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Stewardship Briefing Note 2014/1

Charity Accounting – forthcoming changes

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Stewardship, 1 Lamb's Passage, London EC1Y 8AB
t: 020 8502 5600 e: enquiries@stewardship.org.uk w: stewardship.org.uk

CONTACT DETAILS
Stewardship
1 Lamb's Passage, London EC1Y 8AB
t: 020 8502 5600
e: enquiries@stewardship.org.uk
w: stewardship.org.uk

With two new charity SORPs taking effect from 1 January 2015, what might be the impact on your church or charity?

1. introduction

From 1 January 2015 (but impacting 2014 comparative figures), there will be not one, but two new Statements of Recommended Practice (or 'SORPs' applying to charity accounts. Although entitled 'Recommended Practice', the requirements of SORP are underpinned in law by the Charities (Accounts and Reports) Regulations 2008 and therefore have statutory force for charities preparing 'accruals' accounts. All charitable companies must prepare accruals accounts. In England, Wales and Scotland, unincorporated charities and CIO's are only required to prepare accruals accounts if their gross income in the year exceeds £250,000.

In Northern Ireland, where the Charity Commission for Northern Ireland ('CCNI') is in its infancy, different, interim rules apply. Until the beginning of 2015, when new accounting and reporting regulations are expected to come into force, charities in NI can submit their accounts to CCNI in the format that they currently prepare them. It is expected that the new regulations will require compliance with the new SORPs.

Most churches and Christian charities will be eligible to follow either SORP, and so will need to make an informed choice. Both routes will involve some changes (although one considerably more than the other) but even choosing the SORP that will have the least immediate impact may not be completely straightforward. This short article, paving the way for a more detailed analysis to follow later, highlights some of the key areas of change and what those changes may mean for you and your administrative and accounting systems.

The roadmap for this paper sets out:

- Why the new SORPs were needed and what are the choices;
- The more significant changes that will be required should you choose to follow the FRSSE[1] SORP;
- The more substantial changes that will be required should you choose to follow the FRS[2]102 SORP;
- What to do now

Note, the FRSEE and FRS 102 are accounting standards that apply equally to commercial and non-commercial entities. The FRSEE SORP and the FRS 102 SORP seek to apply the principles in the relevant 'parent' accounting standard to charity accounts, so that charity trustees should only need to refer to their SORP in order to also comply with the 'parent' standard.

[1] Financial reporting standard for smaller entities
[2] Financial reporting standard

2. Why are they needed and what are the choices available?

The underlying basis for UK accounting is called 'GAAP' (that is, 'generally accepted accounting principles'). GAAP is changing and, as a result, the Charity SORP also needs to change so that it keeps in step. This change resulted in the 'FRS102 SORP' being introduced. However, to help ease the burden that this fundamental change makes to **smaller** charities, the Financial Reporting Council has retained the old style GAAP in the form of a 'FRSSE SORP'. So the two new SORPs are:

- FRSSE SORP
- FRS102 SORP

To be able to apply the FRSSE SORP a charity must fulfil two of the three necessary criteria – gross income below £6.5m; total assets not exceeding £3.26m; employing no more than 50 staff. With an estimated 98% of the whole charity sector fulfilling these criteria almost every church and Christian charity will be able to opt for this, if they wish to.

Because the FRSSE SORP is still based on the old style GAAP there are no significant changes to current practice and therefore choosing to follow this SORP will result in little additional work for churches. However, there are two significant caveats to this:

- There are areas that the FRSSE does not cover and as such you would be required to look towards the FRS102 SORP for a suitable treatment, and comparative figures would need to be restated. 'Non-exchange items' (that is, donations, grants, legacies etc.) and donated goods are perhaps the more significant areas that might apply to churches which are not covered by the FRSSE SORP.
- The FRSSE itself is due to be reviewed in 2016 and any change will then have to be reflected in the FRSSE SORP. It is highly likely that the direction of travel will be to bring the FRSSE more in line with FRS102 and it may even be that the FRSSE is withdrawn altogether leaving only the FRS102 SORP applying to all charities. One leading commentator has said that: "Going forward, there may not be much difference between the FRSSE and the FRS 102 SORPs – this may influence the choice of which SORP to adopt."[3]

Any charity of any size can opt to follow the FRS102 SORP.

