SORP Research Study

1 Introduction

1.1 At the July 2010 meeting a recommendation was made to undertake research with a particular emphasis on those charities that may opt to account under the Financial Reporting Standard for Smaller Entities (FRSSE).

1.2 The desk research was undertaken by Janet Slade of the Charity Commission's Accountancy Policy Team. It was conducted in the autumn/winter of 2010/2011. A stratified sampling approach based on income was taken. The selection was on a random basis using a computer programme from charities filing accounts with the Charity Commission. The sample selected provides 90% confidence that the results are applicable across the whole register. In total 536 sets of accounts were reviewed split between company and non-company charities.

1.3 The aim of the research was to identify the impact of some of the accounting treatments permitted under the FRSSE (an option for charities with incomes under £6.5m) which are not permitted under the draft Financial Reporting Standard for Medium-sized Entities (FRSME). It is hoped that this research will inform the SORP Committee's response to the Accounting Standard's Board's consultation on the future of UK Generally Accepted Accounting Practice (UK GAAP).

1.4 The findings will also identify to what extent additional guidance needs to be given in the next SORP to enable a more consistent approach to be taken by charities in accounting for legacy income and multi-year commitments.

1.5 This paper looks at five areas where there are differing accounting treatments adopted by charities in the preparation of their accounts. The areas reviewed were:

- The use by smaller charities of natural categories.
- Accounting for buildings at historic cost or valuation.
- The extent to which charities capitalise borrowing costs.
- Accounting for legacies and Legacy policies.
- Accounting policies adopted for multi-year funding.

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2 The use by smaller charities of natural categories

2.1 Appendix 5 of SORP 2005 provides some simplifications and concessions in the accounting for smaller charities below the statutory audit threshold. It provides a concession in paragraph 5.3.1 for charities which are not subject to a statutory audit to enable them to choose categories other than activity categories in the Statement of Financial Activities (SOFA).

2.2 Charities reporting on a natural basis have discretion to use their own income and expenditure headings. Expenditure headings for example might include wages and salaries, and depreciation.

2.3 Of the sample of accounts reviewed, 189 were for charities with an income below the audit threshold. Of these 94 were for companies with incomes between £25,000 and £500,000 and 95 were for non-companies with incomes between £250,000 and £500,000. The higher minimum income for non-company charities was chosen as they are only required to produce SORP accounts once income reaches £250,000.

2.4 The following table summarises the findings estimating the proportion of charities registered in England and Wales which are reporting on a natural basis.

Charity type	Gross income band	Sample Number	Number using natural categories	% of total	Estimate for the whole sector
Companies	£25k-£500k.	94	12	13	1763
Non-companies	£250k - £500k	95	11	12	313
Total		189	358	-	2076

The sample indicates that the concession to analyse other than by activity is not widely used by charities that have to report on an accruals basis.

Question:
Does the SORP Committee agree that the concession to use categories other than activity categories in the SOFA should be retained for smaller charities?

3 .Accounting for Buildings

Cost or Valuation

3.1 SORP 2005 sets out the treatment of tangible fixed assets including functional buildings in paragraphs 253—284. Either historical cost or valuation is acceptable; however paragraph 265 states that where there is a policy to revalue fixed assets their value must be updated on a regular basis.

3.2 Of the 536 charities accounts reviewed, 276, just over half, held a significant value in buildings on their balance sheet. The table in appendix 1 shows whether charities are valuing their buildings under historic cost or at valuation. Only functional buildings have been included in the table. Details of buildings held as investment assets were not noted. The category of buildings includes freehold properties and some leasehold properties.

3.3 It should be noted that some larger non-company charities have a mixture of treatments so that they have some property at historic cost and some at valuation. This arises for a number of reasons;

- Buildings were included at valuation, perhaps on first adoption of FRS15, and have stayed at that valuation. This may be because the accounting policy is to value assets at cost or the charity has reverted to historic cost because that method provides a fairer presentation.
- Some classes of buildings are included at cost and others at valuation.
- Charities have merged and the treatment of each building assigned by the original organisation has continued.
- Buildings are capitalised at cost on acquisition and then revalued annually.
- A nominal value has been attributed to religious buildings eg Mosques for reasons of faith. Other buildings are accounted for at cost.

3.4 Overall more non-company charities than company charities have buildings on their balance sheets and they are more likely to be at valuation rather than historic cost.

3.5 The *research indicates that:*

- the valuation approach is adopted by about one third of charities;
- the spot estimate for the sector is only 384 registered charities with incomes over £6.5 million adopt valuation; and
- historic cost remains the most popular accounting policy for recognising buildings and similar assets.

Questions:
Does the SORP Committee agree that the prohibition of valuation by the FRSME is a significant issue?

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Capitalisation of borrowing costs

3.6 The capitalisation of borrowing costs is currently permitted under UK GAAP where a tangible fixed asset (non-current asset) is constructed or acquired. For examples in the construction of a new building, the interest cost is added to the value of the asset rather than charged as an expense in the year.

