

CONSULTATION ON WITHDRAWAL OF THE CHARITIES SORP (FRSSE) AND DRAFT UPDATE BULLETIN NO 1

Charity Commission/OSCR Joint-SORP-Making Body Consultation – June 2015

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1. About myself

- 1.1 I am Professor of Charity Studies and former Leader of the Centre for Voluntary Sector Research at Sheffield Hallam University. I am also course leader for the University's MSc in Charity Resource Management which can enable students to achieve the ICAEW Diploma in Charity Accounting and/or the ACIE Charity Accounting Certificate.
- 1.2 Over the last 20 years I have led a wide range of research – in some cases with colleagues from other universities – on issues of charity regulation and accounting. Much of this has been focussed on small/medium charities – generally those subject to independent examination or at the smaller end of the audit band.
- 1.3 My work has spanned all three UK jurisdictions, and I am also currently involved as a member of the working party advising the Charities Regulation Authority (in Ireland) on the preparation of charity accounting regulations under the (Irish) Charities Act 2009. My research has included a major study for the Charity Commission for England and Wales (CCEW) on public benefit reporting in trustees' annual reports¹ and I have also led research for the CCAB on the possibility of international standards for financial reporting by not-for-profit organisations². I am also the author of a book which is widely used as an introduction to charity accounting by smaller charities.³
- 1.4 Outside the university I also act as professional adviser to a number of charities, primarily on accounting and regulatory issues, through The Kubernesis Partnership LLP and support a number of accountants by providing a forum for discussion of technical issues in charity accounting. I also act as independent examiner – including some charities which have relatively complex accounts whilst falling within the IE band.

¹ Morgan, GG & Fletcher, NJ (2011). *Public Benefit Reporting by Charities: Report of a Study Undertaken by Sheffield Hallam University on behalf of the Charity Commission For England And Wales* (RS25)

www.gov.uk/government/publications/public-benefit-reporting-by-charities-rs25

² Crawford, L; Morgan, GG et al (2014). *International financial reporting for the not-for-profit sector: A study commissioned by CCAB - Final Report* www.ccab.org.uk/documents/IFRNPO-FullReport-Final-07022014.pdf

³ Morgan, GG (2014) *The Charity Treasurer's Handbook* 4th edn (London: Directory of Social Change)

2. Applicability of Response and Terminology

2.1 In this document I am responding to both consultations issued by the joint SORP-making body, i.e.

- Invitation to Comment – Withdrawal of the Charities SORP (FRSSE)
- Invitation to Comment – Draft Update Bulletin 1

2.2 However, in order to comment meaningfully on the impact of these proposals, I feel it is important to consider *four separate bands of charities* in terms of the *current* accounting requirements.

2.3 I will refer to the following bands of charity accounting requirements. For clarity I mention the current thresholds in England/Wales (EW) and in Scotland (SC) – though my comments take on board that the new SORP will also apply in Northern Ireland and the Republic of Ireland once new regulations take effect. (Also, for simplicity I am only mentioning income thresholds though I realise assets and employees are also relevant in some cases.)

- Band 1: Charities eligible to prepare receipts and payments (R&P) accounts (up to £250K income for non-company charities in EW & SC).
- Band 2: Charities required to prepare accruals accounts in accordance with SORP but taking account of the simplifications permitted for charities below the audit threshold (up to £1m EW / £500K SC) – at present eligible to apply the FRSSE SORP
- Band 3: Charities over the audit threshold but still within the “small” definition in company law (up to £6.5m EW/SC⁴) – at present eligible to apply the FRSSE SORP
- Band 4: The largest charities above this level, required to apply the FRS102 SORP.

2.4 The issues raised by the consultation are directly relevant to charities whose accounts fall in Band 2 or Band 3 – what we might call “FRSSE charities”. It will also affect many in Band 1 which have elected to prepare accruals accounts even though they are non-companies with income < £250K.

2.5 *The vast majority of charities are thus affected.* All those whose accounts starting in 2015 will follow the FRSSE SORP are directly affected: this will include the vast majority of those in Bands 2 and 3 plus a good number in Band 1. So this consultation has huge implications. Only the small number of charities in Band 4 and those in Band 1 using R&P are unaffected.

3. Comments on the Consultation Process

3.1 I was disappointed by a number of aspects of the consultation process, which in my view, has made it relatively hard for the medium-sized charities that will be directly affected by these changes – primarily those in Bands 2 and 3 – to understand what is proposed and hence to respond to the consultation.

3.2 Whilst I accept that the SORP Committee had no real choice but to withdraw the FRSSE SORP, the implications of this on medium-sized charities are enormous. It is essential that the change is managed in a way that *does not make matters* worse for these charities.