[3] Pesh Framjee FCA – https://www.accountancylive.com/charity-sorp-2015-applying-new-accounting-rules as seen on 18 September 2014

3. What are the changes from current practice if you choose to adopt the FRSSE SORP?

3.1 Changes as a result of adopting the FRSSE SORP

If you choose to follow the FRSSE SORP, then generally speaking there will be little or no change required to your accounting processes and practices. One area that may change relates to the write-down of fixed assets (see below).

- Where fixed assets continue to be used by the church, the amount recorded in the accounts continues to be calculated as now, being the net position of cost less accumulated depreciation. This only changes where the church has plans to dispose of an asset earlier than expected. Where this is the case, the asset should be written down to its net realisable value.

3.2 Changes as a result of areas not covered by the FRSSE

1. 'Non-exchange items' (gifts) and income recognition.

Aside from the treatment of Government grants, the FRSSE does not deal with the recognition of income from non-exchange transactions (gifts). The FRSSE SORP therefore points the reader towards FRS 102.

Section 5.11 of module 5 states that: "This SORP requires charities to adopt current practice when accounting for income from non-exchange transactions. Income from donations and grants is recognised when there is evidence of entitlement to the gift, receipt is probable and its amount can be measured reliably."

There has been considerable comment made regarding the second criteria which now says that to recognise income in the accounts, the relevant receipt should be 'probable' and not 'virtually certain', the term currently used. What does this mean for churches that are in receipt of future gift pledges to fund building work or are anticipating income from legacies?

In reality, this change is likely to make little if any difference to the way in which churches recognise income. The probability of receipt is only one of the three criteria that should be fulfilled in order to recognise income, the other two are equally important and in this context particularly the entitlement criteria. A pledge given to a church for a future gift is likely to be regarded as an intention and will not normally meet the entitlement criteria. As such, the question of probability of receipt will not arise.

In the case of a legacy, entitlement occurs when the charity has sufficient evidence that a gift has been left to them and the executor is satisfied that the property in question will not be required to satisfy other claims in the estate. Only then will the probability question be addressed. Receipt normally becomes probable when there has been a grant of probate; the executors have established that there are sufficient assets in the estate; and any conditions attached to the legacy are either within the control of the charity or have been met.

Where the estate includes assets whose value is uncertain, or that may fluctuate prior to realisation by the executors, the measurement criterion will also need to be considered.

2. Accounting for donated goods for distribution to beneficiaries

Module 6 of the FRSSE deals with the accounting treatment for all donated goods and sections 6.24–6.27 deal specifically with the accounting treatment of donated goods for distribution to beneficiaries. With more churches getting involved with food banks as a way of helping those in more need in their communities, this section of the FRSSE will apply.

In essence, goods given in this way should be recognised as income at the point of donation and expensed at the point of distribution. Donated assets that are held by the charity over its balance sheet date should be held as stock. There is a concession granted where it is deemed to be impractical or where the cost involved in undertaking the valuation outweighs the benefit of providing the information to the readers of the accounts. Where this is the case, then the gift must be recognised as a component of donations when it is distributed with the equivalent amount recognised as charitable expenditure.

So churches that are involved in food banks or the distribution of other goods (e.g. second-hand furniture) need to consider:

- Whether it is practical to account for donated goods on receipt, and if so, what systems need to be put in place to capture this information and to value the donation. Valuation may, for example, be affected by the proximity of a product expiry date.
- How to value stock that is held over the year end and to decide whether it should be written down to its recoverable amount. In a church context this is likely to be a rough estimate of what the 'real value' is to the potential recipient.
- Whether the costs involved in providing this information outweigh the benefit to the reader of the accounts. This decision may, amongst other factors, be influenced by the significance of the food bank, or other, activity to the overall charity accounts.

If the church decides that the costs of providing this information are too high or that the benefit to the reader is not sufficient, the value of the gift at a 'best estimate' must be recognised as a donation when it is distributed, with the equivalent amount recognised as charitable expenditure. The donated asset cannot simply be ignored in the accounts.

