

SORP Committee

Minutes of the SORP Committee Meeting of 5 April 2011 (Approved at the May 2011 SORP Committee Meeting)

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Present:

Tidi Diyan
Peter Gotham
John Graham
Pesh Framjee
Chris Harris
Keith Hickey
Noel Hyndman
Ray Jones (Acting Chair)
Lynne Robb
Kate Sayer
Catriona Scrimgeour
Paul Spokes

In attendance:

Nigel Davies, Secretary to the SORP Committee
Joanna Spencer, Accounting Standards Board (for items 2, 3 and 4)

Apologies:

Debra Allcock-Tyler
Laura Anderson, Joint Chair of the SORP Committee
Tris Lumley
Frances McCandless, Chief Executive, Charity Commission Northern
Ireland (observer member)
Carol Rudge
Sam Younger, Joint Chair of the SORP Committee

Item 1: Opening remarks and declarations of interest

1.1 Ray Jones opened the meeting and explained that due to extraordinary circumstances both Sam Younger and Laura Anderson were not able to be present to chair the meeting. In their absence it was agreed he could act as a temporary chair so that the meeting could continue.

1.2 He then invited any declarations of interest to be declared. None were noted.

Item 2: Approval of the minutes and matters arising

2.1 The minutes of the meeting of the 10 March 2011 were considered and were approved with two amendments.

2.2 An additional bullet point should be added to minute 5.12 to state: the next draft of the SoFA should consider how comparability in the analysis of income can be maintained given the switch in funding of charitable activities from grants to contracts.

2.3 The bullet point in minute 5.12 referring to support costs should be changed to read: support costs be analysed separately and disclosed but a consultation question should be put to see whether the sector supports this approach or would prefer simple absorption of support costs without separate disclosure.

Item 3 UK GAAP Consultation

3.1 Ray Jones introduced the discussion of the Accounting Standards Board's (ASB) proposals to change UK Generally Accepted Accounting Practice (UK GAAP) by seeking macro comments. He noted that the response would be from the SORP making body as advised by the SORP Committee.

3.2 The Committee discussed the desirability of the charities SORP and Financial Reporting Standard for Public Benefit Entities (FRSPBE) applying to all three tiers. The Committee was advised that the ASB considered the FRSPBE and IFRS to be incompatible due to FRSPBE's retention of merger accounting and a transaction value option for the valuation of concessionary loans. IFRS1 required that accounting policies fully comply with IFRS for an entity to be able to assert it was preparing its financial statements in accordance with IFRS although a departure for particular matters is justifiable if it provides a more faithful representation. SORP and the FRSPBE would only be best practice.

3.3 Tier 1 would apply where to charities if either their primary business was extending credit and the taking of deposits or they issued publicly traded debt. The exception for small micro credit activities was noted. Also the emphasis on primary business was important because international charities operating micro credit schemes overseas would not be caught by tier 1. It was noted that the stewardship duty on reporting to donors and financial supporters on the charitable activities undertaken differed from the interests of world capital markets where the interest is security and rate of return.

3.4 Considering each consultation in turn, the Committee reviewed the draft response. It was agreed that a covering letter would be valuable highlighting the main points in addition to a detailed question by question response.

3.5 Response to question 1 agreed. The response to question 2 could usefully emphasise that the FRSPBE and charities SORP apply to all three tiers. The response to question 3 might emphasise the need for the Financial Reporting standard for Medium-sized Entities (FRSME) adopting terms for the Statement of Financial Position which accord with company law.

3.6 To question 4 the importance of the primary business being deposit taking might be emphasised and that the charities SORP should apply to tier 1 in so far as its recommendations are not in conflict with European Union (EU) adopted International Financial Reporting Standards (IFRS). It was noted that with the demise of UK GAAP, the requirement to follow a sector SORP for a true and fair view would be lost as FRS 18 Accounting policies would be withdrawn.

3.7 Response to question 5 agreed. The SORP needs to be extended to explicitly deal with incidental micro credit activities where these activities are not the primary activity of the charity. The responses to questions 6 to 10 were agreed. Since question 11 did not have a charity specific context it was agreed that no comment be made.

3.8 The response to question 12 was agreed. It was noted that in the charity context the potential use of subsidiaries to conceal fraud and private benefit such as director remuneration meant it was important that the related parties module require full disclosure of related party transactions with subsidiaries and related parties whether group accounts are prepared or not.

3.9 The responses to questions 13 to 21 were agreed. In discussing question 22 the Committee noted that the future of the UK GAAP Financial Reporting Standard for Smaller-sized Entities (FRSSE) needs to be confirmed. It would not be worthwhile revising the FRSSE thresholds upwards to enable more entities to adopt it if it has a short life. There would be merit in having a FRSME which had lighter disclosure requirements and offered accounting treatment concessions to smaller entities as a longer term solution.

