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New Charities SORP published for comment

The long awaited new Charities SORP – expected to become "SORP 2015" has at last been published for comment.

The new standard will affect all charity accounts in the UK from 2015 onwards, apart from small non-company charities under £250K income which have the option of just producing receipts and payments (R&P) accounts. It will mark some fundamental changes in charity accounting as UK accounting standards, and the SORP itself, move much closer to IFRS (International Financial Reporting Standards).

This Kubernesis Bulletin is issued on the day that the draft is published (9 July 2013) – ***it only offers a quick first look***: not a detailed analysis. It briefly reviews some of the changes, but using a series of questions and answers *it seeks to explain why this new standard is so important* for everyone concerned with charity accounts.

We start from the most basic questions – those who understand the background may wish to skip ahead.

Q1: What is a SORP?

A *Statement of Recommend Practice* or "SORP" is an accounting standard which sets out the specific rules for accounting in specific industry of type of organisations. There are currently a number of SORPs in the UK (all of which are having to be updated for the latest accounting changes). However, the Charities SORP is the most detailed of these – the whole framework of charity accounting rests on the SORP.

Q2: Why is it so important if it only a statement of "recommended" practice?

The name is somewhat misleading. In the case of the Charities SORP it is directly cross-referenced by regulations under the Charities Act 2011 (for charities established in England and Wales), and the Charities and Trustee Investment (Scotland) Act 2005 (for Scottish charities) and the charity accounting regulations expected soon in Northern Ireland will almost certainly take the same approach. The rules are slightly different for charitable companies, but under company law, the accounts of a company must be prepared to give a true and fair view, taking account of relevant accounting standards, and if the company is a charity, the Charities SORP is a relevant standard.

So in practice most aspects of the SORP are compulsory (except for smaller charities using R&P accounts).

Q3: When does the new SORP have to be used?

It will take effect from accounting periods (financial years) beginning on or after 1 January 2015. So if your charity has a 31 December year end, the first year directly subject to the new rules will be the year ending 31 December 2015 (accounts you will be preparing in spring 2016). If your charity has a 31 March year end, the first year subject to SORP 2015 will be the year ending 31 March 2016.

However that does not mean you can wait until 2016 before thinking about the new SORP because:

- once the new SORP is used, the *prior year's figures* will also have to follow the new rules – so for most charities the 2014 accounts will be produced under SORP 2005 and then the figures will have to be adjusted to the SORP 2015 basis (if this leads to changes) so they can be used as comparatives in the 2015 accounts – so, in practice, you could be affected any time from 1 Jan 2014 onwards
- it will also be necessary to plan well ahead for any changes to accounting systems or internal procedures so that figures can be correctly produced in SORP 2015 when required.

Q4: How do I get a copy of the new draft SORP?

See www.charitysorp.org – a special consultation website established by the Charity Commission and OSCR. It is available in separate modules – or the whole SORP can be downloaded as a single document (200 pages).

Q5: But is this only a consultation?

At this stage, the SORP Committee has simply published a *consultation draft* of the new SORP. Details could still be subject to change – it is not yet a formal standard to be followed. But by getting involved at this stage you may wish to comment on any aspects where you are unhappy.

The consultation runs from now until 4 November 2013. After that, the SORP Committee will review the comments, make what changes it feels necessary, go back to the FRC, and then the final version of SORP 2015 will be issued in mid-2014.

So summer/autumn 2013 is the *last chance to comment* on some important changes to charity accounting which will certainly last for many years. If SORP 2015 lasts as long as SORP 2005, it could be 2025 before there is a further update!

Q7: Why a new SORP now – what's wrong with SORP S005?

The current Charities SORP – known as SORP 2005 – has generally worked well. It has lasted a good deal longer than the previous versions (SORP 1995 and SORP 2000). But the main reason for the change was *to* address *fundamental changes* in UK accounting standards *as UK accounting requirements converge with IFRS.*

Q8: Who produces the Charities SORP? Who decides the requirements?

Accounting standards in the UK have until recently been the responsibility of the Accounting Standards Board (ASB) – nowadays the ASB has become part of the Financial Reporting Council (FRC). High-level accounting standards which affect all types of entities, such as the new FRS102 (see below) are directly produced by the FRC. In the case of SORPs, the FRC approves appropriate industry bodies to prepare them, though they still have to go back to the FRC for approval.

