



Proposed withdrawal of the Charities SORP (FRSSE) and other matters impacting on charity accounts

RESPONSE FROM ICAS TO THE CHARITIES SORP-MAKING BODY

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CA House 21 Haymarket Yards Edinburgh EH12 5BH
enquiries@icas.com +44 (0)131 347 0100 icas.com

Direct: +44 (0)131 347 0238 Email: cscott@icas.com

Introduction

The ICAS Charities Committee welcomes the opportunity to comment on:

- The withdrawal of the Charities SORP (FRSSE) and proposals to widen the scope of the Charities SORP (FRS 102); and
- Draft Update Bulletin 1: Charities SORP (FRS 102)

Our CA qualification is internationally recognised and respected. We are a professional body for over 20,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public and charity sectors.

Our Charter requires ICAS committees to act primarily in the public interest and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key points

We support the two main proposals set out in the consultation papers. First, we believe it is appropriate to require all charities to apply the Charities SORP (FRS 102), following the withdrawal of the Financial Reporting Standard from Smaller Entities (FRSSE): we believe this is necessary for charity accounts to give a 'true and fair view'. Second, we support the introduction of a definition for 'larger' charities, within the Charities SORP, which applies to all forms of charity for periods ending on or after 31 March 2015. However, we are not clear on what authority the Charities SORP-making body is relying on to prohibit charitable companies from applying the new small entities regime set out in Section 1A of FRS 102.

The Financial Reporting Council's (FRC's) consultation on the implementation of the small entities regime makes it clear that the new regime is available to charities and we understand that, in the case of non-company charities, the SORP-making body can dis-apply the small entities regime, through the status of the Charities SORP as mandatory under charity law. However, not all charitable companies in the UK are required to prepare their accounts under charity law but they must all prepare their accounts under company law. The position under company law is that the Financial Reporting Council (FRC) which sets UK accounting standards cannot require companies eligible to apply the new small entities regime to make disclosures over and above those set out in company law. We would therefore urge the SORP-making body to open discussions with the Department for Business, Innovation and Skills (BIS) and the FRC as to how the small entities regime can be dis-applied for charitable companies. Also, to ensure that the financial reporting regime for charities is absolutely clear and consistent across all forms of charity, it may also be appropriate to request that the FRC does not permit non-company charities to apply the small entities regime.

We refer to the status of the Charities SORP under charity law above. However, this has been undermined by the failure of the Cabinet Office to update the Charities (Accounts and Reports) Regulations 2008 to refer to the two new versions of the Charities SORP which will be in place for periods commencing on or after 1 January 2015 but before 1 January 2016. By weakening the status of the Charities SORPs under English charity law, complexity is added to the accounting framework for charities which apply the 2008 Regulations and their auditors and independent examiners.

In order to achieve a clear and consistent accounting framework for charities it may be necessary to forgo the idea of introducing a statement of cash flows exemption for charities defined as 'larger' by the Charities SORP. We support the proposal to establish a fixed threshold of gross income exceeding £500,000 to apply to charities defined as 'larger' and we support making the existing concessions within the Charities SORP available to charities smaller than this in relation to the preparation of the trustees' annual report and the Statement of Financial Activities.

The proposed definition for a 'larger' charity is being driven by the recent increase in the audit threshold under English charity law to gross income of £1,000,000. We believe that this is too high given the level of public accountability which should be offered by charities to their stakeholders. Fixing the definition of 'larger' at £500,000 will go some way to mitigating our concerns by ensuring that charities above this level do not receive the concessions we refer to above.

We also comment on the content of proposed Update Bulletin 1 which is being issued to deal with amendments to the Charities SORP (FRS 102), as a consequence of proposed 'minor' amendments to company law. We believe that some of the proposals do not quite capture the amendments accurately and we set out alternative amendments with supporting commentary in our response to the consultation question on these matters. Our main concern about the proposed amendments is the prohibition on the use of merger accounting for true mergers involving charitable companies. While we understand that it is company law which is driving this, we do not believe the prohibition is appropriate in this instance.

Our responses to the consultation questions are included in the Appendix.

Any enquiries should be addressed to Christine Scott, Assistant Director, Charities and Pensions, at cscott@icas.com

Responses to consultation questions

The withdrawal of the Charities SORP (FRSSE) and proposals to widen the scope of the Charities SORP (FRS 102)

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 dis-applying 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?

