Charity Commission analysis and review of SORP Compliance

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1 Introduction

1.1 This report summarises issues that may be of interest to the SORP Committee that were identified in a programme of accounts scrutinies undertaken by the Commission in 2006-07. The programme was designed to:

- Identify potential risks and concerns; and
- Check levels of compliance with the SORP.

1.2 SORP compliance checks incorporated the following elements:

- Annual Reports were compared to the previous year's report and an assessment made as to whether the report may have been written by the auditors or examiner (using a template approach) rather than by the trustees.
- Annual Reports were given a basic assessment and categorised as follows:

  (i) Good (contains all key information and policy notes, informs about the year's performance, and is transparent and promotional).

  (ii) Adequate (contains all key information and policy notes but lacks insight and transparency).

  (iii) Poor (missing key information/policy notes).

1.3 Accounts were checked using the checklist shown in Appendix 1, to ensure that the primary statements were filed adopting SORP formats and the required external scrutiny report was attached and unqualified. Key issues including excessive governance costs, related party transactions and insufficient disclosure of grants paid were examined in greater detail. It is important to emphasise that the initial work was not carried out by qualified accounting professionals and was not intended to be an exhaustive review of full SORP compliance.

1.4 This report was also informed by the experience of the Commission's accountants who deal with escalated helpline enquiries via the Commission's Contact Centre. Appendix 2 refers.

2 Accounts inspections

2.1 A total of 647 accounts inspections were completed. The findings of these inspections are summarised in Appendix 3.

2.2 Overall 23% of TARs were deemed to be poor, i.e. missing key information and/or policy notes. The problem is much more apparent at lower income levels with more than 60% of TARs received from charities with income below £100,000 considered to be poor. Surprisingly, 8% of large charities with income of more than £5m also received a poor grading on their report. One third of reports were considered good with a significantly higher percentage of good reports among the larger charities.

2.3 The TAR evaluation identified the information and policy details that are frequently omitted from the reports submitted. One quarter of reports did not detail the current level of reserves and in nearly 20% of cases the report did not comment on the investment performance (where required) or detail the methods adopted for the recruitment and appointment of new trustees.

2.4 In many cases (14%) the report was virtually identical to the previous year, the only difference being a change of dates and relevant figures. In 13% of cases the report was brief and lacking information on the achievements and performance of the charity. The template style may suggest a report not prepared by the trustees but the adoption of templates often used by accountants for private company reporting. .

2.5 The empirical work revealed that a significant number of accounts reported high governance costs (20% or more of total expenditure or greater than £5m). This was generally attributable to the incorrect or incomplete allocation of expenditure. This can give the reader of the financial statements the misleading impression that the charity is not spending enough of its resources on its charitable activities and in extreme cases has been known to attract press interest.

2.6 Where problems were noted with disclosures of accounting issues or where themes emerged from the IQ team's work then a further review was undertaken by the qualified accountants within the Information Division and these issues are set out in detail in the next section and, for convenience, also summarised in Appendix 4.

3 Recurring accounting issues

3.1 Misclassifications in Statement of Financial Activity (SoFA) / Balance Sheet

3.1.1 Misclassification of income or expenditure within the SoFA was one of the most frequently noted issues representing approximately 20% of all issues identified.

3.1.2 A significant number of charities appear to be inconsistent in their analysis of income and related expenditure suggesting a lack of understanding of activity based accounting. Inconsistency in the analysis of income and related expenditure may give rise to anomalies when ratio analysis is carried out on income/expenditure categories. “Other incoming resources” in particular was misused with the inclusion of material identifiable amounts which should be properly classified elsewhere.

3.1.3 On the balance sheet the main problem area was investment properties that were often included under the tangible assets heading and not classified separately within fixed assets. This was easily identifiable from the SoFA where rental income was reported without a corresponding investment asset in the balance sheet. Freely tradable investments, such as equities, were generally classified correctly.

3.2 Reserves policy statement (Para. 55a, GL 51)

3.2.1 Inadequacies with reserves policy statements were another common theme in almost 25% of reports and accounts. The main observations were:

(i) Total omission of a reserves policy statement in Trustees Annual Reports.
(ii) Failure to quantify freely available reserves.
(iii) Incorrect calculation of freely available reserves with the most frequent error being the failure to exclude tangible fixed assets held for charity use.
(iv) Bland statements on expenditure cover without providing context.
(v) Notes to the accounts being used instead of TAR.

3.2.2 It is reasonable to conclude that in a significant minority of cases poor reserves policies prevent the report and accounts being sufficiently transparent.