3.3 For charities in Bands 2 and 3, the changes proposed in this consultation are, in my view, *at least as big as the switch from SORP 2005 to the SORPs 2015*. But I feel the SORP

⁴ Increasing to £10.2m from 1 Jan 2016.

Committee could have done much more to publicise the significance of these issues and encourage engagement with this consultation. I believe there are very few charities in these bands where the staff and trustees, or even their accountants, understand clearly what is proposed.

- 3.4 I also think the consultation documents were extremely confusing. It is difficult for people to get the overall picture. Three separate documents were published, with no simple explanation of the relationship between them. The consultation questions which greatly overlap with each other are split across two documents. It is also very unhelpful that across closely related consultations the questions are not separately numbered – there are two separate Q1s and Q2s. Compared to the consultation in summer 2013 when the new SORP was issued as an exposure draft with a great deal of helpful commentary and publicity, the present consultation is very confusing.
- 3.5 Some of the consultation questions are themselves extremely confusing and seemed designed to make it very hard for respondents to understand the issues and respond clearly. For example, question 1 shown immediately below is 97 words and conflates several issues. This would have been much clearer if broken down into two or three separate questions.
- 3.6 The issue is further compounded by the fact that it is based on the *draft* proposed changes to FRS102 in FRED59, rather than the final changes published by the FRC in July 2015.⁵ This makes it almost impossible for anyone who has not been involved in the FRED59 consultation to respond to this consultation. Given that the FRC published the resultant changes to FRS102 in July 2015, it would have been clearer if the SORP-making body had waited until then to issue this consultation – even if this had meant a slightly tighter timescale in autumn 2015. The consultation documents could then have referred directly to FRS102 as amended. It would also have enabled the Draft Update Bulletin to take account of the FRS102's amended directions on merger accounting.
- 3.7 I also feel that in many respects the stance of the consultation documents is unfortunate. In these documents the SORP-making body appears to be moving away from the approach of “thinking small” and trying to avoid unnecessary financial reporting requirements for small and medium sized charities.

4. Withdrawal of the Charities SORP (FRSSE) – Response to Consultation Questions

Question 1 Given the underlying requirement for the accounts to give a true and fair view and the requirements of FRS 102 that result in all charities applying the same underlying recognition and measurement policies, do you agree with the SORP-making body disapplying the small entities regime proposed in FRED 59? This would have the result that all charities will have to apply the Charities SORP (FRS 102) for reporting periods beginning on or after 1 January 2016. Please give reasons for your response. If your answer is no, what alternate approach would you recommend and why?

- 4.1 No, I do not agree with the proposals in this question.

⁵ Financial Reporting Council (July 2015) *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Small entities and other minor amendments* – hereafter referred to as *FRS102 2015 Update*.

- 4.2 Of course I accept the premise that charity accounts prepared on an accruals basis must give a true and fair view, but I consider that in proposing a way forward on these lines, the SORP-making body is proposing to subject vast numbers of charities in Bands 2 and 3 into a much more demanding regime of financial reporting than is required by the FRC.
- 4.3 I think it is widely accepted that the Charities SORP should *only add* to the requirements of general purpose financial reporting standards in order to address issues that are manifestly charity-specific. By proposing that charities cannot make use of the simplifications offered by Section 1A of FRS102 which are available to other entities, the SORP Committee is proposing changes from the FRSSE SORP which go much further than needed, and which will result in significant additional burdens for medium sized charities.
- 4.4 Whilst the Section 1A simplifications in FRS102 arise from the EU Company Law Directive (and hence are not mandatory for member states to apply to entities such as charities) the Accounting Council's advice to the FRC was that the simplifications should *not* be restricted solely to companies and hence that "Section 1A should apply to all entities meeting the relevant criteria".⁶
- 4.5 Moreover, the Accounting Council's advice to the FRC is simply that a small entity should be *encouraged* to consider all the disclosures that would be needed in the absence of Section 1A.⁷ This principle should be reflected in the SORP which should simply *encourage* such additional disclosures, but not make them mandatory except in Band 4. There are many instances in the SORP at present where certain reporting practices are encouraged, so I do not consider this approach raises any new problems.
- 4.6 So, for the SORP-making body to prevent charities taking advantage of this is a serious step. It would amount to a major increase in the regulatory burden on charities in Band 2 and Band 3.
- 4.7 Given the Government's desire to reduce regulatory burdens on charities it is difficult to see in England & Wales how the Charity Commission could persuade the Minister for the Cabinet Office to amend the Charities (Accounts and Reports) Regulations 2008 to implement a new Charities SORP which imposed much tougher reporting requirements than previously. Similarly, in Scotland, the removal of the FRSSE SORP option from the Charities Accounts (Scotland) Amendment (No. 2) Regulations 2014 could present similar difficulties unless it was clear that the FRS 102 SORP (as amended) was not substantially more demanding than the previous regime.
- 4.8 So, following the principle of "think small" which has been rightly adopted in the 2015 SORP, I consider that the right way forward would be for each module of the SORP to be structured as follows:
- (a) Essential requirements for all charities – following FRS102 principles but making maximum use of Section 1A (Band 2 – and Band 1 if applying SORP)
 - (b) Additional requirements for auditable charities – but still making maximum use of Section 1A (Band 3)
 - (c) Requirements which apply to the very largest charities where FRS102 must be applied without the Section 1A simplifications (Band 4).

