

Charities Alert FRS 102 and the new SORP: a reminder



In a nutshell

As the time to implement FRS 102 and the new Statement of Recommended Practice (SORP) draws closer, this briefing updates our earlier charities alert on the FRS 102 SORP. The FRS 102 SORP is effective for periods beginning on or after 1 January 2015 and the comparative period has already passed for most charities. Charities who have not yet started their implementation planning should start now.

This briefing focuses on FRS 102 and the FRS 102 SORP which provides guidance to those preparing accounts under FRS 102.

The key changes from old UK GAAP and SORP 2005 are the following:

- SOFA formats simplified using 'plain' English.
- Comparatives required for all funds disclosed in the statement of financial activities.
- Income should be recognised when receipt is probable rather than the current criteria of virtually certain – which may be particularly significant for charities with sizeable legacy income. Specific guidance on legacy income recognition is provided by the FRS 102 SORP.
- Donated goods for sale or distribution are to be recognised on receipt at fair value where practical unless not justified on cost/benefit grounds.
- No cash flow statement exemption for small charities.
- Deficit funding agreements must be recognised as liabilities for multi-employer defined benefit pension scheme arrangements.
- Total remuneration for key management personnel is required in the notes to the accounts and larger charities must disclose their arrangements for setting the pay and remuneration of the charity's key management personnel in the trustees' report.
- The trustees' report will need to be more balanced, with increased emphasis on public benefit, successes, failures and lessons learned.
- The requirements that previously only applied to charitable companies requiring specific disclosure of the principal risks and uncertainties have been extended to all larger charities and mitigating actions must also be included.
- The reserves policy must be fully explained or an explanation given of why there is no policy.
- An accrual for holiday pay and other short term employee benefits should be considered.
- The future minimum lease payments are now required for operating lease disclosures.
- The 90% test for finance leases is no longer a rebuttable presumption for lease classification but several indicators must be considered: For a finance lease substantially all the risks and rewards incidental to ownership must be transferred under the lease.

The Charities SORPs are available at <http://www.charitySORP.org/>

Background

The Charity Commission and the Office of the Scottish Charity Regulator (OSCR) have issued two Charities SORPs. The SORPs are referred to here as the FRS 102 SORP and the FRSSSE SORP and the charity must use the appropriate SORP depending upon its choice of underlying accounting standard. This briefing is directed at those charities who will apply FRS 102, either because they have chosen to do so or because they do not meet the criteria for applying the FRSSSE. Our separate briefing "Which SORP?" covers the choice available to the small charities who can choose whether to apply the FRSSSE or FRS 102. Any UK charity is able to apply the FRS 102 SORP. Charities should note that the FRSSSE will only be available for one year.

Charities Alert: Which Charities SORP to apply is available at www.deloitte.co.uk/charitiesandnotforprofit/

The Charity Commission has consulted on replacement for the FRSSE SORP and proposed that all charities use the FRS 102 SORP for reporting periods beginning on or after 1 January 2016 with only larger charities required to prepare a Statement of Cash Flows. The outcome of the consultation is awaited.

We encourage all charities to review FRS 102 and the new FRS102 SORP and consider the impact on their specific operations.

Modular guidance

Although twice the length of the old SORP, the new SORP includes numerous references to FRS 102 for further detail and cannot be read as a standalone document. However, to assist charities that have less complex operations, the FRS 102 SORP adopts a modular approach with core modules covering the fundamental principles. Additional modules cover more specific areas which may not apply to all charities. It also includes illustrative formats for the statement of financial activities, balance sheet, statement of cash flows and selected notes.

This alert highlights some of the key points along with links to more detailed information and contacts should you wish to consider these changes further

Must, should and may

Terminology

The SORP is drafted to clearly identify 'must' requirements (those driven by law or the accounting framework and which are required for compliance with the FRS 102 SORP); 'should' (which charities are encouraged to follow as a matter of good practice); and 'may' (which are options and illustrations which may be adopted at the discretion of the charity). A failure to follow a 'should' or a 'may' would not be seen as a departure from the SORP. Larger charities¹ are required to make more extensive disclosures to comply with the FRS 102 SORP and these are clearly signposted within the text. Sentences introduced by the statement 'This SORP requires' are requirements which go beyond the requirements of FRS 102.