3.3 Netting off of expenditure against income (Para. 95)

3.3.1 This accounted for 8% of all reported issues and was a frequent feature within the accounts of independent schools. In the context of the public benefit debate further consideration of the accounting treatment of bursaries and scholarships may be desirable. Are these trade discounts or the funding of an activity which should be reported in the school's accounts? The usual practice is for school charities to "net off" bursaries and scholarships against school fees receivable.

3.4 Gains on disposal of fixed assets held for charity's own use (Paragraphs 217 -218)

3.4.1 Gains arising from the disposal of fixed assets held for charity use were incorrectly disclosed included within revaluation gains/losses. This was observed in approximately 8% of all reported issues. In some cases the gains were very large and merited disclosure as exceptional items but the disclosure was not consistent with FRS 3.

3.5 Exclusion of brought forward reserves in the SoFA (Para. 74)

3.5.1 Capital reserves and revaluation reserves were omitted from the reconciliation of funds section of the SoFA but included in the analysis of funds on the balance sheet. These omissions accounted for 25% of those accounts in the sample which did not balance.

3.6 Consolidated accounts-subsidiary undertaking not properly disclosed (Para. 401)

3.6.1 Consolidation issues accounted for 10% of all reported issues. Where group accounts were examined there was often insufficient or no detail provided to differentiate the gross income and results of the parent charity and its subsidiaries. Consolidations were not always properly performed or not performed at all in some cases.

3.7 Foreign currency translation (Appendix 2)

3.7.1 Gains/Losses on foreign currency translation were reported under a range of different SOFA headings. Exchange losses in particular were disclosed under "Other resources expended" and not as a support cost of the relevant activity category. This was only relevant a very small number of charities in the sample.

4 Charities Act/Companies Act Issues

4.1 Exemption from consolidation

4.1.1 Incorporated charities were observed to be relying on the exemptions available for small groups under Section 248 of the Companies Act 1985 and therefore not producing group accounts as required under SORP where gross income of the group exceeds £250,000. (Permissible SORP exemptions from consolidation are referred to in Paragraphs 383-385).

4.2 Joint ventures and associates (Paragraphs 413-418)

4.2.1 Incorrect and inconsistent accounting treatments were used to recognise the results of joint ventures and associates in the consolidated SoFA and balance sheets. A recurrent observation was the failure to account on the gross equity method for joint ventures and the tendency to use the net equity method applicable to associates instead. The logistical problems of obtaining and agreeing information with a third party could be a relevant factor here. Although joint venture accounting will only be an issue for a relatively small number of charities the data shows that it is quite likely to be performed incorrectly in those cases.

5 AREAS LACKING SUFFICIENT DETAIL/GUIDANCE IN SORP 2005

5.1 Recurring issues

5.1.1 There are issues arising in a minority of charities where the guidance in SORP 2005 is either insufficiently detailed or fails, at present, to provide a specific recommendation.

5.1.2 The 2 areas which occurred with the highest frequency were:

- Interest Payable - The treatment of interest payable and finance costs is inconsistent between charities. Amounts were most frequently reported under “Costs of generating funds” without regard to the activity giving rise to the cost. This was highlighted when income/cost ratios were analysed.

- A transfer of funds in/out of the charity - Inconsistent accounting treatment of funds transferred between charities or on the incorporation of an existing charity was observed. Some disclosed these transfers on a separate row beneath net incoming resources others recorded the receipts as incoming resources and the outflow as expenditure.

6 Other disclosure issues noted

6.1 Cost of Capital

6.1.1 A handful of charities included an amount for “notional cost of capital” within resources expended, with a corresponding credit shown following net incoming resources. Guidance would be useful as to the inclusion or exclusion of notional cost of capital in charity accounts.

6.2 Royalties

6.2.1 Royalties receivable were reported under a variety of SoFA headings. It was difficult to conclude if the analyses were correct because of the lack of any further disclosure in the notes to the accounts. In some cases these were material amounts in relation to the charity's total incoming resources therefore some SORP guidance would be useful.

6.3 Taxation

6.3.1 Parent charities with trading subsidiaries were reporting corporation tax charges/credits and any movements on deferred tax liabilities beneath net incoming resources on the SoFA. This was observed in a minority of the group accounts reviewed but there is little guidance on disclosure of taxation in SORP.

6.4 Follow up

6.4.1 The Commission is looking to undertake future, periodic, SORP compliance checking using the annual return introduced in 2007. This will allow us to use new techniques to identify concerns and difficulties.