Response

We support the option favoured by the Charities SORP-making body which is to require all charities to apply the Charities SORP (FRS 102) in order for their accounts to give a true and fair view. We do not believe the more limited disclosure requirements set out in the small entities regime are suitable for charities, especially in view of the increase in the size threshold for 'small' under this regime. For example:

- Charities are currently required to make detailed disclosures about their reserves by the Charities SORP which are specific to the sector and align with the presentation of the main statements; these could be lost through the application of the small entities regime.
- Disclosures on a number of issues are only encouraged and we are particularly concerned that the disclosure of material uncertainties relating to going concern fall into this category. In theory, the overarching requirement contained in the small entities regime for the accounts to give a 'true and fair view' should mean that going concern issues are always reported in the accounts. This is not guaranteed and is one area among others which could lead to disagreements between charities and their auditor or independent examiner on what constitutes a 'true and fair' view.

The increase in the size threshold for 'small' through the raising of the turnover criteria to £10.2 million and the raising of the gross assets criteria to £5.2 million would capture all but a few UK charities, including those which will, by then, have implemented FRS 102 for their 2015 accounts. Public trust in charities is essential to the sustainability of the sector and we believe that trust would be better maintained through the application of full FRS 102 rather than through the new small entities regime.

However, it's not clear what mechanisms are available to dis-apply the small entities regime:

- to charitable companies; or
- to charities not classified as 'larger' charities by the Charities SORP which wish to take advantage of the proposed exemption from preparing a statement of cash flows.

The FRC specifies in its 'Consultation Overview: FREDs 58, 59 and 60 - Implementation of the EU Accounting Directive' those entities which are entitled to use the small entities regime, subject to size criteria. This paper specifically refers to companies and charities falling within the new small entities regime.

From a company perspective, the small entities regime has statutory backing via amendments to company law. In bringing the requirements of the EU Accounting Directive into UK company law, member states are obliged to limit the disclosures small entities are mandated to provide. This limitation now flows through company law to the small entities regime set out in the new Section 1A to FRS 102.

While the Directive itself scopes out charitable companies, it has been implemented in the UK in a way which seems to include charitable companies. It therefore appears that company law now prohibits the FRC, as the UK accounting standards setter, from mandating charitable companies from making additional disclosures. Therefore, we would support an approach by the Charities SORP-making body to BIS and the FRC to request that charitable companies are not permitted to apply the small entities regime set out in Section 1A of FRS 102.

In respect of England and Wales, the accounts requirements for the individual accounts of charitable companies are contained solely within company law and compliance with the Charities SORP is adopted on the basis that this is necessary for the accounts to give a 'true and fair' view. While we recognise that this practice could go some way to easing the transition from the FRSSE to full FRS 102, the availability of the small entities regime to charitable companies undermines this position and there is no obvious mechanism for the Charities SORP-making body to dis-apply it.

In England and Wales, group accounts must be prepared in accordance with both charity and company law and in Scotland charitable companies must prepare their accounts in accordance with both Scottish charity law and company law (including cross-border charities based in England and Wales but registered with OSCR). This means that the charity law regime for the preparation of accounts for such charities is incompatible with the new small entities regime as charity law requires additional disclosures to be made, largely through the Charities SORP, and company law prohibits any additional disclosures from being mandated.

Taking all these issues together, additional clarity is needed to ensure that the accounting framework for charitable companies from 1 January 2016 is understood by the sector.

The position for non-company charities is different as there are no changes to charity law to accommodate the Directive, meaning that the Charities SORP-making body has clear authority to place stricter requirements on non-company charities than those imposed by UK accounting standards. However, it may be worthwhile requesting that the FRC remove non-company charities from the scope of the small entities regime to avoid any doubt as to the expectation that all charities, preparing 'true and fair' accounts comply with the Charities SORP (FRS 102)

We provide further detail on our point about the statement of cash flows exemption in our response to question 2.

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.

Response

It may be necessary to require all charities applying the Charities SORP (FRS 102) to prepare a statement of cash flows, in order to give sufficient weight to the argument that charitable companies should not be permitted to adopt the new small entities regime. Making this exemption available could weaken the argument that charity accounts must comply with the Charities SORP (FRS 102) in order to give a 'true and fair' view.

If the Charities SORP-making body is still minded to offer an exemption to charities with gross income of less than £500,000, we are not aware of an existing mechanism under FRS 102 which would enable the exemption to be given.