More integrated reporting

Trustees' report

One area of change for many charities relates to the new trustees' report, where additional disclosures will be required.

Charities should ensure that all contributors to the trustees' report and financial statements are clear on which activities are the main focus of the charity and how they will form the key headings for the SOFA and the trustees' reporting. This may require more and earlier communication than in prior years between finance, communications departments, senior management and trustees to ensure consensus and no last minute requests or surprises.

The trustees' report will include the same major headings as in *Accounting and Reporting By Charities: Statement of Recommended Practice (revised 2005)* (SORP 2005) although there are changes in emphasis as noted below. All trustees must now be listed in the report; previously this could be restricted to 50 if there were more than 50 trustees. The FRS 102 SORP also includes additional guidance on the interaction of the trustees' report with the new strategic report for charitable companies. The strategic report is designed in part to replace summary financial statements which are produced by a number of charities as a key marketing tool. Charities that wish to prepare summary financial statements will need to consider the implications and, in particular, how they will present their results in future.

Acknowledgment of both significant successes and failures

Fair and balanced

The FRS 102 SORP places increased emphasis, in line with corporate reporting, on the trustees' report being fair and balanced. This will mean acknowledging both significant successes and failures in activities and their intended impact. In addition, when reporting on performance, there will be a need to include both the positive and negative factors which have affected the achievement of the charity's objectives. This will challenge a number of trustees and charities to consider how they present their report.

This change in balance and messaging needs to be communicated throughout the charity early so that those responsible for 'telling the charity's story' can consider how reporting challenges faced and achievements of the year may impact on all stakeholders, including employees, recipients, donors and potential donors and trustees.

¹ Those charities subject to audit under charity law in their jurisdictions of formation, registration or operation, or charities with a gross income exceeding £500,000 (UK) or 500,000 euros (Republic of Ireland) in the reporting period.

More extensive disclosure of risk and financial impact of significant events

Financial review

The financial review for all charities must include an explanation of the policy it has for holding reserves and state the amounts of reserves and why they are held. The need to disclose reserves policies is not new, however now where no policy is disclosed an explanation must also be given.

For larger charities the report must now explain:

- the financial effect of significant events (going beyond the previous requirement to report significant charitable activities undertaken);
- a description of the principal risks and uncertainties together with a summary of their plans and strategies for managing those risks (this extends the requirement that previously applied only to charitable companies); and
- any factors that are likely to affect the financial performance or position going forward.

Risk and reserve policies should be approved annually by trustees. New policies may need to be considered and reviewed in the light of the new requirements. Key judgments and estimation uncertainty should be presented by management and considered by the trustees as part of their accounts preparation. These disclosures are required in the notes to the accounts.

Public benefit requirement to be considered in review of achievements and performance

Public benefit

The FRS 102 SORP includes for the first time the legal requirements for all charities to explain those activities undertaken to further the charity's purposes for the public benefit and confirm that they have had regard to the Charity Commission's guidance on public benefit. Whilst this formalises the current position, the FRS 102 SORP does not restrict public benefit considerations to objectives and activities but requires that charities also discuss how they have met public benefit guidance in respect of achievements and performance. All charities should 'identify the difference the charity's work has made to its beneficiaries and, if practicable, explain any wider benefits to society as a whole'.

Charities will need to ensure that they clearly make a statement that they are a public benefit entity and further how this impacts on their performance. Based on our trustees' reporting survey² it is clear that current practices vary from a single statement of observance, with public benefit assumed, to longer or more integrated reporting. Charities will need to consider the changes that need to be made to their current reports to fully meet the new requirements.

Pay policies required

Key management personnel

Larger charities must describe in their trustees' report their arrangements for setting the pay and remuneration of the charity's key management personnel and any benchmarks, parameters or criteria used in setting their pay.

Charities will need to ensure that any reports or analyses that they are likely to rely on in making this analysis have been commissioned or are in place in advance of the year end.

