

THE FUTURE OF UK GAAP

Response to consultation by the Accounting Standards Board

Submitted by:

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January 2010

Basis of comments

These comments are submitted on an individual basis by Gareth Morgan, Professor of Charity Studies at Sheffield Hallam University and leader of the University's Centre for Voluntary Sector Research.

They draw in particular on the points raised at a conference *The Future of Charity Accounting: SORP, GAAP and IFRS* held at Sheffield Hallam University on 14 January 2010, with over 90 participants and with speakers from the Charity Commission and Accounting Standards Board. (However, no votes were taken on any issue, and this should not be seen as a formal response on behalf of those present at the conference.)

The comments also draw on the author's experience over some 15 years of academic research on charity accounting, and experience in working with several hundred small/medium charities either as an independent examiner (reviewing the accounts under s43 of the Charities Act 1993) or as a consultant on accounting and financial management issues.

Applicability

My comments are *only* concerned with the impact of the consultation on *Tier 3 Entities* within the terminology of the paper (broadly, those up to £6.5m income) and within this, only with *Public Benefit Entities with charitable status*. No firm opinion is expressed on the issues in the paper in terms of other entities.

The comments below thus focus on Questions 8 onwards.

However, I recognise that any future GAAP cannot consider charities in isolation, and my comments take account of the need for consistency with the financial reporting requirements for other types of entities.

Responses to Consultation Questions

Question 1 – *Which definition of Public Accountability do you prefer: the Board's proposal (paragraph 2.3) or the current legal definitions (paragraph 2.5)? Please state the reasons for your preference. If you do not agree with either definition, please explain why not and what your proposed alternative would be?*

A1 – No particular opinion as the issue does not affect Tier 3 charitable entities.

My only comment, though, is that if the definition of Public Accountability includes *any* deposit-taking entity regardless of size, this will include small credit unions. Although credit unions are not charities, they are widely seen as part of the third sector/voluntary sector, and compliance with full EU adopted IFRS would be a huge burden for such organisations which, though regulated by the FSA, are voluntarily governed and often run by very small staff teams, often part-time.

Question 2 – *Do you agree that all entities that are publicly accountable should be included in Tier 1? If not, why not?*

A2 – See comment to A1.

Question 3 – *Do you agree with the Board's proposal that wholly-owned subsidiaries that are publicly accountable should apply EU adopted IFRS? If not, why not?*

A3 – No opinion.

Question 4 – *Do you still consider that wholly-owned subsidiaries that are publicly accountable should be allowed reduced disclosures? If so, it would be helpful if you could highlight such disclosure reductions as well as explaining the rationale for these reductions.*

A4 – No opinion.

Question 5 – *Do you agree with the Board's proposal that the IFRS for SMEs should be used by 'Tier 2' entities?*

A5 – This would seem sensible, though I would not wish to comment in detail as this response is primarily concerned with Tier 3.

Question 6 – *Do you agree with the Board's proposal that the IFRS for SMEs should be adopted wholesale and not amended? If not, why not? It would be helpful if you could provide specific examples of any amendments that should be made, as well as the reason for recommending these amendments.*

A6 – No opinion.

Question 7 – *Do you agree with the Board's proposal that large Non-Publicly Accountable Entities should be permitted to adopt the IFRS for SMEs? Or do you agree that large entities should be required to use EU adopted IFRS? Please give reasons for your view.*

A7 – No opinion.

Question 8 – *Do you agree with the Board that the FRSSE should remain in force for the foreseeable future?*

A8 – Yes, definitely. The FRSSE is very helpful in enabling smaller entities to comply effectively with accounting standards without being overwhelmed by individual standards which would be impossible for such entities to apply meaningfully. This applies both within the framework of UK GAAP as it stands at present, and in the context of future implementation of IFRS as part of UK GAAP. Compliance even with the IFRS for SMEs would be a huge challenge for entities under £6.5m income, especially for charities where there are also so many sector-specific factors to consider in addition.

Question 9 – *Do you agree that the FRSSE could be replaced by the IFRS for SMEs after an appropriate transition period, following the issuance of the IFRS for SMEs?*

A9 – For the reasons given in A8, this would present considerable difficulties. Whilst one cannot say “never” I would encourage the ASB to commit to retaining the FRSSE for at least 10 years following convergence.

Question 10 – *Do you agree with the Board’s current views on the future role of SORPs. If not, why not?*

A10 – This issue is critical to the consultation, but the consultation paper does not seem to have a clear overall recommendation. The table in para 2.36 gives proposals for some SORPs but refers to reader to Section 3 in the case of the SORPs for Charities, Universities, and RSLs. But Section 3 raises a number of options for these, rather than offering a single recommendation.