FRS 102 requires all entities applying the full version to prepare a statement of cash flows with only the small entities regime in the new Section 1A to FRS 102 making such an exemption available. As things stand the only way to achieve the exemption appears to be as follows:

The Charities SORP (FRS 102) would need to permit charities which it does not classify as 'larger' to adopt the small entities regime but then limit the concessions available under that regime to the cash flow exemption. Such charities in describing their accounting framework would then need to state that they were applying the small entities regime to the extent permitted by the Charities SORP (FRS 102).

Any complications arising from UK company law, as described in our response to question 1, would need to be considered in the design of this exemption.

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.

Response

As stated above, it may not be feasible to offer an exemption from the preparation of a statement of cash flows.

Draft Update Bulletin 1: Charities SORP (FRS 102)

Question 1

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

Response

We have a number of comments on the proposed amendments to the Charities SORP (FRS 102) set out in the draft Update Bulletin.

Donated goods and services – proposed changes to paragraph 6.12

The proposed amendments are difficult to understand and do not seem compatible with the changes made to FRS 102.

The amendments to FRS 102 are set out in the table below.

Paragraph 13.3 is amended as follows:

Other than the disclosure requirements in paragraph 13.22. This section does not apply to the measurement of inventories measured at fair value less costs to sell through profit or loss at each reporting date. Inventories shall not be measured at fair value less costs to sell unless it is a more relevant measure of the entity's performance because the entity operates in an active market where sale can be achieved at published prices, and inventory is a store of readily realisable value.

Paragraph 13.4A is amended as follows:

Inventories held for distribution at no or nominal consideration shall be measured at the lower of cost adjusted, when applicable, for any loss of service potential, and replacement cost.

The Charities SORP (FRS 102) requires donated goods to be measured at fair value including those to be distributed to beneficiaries for free or for nominal consideration whereas the equivalent requirement in FRS 102 is for such goods to be measured at the lower of cost and replacement cost. If this approach was taken by the Charities SORP (FRS 102), donated goods would be measured at 'nil'.

It may therefore be appropriate to prepare an amendment to the Charities SORP (FRS 102) to require charities to measure donated goods for distribution for free or for nominal consideration at fair value less any loss of service potential.

Goodwill and intangible assets – proposed changes to paragraph 10.3

We agree that the proposed changes reflect the proposed amendments to FRS 102 on the life of goodwill and intangible assets.

Impairment of assets – proposed changes to paragraph 12.20

We agree that the proposed changes reflect the changes made to FRS 102 to prohibit the reversal of any impairment losses incurred on goodwill. However, we believe that additional amendments are needed to paragraph 12.20 to reflect the full extent of the proposed changes to FRS102 on the impairment of assets.

The amendments to FRS 102 on the impairment of assets include the following:

Paragraph 27.29 is amended as follows:

For all assets other than goodwill, if the reasons for the impairment loss have ceased to apply, an impairment loss shall be reversed in a subsequent period. An entity ...

The proposed changes to FRS 102 link the reversal of the impairment loss directly to the circumstances which initially caused the loss. This link prevents accounting for the reversal of impairment losses being confused with unrealised gains on revaluation. The Charities SORP (FRS 102) should be amended accordingly.

Goodwill on consolidation – paragraphs 24.32 and 24.39

We agree that the proposed changes reflect the proposed amendments to FRS 102 on the life of acquired goodwill in the accounts of a charitable group.

Charity mergers – paragraphs 27.4 and 27.4A

We are concerned about the proposed amendments to module 27 of the Charities SORP (FRS 102) on the prohibition of merger accounting by charitable companies for two reasons:

- First, while we understand the amendments are driven by a proposed change in company law, we question whether a prohibition on the use of merger accounting is appropriate. While charities may have strong financial reasons for entering a merger, they are not doing so for commercial gain. Therefore, a charity merger is fundamentally different from a merger between profit-distributing entities meaning that the fair value approach to assets and liabilities required for acquisition accounting is difficult to justify on the basis of the legal form of one of the participants alone.

In the case of charitable companies involved in mergers there could be a strong argument for applying a ‘true and fair’ override. This could be justified on the basis that merger accounting is still considered appropriate for, and must be applied by, business combinations not involving charitable companies when the criteria are met.