3.10 The responses to questions 23 to 27 were agreed.

3.11 The Committee agreed that:

- **Charities reporting under tier 1 had a dual reporting duty: to world capital markets and to donors and financial supporters.**
- **The covering letter should emphasise the need for charities SORP to apply to all three tiers and for the FRSPBE to apply to tiers 1 and 3, where the FRSPBE was not inconsistent with these tiers or the accounting issue was not considered by tier 1 or 3.**
- **The draft response should be amended as discussed in the meeting.**
- **The module on related parties should be checked to ensure full and appropriate disclosure of related party transactions involving subsidiaries including director and executive remuneration.**
- **The ASB be requested to confirm its plans for withdrawing or updating the FRSSE with the Committee in support of developing a ‘FRSME light regime’ with exemptions in the FRSME for smaller charities.**
- **To facilitate discussion, the order of consideration of later agenda items be changed.**

Item 5: Income Recognition module

5.1 Nigel Davies introduced this draft module. He noted that the major change was the FRSME’s recognition criterion that income is recognised where it is

‘probable that the economic benefits would flow to the charity’ rather than the current SORP criterion of ‘virtually certain’. Probable meant more likely than not and so this may mean that income is recognised earlier and it may require a greater use of judgement by trustees compared to the existing criterion of virtually certain. It was noted that the criterion of probable would not lead to booking regular income from donors received by direct debit or standing order unless the other criteria of income recognition of entitlement and measurement were also met.

5.2 The Committee noted that criteria of entitlement, probable, and measurement applied to all types of income but the new criterion of cost only applied to exchange transactions involving the supply of goods and services. To avoid confusion this criterion should be mentioned with the others but the explanation of it should be located in the section dealing with contract income.

5.3 The Committee discussed the proposed reference to pledges and promises in the context of the new criterion of probable. The existing SORP (paragraph 104) made reference to evidence of entitlement will normally exist when formally expressed in writing. However the context was receipt being ‘virtually certain’ rather than ‘probable’. In practice charities knew whether from an existing relationship with a donor or from experience of the type of fundraising activity undertaken to what extent pledges would follow through to a donation. This experience would inform the trustees’ decision on whether receipt was probable.

5.4 The Committee considered to what extent illustrative examples should be given. It was noted that although examples are useful, the use should be minimised because there was a danger that users of the SORP see the examples as a rule.

5.5 Sections 5 and 6 are a continuation of section 4 and so the text should be merged as a discussion of the general principles for establishing entitlement to donations, grants and legacies. The separation of income from donations and similar gifts from income earned through contracts was useful. The distinction between a trust law restriction which does not affect recognition and other terms and conditions, contractual and non-contractual which do, is also useful. The sections 7 to 9 which refer to terms and conditions should be merged.

5.6 On occasion the conditions of with multi-year grants, terms can be inferred as part of the application process, for example the agreement of a budget plan for the grant period. Reference to such terms might usefully be added.

5.7 In considering legacies, the Committee noted that the key criterion for recognition was entitlement. Although probate established a basis for a claim against the estate but it was at best an indication of a likely receipt. Probate was not of itself a guarantee of a receipt. Recent case law had shown that wills can be contested and so communication of payment or notification of distribution will provide greater certainty. Practice may vary with larger charities having an aged debtor analysis or ‘pipeline’ of legacies which are monitored through to small charities with very few legacies. Committee members shared their experience and concluded that in most instances a charity was aware of the minority of legacies with many receipts received without much prior notice.

5.8 The experience of Committee members regarding the adjustment or discounting of legacy debtor valuations varied. In some cases aged debtors were adjusted for the probability of settlement, especially if contested, and for fluctuations in the valuation of the legacy due to changes in asset prices. Others awaited final notification of settlement and then valued on the basis of notified or anticipated settlement values without discounting. If recognition was attempted at probate there may be greater problems in reliably measuring the debtor due to the potentially longer delay between valuation and receipt. In some instances by offering an indemnity to the Estate this facilitated earlier settlement but this did have a risk that a settlement would be disputed leading to partial or complete repayment.

5.9 It was noted that IFRS sought to identify embedded credit arrangements and separately show such financing transactions. Since legacies are a gift and so a non-exchange transaction it was illogical to apply this approach. Neither are legacies a form of financial instrument analogous to a trade debtor. However discounting may be appropriate to reflect the effect of delayed settlement on purchasing power. In any event the unwinding of a discount is an adjustment to income and not interest.

5.10 Similarly where the valuation of a legacy debtor is impaired due to a change in Estate valuation or as a result of a contested will this should be treated as an adjustment to income because the legacy is a gift and not a type of exchange transaction. The commercial treatment of the impairment of trade debtors as an expense would be inappropriate, as a reduction in the expected settlement of a legacy is not a form of charitable expenditure, nor is it analogous to cost of goods sold.

