownership rights are conferred against a charity.

2.3 For public benefit. Charities are established expressly for exclusively charitable purposes for the public benefit. The law defines what charitable purposes are and public benefit explicitly focussed on the beneficiaries of the charity who may or may not have donated to that charity. Whilst the charity has a beneficiary focus, those same

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beneficiaries have no ownership rights over the charity but their interests (both current and future beneficiaries) are the focus of the charity's endeavours.

2.4 Independence and the role of trustees. Charity trustees are not owners because the charity's assets are not their own, neither are they normally employees (as private benefit is forbidden unless expressly authorised), nor are they normally beneficiaries (unless a beneficiary on the same basis as the general class of beneficiaries eg as monks of a monastery). However they are responsible in law for ensuring that the charity's activities are within its objects and for the public benefit and that funds are not spent in breach of trust, otherwise they have potential personal liability for any loss. The trustees act in the interests of the charity exclusively and weigh the needs of current and future beneficiaries in the use of resources and are accountable to the stakeholders interested in the charity's work.

2.5 Not-for profit. Whilst charities may generate funds or indeed surpluses to fund their charitable work, the aim is not to generate profit for remittance to shareholders or owners.

2.6 Absence of the simple yardstick of profit or loss surplus or deficit. The aim is to use funds for a charitable purpose and for some charities the charity is not necessarily planning to continue indefinitely unlike Government or a commercial entity. Neither is a charity required to accumulate funds by way of surplus, although it may have a legal power so to do. Whist an unplanned deficit or surplus may be indicative of operational issues; of itself it is not a cause of concern though in the context of a particular charity's situation it may raise significant operational issues. This neutrality has been reflected in the SORP's use of the phrase 'net incoming (outgoing) resources'.

2.7 Public money and fundraising. Charities hold public money whether received by way of gift, in exchange for goods or services, or by way of charitable appeal, subscription, or from investments. All the funds, howsoever acquired, are impressed with charitable trusts. A particular and distinctive form of appeal is fundraising which involved charities seeking support from donors, whether public bodies, corporate bodies, private businesses or private individuals or other charities. These public appeals and the nature of money held for the public benefit are unique to charitable activities.

2.8 Public interest and tax relief. Charities are not restricted to only providing public goods, where they may be market failure, for example by rescuing stray animals. Charities promote the civic endeavour for the public benefit and charities enjoy certain tax privileges unavailable to public bodies or commerce. There is therefore a legitimate public interest, articulated through Parliament or government, in the conduct of charities in receipt of tax relief. Such tax reliefs are not intended to promote economic behaviour but charitable endeavour.

2.9 Non-exchange transactions. Non-reciprocal transactions are a feature of the sector in terms of income, gifts and donations, and expenditure in grant giving and the provision of goods and services at nil consideration. Such expenditure is often on the basis of a constructive rather than contractual obligation where the beneficiary cannot legally require a particular level of benefit with the decision on the level of benefit remaining with the trustees.

2.10 Functional assets are retained for 'service potential'. Many charities do trade, for example schools, care homes, leisure, educational and artistic charities to name but a few but not all charities trade for example faith charities, advisory charities, rescue charities. Cash flow potential is therefore a feature of assets held by some but not all charities, however all charities use their assets for service potential (FRS11 paragraph 20) to provide public benefit.

2.11 The charity sector holds 'heritage assets' where the character of the asset has historic, artistic, scientific, technological, geophysical or environmental qualities and they are retained to further a charity's objects. Such assets are unknown to commerce where assets are retained to generate economic returns.

2.12 Absence of equity and ownership when considering combinations with combinations at nil consideration. In commerce business combinations are intended to generate returns for owners and the providers of debt financing. In law a charity cannot own another charity but it can manage a charity as trustee and then as trustee has the same legal obligations to operate solely in the interests of that charity to further its charitable objects for the public benefit. There are therefore no reserves created on combination that cannot be lawfully distributed and all the funds remain in trust. In the absence of a beneficial acquirer the sector may be better served by merger accounting where combinations come about through agreed merger.

2.13 Furthering charitable objects via programme related investments. Charities exist to further their objects and may give grants where the funds pass across to the recipient or they may offer interest free or preferential loans. In no sense is the charity sacrificing a return by such arrangements but rather it is furthering its objects and some commentators argue by making loans rather than grants thereby facilitating a greater number of projects or activities.

2.14 Sales at 'under value'. Whilst in commerce 'loss leaders', discounts and similar marketing practices are transactions at undervalue, the motive is to gain or preserve market share with the ultimate objective of generating current or future returns. For charities an under value or nil consideration transaction is a mechanism to further charitable objects. Those charities that trade may well use undervalue transactions in a comparable manner to commerce but for many charities there is no trading motive.

3 Provisional themes from the roundtables

3.1 The roundtables were not convened to revisit the precepts of why accounting for charities is unique as that was very much a given reflected in the charity SORP. However from the responses to the questionnaire and debate a number of features emerge as being emphasised as important to charity reporting and accounting. These features are best considered provisional until Queen's University has reported.

3.2 The provisional features of charity reporting identified from the roundtables are:

- Broad support for the annual report to have a high stewardship content, reporting on what has happened in the past year.
- That the reporting of funds, and in particular restricted funds, is a key aspect of accounting.
- That constructive obligations are a feature of charity accounting reflecting the way charities operationally manage their work.
- Merger accounting fairly reflects the nature of combinations by agreement, as opposed to rescue situations.
- Overall the SORP was viewed as a force for good enhancing the quality of reporting.