In the case of the Charities SORP, the FRC has appointed the Charity Commission for England and Wales (CCEW), and the Scottish Charities Regulator (OSCR) jointly as the SORP-making body. CCEW and OSCR then established a SORP Committee comprising representatives of the charity sector, accountants working specially with charities, and staff from CCEW and OSCR themselves. The current SORP Committee was formed in 2006 soon after the last SORP (SORP 2005) was finalised – so they have had around seven years to work on the latest draft. Initially they undertook research on broader issues with those who prepare and use charity accounts. More recently they have focussed on detailed drafting of the new SORP.

Q9: Why are UK accounting standards following IFRS – won't this be a problem for charities?

Under EU law, it has been a requirement since 2005 for listed companies' accounts to following international standards (IFRS). This has the advantage that accounts of multinational companies can be easily compared from one country to another.

But until now, the option of following IFRS has not been available for charities because of a different legal framework – charity accounts are based on UK Generally Accepted Accounting Practice (UK GAAP). Most companies which are not charities have had the choice of following IFRS or UK GAAP.

However, this has created confusion and uncertainty with two different accounting frameworks – IFRS and UK GAAP – both in use in the UK. Following various consultations, the ASB agreed some years ago that there would gradually be a process of convergence under which UK GAAP is amended to follow IFRS as closely as possible. A number of small changes have already been made, but the process will be completed in what has been called a "big bang" on 1 January 2015. From that date, UK GAAP and IFRS become almost the same – at least in terms of underlying principles.

Charity accounts thus have to follow this path, which requires a new Charities SORP – otherwise charity accounts would but out of line with general standards and the accounts of other entities.

Q10: So do we know *in what ways* UK GAAP is changing to converge with IFRS?

Yes, this is now agreed, as a result of the new standard FRS102 published by the FRC in March 2013. FRS102 is called simply *The Financial Reporting Standard applicable in the UK and Republic of Ireland* – it replaces numerous former accounting standards (FRSs and SSAPs) dealing with specific accounting issues. FRS102 only becomes compulsory for accounting years starting on or after 1 January 2015 – but it has been issued in good time, to allow for preparatory work: for example, in industries like charities where SORPs need to be revised.

In many respects, at 334 pages, FRS102 is actually a good deal simpler than the former standards it replaces. In particular, the FRC decided not to force UK organisations to follow the whole of IFRS, but they based FRS102 on an international standard known as the "IFRS for SMEs" (small and medium entities).

However, the FRC has retained the FRSSE (Financial Reporting Standard for Smaller Entities) which simplifies the requirements for "smaller entities". This can be used by organisations which are small under company law definitions (not over £6.5M income, £3.25M assets or 50 employees – exceeding any two of these criteria means a company is no longer "small"). In practice there are fewer than 2000 UK charities over the FRSSE limit, so in for most charities the revised FRSSE rather than FRS102 can be used as the basis..

The FRSSE has also been updated from 1 January 2015 so that major principles tie up with FRS102. (The new FRSSE has not yet been issued in full, but the changes are set out in FRS100 – this is the standard which explains the accounting framework behind FRS102.)

Q11: I can just about understand the SORP, but are you saying I must also understand FRS102/FRSSE?

Fortunately, most charities will not need to worry about the detail of FRS102 or the FRSSE – at least not on a day to day basis – because as far as possible the new SORP is written as an inclusive document which covers most of the broad accounting principles from these standards (as applied to charities).

However, there are some differences in the SORP between smaller charities (whose underlying basis will usually be the FRSSE) and larger charities following FRS102. In a number of places the SORP allows for two different approaches, depending on whether the charity is subject to FRS102 or FRSSE.

However, notes to the accounts will need to refer to both the SORP and the general purpose standard – for example, from 2015 many charities' accounting policies will probably say:

- These accounts are prepared in accordance with the standard *Accounting and reporting by charities: statement of recommended practice* (Charities SORP 2015) and with the *Financial Reporting Standard for Smaller Entities* (FRSSE) effective from January 2015.

Q12: Does this mean we will have to use IFRS terminology in our accounts from 2015?