5.11 The IASB in considering proposed changes to revenue recognition (21 to 23 March) had tentatively decided that as a practical expedient an assessment as to whether there is a financing component to a transaction need not be undertaken if settlement is within 12 months of the transaction date. This gave further support to the proposal to not require discounting to be applied if settlement is within 12 months. Thus the transaction value is taken as the fair value.

5.12 The Committee noted the research conclusions (March meeting) about the variation of treatment of life memberships. The non disclosure of the basis for recognising life memberships rather than the observed variation in practice was the main concern. Very often income from life memberships may not be material and so prescribing a method may be disproportionate.

5.13 The Committee noted that a sector practice of netting off an insurance settlement against the impairment or expense of an insured loss was common place. However this practice was not permitted by the FRSME or in EU adopted IAS37. Although a practical expedient which reduces reported income, and so facilitates in some cases smaller charities not to trigger the accruals or audit requirement, there is no theoretical justification for the practice. Since the SORP must comply with standards the proposal to retain an option of netting off was rejected.

5.14 The Committee concluded that:

- **A single set of criteria for income recognition can apply because the criteria proposed are not inconsistent with the FRSE.**

- **The heading of the income recognition criterion of ‘certainty’ be replaced with ‘probable’ throughout.**
- **The meaning of probable should be clearly explained early in the text.**
- **The cost criterion should be explained under contract income.**
- **The SORP 2005 text on the treatment of deferred income should be reinstated.**
- **Reference to inferred terms from the application process for grants should be added.**
- **The reference to fair value being settlement value should include consideration of discounting by inflation to allow for a decline in purchasing power where settlement of a legacy is delayed with the unwinding of the discount adjustment shown in legacy income.**
- **A reference to treating an impairment of a legacy debtor as an adjustment to income and not an expense should be added.**
- **Donated goods and services should be a separate module as not all charities receive them.**
- **Discounting of exchange transactions is not required unless settlement is delayed more than 12 months.**
- **The recommendations on life membership should be changed to require a disclosure in the accounting policies of an appropriate method for recognising income from life memberships without being prescriptive of the method to be adopted.**
- **The treatment of insurance claims should accord with the FRSME.**
- **The SORP Secretariat give consideration to an annex being added to the modular SORP to highlight significant changes in approach due to the switch to the FRSME and the provision of illustrative examples for particular points as a guide to preparers of financial statements.**

Item 6: Consideration of the liability recognition module was deferred due to time constraints.

Item 7: Funds received as intermediary

7.1 Nigel Davies introduced this paper and noted that the underlying approach proposed was unchanged from SORP 2005 with the clear distinction being drawn between funds held as agent and those held as principal. Funds held as agent are disclosed whereas funds held as principals are included within the financial statements and disclosed.

7.2 Committee members noted that since SORP 2005 was written there was a growth in consortia arrangements where one charity acted as the lead in handling the contractual arrangements and distributing funds to other members of the consortia. There was a need to clarify the accounting for these arrangements and this module may be the most appropriate for setting out an accounting treatment.

7.3 The Committee noted that many small faith charities collected funds as agent by way of special collections or facilitated gifts to be made by individuals anonymously to other members of the congregation who are in need. Charities needed to also consider any commercial risk from acting as agent and having some

form of responsibility for these funds. The module could usefully draw on existing Charity Commission operational guidance on the role and responsibility of trustees in these circumstances. Also it should outline how the terms ‘agent’ and ‘principal’ related to the terms in existing use of ‘custodian trusteeship’ and ‘conduit funding’.

7.4 The Committee concluded that:

- **Committee members Pesh Framjee and Kate Sayer be invited to provide additional text on the accounting for consortia and similar arrangements involving a lead charity.**
- **The module should clarify that funds held as agent normally fall within the purposes of the charity holding those funds.**
- **The module might usefully draw on existing HMRC guidance which set out how certain funds are ineligible for gift aid as they are effectively conduit payments to benefit particular individuals.**

Item 4: Public Benefit Entity Standard Consultation

4.1 Ray Jones introduced the discussion of the Accounting Standards Board’s (ASB) proposals to issue a Financial Reporting Standard for Public Benefit Entities (FRSPBE) as part of the proposed changes in UK Generally Accepted Accounting Practice (UK GAAP). The Committee agreed to consider the draft response to each of the consultation questions in turn.

4.2 To question 1 the Committee agreed that the definition of a public benefit entity (PBE) was adequate. The Committee welcomed the proposal that equity was permitted if it supported the primary objectives of the entity as this may permit other forms of social enterprise to be categorised as a PBE.