⁶ FRS 102 2015 Update p67, paras 15-16.

⁷ FRS 102 2015 Update p67, paras 18.

The requirements in (b) and (c) could be encouraged as good practice for smaller charities, particularly where additional disclosures could assist in giving a true and fair view, but should not be mandatory.

The current structure of each module of the SORP is well drafted in “starting small” and then adding requirements for larger charities. So I believe that only minor changes will be needed to achieve this three-tier approach.

Question 2 Do you agree with the proposal to amend the Charities SORP (FRS 102) so that it requires only larger charities to prepare a Statement of Cash Flows? This would mean that all charities with a gross income exceeding £500,000 (€500,000 in the Republic of Ireland) would have to prepare a Statement of Cash Flows. Please give reasons for your response.

- 4.9 I do not agree with the proposal to require all charities over £500,000 or €500,000 to prepare a cash flow statement. This threshold is far too low.
- 4.10 Even to impose the requirement on all auditable charities would be excessive. FRS 102 *Section 7 Statement of Cash flows (as amended)*⁸ states “A small entity is not required to comply with this section.” In this context “small” is as defined in company law – it covers all entities in Bands 1, 2, and 3.
- 4.11 The SORP (as amended) should directly reflect the requirements of FRS 102 and *only* require a Statement of Cash Flows for charities in Band 4.
- 4.12 In my experience the circumstances when the cash flow statement is useful in charity accounts are very rare and it should certainly *not* be mandatory except in Band 4. Because the cash flow statement does not distinguish the funds of the charity, and because it only gives a historic perspective, it has little value for users of charity accounts. There may be occasions when charities in Bands 1-3 would find it helpful to include a cash flow statement in their accounts, but it should certainly be optional.

Question 3 If your answer to question 2 was no, what alternative threshold would you propose for the preparation of a Statement of Cash Flows? Please state what threshold you would propose and give reasons for your response.

- 4.13 I would propose that the threshold should be the point at which a charity ceases to be “small” within the thresholds in company law, thus directly reflecting the requirement in FRS 102. In other words, the Statement of Cash Flows should *only* be mandatory for charities in Band 4.

5. Draft Update Bulletin 1 – Response to Consultation Questions

Question 1 Do you agree with the proposed amendments in draft Update Bulletin 1? If not, why not?

- 5.1 Insofar as the proposals in the Draft Update Bulletin directly reflect changes in FRS 102 I have no specific concerns (although the mergers section will need updating further to take account of further changes made by the FRS 102 2015 Update).

⁸ FRS 102 para 7.1B as inserted by FRS 102 2015 Update.

- 5.2 However, in my view much more extensive amendments to the SORP are needed, to allow charities in Bands 1-3 generally to take accounts of the reduced disclosures permitted by Section 1A of FRS 102 and the limited requirements for a Statement of Cash Flows in Section 7 (as amended).
- 5.3 As a concrete example of this point, the requirements for disclosure of fixed assets in module 10 of the FRS 102 SORP would appear to be rather simpler if the charity is allowed to follow the principles in paras 1AC.12 to 1AC.17 of FRS 102 as amended by the 2015 Update.
- 5.4 There may be some exceptions to these simplifications because of charity specific issues. I do not have any concern with requiring charities to produce a SOFA rather than the abridged profit and loss account in para 1AB.3 of FRS 102 as amended. Likewise, para 24 of the FRS 102 SORP *already* makes the point that charities may not opt out of the disclosure of trustee and staff remuneration and related party transactions simply on the grounds that FRS 102 may permit such exemptions. It is entirely reasonable for the SORP to prohibit certain simplifications which FRS 102 would otherwise allow if the use of these simplifications would lead to inadequate disclosure of issues which have a clear charity-specific nature. But *only* where there is a clear justification on those lines should any of the Section 1A simplifications be excluded.
- 5.5 So – the fact that the Draft Update Bulletin does not (as yet) amend the FRS 102 SORP to permit the FRS 102 Section 1A simplifications – means that, in my view, the Update Bulletin needs substantial further content in relation to many modules in order to allow these concessions. See my comments above (paras 4.1 to 4.8).
- 5.6 As noted above, I fully accept that charities in Bands 1-3 will sometimes need to include additional disclosures beyond the Section 1A simplifications in order to give a true and fair view – but the Update Bulletin should simply draw attention to this possibility, rather than seeking to impose additional disclosures on all charities in all cases.
- 5.7 Likewise in relation to the Statement of Cash Flows, the Update Bulletin should amend module 14 of the SORP to make clear that the Statement of Cash Flows is only mandatory for charities in Band 4. See my comments above (paras 4.9 to 4.13).
- 5.8 On that basis it would also be clearer to move module 14 out of the *Core Modules* and into the modules in *Selection 1*.
- 5.9 Even once these issues are addressed, a SORP which is extensively amended on these lines by an Update Bulletin will, in practice, be almost impossible to use. So, notwithstanding the publication of the new 2015 SORPs in summer 2014, the FRS 102 SORP will need to be re-issued with these changes included.