3.7 The study found that 39 (7%) of the charities reviewed indicated that at the financial year end they had buildings under construction. Of these only 7 made clear that they capitalised interest and all of these were Registered Social Landlords. No universities were within the sample.

Question:
Does the SORP Committee agree that the FRSME's prohibition on capitalising borrowing costs will only significantly affect charitable Registered Social Landlords?

4. Legacies and Legacy policies

4.1 Paragraphs 123 to 128 of SORP 2005 describe the areas of consideration with regard to recognising legacy income. The 11 policies set out in appendix 2 all show signs of having been drawn up with reference to the SORP and yet the treatment which results from each of those policies can vary considerably.

4.2 Voluntary income in 125 of the accounts of the charities reviewed clearly included legacy income. Slightly more, 147 had an accounting policy for legacy income.

4.3 The study demonstrates that there is no standard practice in this area and charities recognise legacies at various points along the timeline between the death of the donor and the receipt of payment by the charity. In practice it will be hard for all legacies to be treated consistently all the time because some of these accounting policies include trigger points for recognition which may happen without the charity being aware of them.

4.4 In undertaking this study it was also found that is quite hard from the wording of the policy to identify the actual recognition point being used to determine in which accounting period legacies are being recognised. Options the SORP Committee could consider as a criterion for a specific recognition point include:

first notification by the Executors to the estate; or
the granting of probate; or
notification of payment or transfer of title; or
receipt of cash, disposal of asset or transfer of title.

Questions:
Does the SORP Committee agree that the current guidance provided by the SORP has led to too great a variation in practice in accounting for legacy income?

Does the SORP Committee agree that legacy policies would be more transparent if the SORP specified a specific recognition criterion on the timing for inclusion of legacy income in the financial statements?

5. Policies adopted for multi-year funding and commitments

Grants payable

5.1 Grants payable and future obligations are covered in paragraphs 154 to 163 of the SORP. Paragraphs 155-159 clarify a number of points:

- A funding decision by trustees does not create a constructive obligation to pay the grant until it has been communicated to those affected.
- General or policy statements of future intentions do not create a constructive obligation.
- Where the funding is dependent on explicit conditions being met the expenditure needs to be recognised once those conditions fall outside the control of the giving charity.

5.2 The accounting treatment of grant awards which cease to qualify as a contingent liability and are accrued is covered by paragraph 343 of the SORP. Items should be accrued where it is probable that there will be a future outflow of funds which is capable of being estimated with reasonable accuracy at the date on which the financial statements (accounts) are approved.

5.4 The SORP research findings identified that there was unanimity amongst all stakeholders that the principle of matching should apply to grants with the grant matched to the period over which it is paid. Paragraph 103 of the SORP does permit timing to be taken into account as a performance condition when recognising grant income. However paragraph 159 does not provide for an equivalent treatment when recognising a liability to make a grant payment.

5.5 The study found 85 sets of accounts had accounting policies setting out the treatment for grants awarded. Of these 50 of them had a basic policy just indicating when the award was recognised in the accounts. A further 32 also stated how amounts awarded and unpaid at the financial year end were treated in the accounts. Such unpaid amounts were treated by charities as commitments, provisions or contingent liabilities. The disclosure of ‘intentions to spend’ which is required by paragraph 328 of the SORP was rarely given.

Questions:
Does the SORP on accounting for grant and multi-year commitments need further clarification?

Is the separate disclosure of those grant awards which are not accrued necessary?

6. Multi-year income receivable

6.1 Paragraphs 108 to 111 of the SORP consider the circumstances under which income can be deferred to a future time period and the recognition of contingent assets where it is probable that conditions will be met in future.

6.2 The SORP research found an ambivalence towards the SORP's requirement to recognise income from capital grants upon entitlement rather than over the life of the related asset. Opinion was divided as to whether the SSAP 4 treatment, which permits capital grants to be deferred, should be permitted. However many spoke in its favour at the SORP roundtable events. The study (refer to table 4) found that some charities adopted the SSAP 4 approach even though this is not permitted by the SORP. Section 24 of the draft FRSME does not permit the SSAP 4 treatment but section 6 of the FRSSE does.

6.3 Three specific types of multi year income accounting policy were noted:

- School fee schemes
- Grants and other income receivable
- Life memberships

6.4.1 School fee schemes

15 of the charities in the sample were schools operating advanced fee schemes for parents. These enable parents and future parents to pay fees in advance for future years. The various policies outline the terms of the scheme covering such things as:

- How the advance fees are invested.
- How future shortfalls are covered.
- Whether and how the advance payment can be returned.

6.4.2 Grants and other income receivable

Most of the policies identified in the study related to only one charity and so extrapolation to the sector as a whole was not considered appropriate. Generally the study found charities had a general policy for income recognition.