4 Other distinct sector features

4.1 The sector in terms of trusteeship and particularly at the smaller end (below £500,000 gross income) predominately relies on volunteers. These volunteers in the roles of trustee, manager, treasurer or book-keeper are not necessarily conversant with UK GAAP (over 2000 pages) nor would have the skill set to fully grasp UK GAAP (or indeed IFRS) were they to read it. The support for a SORP, or similar style of guidance, is that it provides an abridged narrative (121 pages including index) in a less technical style than UK GAAP and includes illustrations. Indeed retaining a 'one stop' shop is a key feature so that the cross referencing to UK GAAP is not required. The roundtables articulated a demand to further simplify the language of the SORP and gear it more towards smaller charities preparing accruals accounts.

4.2 The sector in the UK is skewed in size. At the October 2007 SORP Committee meeting, a provisional view was taken about what model of

What are the distinctive features of accounting and reporting by charities?

convergence SORP should follow with the move to international accounting standards. In England and Wales 97% of registered charities have an income below £1m (164,000 charities) and in Scotland similarly 97% of charities are below £1m gross income (22,000 charities). These smaller charities lack expert accountancy resources and are commensurate in size to the 'micro entities' identified by the European Union. The framework needs to fit the breadth of scale and address the capabilities of the full range of charities if high quality reporting and accounting is to be maintained.

4.3 Access to professional accountants is limited in the sector and in England and Wales an examiner skilled in accountancy is only required where gross income exceeds £250,000. In Scotland access to a skilled examiner is required wherever accruals accounts are attempted. The role of the examiner is therefore key to maintaining quality accounting but the examiners will not have access to the technical expertise of medium and large accounting firms and so any framework to be robust must be in a format readily understood by a sole practitioner without access to peer review or a technical partner.

4.4 Public accountability is a feature of the sector. The International Accounting Standards Board identifies an entity as having public accountability if: 'it has issued (or is in the process of issuing) debt or equity instruments in a public market; or it holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/ dealer, pension fund, mutual fund or investment bank'. Were charities deemed publicly accountable in a comparable fashion they would need to be familiar with IFRS (over 2600 pages) or the adapted IFRS developed for public benefit entities. It is doubtful that the sector would have the capability to assimilate IFRS and this would be an obstacle to volunteering and a costly compliance burden. To date public accountability for charities has been developed through distinctive reporting in the annual report and a specific accounting regime with additional disclosures of issues of public concern, for example related party disclosures.

5 Conclusions

5.1 The available evidence on reporting and accounting by charities supports the view that the charity sector merits its own framework within UK GAAP and the distinctive features should actively shape that framework so that the needs of those reporting and their stakeholders are fully met.

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Questions:

1. **Does the SORP Committee agree with the distinctive features of charity reporting and accounting identified?**

2. **Has the SORP Committee any initial views or comments on the provisional findings from the roundtable research as they identify features of reporting and accounting by charities?**

3. **Does the SORP Committee agree that the additional sector related features are important in determining the development of UK GAAP for charities?**

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Appendix 1: Initial issues identified by CAPE (May 2007).

In considering the development of UK GAAP with public benefit entities in mind, the ASB is currently considering what the distinctive features might be with respect to adaptations to accounting standards. Below is an extract, produced by permission of the ASB, of the CAPE committee's consideration of the issue:

Not-for-profits face a number of accounting issues that profit-oriented entities rarely encounter. The following table sets out examples of issues that are distinctive to the not-for-profit sector and could therefore usefully be covered in a not-for-profit standard. The list of issues is not intended to be exhaustive.

Accounting issues	**What is different about not-for-profits**
The presentation of the primary financial statements	Specific requirements may be needed for issues such as restricted assets; classification of expenditure (by object, function or programme?); how residual interest should be presented, etc.
Fund accounting	How to report different kinds of funds (restricted and unrestricted), the effect of conditions when resources are received and the way in which they are subsequently treated.
Revenue from non-exchange transactions	Non-reciprocal transfers, such as income from donations, legacies and grants, including the impact of any restrictions and conditions that might be attached to these contributions.
Valuation of assets, including impairment	Assets are generally held to deliver services to members of the public that are often free or subsidised. The absence of any direct cash inflows to the entity may result in these assets being valued in terms of their service potential.
Business combinations	Acquisitions may take place at nil or nominal consideration and there may sometimes be an alternative to acquisition accounting.
Financial instruments, e.g. soft loans	How to account for loans that are made (or received) at a below market rate of interest to support the economic and social policy objectives of a not-for-profit entity.
Liabilities	How to report liabilities for non-performance related commitments to provide public benefits or obligations arising from multi-year grant

What are the distinctive features of accounting and reporting by charities?

	awards made by grant-giving charities.
Identifying the reporting entity	The boundary of a reporting entity is determined by the scope of its control – but how does this principle apply in the not-for-profit context, particularly in terms of the indicators of control?
PFI schemes and similar contractual arrangements	How should not-for-profit entities account for PFI/PPP contracts and similar arrangements?
Narrative reporting	How to report the extent to which the entity is achieving its strategic objectives, particularly with regard to service delivery, and, more broadly, to promote accountability.