4.3 The draft response to questions 4 to 6 were agreed. In considering the response to question 7 on impairment, the Committee noted that value in use may require different approaches and so welcomed the ASB’s proposal that alternate methods be permitted to depreciated replacement cost. The response therefore should simply concur with the ASB’s proposal.

4.4 In considering question 8, the Committee noted that the statement in the appendix to section 6 that: ‘an undertaking to provide cash made on the expectation of future income will not give rise to a liability if the entity cannot be required to fulfil it if the future income is not received’ appeared at odds with current practice and SORP 2005. Whilst such terms are common practice they are in practice seldom invoked due to the need to maintain confidence in the grant maker and to safeguard its reputation it was unlikely a grant maker would renege on a grant for this reason. Although not contractual it was unrealistic to withdraw from such constructive obligations without potentially damaging confidence in the integrity and capacity of the grant maker.

4.5 The key with grants was that it was the recipient’s view that created the constructive obligation because it is their knowledge of the grant and their expectation that it will be met that creates the obligation. The recipient will be fully expecting to, and is capable of, fulfilling any grant conditions and so unless the grant is a

performance related grant the full amount is expected. There was a danger this guidance would lead to cash accounting for grants based on the time of payment and the practice of matching where recognition could be timed at the trustees' discretion by judicious wording rather than reflecting the substance of the arrangement and the probability of payment.

4.6 Although the research report on the SORP roundtables had identified a great fondness for matching amongst auditors and practitioners, this practice was not supported by accounting standards. The response should be amended to add a recommendation that this advice be removed due to the likelihood to encourage cash accounting and matching. In practice from members' experience large grant makers managed the income risk through systematic planning and profiling of grants and through their reserves.

4.7 In considering question 9 and the treatment of incoming resources from non exchange transactions, the Committee noted that gifts of donated goods fell into three categories: gifts for the charity's own use, gifts for distribution and gifts for conversion into cash. The last category was unique to the charity sector. The Committee was advised that the ASB's Committee for Public Benefit Entity's (CAPE) had considered the treatment of donated goods by the International Public Sector Accounting Standards Board (IPSASB) in its standards. However the Committee noted that government did not receive gifts of goods for conversion into cash but rather for its own use as functional assets or distributable items. CAPE had therefore erred in seeing IPSASB's standards as a precedent for goods donated for sale.

4.8 The Committee noted that under the application of gift aid to such donated goods, the charity had no title to the gift and acted as agent to sell the item. The donor then certified that the cash received was indeed a donation and so eligible for gift aid but the amount of the donation was only accepted for gift aid upon sale. It seems anomalous for there to be one treatment to be required by the ASB and another by HMRC. In this instance for larger charities there was no stock and indeed the process of converting a donated item into cash was not really a trade for gain analogous to stock purchased for sale but a conversion process. To show such donated gifts as income from trading activities would mislead the public and donors since donors had made a gift of goods and expected to see that recognised in the financial statements.

4.9 On pragmatic grounds it was difficult to see how a holding of stock would inform users of the accounts. Also the valuation approach needed to be robust due to the requirements of auditing standards and so there would be a significant cost burden resulting from stock takes, audit verification of stock, and a robust valuation process. The response to question 8 should reflect the wider issue about whether the analogy to commercial stock drawn by the ASB was the right one.

4.10 In considering question 10 the Committee noted that the points discussed earlier about legacies and the timing of entitlement should be reflected in the response. The appendix to section 7 asserted that the criteria for recognition 'will normally be met following probate' but this was not the case. Instead the emphasis should be on notification of an intention to make a payment from the estate and the wording changed to 'may be met following probate'.

4.11 Although some charities may have a methodology for valuing general volunteers in addition to valuing volunteers providing professional services but few did. Hence the phrase in paragraph 7A.10 'it may however not be possible' should be changed to 'normally it is not possible'. The current wording appeared to create an onus to valuation of general volunteers.

4.12 The Committee agreed with the responses to questions 11 and 12. To question 13 an additional point should be made that guidance on interpretation of the indicators of control should be left to sector SORPs until such time as the IASB have considered control in the Phase G, the Interpretation of the Framework for Not-for profit Entities. The answer to question 14 was agreed.

4.13 The Committee did not agree that an option to net off the settlement of insurance claims against a related loss should be sought as an exception to the FRSME.

4.14 The Committee concluded that:

- **The draft response should be amended as discussed in the meeting.**
- **The revised draft should be circulated for any additional comments prior to review by the SORP making body and submission to the ASB.**

Item 8: Dates for Committee meetings

8.1 The meetings scheduled for the remainder of 2011 are, May, June, July, September, October, November and December.

Item 9: Any other business

9.1 There being no other business the meeting closed.