

Background paper – Proposals for the publication of an Information Sheet

1. Introduction

- 1.1. At the last SORP Committee meeting it was agreed that one product of the 2007 review should be the preparation of an Information Sheet clarifying issues where uncertainty or interpretational issues have arisen in applying SORP 2005.
- 1.2. An information sheet does not amend the SORP and cannot create new recommendations. An Information Sheet does not require consultation before it is issued provided it remains within the boundaries set by the ASB's Code of Practice and, in particular, does not set new recommendations without consultation.
- 1.3. The attached document (paper 4.1) is a working draft of the proposed Information Sheet and draws on recurring issues raised with the Commission's helpline staff. This working draft is presented in order for the SORP Committee to give an initial view on the issues identified and their interpretation, it is anticipated that the Committee will wish to add additional issues as well as reviewing the approach taken in the draft.
- 1.4. The Committee is invited to comment on the style and format of the Information Sheet, as it is recognised that further editing for both style and content will be necessary before publication.

2. Target date for publication

- 2.1. The information is designed to assist preparers of accounts and whilst there is no external deadline that needs to be met, there may be advantages if it were available to preparers when finalising the March 2007 accounts.
- 2.2. The audience for an Information Sheet is likely to be preparers of accounts with an interest in technical interpretation and those advising charities on the application of the SORP, typically auditors. This audience is such that a web only publication is favoured.

Questions:

- **Is a target date of early summer 2007 reasonable?**
- **Is a web only publication as reasonable approach?**

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Issues for consideration:

3. Accounting for grants

Analysis of grant income

- 3.1. Grant arrangements can contain very different restrictions and conditions, varying from unrestricted gift through to quasi-contractual arrangements described by the SORP as Performance Related grants. Preparers have sought further guidance as to how these differing “grant receipts” should be analysed in the SoFA.
- 3.2. The Commission currently advises that Grant Receipts should be analysed in the SoFA based on the substance of the arrangement and the operation of legal restrictions on the purposes for the funding can be applied.
- 3.3. Performance related grants, where entitlement to income arises with the performance of a specific service, are likely to be analysed as income derived from charitable activities, whilst grants without performance conditions will be categorised as Voluntary Income. This reflects the substance of the arrangement – performance related grants being analogous to the provision of services in exchange for consideration, whilst grants as enabling payment are analogous to gifts.

Question:

- **Does the Committee concur with the guidance provided in the Draft Information Sheet?**
- **Are there any addition issues that should be considered when analysing grant receipts?**

Negotiation of contracts and performance related grants

- 3.4. A charity may often target grantmakers in raising voluntary income and such costs will be analysed in the SoFA as part of the cost of generating voluntary income. This enables users to understand the amount of Voluntary Income received and the cost to the charity of generating this income.
- 3.5. The SORP states that the cost of generating funds should not include costs associated with service delivery or the costs of any subsequent negotiation, reporting or monitoring of grants or contracts. However, the SORP is silent on how the initial costs of negotiating a contractual

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arrangement (inc. performance related grants) should be analysed. Some practitioners include such costs as part of the cost of delivering the charitable activity whilst others show such costs as part of the costs of generating income. This latter approach however can distort the costs of generating income. Also the negotiation of contract terms (including performance related grants) tends to be undertaken by the operational staff of charities rather than being seen as a fundraising activity.

Questions:

- **Does the Committee agree that costs of negotiating contract (inc. performance related grants) for service delivery should be excluded from costs of generating voluntary income?**
- **Should guidance be provided on this issue in the Draft Information Sheet?**

Multi-year grant awards

- 3.6. Preparers of accounts still have difficulties in distinguishing between grants which are performance related in nature and those which are recognised as constructive obligations under FRS 12. The recognition basis adopted can have a significant affect on performance statement and the position reported in the balance sheet of a charity.
- 3.7. Paragraph 159 of the SORP provides an illustration of how the operating of a review clause may limit the recognition of a constructive obligation (under FRS 12). The SORP gives the example of evidence of past reviews as providing necessary evidence that discretion over future payments is retained by the funder thereby limiting the recognition of potential constructive obligation.
- 3.8. This example may however lead preparers to focus too much on review clauses in multi-year funding awards without first establishing whether or not the arrangement is performance related. If a grant payment is, in substance, dependent on the recipient providing a specified service then the arrangement is likely to be performance-related.