6.4.3 Life memberships

Paragraph 362e of the SORP states that an accounting policy for the basis for including subscriptions for life membership is required but it is silent on how life membership income should be treated.

Three sets of accounts had policies for life membership fees received. They were each completely different:

> Life Memberships are written off on a straight line basis over 12 years.
> Life subscriptions and 5 yearly subscriptions are carried forward and written off over a period of 15 years or 5 years respectively
> Life members subscriptions are accounted for on full receipt

Question: **Should the SORP give guidance to charities on how subscriptions for life memberships should be treated?**

Appendix: Table 1 Valuation of buildings

The following table looks at the way charities are showing the value of their functional buildings in their balance sheets and how that divides between historic cost and valuation.

Charity type	Gross income band	Total in sample	Buildings on the balance sheet	Historic cost	%	Est. No. of charities	Valuation	%	Est. No of charities
Companies	£25k- £500k.	94	21	19	90	2740	2	10	289
Non-companies	£250k - £500k	95	42	30	71	824	12	29	330
Companies	£500k- £6.5m	92	52	46	88	2920	6	12	381
Non-companies	£500k - £6.5m	95	37	28	76	687	11	30	270
Companies	Over £6.5m	74	48	39	81	540	16	33	221
Non-companies	Over £6.5m	86	76	60	79	236	29	38	114
Total		536	276	222	**80**	**7947**	**76**	**28**	**1605**

Note the table in appendix 1 adds to more than 100% because some charities took a combined approach and valued some buildings at historic cost and others at valuation.

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Appendix: Table 2 Legacy policies

Policies 1-8 are arranged approximately on a time line starting from the earliest disclosure.
Policies 9 and 10 only occurred once each but did not fit entirely with any of numbers 1-8. The other 16 charities identified by the study dealt with legacy income in the same way as other income.

Policy	Number of charities	% of legacy policies
1. Legacies are accounted for when receivable	5	3
2. Legacies are included in the SOFA unless they are incapable of measurement	16	11
3. When three factors are met, entitlement is legally enforceable, certainty of receipt is notified and the monetary value can be reliably measured	42	29
4. When there is reasonable certainty of receipt	6	4
5. Entitlement is the earlier of the charity being notified or the legacy being received.	27	18
6. Legacies are accounted for as incoming resources either upon receipt or where the receipt of the legacy is virtually certain, this will be once confirmation has been received from the representatives of the estate that payment of the legacy will be made or property transferred and once all conditions attached to the legacy have been fulfilled.	9	6
7. Entitlement is the earlier of the estate account being finalised or cash received.	5	3
8. Legacies credited in the year in which they are received	19	13
9. Material legacies are recognised when the conditions for recognition under the charities SORP have been met	1	1
10. Pecuniary legacies are recognised following formal notification. Residuary, when the charity interest can be measured. Bequeathed properties: when the charity takes possession.	1	1
11. As other income	16	11

Appendix: Table 3 Grants payable

The table shows policies for disclosure of grants payable and how many charities gave additional information about their treatment of amounts awarded but unpaid at the year end.

	Numbers of charities using approximately this policy.	With additional information on treatment of unpaid amounts
Recognised at date of award	23	
When approved for payment	7	
When decision conveyed to beneficiaries and grantee capable of doing the work	1	
When decision conveyed to beneficiaries and conditions met	38	27
When commitment arises	12	1
Charged when funds paid to recipient	3	
Future Commitments on a discounted basis	1	
	85	**35**

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Appendix: Table 4 Grants and other income receivable

The following are accounting policy notes relating to grants and other income receivable. Most of the policies have only been used by one charity in the sample so no extrapolation to the rest of the sector has been done.

Accounting policy	Number of charities using policy
Receipt deferred to period for which they are expected to be used.	5
Fees for cemetery plots which are sold for future use are carried forward for two years or until those plots are used, whichever is the sooner.	1
Following the grant of a licence to develop on charity land, the payments due over a number of future years have been valued in the balance sheet using a 5% annual discount rate. The reported income arises from the unwinding of the discount as each year passes.	1
The grants received towards the cost of buildings are credited by equal annual instalments to the Statement of Financial activities. The estimated remaining life of the building which is taken as 50 years. The amounts not yet credited in this way are carried forward as long term liabilities	1
Grants and donations towards the cost of buildings are included in the balance sheet as deferred capital grants and are released to match depreciation over the useful life of the buildings.	1
Revenue grants are credited to incoming resources when they are receivable provided conditions for receipt have been complied with, unless they relate to a specified future period in which case they are deferred.	1
Grants where related to performance and specific deliverables are accounted for as the charity earns the right to consideration by its performance. Where income is received in advance of its recognition it is deferred and included in creditors: where entitlement occurs before income being received the income is accrued. Capital grants are receivable as income as soon as they are receivable.	2