Comparatives required for all classes of funds

The Financial Statements

The FRS 102 SORP reduces the number of headings on the SOFA and uses plainer English. For example, "voluntary income" is now "donations and legacies" (which includes grants, donated goods, membership subscriptions and sponsorships that are in substance donations). "Resources expended" is now "expenditure", with three simplified headings: "raising funds"; "charitable expenditure"; and "other". Governance costs are only disclosed in the notes as part of support costs. Net gains/losses on investments are now disclosed above the net income/expenditure subtotal.

In addition to the existing requirement for comparative amounts for the total funds of a charity to be presented on the face of the SOFA, comparatives must be presented for each separate class of funds. This may be done either on the face of the SOFA or in the notes. Charities will therefore need to consider how best to present their results which could include a SOFA with eight columns.

More emphasis is placed on the links between the activities reported in the trustees' report and the financial statements and charities are able to vary the order of the headings and add their own tailored sub-headings. Expenditure headings should enable the user of the accounts to understand the relationship to the income derived from that activity.

The design and layout of the financial statements should not be decided in isolation but should be coordinated with the report writing as discussed above.

Income to be recognised when probable not virtually certain

Income recognition

Income will need to be recognised when all of the following criteria are met:

- Entitlement – control over the rights or other access to the economic benefit has passed to the charity;
- Probable – it is *more likely than not* that the economic benefits will flow to the charity; and
- Measurement – the monetary value or amount of the income and the costs to complete the transactions can be measured reliably.

This will be one of the most significant changes as one of the income recognition criteria will move from “virtually certain” to “probable”. This may mean that some donated income is recognised at an earlier point in time where there is documentation of the promise that makes receipt more likely than not. If the impact of the change in accounting policy is material, in the year of transition to FRS 102 this adjustment may lead to some income not previously recognised in prior periods being recognised directly in reserves. As at present, insurance claim income will only be recognised when receipt is virtually certain.

One of the main areas of impact is likely to be legacies. The FRS 102 SORP offers new guidance and identifies three points when the receipt of legacy income becomes probable:

- there has been a grant of probate;
- the executors have established that there are sufficient assets in the estate; and
- any conditions are either within the control of the charity or have been met.

A portfolio approach can be taken by charities which receive a significant number of immaterial legacies in a reporting period³. Notifications after the reporting date should be adjusted and accrued as income where it is clear that payment had been agreed by the executors prior to the end of the reporting period. Where a legacy debtor is impaired an adjustment should be made to the debtor and income rather than charging the adjustment to expenditure.

Charities should calculate their legacy, and any other revenue streams affected by this change under both old and new SORP so that they are prepared to assess the need for a restatement on transition and have the data for any necessary disclosures⁴.

Donated items to be recognised on receipt at fair value wherever possible

Donated goods and services

The FRS 102 SORP contains a separate core module for ‘Donated goods, facilities and services, including volunteers’. This requires donated items to be used in the course of the charity’s work (e.g. tents and blankets received for a disaster appeal) to be valued and recognised in stock, unless it is impractical to assess the value at the time of receipt. This is a change from SORP 2005 where such items would be recognised only on distribution. Where valuation on receipt is impractical, the gift will be recognised in donations and as charitable expenditure when it is distributed.

In the same way donated goods for resale should be valued and included in stock. Where it is impractical to recognise donated goods on receipt the proceeds of sale will be recognised as ‘income from other trading activities’ in the SOFA.

More guidance is given in the new SORP on the UK retail gift aid scheme. Charities with historical data may use an estimation technique to recognise income from such arrangements at the point of sale, with an adjustment to income for sales which are not expected to result in a donation.

In the case of goods for distribution an indicative value of the gift may be supplied by the donor. Where charities are involved in the retail goods scheme then the estimation techniques should be assessed and results discussed with trustees and auditors prior to the year end. These judgements and estimates may require disclosure in accounting policies.

³ Where a charity has numerous immaterial legacies, the charity may estimate the monetary value of the income that may be received from legacies to which they are entitled by applying a formula or mathematical model.

⁴ For example, a charity with a December year end would need to consider the impact on the opening reserves of its opening balance sheet, ie reserves at 1 January 2014; the impact on the 2014 result previously reported and then impact in 2015.