Question:

- **Should guidance be provided on this issue in the Draft Information Sheet to help preparers identify performance related grants?**
- **Is any further clarification needed in relation to the recognition of multi-year grants generally?**

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4. The Charities Act 2006 and disclosures for grantmaking charities

4.1. The SORP requires, where this is material, the disclosure of the names of institutions supported by grant funding and amount provided. This disclosure is limited to a sufficient number of institutions supported by the grantmaker to give the user of accounts a reasonable understanding of the range of institutions supported.

4.2. The new Charities Act, on implementation, will give a statutory basis in England and Wales for this recommendation to be over-ridden during the lifetime of a settlor (or spouse) of a charitable trust funding such a grant. Charities registered in Scotland will not be able to adopt this exemption.

Question:

- **Does the Committee agree that the impact of this legislative change should be explained in the Information Sheet?**
- **Does the Committee agree that such disclosures should still be regarded as best practice, notwithstanding the availability of a legal opt-out from this disclosure in England and Wales?**

5. Investment management costs

5.1. A principle of the SORP is that incoming resources should be reported gross before the deduction of costs relating to its generation. This principle applies equally to investment income with fees and other investment management costs reported separately in the SoFA.

5.2. Where a charity invests in collective investment schemes such as unit trusts or common investment funds such costs are recovered by investment managers from the investing entity prior to its distribution of income. Some preparer have sought to estimate the costs inherent in such products whilst others regard the distribution received by the charity as gross and see any estimated or notional adjustment to reflect such costs as onerous and at best providing only an indicative cost.

Question:

- **Does the Committee believe guidance on this matter is necessary and, if so, is the SORP's recommendation intended to extend to the investment management costs inherent in such collective investment vehicles?**

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6. Bank interest and other finance costs

6.1. SORP 2005 provides no specific guidance on how interest and other finance costs should be allocated within the statement of financial activities. Most preparers of accounts appear to allocated interest costs on the basis of the activity funded by the loan. However, some preparers take the view that borrowing costs are financing in nature and should be allocated to costs of generating funds. This approach can however distort the costs of generating funds as there is no corresponding income generated. The draft information sheet therefore indicates that interest and borrowing costs should be allocated to the activity funded by the borrowing or where this is not practicable allocated to activities on a reasonable basis.

Question:

- **Does the Committee agree that interest and other borrowing costs should be allocated or apportioned to the activities funded by the related borrowing?**
- **Do we need to remind users of Companies Act disclosure requirements for interest paid?**

7. The business review and reporting by charities

7.1. Section 234 of the Companies Act 1985, as amended, requires the Directors' Report of companies to include a business review. Charitable companies applying the SORP recommendations for the Trustees' Annual Report are likely to meet the general requirements for a business review if an expanded narrative is provided on the risks and uncertainties faced by the charity.

Question:

- **Does the Committee consider this clarification, explaining how the SORP's existing recommendations fit with the Companies Act requirements of the business review, helpful?**

8. The operating and financial review (OFR) and reporting by charities

8.1. The OFR, although designed primarily for quoted companies, has attached considerable interest and debate in recent years. Indeed the

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SORP's recommendations for the full Trustees Annual Report (TAR) fits comfortably within the principles and framework of the OFR.

- 8.2. Some larger charities have embraced an OFR style of reporting and although the SORP does not create a requirement for an OFR, preparers of the Trustees Annual Report may find guidance on how the existing TAR relates to existing best practice recommendations helpful.

Question:

- **Does the Committee agree that guidance on the application of the OFR to charities is helpful?**

9. General

- 9.1. Whilst the Information Sheet attached is currently a working draft, the initial views of the Committee would be welcomed on any further issues the Information Sheet should address, or any inaccuracies contained in the working draft.

Questions:

- **Are there other issues that should be included in the Information Sheet and if so, what is the nature of the problem and what is the potential solution?**
- **Is the Committee content with the technical accuracy of the content of the draft Information Sheet?**
- **Are there any explanations provided that could be interpreted as a new recommendation and create a requirement for consultation?**