Question 2 Do you agree with the proposal to amend the definition of larger charities so that it is no longer linked to the statutory audit threshold for accounts prepared under the Charities SORP (FRSSE) or Charities SORP (FRS 102) for reporting periods ending on or after 31 March 2015? If not, why not?

- 5.10 No, I do not agree with this proposal – and hence I do not agree with para 2.14 of the Draft Update Bulletin.

- 5.11 The concept of an auditable charity being subject to additional demands, as first used I believe in SORP 2005 (rather than stating particular financial thresholds) was very clear. I personally preferred the term “auditable charity” rather than “larger charity” because the latter term means different things to different people. But given that the 2015 SORPs define a larger charity in terms of the audit requirement (Glossary, page 184) that is clear and I suggest the definition is best left unchanged.
- 5.12 It seems to me very clear and simple that additional reporting demands should take effect at the same threshold as where a charity is required to move from independent examination to audit.
- 5.13 I agree this will lead to different levels of reporting requirements between the different jurisdictions of the UK and Ireland, but that is already the case on other issues and in any case the thresholds would never be precisely aligned between the Republic of Ireland and the UK due to the currency differences. In my view it is much clearer for *preparers and users* of charity accounts if the additional reporting requirements are triggered when a charity exceeds the applicable audit threshold.
- 5.14 Moreover, if the SORP-making body were to move this threshold *down* to £500,000 in England and Wales when it has stood at £1M for the last year, this would amount to a substantial increase in the regulatory burden on charities, which I think the Government would not be able to justify when implementing the SORP in regulations.
- 5.15 Where a charity is registered in more than one jurisdiction then it is perfectly reasonable that the additional reporting requirements are triggered at the lowest audit threshold applicable.
- 5.16 However, as indicated above, the SORP needs a clearer terminology to distinguish the largest charities (Band 4 in my terminology). Terms such as “smaller” and “larger” are not very clear when there are three or more levels. Perhaps those in Band 4 should be described as “very large”?

6. A Clearer, Kinder Way Forward

- 6.1 Given the circumstance in which the SORP Committee finds itself, my preferred way forward would be as indicated in my comments above. I consider this approach would be fully compatible with FRS102 and with the requirement to give a true and fair view.
- 6.2 So this is the message that I would hope the SORP-making body will be able to give to charities, once the proposals are revised taking account of the concerns raised above:
- *We know that you are still in the process of changing over from SORP 2005 to the 2015 SORPs.*
 - *However, we are very sorry to say that the FRSSE SORP will have to be phased out for financial years starting from 1 Jan 2016 onwards because the FRSSE itself is going.*
 - *We appreciate many medium-sized charities will be using the FRSSE and the FRSSE SORP for their accounts this year as in several respects it is simpler than applying FRS102 and the FRS102 SORP.*

- *In future, this means all charities will have to follow the FRS102 SORP – but this is not as hard as you might think, because we have made things easier.*
- *The good news is that FRC has made some significant changes to FRS102 to make things simpler for organisations in the former FRSSE band and the SORP Committee is taking account of these in making updates to the FRS102 SORP.*
- *So the net effect is that whilst you may have to adopt some new measurement rules, in most respects your accounts under the FRS 102 SORP (as revised) will be no more complex than if you had been able to keep to the FRSSE SORP.*

6.3 As a final suggestion, since there will no longer be a FRSSE SORP, please can the term “FRS 102 SORP” be phased out? It is meaningless to non-accountants. It would be much clearer for everyone if the FRS 102 SORP as revised is simply known as *SORP 2016*.

7. Conclusion

I trust these comments are of help.

*Gareth G Morgan
18 September 2015*