Stock may include items distributed freely to beneficiaries

Stock

Guidance on what should be included in stock and how it should be valued was not specifically included in SORP 2005. However the FRS 102 SORP defines stock as items that will be used by the charity in providing goods and services which may include goods held for distribution to beneficiaries, educational literature or brochures for distribution. Where items of stock are distributed for free they should not be written down to a nil net realisable value if they continue to meet the need for which they were purchased and they are not damaged or obsolete.

The FRS 102 SORP also requires charities to disclose in a note the cost of stock recognised in the SOFA as an expense.

Similar to the valuation of donated items, the SORP encourages earlier recognition of the stock. Charities will potentially need to talk to donors to help assess the value of their year-end stocks.

No exemption for small charities

Cash flow statements

There is no exemption for small charities from preparing a cash flow statement, as is permitted under current UK GAAP. Therefore, unless the charity is able to and chooses to follow the FRSE, it will have to prepare a cash flow statement.

Subsidiaries of charities (regardless of whether they are trading or charitable subsidiaries) are able to take advantage of the disclosure exemptions permitted by FRS 102 and not prepare a cash flow statement.

The SORP consultation in summer 2015, which has not yet been finalised, proposed amending the requirement so that only 'larger' (proposed to mean those with income over £500,000) charities are required to produce a cash flow statement. The outcome of the consultation is awaited.

Deficit funding agreements must be recognised as liabilities

Multi-employer defined benefit pension schemes

Where a multi-employer scheme is a group scheme, the previous exemption (in FRS 17) from recognition of pension assets and liabilities in individual financial statements where attribution to individual entities was not possible has been removed.

Where a charity is part of a defined benefit multi-employer plan that is not a group scheme, and it is not possible to attribute the scheme's assets and liabilities between the employers, charities can continue to be able to account for the scheme as a defined contribution scheme. However, the charity will need to recognise any liability (including discounting if material) to make payments to fund any deficit relating to past service benefits where it has entered into an agreement to make those payments. However, for a group scheme FRS 102 requires group companies to recognise their own share of scheme assets and liabilities – in practice this means including all of the surplus or deficit in the sponsoring employer's own balance sheet unless an alternative agreement can be reached.

The FRS 102 SORP requires a description of the extent to which the charity can be liable to the plan for other entities' obligations; and an explanation of how any liability arising from an agreement to fund the plan has been determined.

Actuarial input is likely to be required for the calculation of the present value of contributions payable that result from the terms of the agreement with the multi-employer plan.

Total remuneration for key management personnel required

Key management personnel and trustee donations

All charities must include disclosure for any employees whose remuneration is over £60,000 in bands of £10,000 starting at £60,000. This is an extension from SORP 2005 which included an exemption for smaller charities.

There is a new requirement to disclose the total pay for key management personnel in the notes to the financial statements. This is complemented by a requirement that the trustees' report explains the arrangements for setting the pay and remuneration of the charity's key management personnel and including any benchmarks, parameters or criteria used. Disclosures by individual remain voluntary.

For the first time, donations from the trustees and other related parties must be disclosed in aggregate. There are exemptions for disclosure of individual trustees' donations which are not subject to significant conditions over use.

The FRS 102 SORP allows subsidiaries (and the parent charity's own balance sheet) to adopt the reduced disclosure framework as set out in FRS 102. However, the disclosures required by the module 'Disclosure of trustee and staff remuneration, related party and other transactions' must be given in all circumstances.

For example, disclosure is not required for trustees' services provided on a voluntary basis to the charity, the purchase of minor articles, including tickets to events, which are offered for sale on the same terms as they are offered to the general public, the provision of services to a trustee where the service is on the same terms as for any other beneficiary, nor the amount of expenses waived by a trustee (unless material in the context of the charity's total expenditure). However, systems will be required to capture sufficient information for the aggregate disclosure.

Explanation of uncertainties in the notes to the accounts

Going concern

The trustees' report should contain an explanation of uncertainties about the charities ability to continue as a going concern. The accounting policies within the financial statements must explain if there are material uncertainties related to events or conditions that cast significant doubt on the charity's ability to continue as a going concern.

