

SORP 2: THE ACCOUNTANTS' PERSPECTIVE

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The enactment of the Charities Act 1992 engendered, if nothing else, a wave of frustration among the voluntary sector's professional advisers. No more so than in the accounting profession, where we have vainly sought to fill our responsibility to our clients by explaining the Act's accounting implications. Section 20, we would say lamely, would have major implications leading to wholesale changes in the format and content of charities' accounts. How, when or where these changes were to take place, however, must alas remain shrouded in mystery for the present.

Small wonder that our clients regarded us with disappointment. Small wonder, therefore, that the publication of the Statement of Recommended Practice (SORP) 2 Exposure Draft under the auspices of the Charity Commission on 17th March 1993 has been welcomed as the first glimmer of light in the accounting world.

At the time of the draft SORP's publication there was an amount of surmise as to the influence it might have upon the drafting of the Section 20 Regulations. Historically, of course, there has been no question of conflict between legislation and recommended practice. The 1960 Act did not concern itself with detailed accounting requirements and the then SORP remained our sole authority on such matters. Now we not only had a draft SORP which was itself far more prescriptive than the original but would shortly have legislation which would also contain detailed accounting requirements.

Clearly, any legislative requirements which were contradictory to the SORP would make nonsense of the SORP, since legislation must always override recommended accounting practice. Given the complexity of the issues involved and the variety of potential accounting treatments, it seemed almost inevitable that legislation drafted without reference to the SORP would contain contradiction. Fortunately, the Home Office has now ended speculation by confirming to the Charity Lawyers Association that no conflict will ensue following publication of the Accounting Regulations in June 1994. The accounting requirements will be minimal, leaving the SORP to prescribe detailed accounting treatments in the same way as the old legislation.

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This makes the new SORP even more significant for charity officers and for professional advisers to the voluntary sector. We must not lose sight of the fact that the SORP Exposure Draft published in March will undoubtedly be the subject of further drafting before the final SORP emerges. At the same time, we can bear in mind that the Exposure Draft's publication followed a lengthy consultation process, involving representatives from the key sector bodies at committee stage.

Prescriptive Approach of Revised SORP

A noticeable change from the original SORP lies in the revised SORP's prescriptive approach. The original SORP permitted alternative accounting treatments in a number of areas. Whilst such flexibility has definite advantages, its drawback is that it makes for inconsistency in reporting between one entity and another. Given the increased focus on the financial performance of charities and the fact that such scrutiny is often performed by users who have no accounting background, this inconsistency can only lead to confusion. Recent months have seen increasing, and often misguided, media comment on the financial performance of individual charities exaggerated by the publication of sector league tables and performance ratios. Although this slanted media exposure is far from encouraged by the representative bodies, it will have been a factor pushing charities towards the adoption of standard practices.

The prescriptive approach (what the Commissioners refer to as 'precision in wording') has its own drawbacks. Chief among these is the diverse nature of the sector. Inevitably, some entities will find themselves squeezed into accounting treatments which are not appropriate to their operating circumstances.

Emphasis on Narrative

An interesting aspect of the revised SORP is the emphasis it places on narrative as well as figures. The trustees' report has always provided the narrative accompaniment to financial statements but in the past there has been considerable variation as to the way trustees of different charities perceive this duty. The revised SORP gives, for the first time, specific guidance as to the matters which the trustees should address. While some trustees may perceive this as yet one more onerous burden coming out of the legislative changes, it behoves us as professional advisers to impress upon our clients the potential value of the trustees' report. This report should be seen by the trustees as an opportunity. Here, the trustees can promote the charity's achievement to date and justify to donors, potential and present, the future funding requirement.

Format of Accounts

The most fundamental change in the financial statements themselves is to the format of accounts. Most trustees will have grown up with the traditional notion of a set of accounts as essentially a two page document comprising an income and expenditure account and a balance sheet. There may have been peripheral changes over the years in the form of supporting notes and funds flow statements but the primary financial statements have remained unchanged.

Statement of Financial Activities

In the revised SORP 2 we see a fundamental change, however, in that the old income and expenditure account disappears and is replaced by a new primary financial statement, the 'statement of financial activities'. In this respect, the revised SORP is in line with a general change in current accounting practice. The latest statement issued by the Accounting Standards Board, FRS3, deals with a new primary financial statement for all entities, the 'statement of recognised gains and losses'. The trend in accounting thinking is that the primary financial statements should provide a complete picture of the change in the entity's financial circumstances over the period of account.