- Second, the way the amendments are drafted may lead charitable companies to believe that this is a change of greater significance than it may actually be. This is on the grounds that company law still permits merger accounting for group reconstructions and the Charities SORP (FRS 102) continues to require it. Module 27 of the Charities SORP (FRS 102) should include amendments which make this clear, in the event that the concerns we set out in our first point above cannot be addressed.

We set out below the categories of business combination likely to be relevant to charities, including commentary on how the proposed company law change would impact on the sector:

- Normal acquisition made on a commercial basis - acquisition accounting applies to the preparation of group accounts and the proposed company law change would have no impact.
- Combination which is in substance a gift - a modified form of acquisition accounting applies to the ‘acquiring’ entity and the company law change would have no impact.
- True merger – merger accounting would no longer be possible in relation to the preparation of group accounts if a standalone charitable company or parent charitable company is party to a combination entered into with a third party. Otherwise merger accounting must be applied.
- Group reconstruction (including change of legal form) – merger accounting must be applied by entities which are already part of a group and the company law change would have no impact.

The FRC’s Financial Reporting Exposure Draft 59 which deals with the ‘minor amendments to FRS 102’ contains the following comments from the Accounting Council (paragraph 24e, page 47, paragraph 24e), which supports our comments on group reconstructions:

“The new Accounting Directive only permits companies to apply merger accounting for group reconstructions and the Accounting Council advises that this amendment is made to ensure merger accounting is not applied by public benefit entities that are companies where not permitted in law.”

The Accounting Council’s comments also indicate that a change should be made to FRS 102 which prohibits charitable companies from using merger accounting in instances which would otherwise be a true merger. Should there be no alternative to prohibiting merger accounting for charitable companies in FRS 102 and the Charities SORP (FRS 102), we believe that the proposed amendments to the SORP could be clearer. Rather than adding a criterion to paragraph 27.4 which states that merger accounting must be applied when ‘It is permitted by the statutory framework’, it may be more helpful to state something along the lines of the following within paragraph 27.4:

“If a standalone charitable company or a parent charitable company enters a business combination with a third party, merger accounting is prohibited for that combination and an acquirer must be identified.”

Paragraph 27.4 could then be further amended as follows:

“Subject to the above....A charity combination must be accounted for as a merger if all of the following criteria apply.”

There would then be no need to add the criterion ‘It is permitted by the statutory framework’.

Paragraph 27.4A may then be helpfully redrafted to explain the position with regard to group reconstructions and any further explanations which the Charities SORP-making body believe are still required.

In paragraph 27.4A, the words ‘be able to apply merger accounting’ should be amended to ‘be required to use merger accounting’, if needs be.

Related party disclosures

FRS 102 proposes the following amendment which is not covered by draft Update Bulletin 1:

Paragraph 32 (b). An entity is related to a reporting entity if any of the following conditions apply:
(viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Paragraph 9.15 of the Charities SORP (FRS 102) includes a cross-reference to the glossary of terms and a full list of persons or entities deemed to be related parties. Therefore, consideration should be given to including this additional item to the list of related parties.

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?

Response

We support the proposals to amend the definition of ‘larger’ charities under the Charities SORPs from 31 March 2015. This change will make the threshold for the availability of concessions consistent and much clearer.

We agree that it is necessary to introduce the definition for periods commencing on or after 31 March 2015 to mitigate the impact on charity reporting of the increase in the charity law audit threshold for England and Wales, which ICAS strongly opposes. However, charities with 31 March 2015 year-ends will be complying with the Charities SORP (2005) (as amended) in the first instance so the scope of proposed Update Bulletin 1 will need to be extended to implement the change for the intended accounting period. However, we recognise that many charities with 31 March 2015 year-ends will have filed their accounts before the Update Bulletin is issued.

The definition of ‘larger’ in the new SORPs is linked to the charity audit threshold for a charity’s particular form. However, charitable companies, in England and Wales, which exceed the company law audit threshold, are outside the scope of the charity law audit regime. Therefore, the change in the definition of ‘larger’ is a helpful clarification for charitable companies in this position and will ensure their compliance with the more detailed reporting requirements of the new SORPs.

With regard to the Charities SORP (2005) (as amended), Appendix 5 refers to concessions available for charities below the ‘statutory’ audit threshold. Therefore, it is easier to interpret this as being a reference to the company law audit threshold where this is the relevant threshold. We believe this is the case even though Appendix 5 cross-refers to thresholds set out in Appendix 4 which contains charity law audit thresholds only.