Explanations should be consistent between the trustees' report and the financial statements.
Risk assessment and reserves policies should reflect any disclosures made regarding uncertainties.

Volunteers disclosures required in the notes to the accounts as well as the trustees' report

Volunteers

Under the FRS 102 SORP a charity must include a description of the role played by general volunteers and provide an indication of the nature of their contribution in the notes to the accounts. This is in addition to the disclosure required in the trustees' report which was required in SORP 2005 and is also required in the FRS 102 SORP. Neither SORP requires volunteers' costs to be included in the accounts.

Charities need to consider how they track their volunteers, whether by number, hours provided or other method. It may be that even within a single charity different volunteers are tracked in a different manner for different activities. There should be an adequate audit trail for any disclosure.

Other areas to look out for:

- For those charities with complex financial instruments who had not previously applied FRS 26, one of the biggest areas for change will be accounting for **financial instruments**. These changes are reflected in the SORP modules on accounting for financial assets and liabilities. Complex financial instruments, such as derivatives which may historically have been off balance sheet, will now come on balance sheet and be measured at fair value through profit and loss. Limited hedge accounting will be permitted and may be of use, for example, with charities using foreign currency hedges.
- The requirements in respect of providing a five year summary of transactions relating to **heritage assets** held have been clarified and a template for the relevant disclosures is included in the SORP and the definition of heritage assets has been extended to include charities without conservation or preservation objectives
- **Social investments** now include both programme related investment and a new class of investment: mixed motive investment. (Where social investments are material larger charities must provide an explanation of their social investment policies and explain how investments contributed to the achievement of the aims and objectives).
- The SORP includes a guide to **accounting for charity combinations** flowchart which signposts modules to be used for specific accounting issues such as charity mergers and joint operations.
- Where the useful economic life for **goodwill and intangibles** cannot be reliably estimated, amortisation will be calculated over no more than five years⁵ rather than a 20 year maximum life. Change will not necessarily be required where a longer life has been appropriately justified.
- **Grants given** may now be listed in the notes to the accounts or on website with a weblink clearly given (the separate document permitted by SORP 2005 is no longer an option).
- **Operating and finance leases** should be reviewed and terms and conditions considered for each to reassess the nature of the lease following the removal of the 90% test. A finance lease is one which transfers substantially all the risks and rewards incidental to ownership, an operating lease is one which does not
- **Operating lease disclosure** is now consistent with IFRS and the total of future minimum lease payments should be disclosed for less than a year, one to five years and beyond five years.
- The impact of the requirement to **accrual for holiday pay** and unused benefits to which the employee retains the right at the end of the reporting period will need calculating for the current and prior year.
- The SORP does not allow charities to subsequently measure **investment properties** at cost less accumulated depreciation and any accumulated impairment losses.

⁵ The SORP consultation of summer 2015 recommended a change to 10 years in line with amendments made to FRS 102 subsequent to the FRS 102 SORP being issued.

- There are a number of one off transitional reliefs available for property, plant and equipment:
 - An item of Property, plant and equipment may be revalued to fair value on the date of transition, and that fair value may be used as 'deemed cost' at that date
 - A previous UK GAAP revaluation may be used a 'deemed cost' at the date of transition
 - FRS 102 requires the cost of a fixed asset to include an estimate of the costs of dismantling and removing the item and restoring the site. A first time adopter may elect to measure any such estimate as at the date of transition rather than on the date when the obligation arose

More resources and how we can help are available in our resource centre

Timing and resources

The FRS 102 SORP and FRS 102 both apply for periods beginning on or after 1 January 2015. As comparative information will be required, the first relevant balance sheet for 31 December 2015 financial statements will be 1 January 2014, and therefore, charities who have not started on their transition planning should start now.

When developing the plan discuss the timing with your auditors as you may be able to manage the process in stages. For example work on the format of the accounts, restatement of the prior year figures, recalculation of the allocations and identification of any other restatements could all be considered and reviewed in advance of the final audit visit.

More resources on new UK GAAP and how Deloitte can help you are available in our resource centre at www.deloitte.co.uk/futureofukgaap.

Contacts

If you would like further, more detailed information or advice and to discuss how this will affect you, please contact your local Deloitte partner or:

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