If the recommendations of the draft SORP are confirmed, the answer to this is *no.*

We had wondered if the SOFA and Balance Sheet would be replaced by the IFRS terms *Statement of Comprehensive Income* and *Statement of Financial Position*. But from the draft published today, it is clear that the SORP Committee favours keeping the existing terms – so the primary statements in a set of charity accounts will continue to be:

- the *Statement of Financial Activities (SOFA)* and
- the *Balance Sheet*.

Likewise, the SORP Committee is recommending charities to keep to terms such as "debtors" and "stocks" rather than the IFRS terms "receivables" and "inventories".

All this is permissible because FRS102 (and the FRSSE) do not insist on specific terminology – so long as the financial statements are clear and follow the appropriate underlying principles, terminology can be used which is most appropriate for readers.

However, whilst it may be attractive in the short term to keep to the current terms, it is not clear how far commercial firms will follow the terminology of FRS102 more directly. If they do, after a few years, charity accounts will be using what will be seen as old fashioned terminology compared to other businesses.

Q13: Will the SOFA and Balance Sheet still look like they do under SORP 2005?

Based on a very quick initial review, our assessment is that the SORP Committee does not appear to be introducing any significant changes the format of a charity Balance Sheet as compared to SORP 2005.

A few changes are proposed to the SOFA, but they are less extensive than we anticipated. The SOFA will retain the multi-column format with unrestricted funds/restricted funds/endowment funds. Similarly the SOFA will continue to have lines for inter-fund transfers and for gains and losses on revaluation of fixed assets.

But the main headings will change from "incoming resources" and "resources expended" to *Income and endowments* and *Expenditure.* The breakdowns of SOFA headings within this will also change slightly, as they did with the move from SORP 2000 to SORP 2005. Governance costs will no longer need to be shown as a separate expenditure heading.

We will issue further guidance in due course on the changes of SOFA headings, but it would be a mistake to see SORP 2015 as being purely about *layout* – the most significant changes relate to *measurement* – how figures on the SOFA and Balance Sheet are determined.

Q14: Are there any fundamental changes?

Possibly the biggest issue – which potentially affects all figures in the SOFA and Balance Sheet – is that the draft SORP 2015 reflects the IFRS principle of accounting at *fair value*. This means, for example, that (subject to certain exceptions), assets and liabilities are stated at a fair value of what they would be worth to a third party dealing with the charity at arms length.

This does not mean, however, that everything has to be revalued. A charity can decide to continue to show tangible fixed assets at historic cost. But if it decides to revalue one building, for example in anticipation of selling it, it must take the same approach with all similar buildings.

There was a lot of debate in advance that fair value accounting would force charities to invest huge amounts of effort, for example, in valuing stocks of donated goods held for resale in charity shops. However, whilst this is still the preferred approach, the draft SORP 2015 recognises that many charities may not have the mechanisms to do this, and in that case the donated goods are recognised only as they are sold.

However, financial assets and liabilities must always be recognised at fair value, and the draft SORP includes a major new module on "Accounting for financial assets and liabilities". It points out, for example, that a long term debtor (where the charity does not expect to receive repayment for over a year) may need to be adjusted to allow for the loss of interest in the meantime.

Q15: Any new notes or disclosures?

Many issues will need changes to the wording of notes to the accounts to reflect new approaches. The requirements on related party transactions (with trustees and connected persons) are tightened up considerably. In many cases the SORP will also now require explicit disclosure of senior staff salaries if they have significant management influence (rather than just the numbers of staff in each £10K band above £60K income). However, this is one of the areas where questions are explored in the consultation, so the details could change.

Q15: What about the "modules" of the new SORP?

As explained, the new SORP takes a "modular approach" so charities only have to refer to those modules which apply to their situation. But great care will be needed to ensure all relevant modules are considered. Several issues which were only considered very briefly or not at all in SORP 2005 now have a whole module!

There are 14 "core modules" which potentially apply to all charities and a further 15 modules covering specific situations. Major new modules in the second list include:

- *Total return (investments)*
- *Accounting for social investments*
- *Charities as subsidiaries*
- *Charity mergers.*

Q16: How easy is it to read?

Based on an initial review of certain sections only, we feel the language is for the most part a good deal clearer than SORP 2005 and will be easier for non-accountants to follow. Paragraphs are generally shorter and the use of headings and sub-headings seems clearer. There are good cross-references between sections.

There is also clearer distinction between essential issues where the SORP uses "must" and other aspects which are simply recommended – and the modular structure will also make it easier to use.

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