3. Other areas not covered by the FRSSE

Of less importance to most churches, other areas not covered by the FRSSE include:

- Heritage assets

- Mergers
- Accounting for associates and joint ventures

3.3 The more significant changes to the trustees' annual report for all charities

- A charity must disclose its reserves policy or state that it does not have one and provide an explanation as to why not. Arriving at a reserves policy is not an onerous responsibility, so on the face of it meeting this requirement should cause little difficulty. However, we see many churches that appear to put little or no thought into what should be a sensible reserving policy and we would encourage churches not to wait for this requirement to come into existence before giving the matter some serious thought.
- All trustees (not limited to 50) who served in the accounting period together with those who were trustees on the date that the report was approved must be named. This will really only impact very large charities and in practice will mean no change for most churches.

3.4 The more significant changes to the trustees' annual report for larger charities (those requiring a full audit)

- A description of the principal risks and uncertainties facing the charity together with a summary of the trustees actions to manage, mitigate or transfer those risks.
- The arrangements for setting the pay and remuneration of the key employees.
- An explanation of social investment policies and how they contribute to the aims of the charity.

4. What are the incremental changes (beyond the FRSSE SORP) if you choose to adopt the FRS102 SORP?

The more significant accounting policy changes:

- Where there is an agreement in place to make additional contributions to a multi-employer defined benefit pension scheme based on current and past service of employees, a liability must be recognised for the present value of outstanding additional contributions (module 17). This is likely to be a significant issue for many Baptist churches and others that might operate a denominational or other form of multi-employer scheme, particularly in cases where the agreement to fund the shortfall is large.
- Most pension funds are subject to a valuation at least every three years. The impact of having to carry the liability in the balance sheet may result in significant movements in the SOFA as deficit values are revised. If you are involved in such a scheme, we would suggest that you take advice from the schemes operator before deciding how to account for it.
- Any material uncertainties when considering if the charity is a going concern must be disclosed, with trustees looking forward for at least 12 months from the date that the

accounts are approved (module 3). The FRSSE SORP is not so prescriptive in setting out a time frame for making this judgement, but that in no way alters the responsibility that rests with the trustees and a 12 month view would be considered to be best practice under any scenario.

- Changes in the value of financial instruments (including investments) measured at fair value are taken through the Statement of Financial Activities (module 4).

- The income and expenditure headings included in the Statement of Financial Activities have been renamed, simplified and reduced (module 4). In practice these changes will make little or no difference to the way that churches accounting systems are structured.

- Outstanding paid annual leave and sick leave should be recognised as a liability (module 7). Not a major issue as churches tend to have few employees, but an additional administrative burden none the less.

- There are some changes regarding the disclosure of trustee and staff remuneration and also related party transactions (module 9). The emphasis of module 9 remains on demonstrating that the charity is operating for the public good and that disclosure of related party transactions and staff remuneration is important for stewardship purposes. The key elements of this module will already be captured by most churches, but the need to disclose financial fees incurred other than simply for the audit or independent examination is worth considering.

- Module 14 requires charities to provide a statement of cash flows which shows the net increase or decrease in cash during the reporting period. This requirement does not extend to providing a forecast of future flows.

- A new class of investment (mixed motive investment) is introduced to include investments that are used partly to further the aim of the charity and partly to provide an investment return (module 21).

A mixed motive investment is an asset held by a charity that provides funding to individuals and organisations in order to generate a financial return for the charity but that also contributes to the investing charity's charitable purposes. The investment is not justified wholly by the return or the contribution it makes to the investing charity's aims but by a combination of the two.

This might apply to churches that have provided financial support to another church or organisation in accordance with its own charitable purposes but which is also expecting a financial return on that investment.

5. What to do now

- As a collective group of trustees, decide which SORP route you intend to follow taking into account both the advantages and the uncertainties of following the FRSSE SORP.
- Although the new SORPs do not come into effect until January 2015, comparative figures will need to be restated and so are likely to impact current year (2014) accounts. So having decided which route to follow, consider the areas that might impact you and take a look at the relevant SORP module(s). These can be found by visiting www.charitysorp.org/choose-sorp-modules/
- Keep abreast of any information that is made available by your denomination or other umbrella organisation that your church might belong to.
- Read the various help-sheets provided at www.charitysorp.org