7 Conclusion

7.1 It is disappointing to note that there are still a significant number of audited accounts failing to comply fully with SORP and legislative requirements, however, these compliance issues only result in a relatively small number of qualified audit reports.

7.2 SORP 2005 has improved the overall quality of accounts submitted. Whilst there are no "hard stats" to back this up but during the course of the analysis work successive years of the same charity's accounts were frequently examined and the impression was of an improving picture.

7.3 The greatest improvements were probably within the reports and accounts of medium sized charities which in some cases had moved from a basic list of income, expenditure and assets to a fully compliant set of financial statements.

7.4 In addition the income categories of SORP 2005 format give users greater insights and opportunities for analysis than was previously possible and potentially improve comparability between charities.

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APPENDIX 1

Information Quality Accounts Assessment

TAR Evaluation

- Missing Trustees' Annual Report ☐
- Wrong TAR: (E.g. Minutes of AGM) ☐
- Reference and admin - Name Missing ☐
- Reference and admin - Address missing: ☐
- Reference and admin Trustee names missing ☐
- Governing Doc/Constitution missing ☐
- Recruit/Appoint of trustees missing ☐
- Objects summary missing ☐
- Activities summary missing ☐
- Activities not in accordance with objects ☐
- Missing/Insufficient achievements or performance ☐
- Risk Statement, (>£250k) missing ☐
- Reserves statement missing ☐
- Details of why reserves are held missing ☐
- Current level of reserves not detailed ☐
- Target level of reserves not shown ☐
- Not meeting target level ☐
- Details of funds in deficit, if required, missing ☐
- Investment policy, (>£250k) missing ☐
- Investment objectives missing ☐
- Investment performance missing ☐
- Grantmaking policy (>£250) missing ☐
- Financial Review indicates problems ☐
- Report same as last year ☐
- Report may be written by accountant ☐

Objective Issues

- Missing Primary Statements:
  - Missing SOFA/R and P account ☐
  - Missing Balance Sheet Exception ☐
  - Missing Notes ☐
  - Missing Cash Flow (if reqd) ☐
  - Missing Scrutiny report ☐
- Incorrect Format of Primary Statement ☐
- Sofa/balance sheet (Cash/balance)do not agree ☐
- Incorrect Scrutiny report ☐
- Scrutiny Report qualifi ☐
- Scrutiny Report restriction of scope ☐
- Restricted funds not shown (if required) ☐
- Endowment funds not shown (if required) ☐
- Investments not at Market Value ☐
- Error in Employee Information ☐

Subjective Issues

- Incorrect description/cost classification used ☐
- Excessive Governance Cost ☐
- Deferred Income used incorrectly ☐
- Related parties note cause for concern ☐
- Insufficient disclosure of grants paid ☐
- Inappropriate transfer between funds ☐

Comment on any Yes (=1) indicators

Quality of Report

1 Very Poor. Token report or wrong report (e.g. Minutes of AGM)

2 Poor. A key policy statement, e.g. reserves, risk (>£250, grantmaking, missing.

3 Adequate. All key information and policies present but lacking insight.

4 Good. All key information and policies present and informs about the years performance.

5 Very Good. All key information and policies present, very transparent and promotional.

☐

Overall Assessment ☐

0= No problem
1= Accounting Issue
2= Governance Issue
3= Both

Comment on Proposed Action

Proposed action ☐

0= No problem
1= Low risk - no action
2= Review next year
3= Escalate
4= Referral
5= I.Q. to Action
6= I.C. to Action

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APPENDIX 2

Observations of Charity Commission accountants in regular contact with charity trustees, employees and professional advisors

Issue	SoRP para. ref	Observation
Responsibility of preparing Trustees Annual Report	10	Charity trustees and employees are sometimes of the opinion that it is not the responsibility of the trustees to write this report.
Understanding activity based reporting		Some professional advisors, trustees and charity employees don't appear to understand the relationships between the categories of incoming resources and resources expended within the SoFA.
Recognition of grant income	GL 61 GL 45	There is often confusion as to whether grant income should be recognised as voluntary or contractual income, with subsequent VAT implications (VAT is chargeable on contractual income).
Recognising donated services and facilities	134	Some charities wish to recognise the value of volunteer time in their financial statements. Whilst paragraph 134 of SoRP states that the contribution of volunteers **should** be excluded, this is often interpreted as being an option.
Treatment of funds received for the restricted purpose of providing/building fixed assets	117	Whilst trustees, employees and charity advisors are comfortable with initially recognising these funds as restricted, many are unclear of the correct accounting treatment on completion of the acquisition/building of the asset when the restriction no longer applies.
Reporting gift aid claimed	121	Employees and advisors are often unclear as to where to report gift aid claimed, often querying whether or not it follows the original gift.
Lack of awareness of concessions available to smaller charities	Appx 5	There appears to be a need for better signposting of Appendix 5 SoRP2005: Accounting for smaller charities.

