SORP information sheet 2

Statement of principles for financial reporting interpretation for public benefit entities

1. Background

1.1 The Charity Commission and the Office of the Scottish Charity Regulator are the joint SORP-making body and as such are required by the Accounting Standards Board's (ASB) code of practice to keep the SORP under review.

1.2 As part of its work, the SORP Committee may issue "Information Sheets" which seek to clarify the application of the SORP or particular recommendations contained with the SORP. Information Sheets do not amend the SORP and are advisory in nature and are released to assist preparers and auditors of accounts in applying the SORP's recommendations.

1.3 In June 2007 the ASB published its 'Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting' (the Interpretation). The Interpretation sets out the principles that the ASB believe should underlie the preparation and presentation of general purpose financial statements of public benefit entities including charities.

1.4 The primary purpose of the Interpretation is to provide a coherent frame of reference to be used in the development of SORPs or other specific guidance for public benefit entities and to assist preparers and auditors faced with new or emerging issues.

1.5 Whilst the Interpretation does not override the requirements of existing accounting standards and SORPs, as part of its work, the SORP Committee considered the Interpretation, at its October 2007 meeting, to ensure the Interpretation's key principles are consistent with the recommendations contained in SORP 2005. As noted in paragraph 61(d) of SORP 2005, the Interpretation was at a discussion document stage when SORP 2005 was published.

1.6 The SORP Committee concluded that there are no fundamental issues which require addressing by a revision to the current SORP at this stage. However, it was felt that the results of the SORP Committee's consideration, set out as an Information Sheet below, would be helpful to preparers of accounts and auditors.

1.7 It should be noted that Information Sheets do not form part of the SORP, nor are they reviewed by the ASB and therefore do not carry the authority of the SORP.

2. Index of topics:

3. Objective of financial statements (Interpretation paragraphs 1.1 to 1.10) and defining class of user (Interpretation 1.11 to 1.16)

3.1 SORP 2005 (paragraph 10) recognises the accountability and stewardship role of financial reporting but does not mention specifically its role in economic decision making. SORP 2005 recognises a variety of users of financial information including donors, beneficiaries and the general public, however, unlike the Interpretation does not identify a defining class of user.

3.2 The Interpretation provides a detailed analysis of the objective of financial statements noting that many people may have an interest in the financial information of an entity. The Statement of Principles, on which the Interpretation is based, puts forward, in relation to profit-orientated entities, the rebuttable assumption that financial statements focus on the interests that investors have in the reporting entity's financial performance and financial position and in so doing focuses on the common interest that all users have in these matters.

3.3 Public benefit entities, including charities, have no such investors and therefore the Interpretation puts forward funders and financial supports as being similar to investors in profit-orientated entities in terms of their information requirements.

3.4 SORP 2005 deals with the question of the objective of financial statements in less detail that the Interpretation and offers no conclusion as to a defining class of users. The Interpretation deals with an issue not fully addressed by the SORP and therefore assists preparers and auditors deal with an emerging issue that will require consideration by the SORP Committee in developing any new SORP.

4. Multi-period liabilities (Interpretation - paragraphs 4.29 to 4.34)

4.1 SORP 2005 noted that certain grants may contain specific conditions that closely specify a particular service to be performed where the conditions for payment are linked to the performance of a particular level of service or units of output delivered. Often the grant maker will have negotiated the services to be provided to it or its beneficiaries. The SORP refers to such grants as performance-related grants and they are recognised as resources expended to the extent to which the specified services have been provided.

4.2 Under SORP 2005 grant liabilities may also arise as a result of a constructive obligation. Where a multi-year funding agreement has been entered into and a specific funding commitment made to a grant recipient then a liability results and the conditions attaching to the grant will determine whether a liability is recognised for the full funding commitment.

4.3 In developing the Interpretation the ASB's Committee on Accounting for Public-benefit Entities (CAPE) gave considerable thought to this issue. The SORP's approach is consistent with that of the Interpretation.

4.4 The Interpretation confirms that a general or policy statement of an intention to provide goods and services to beneficiaries in accordance with objectives will not necessarily give rise to a liability. The accounting treatment of specific commitments depends on whether:

- The obligation is such that the entity cannot realistically withdraw from it;
- The commitment has been communicated to the other party; and
- The commitment is performance related.

The Interpretation states that where the commitment, giving rise to the obligation, is not performance related a liability arises at the time the commitment is made.

5. Residual interests and designations (Interpretation - paragraphs 4.41 to 4.44)

5.1 Residual interests are disclosed as "funds" in charity accounting and are arrived at by deducting all of an entity's liabilities from its assets. The Interpretation recognises there may be different classes of residual interest that require disclosure, in particular, where resources are held for a particular purpose (a restricted fund) this creates a separate class of residual interest in the balance sheet.

5.2 The nature of the residual interest should be clear from the disclosure in the accounts. The Interpretation, however, goes a stage further than the existing SORP by stating that where, in the event of a winding-up, the ultimate interest would be required to be distributed in a particular way then that fact should be disclosed. Charity law would require a distribution on winding-up to reflect the nature of the restriction represented by a restriction or special trust. Whilst uncommon, some dissolution clauses in governing documents of charities may be more prescriptive than the charity law requirement and in such cases, to be consistent with the Interpretation, an additional disclosure would be required by a minority of charities.

5.3 The Interpretation, however, does not regard designations as creating a separate class of residual interest. This is consistent with the SORP where designations are defined as being part of unrestricted funds earmarked for a particular project. The designation has an administrative purpose only and does not legally restrict the trustees' discretion to apply the fund.

5.4 Paragraph 325 of the SORP reminds trustees that where part of the unrestricted fund is earmarked then this intention to expend funds in the future is not recognised as a provision but may be recorded by setting up a designated fund. The SORP does not create a requirement to set-up designations and is silent on how designations are disclosed apart from reminding trustees that designations remain part of the charity's unrestricted funds.