However, in terms of the specific issues of the Charities SORP, there is certainly ample evidence that this has been extremely effective in bringing about vast standards of improvement in charity accounting and financial reporting (including narrative reporting by trustees). The framework of fund accounting using a Statement of Financial Activities (SOFA) which the Charities SORP created, has been hugely beneficial in enabling charity trustees and other users of charity accounts to understand the nature of the resources available to charities.

Moreover, unlike some other SORPs, the Charities SORP is not just prepared by an industry working party and submitted for the ASB Statement of Assurance. It is directly referred to in the relevant legislation in three separate UK jurisdictions:

- England & Wales: in the *Charities (Accounts and Reports) Regulations 2008* – made under the Charities Act 1993 as amended
- Scotland: in the *Charities Accounts (Scotland) Regulations 2006* made under the Charities and Trustee Investment (Scotland) Act 2005
- Northern Ireland: forthcoming accounting regulations under Charities Act (Northern Ireland) 2008 will almost certainly refer to the Charities SORP.

If for some reason the Charities SORP were to disappear, such legislation would require amendment. It might well be that much of the SORP would end up having to be restated in full in these regulations.

There are also some complex issues here in terms of the interaction between company law and charity law, but it should be noted that less than 20% of charities are companies (based on data from the Charity Commission and OSCR). With the anticipated implementation of the Charitable Incorporated Organisation (in the Charities Act 2006 and expected to take effect from 2010) it is *unlikely* that the proportion of charities choosing the company form will increase in future.

In considering the future of SORPs, it is vital, therefore, for the ASB to note that many of the entities affected are *not* entities subject to company law. This is not just the case with the Charities SORP – it would also apply to the Universities SORP (where most entities are Royal Charter Institutions or HE Corporations).

In summary, therefore, it is very difficult to see how the convergence agenda can be advanced in terms of its application to specific industries *without* the continuance of SORPs. If this is accepted, SORPs should continue to be developed along the lines of the ASB statement (2000): *SORPs: Policy and Code of Practice* (albeit with the principles updated for UK GAAP under IFRS). They should therefore continue to have an ASB Statement of Assurance (SoA)

In the charity context, the ASB SoA is the means by which the SORP is applied even for accounting requirements of company law (where the company is a charity) and in the regulations under charity law (for charities which are *not* companies). Without the ASB SoA, charitable companies would face uncertainty whether their SORP accounts met the requirements of company law, and divergence would emerge between the financial reporting of charities depending on their legal structure. This would be highly undesirable in terms of the users of charity accounts.

Question 11 – *Do you agree with the Board's proposal to develop a public benefit entity standard as part of its plans for the future of UK GAAP? If not, how should (converged) UK GAAP address public benefit entity issues?*

A11 – It is possible to construct good arguments for each of the four options in para 3.12, namely:

- i. A public benefit entity framework**, similar to the ASB's *Interpretation for PBEs of the Statement of Principles for Financial Reporting* – covering principles but not specific accounting requirements;
- ii. A public benefit (not-for-profit) standard** – setting out where different accounting is required for public benefit entities;
- iii. Separate standards on public benefit issues** – for example a standard on contributions, a standard on fund accounting, a standard on the presentation of the primary statements, etc; and
- iv. Supplementary text in UK GAAP** – for example separate paragraphs, or Application Notes, in a fixed asset standard on measuring the service potential of assets, or in a business combinations standard on acquisitions at nil or nominal value or merger accounting.

However, on balance, I would strongly favour option (i) – a *public benefit entity framework* – but still allowing the standards for specific PBEs to be set out in SORPs (so long as the SORP complied with UK GAAP and with the PBE Framework document).

This view also came across with the greatest support in the conference at Sheffield Hallam University on 14 January.

For the reasons argued above, it would be disastrous if the Charities SORP were to disappear. So if the SORP is to continue (at least for charities, but probably for other sectors too) it would be a mistake for the ASB to issue a standard or standards which covered the detailed industry-specific issues that are normally covered by SORPs.

The existing *Statement of Principles on Financial Reporting: Interpretation of Public Benefit Entities* has been very helpful in providing the foundations for SORP-making for PBEs, and a similar *PBE Framework* would be the best way of taking this forward.

However, the PBE Framework should only deal with issues applicable to all types of PBEs – it should not attempt to address detailed financial reporting requirements needed to comply with charity law (for example).

Some of the issues suggested by option (iii) above could possibly be incorporated into a PBE Framework, so I do not see options (i) and (iii) as mutually exclusive, but the focus should only be on issues common to all types of PBEs.