Over recent years, accounting practices have been adopted whereby an artificial distinction between realised and unrealised losses has distorted the presentation of financial results. Amongst charities there has been the additional complication of special fund accounting. Too often, material transactions have been tucked away in the restricted or designated funds movement note without being given the prominence in the charity's financial statements which they merit. The Commissioners' contention appears to be a perfectly valid one. Financial statements should demonstrate the way in which the charity has administered funds for the purpose of its objects. Thus, the proposed statement of financial activities is designed to present a complete picture of the charity's activities. It will show the incoming resources, both capital and revenue, and the way in which and extent to which the funds have been spent. The statement will show the net effect on resources of revenue transactions which, added to capital gains and losses, have been variously expended on new fixed assets or retained for future use.

The revised SORP requires the statement to include a reconciliation to the balance sheet, matching the increase in resources carried forward with the change in the charity's net asset value. Whilst few commentators would dispute the principles behind the proposed statement of recognised gains and losses, few are blind to its considerable practical drawbacks. One likelihood is that users accustomed to traditional accounts may be confused by encountering revenue and capital transactions on the same financial statement. Furthermore, in the case of charities with a large number of designated funds, the statement will be so packed with information that it will be at best confusing and at worst incomprehensible to the average reader. Given the diversity in operating methods between charities, there is likely to be particular confusion in a comparison of the activities between one charity and another. Thus one charity may choose to 'expense' all project funding whilst another may treat capital expenditure on projects as part of the charity's on-going fixed assets.

Cost Category

Another area tackled by the SORP is the thorny problem of cost category. Again, recent media hype has been particularly damaging in this area in recent years. Many charities have been subjected to criticism which is unmerited and unjustified, arising out of media league tables which give no recognition to operating differences between different types of charity. The confusion has been

exacerbated by the lack of precise definitions of administrative overheads and direct charitable expenditure. The revised SORP proposes new definitions for 'fund raising', 'publicity' and 'administration'. It also introduces a new expenditure category, 'support costs'. The latter category will be particularly beneficial to project based charities whose administration expenditure under the existing guidelines often appears disproportionate to the amount of direct charitable expenditure.

Treatment of Investments

The aspect of the revised SORP which has excited the most critical debate is the proposed treatment of investments. The revised SORP requires these to be shown at market value. Concerns have been expressed that this is imprudent and that the distinction between realised and unrealised gains will be blurred. The main justification for the proposed treatment is that these are long term holdings and should therefore reflect the true measure of wealth and avoid a distorted earnings to capital ratio. A counter argument is that this recognition of unrealised gains is effectively to bring into account income which properly belongs to a future period. In the case of investment property in particular, there will be practical drawbacks in obtaining valuations which may lead to charities incurring costly professional fees.

Problems Identified in Debate on SORP

Some of the most informed debate on the SORP has taken place among the representative bodies of the charity sector. Understandably perhaps, since these are the individuals most affected. As associate members of the Charity Finance Directors' Group (CFDG), Chantrey Vellacott attended the CFDG meeting held to debate the SORP in April 1993. Some of the views expressed by this, the sector's most influential body, are set out below. Problems identified were of two categories, those where the CFDG membership considered the requirements impractical and those where they were held to be contrary to usual accounting practice. The former category included:

- Consolidation and branches
- Legacy income
- Donations in kind
- Fund-raising/publicity costs

The latter category included:

- Grant payments
- Investment valuation.

The major change with regard to consolidation is that trading subsidiaries can no longer be excluded from consolidation on the 'dissimilar activity' ground. The vote of the meeting was that more precise definitions of branches and 'connected' charities are required. An interesting point brought out in debate is that some major charities have adopted a mixed consolidation approach in their most recent financial statements. Under this treatment, some subsidiaries are included on a line-by-line basis whilst others are brought in as a one line consolidation, depending on the circumstances of the individual subsidiary.

The debate on donations in kind was with regard to the requirement that the trustees should not only provide details of facilities and services received free but should also give an indication of their value. The vote of the meeting was that it would be impracticable for the trustees to quantify donations in kind in this way.

The proposed treatment of legacies was opposed on prudence grounds and because of the practical difficulties involved in estimating the value of residual legacies. The vote of the meeting was that most charities would continue to account for legacies on a received basis, relying upon the SORP's overriding requirement for a 'prudent and practical' approach.

These thoughts from the CFDG debate are included for interest and as showing the practical difficulties which our clients would face in implementing the SORP in its present form. Clearly, other aspects have been debated by other representative bodies and a variety of comment has been made to the Commissioners.