5.5 Designations were first introduced into the SORP to help explain that funds disclosed within the balance sheet should not be equated with funds immediately available for expenditure as they may have been "earmarked" for a particular purpose. Designations should, under the SORP, also be quantified and explained within a charity reserves policy (paragraph 55) – this was an attempt by SORP to help ensure designations were not used purely as a window dressing technique.

5.6 The Interpretation concludes that designations reflect no more than management intention and correctly points out, as does SORP, that a separate class of residual interest (a fund) is not created. The Interpretation is however more specific and states designations should not lead to the recognition of a transaction in the financial statements (paragraph 4.44). Such information could be disclosed in the notes to the accounts but would more normally be disclosed in the accompanying information (i.e. Trustees Annual Report in the case of a charity).

5.7 The SORP does not create a requirement for designations to be recognised within the primary statements and the SORP is clear that designation has an administrative purpose only, and does not legally restrict the trustees' discretion to apply the resources represented by the designation. The explanation of designations required within reserve policies takes us a long way towards the approach provided within the Interpretation.

5.8 The SORP Committee had considered these issues in the context of the development of the 2005 SORP. The Committee has taken the view that designation provided useful information helping users understand the funding position of a charity. It has also been pointed out that there is no legal prohibition on providing additional information within the separate categories of funds identified by the balance sheet and is not convinced, at this stage, that the identification of a designation within a particular fund would be construed by users of accounts as either resulting from a transaction or as creating a separate class of residual interest.

6. Donated services (Interpretation - paragraphs 4.47 to 4.51)

6.1 The issues surrounding the recognition of the contribution of volunteers in charity accounts has been the subject of sector debate for a number of years. The Interpretation confirms that where volunteering, has an economic impact on an entity that impact should be reflected in the accounts but highlights that in practice it may not be possible to measure some services with sufficient reliability and consequently such services should not be recognised.

6.2 If reliability of measurement issues can be overcome then recognition would take place provided the charity would otherwise have purchased the service (evidence of economic contribution). Under this approach a charity would need to demonstrate that the services provided to the charity would be purchased if volunteers were not available.

6.3 The SORP also recognises that donated services should be recognised where the benefit (economic contribution) is reasonably quantifiable and measurable. The SORP concludes that these tests are likely to be met where the service is provided by an individual (volunteer) as part of a trade or profession but excludes "general" volunteers on the basis that their contribution cannot be reasonably valued in financial terms. Whilst the Interpretation does not over-ride a SORP, and the underlying principle is similar, the Interpretation places emphasis on whether the service would be purchased in the absence of volunteers whilst the SORP looks at whether the service is provided in the course of a trade of profession and excludes the valuation of "general" volunteers.

6.4 In relation to other services or facilities donated to a charity (for example, free advertising, office accommodation etc) the SORP would again require recognition if the benefit to the charity is reasonably quantifiable and measurable. Again, this approach is not considered inconsistent with the principles of the Interpretation.

7. Grants for financing capital projects (Interpretation - paragraphs 5.32 to 5.37)

7.1 The Interpretation states that grants and donations should be recognised as gains unless there are conditions to be met. Where conditions are substantially or virtually certain to be met the gain should be recognised.

7.2 The Interpretation points out that a repayment condition applying to a capital grant, in the event of a future sale of the asset, would not prevent recognition where the decision to sell was within the reporting entity's control.

7.3 Whilst the Interpretation recognises that a capital grant (a grant to finance a capital project, for example, the acquisition or construction of a tangible fixed asset) can represent a subsidy there is no mention of a deferral of its recognition although if the gift establishes an interest (presumably for the donor) in the residual interests then the transaction should be treated as a capital contribution.

7.4 The approach put forward by the Interpretation is seen as consistent with SORP 2005.

7.5 It is important to note that where the Interpretation deals with "capital contributions" (see paragraphs 4.52 to 4.55 of the Interpretation) that this term includes only transactions that establish a financial interest (a right to participate) in the residual interest (funds) of an entity. Charities are unlikely to receive capital contributions of this type as transactions with donors and other funders, including the receipt of capital grants (see 7.3 above) or gifts of endowment, generally create a gain for the charity that is recognised within the Statement of Financial Activities. The SORP does not provide recommendations on accounting for "capital contributions" received as they are unlikely to arise in the context of charities.

8. Accounting for business combinations (Interpretation - paragraphs 8.10 to 8.14)

8.1 Despite the direction taken by International Financial Reporting Standards, the Interpretation continues to recognise that an amalgamation of two or more reporting entities can take a number of different forms. The Interpretation points out that the fact that a business combination involves public benefit entities does not in itself influence whether the business combination is accounted for as an acquisition or a merger. This is again consistent with the accounting options allowed by SORP.

8.2 Helpfully the Interpretation also explains that under acquisition accounting where the acquisition is carried out at nil or nominal consideration the excess of fair value of the assets acquired over the fair value of the liabilities assumed should be treated as a gain and recognised as income (or a loss where net liabilities are acquired). The SORP is currently silent on this matter. This approach is consistent with the accounting advice currently provided by the Commission with the exception that restricted funds that constitute a special trust would normally be dealt with by a transfer of trusteeship and the accounting would reflect the legal nature of such transactions.

8.3 The Interpretation clarifies that the excess of the fair value of assets over liabilities acquired represent a gift of the value of one 'business' to another that should be recognised as income. In charity accounting the effect is likely to be that any 'negative goodwill' arising under FRS 10: 'Goodwill and intangible assets' in context of an acquisition by gift (or nil consideration transfer) would be recognised as income and not deferred.