I also have no problem with option (iv) if used alongside option (i) – so, once the Board had issued a PBE Framework any further generic standards might, where necessary, comment on the specific implications for PBEs. But any such additional paragraphs should take care only to deal with generic principles, and not with industry-specific details which should be left to SORPs. There should be ample consultation with the relevant SORP-making bodies to avoid conflict or uncertainty over implementation timing. (The recent issue of FRS30 on *Heritage Assets* is an example of where such issues and difficulties can arise.)

Question 12 – *If you do agree with the proposal to develop a public benefit entity standard, should the standard cover all the requirements for preparing true and fair view accounts or should it cover only those issues where IFRS or the IFRS for SMEs needs to be supplemented for the public benefit entity sector?*

A12 – For the reasons given in answer to Q11, it would be better for the ASB to develop just a *PBE Framework*. This should *not* attempt to be a comprehensive standard, but should *only* deal with issues where principles of IFRS need different application to PBEs. In terms of providing an “all in one standard” or “one stop shop” for PBEs, this should be left to the SORPs. Trying to produce a standard which covered all PBEs would be unwieldy, and would require massive references to different legislation. It would be almost impossible to use.

Rather, the various SORP-making bodies should be encouraged, where they have the necessary resources, to develop their SORPs in a manner would cover all the requirements for preparing true and fair view accounts within the industry concerned. This has worked very well for the Charities SORP, which is applied by around 50,000 entities.

The approach of the Charities SORP 2005, which includes an appendix referring to all the main accounting standards and their specific impact on charities, is a helpful way of addressing this “all in one” approach (and makes it relatively easy for the ASB then to check the SORP for compliance with accounting standards before issuing an SoA to appear in the SORP).

Question 13 – *Do you agree the issues listed in the above table are distinctive for the public benefit entity sector and should therefore be covered in a public benefit entity standard? What other issues might the proposed standard include?*

A13 – I agree that most of the issues in table 3.15 would need to be addressed in standards for PBEs at some level, but most of these issues would be best addressed in SORPs for the sectors concerned.

There are some underlying *principles* for most of the items in the table, which should certainly be addressed only in a PBE Framework, but the detail should be left to SORPs.

The ASB should also avoid forcing a single approach to any of these issues if, in fact, there is more than one approach which could give a true and fair view. But a *statement of principles* on issues such as fund accounting, and revenue recognition from non-exchange transactions would be helpful.

Question 14 – *The Board accepts there may be a continuing need for guidance to supplement a public benefit entity standard in sectors such as charities, housing and education. Where this is the case, do you think the Board should provide a Statement confirming the guidance is consistent with UK GAAP, including the public benefit entity standard?*

A14 – Yes, the Board should certainly continue to issue a Statement of Assurance for industry-specific guidance, for the reasons discussed in answer to Q10. However, such industry-specific guidance should continue to take the form of a SORP – anything with a lesser status simply would not work, especially in sectors such as charities where the SORP is referred to in legislation.

Question 15 – *If you are an entity whose basis of preparing financial statements will change under these proposals, what are the likely effects of applying those new requirements? Please indicate both benefits and costs and other effects as appropriate. If you are a user of financial statements (such as an investor or creditor) what positive and negative effects do you anticipate from the implementation of the proposals set out in this paper?*

A15 – I am responding to this question as someone involved as a preparer and user of financial statements for a wide range of small/medium charities.

It is hard to answer this question without knowing as yet the full impact of changes to accounting standards as UK GAAP is updated to conform to IFRS. However, at first sight it would appear that there are relatively few cases in charities where the application of IFRS would lead to substantially different figures in the accounts – either on the income statement (SOFA at present) or statement of financial position (balance sheet) than is currently the case.

The real difficulties would arise if the convergence led to:

- (a) major compulsory changes of terminology; or
- (b) major changes to notes or disclosures; or
- (c) new requirements for narrative reporting which did not make sense when applied to charities.

On the issue of terminology, the charity SOFA (Statement of Financial Activities) is now well recognised and accepted as an alternative to a P&L account or I&E account but still meeting the requirements of UK GAAP. The SOFA should *continue* to be accepted as meeting the needs of a SOCI under IFRS. Pragmatic decisions of this kind will reduce the need for massive costs and retraining for those preparing charity accounts.

Question 16 – *What are your views on the proposed adoption dates?*

A16 – The timescale proposed (implementation for financial years beginning on or after 1 Jan 2012) seems reasonable.

However, the ASB will need to issue final confirmation of this timetable very soon if all parties are to be ready. Most SORP-making bodies will need to issue new SORPs in 2011. This would mean the proposed new *PBE Framework* (option (i) in para 3.12) would need to be issued by late 2010 or first quarter of 2011 at the latest.