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Appendix 3a

Accounts Inspections: Quality of TARs by income band

Income Band	No	Poor[1]	Adequate[2]	Good[3]
£10,000 - £100,000	60	37 *(62%)*	18 *(30%)*	5 (8%)
£100,000 - £250,000	63	27 *(43%)*	31 *(49%)*	5 *(8%)*
£250,000 - £500,000	58	17 *(29%)*	33 *(57%)*	8 *(14%)*
£500,000 - £1m	70	23 *(33%)*	33 *(47%)*	14 *(20%)*
£1m - £5m	90	21 *(23%)*	35 (39%)	34 *(38%)*
£5m - £10m	131	10 *(8%)*	60 *(46%)*	61 *(47%)*
£10m plus	175	13 *(7%)*	60 *(34%)*	102 (58%)
Total	**647**	**148 *(23%)***	**270*(42%)***	**229 *(35%)***

[1] The report is missing key information/policy notes
[2] The report contains all key information and policy notes but lacks insight and transparency
[3] The report contains all key information and policy notes, informs about the years performance and is transparent and promotional

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Appendix 3b

Accounts Inspections: Issues noted with more than 10% occurrence

Trustees Annual Report:	SoRP para. Ref	No	%
Governing document/constitution missing	44a	74	11%
Recruitment/appointment of trustees missing	44b	122	19%
Missing/insufficient achievements/performance	53	93	14%
Current level of reserves missing	55a	167	26%
Investment performance missing	53c	110	17%
Report the same as last year	n/a	92	14%
Possibly written by accountant	n/a	87	13%

Accounts:			
Excessive governance costs	GL28	101	16%

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Recurring issues (noted from financial data collection exercise)

Issue	SoRP para. ref	Detail
Misclassifications in SoFA/Balance Sheet		Many charities are reporting income, expenditure and assets incorrectly. ‘Other incoming resources’ in particular is misused with the inclusion of identifiable amounts which should be classified elsewhere.
Reserves policy statement	55a	Statement is missing, does not quantify freely available reserves or calculates reserves incorrectly.
Netting off expenditure against income	95	Primarily noted in the accounts of independent schools which frequently net off bursaries and scholarships against fees receivable.
Gains on disposal of fixed assets	217 - 8	Gains incorrectly included under ‘other recognised gains and losses’ instead of ‘other income’. Exceptional gains are often included in other income and not separately identified as required under FRS3.
Exclusion of brought forward reserves in the SoFA	74	Capital and revaluation reserves omitted from the reconciliation of funds section of the SoFA resulting in non balancing accounts.
Lack of disclosure in relation to subsidiaries	401	Insufficient or no detail provided of the subsidiary’s results to enable turnover or expenditure to be separately identified.
Foreign currency translation	SSAP 20 Appx 2	Gains/losses reported under various SoFA headings. In many instances exchange losses reported under ‘other resources expended’ and not as support cost.

Companies Act and Charities Act conflict (noted from financial data collection exercise)

Issue	SoRP para. ref	Detail
Exemption from consolidation	383	Incorporated charities relying on exemptions available for small groups under Section 248 of the Companies Act which do not apply to charities.
Joint ventures and associates	413 - 8	Incorrect and inconsistent accounting treatment.

Areas lacking sufficient detail/guidance (noted from data collection exercise)

Issue	Detail
Interest payable	Inconsistent reporting of interest payable and often reported under ‘Costs of generating funds’. This results in a mismatch when comparing costs with income raised. With the exception of pension finance costs the SoRP does not provide guidance.
Transfer of funds into/out of the charity	Inconsistent accounting treatment with incoming/outgoing transfers being included within incoming resources/ resources expended or shown below the line following net incoming resources. This has implications for charity audits.
Notional cost of capital	A handful of charities were observed to be including an amount for notional cost of capital within resources expended, with a corresponding credit shown following ‘net incoming resources’. Guidance would be useful as to whether this is appropriate in charity accounts.
Royalties	Royalties receivable are reported under various SoFA headings. The SoRP does not specifically provide guidance on the appropriate treatment.
Taxation	In a minority of cases parent charities with trading subsidiaries were reporting tax credits/charges and movements on deferred tax liabilities beneath net incoming resources on the SoFA. The SoRP provides little guidance on the disclosure of taxation.