

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

### 1 The Future of UK GAAP and the distinctive features of charities?

- 1.1 The ASB in its consultation on 'the Future of UK GAAP' sets out in section 3, 'Financial reporting for public benefit entities', 10 distinct areas which the ASB considers are distinctive to public benefit entities. The consultation invites suggestions as to what issues the proposed public benefit standard might usefully cover, including any additional ones not identified within the consultation.
- 1.2 The final research report from Queen's University, Belfast on the SORP Roundtable events has emphasised a number of areas that are important to the users of charity accounts. In particular, the report highlights the importance of high quality narrative reporting, the need for a focus on what activities were undertaken and what was achieved, and transparency about the types of fund administered by trustees.
- 1.3 This paper is an update of the paper presented at the June 2009 SORP Committee meeting. This paper reviews the areas identified by the ASB and then identifies additional areas for inclusion in the SORP Committee's response to the ASB.

### 2 Initial issues identified by the ASB (August 2009)

- 2.1 In considering the development of UK GAAP with public benefit entities in mind, the ASB states in its consultation that: 'Public benefit entities face a number of accounting issues that profit-oriented entities rarely encounter. The following table below sets out examples of issues that are distinctive to the public benefit sector and could therefore usefully be covered in a public benefit 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.

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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 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.

2.2 In reviewing this list, the emphasis is mainly on technical issues. All the issues identified are well expressed and address the issues relevant to our sector. PFI/ PPP are likely to be less of an issue for most charities but may affect Registered Social Landlords and Higher and Further Education.

2.3 The SORP roundtables emphasised the relevance and importance of the Statement of Financial Activities ('SoFA') to sector reporting. Although

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the SoFA's format and particularly its terminology might be simplified, there is strong support for the statement's retention. The roundtable findings also emphasised the importance of fund accounting and highlighted the debate about non-exchange transactions and accounting for multi-period liabilities. These key issues are all identified in the ASB's list included within the consultation document.

- 2.4 The roundtable findings also emphasised the importance of narrative reporting and this is reflected in the ASB's list.
- 2.5 The Commission recent discussions with HM Treasury and the Financial Reporting Advisory Board has highlighted questions concerning the nature of control exercised through trusteeship and what that means where there is no equity interest. This key issue is also identified by the ASB's consultation.
- 2.6 The ASB's list might usefully have heritage assets added. The ASB have issued a standard 'FRS 30' on heritage assets to UK GAAP and for completeness this issue should be listed.

### 3 Additional areas for consideration

- 3.1 In addition to heritage assets there are two groups of issues that merit inclusion in the ASB's list, the first relate to the capability of the sector. The second are to do with what public accountability means in the context of the sector.

#### **Sector capability to handle UK GAAP and international accounting standards**

- 3.2 **Volunteering is a feature of registered charities at Trustee/ Director level.** Charities, particularly at the smaller end (below £500,000 gross income), rely on volunteers. Volunteers fill the roles of trustee, manager, treasurer or book-keeper and are not necessarily conversant with the existing UK GAAP (over 2000 pages) and are unlikely to have the skill set to fully grasp IFRS (at over 2600 pages). 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 finding of the SORP research. This approach greatly reduces the need to cross refer to UK GAAP on many if not most issues. The roundtables also articulated a demand to further simplify the language of the SORP and gear it more towards smaller charities preparing accruals accounts.

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- 3.3 **The sector in the UK is skewed in size.** In England and Wales and Scotland 97% of registered charities have an income below £1m (186,000 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 requirements of smaller charities. The retention of the Financial Reporting Standards for Smaller Entities (the FRSSE) is proposed for for-profit entities. Perhaps a similar approach is needed for public benefit entities. The SORP roundtables articulated a need for any future framework to think small first.
- 3.4 **Access to professional expertise is limited,** whether to provide assurance services, or as a volunteer. In England and Wales an independent examiner need only be a member of an accountancy or similar body where gross income exceeds £250,000. In Scotland access to a similarly skilled examiner is required whenever accruals accounts are attempted. The role of the examiner is key to maintaining high quality accounting but examiners are unlikely to have access to the equivalent technical expertise of medium and large accounting firms. Any framework should therefore be in a format readily understood by a sole practitioner without access to peer review or a technical partner.
- 3.5 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). It is doubtful that the sector would have the capability to assimilate IFRS and this would be a major obstacle to volunteering and a costly compliance burden.

### **Sector accountability to the donors, financial supporters and other stakeholders**

- 3.6 **Public accountability is a feature of the sector.** 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. This has led to an emphasis on narrative reporting, an approach supported by the SORP roundtables rather than a more complex set of accounting disclosures and requirements.

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- 3.7 **Not for private benefit – no owner interest.** At the point that money is or assets are gifted to a charity it ceases to be the property of the donor 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.
- 3.8 **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, however 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.
- 3.9 **Public interest and tax relief.** Charities are not restricted to only providing goods and services which are not provided either by the public bodies or by commerce. Charities promote civic endeavour for the public benefit and enjoy certain tax privileges unavailable to public bodies or commerce. There is therefore a legitimate public interest, articulated through Parliament and government, in the conduct of charities benefitting from tax relief. This is because these tax reliefs are not intended to promote economic behaviour but charitable endeavour.

### Public benefit in the context of charities

- 3.10 **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 is 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 beneficiaries have no ownership rights over the charity but their interests (both current and future beneficiaries) are the focus of the charity's endeavours.
- 3.11 **Charities are independent and the trustees act solely in its interests.** Charity trustees are responsible in law for ensuring that the charity's activities are within its charitable purposes and for the public benefit and funds are not spent in breach of trust, otherwise they risk

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personal liability for any loss. 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).

### **4 Conclusions**

- 4.1 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.

#### **Questions:**

- 1. Does the SORP Committee agree with the distinctive features of charity reporting and accounting identified?**
- 2. Does the SORP Committee agree that the following additional sector related features are important in determining the development of UK GAAP for charities and should be added as an annex to the committee's submission to the ASB consultation?**  
The proposed additions are:
  - a. The addition of heritage assets**
  - b. The framework recognises the skewed distribution of registered charities as micro-entities**
  - c. The unique character of public accountability of all charities is recognised**
  - d. The special characteristics of public benefit in the context of charities are recognised**