SORP consultation: Update Bulletin 2 – Exposure Draft

Response from the Association of Charitable Foundations (ACF)

March 2018

About ACF

ACF is the membership body for UK foundations and grant-making charities. Driven by a belief that foundations are a vital source for social good, our mission is to support them to be ambitious and effective in the way that they use their resources. We do this through the provision of policy and advocacy, research and information, and a wide-ranging programme of events and learning. Our 350 members collectively hold assets of around £50bn and give over £2.5bn annually.

This submission

This response is informed by direct contact with members as well as our own insight gained from 30 years of working with funders. Our members have a crucial perspective in that they have a dual role:

- They are charities in their own right, required to produce their accounts and report in accordance with the SORP, but distinctive in that the majority have substantial financial assets that they manage.
- They are also organisations that read accounts and need to understand the audited accounts and annual reports submitted to them by charities seeking grants or other forms of financial assistance.

In this submission we comment on three of the 21 proposed changes. These are:

1. Definition of a financial institution *(Exposure Draft paragraphs 5.1 and 5.2)*
2. Additional disclosures on financial instruments *(Exposure Draft paragraphs 5.7 and 5.8)*
3. Investment property *(Exposure Draft paragraphs 4.3 to 4.6)*

Our conversations with members suggest there is a need and a desire to review the purpose, structure and content of charity accounts so that they better serve foundations as both readers and preparers of accounts. It is important to remember that within the foundation, it may not be the same members of staff who both read and prepare the accounts; those who read the accounts may not have expertise in financial reporting standards and may not be in a position to comment on the technical detail of the charities SORP as it relates to FRS 102.

In light of this, we would welcome further engagement with the joint SORP-making body and the SORP Committee to explore ways in which improvements might be made to the SORP in consultation with readers of accounts to whom clarity, readability and accuracy are of paramount importance. We do not feel the constraints of this consultation period allow for broad discussion, but we would like to open the channels of dialogue to think about future iterations of the charities SORP.

Below we set out our comments on the issues identified by ACF and members.

1. Definition of a financial institution

The draft Update Bulletin 2 proposes an amendment to the definition of a financial institution which removes references to 'generating wealth' and 'managing risk', and therefore is likely to catch more charities. For these charities, there will be a significant increase in disclosures required by section 34 of FRS 102.

Feedback suggests that the language used to describe mixed motive investments is unhelpful and to an extent misleading. The underlying intent of a mixed motive investment is to generate returns for charitable purposes; to imply that this activity is similar to that undertaken by financial institutions such as banks would be to misrepresent the different strategies and approaches foundations use in their investments. This amendment should be reviewed to avoid misrepresenting foundations' accounts.

Feedback has also suggested that the additional disclosures required could deter some foundations from making mixed motive investments, if they felt the reporting required was unduly burdensome. We recognise that the intention is not to influence investment decisions, but this may be an unintended consequence of this amendment.

There are also concerns about the value of additional reporting for the charities caught by the definition of a financial institution. The joint SORP-making body might ask whether the lay reader of charity accounts would understand the disclosures and why a given charity classes as a financial institution. The level of detail may be unduly complex for all but those with pre-existing knowledge of financial reporting standards, and therefore would only serve to lengthen and complicate charity accounts. It may even mislead the reader by equating charities with other financial institutions.

We encourage the joint SORP-making body to reconsider this amendment, and engage with those making mixed motive investments or thinking of doing so.

2. Additional disclosures on financial instruments

The draft Update Bulletin 2 proposes an amendment which would see charities investing in certain financial instruments making additional disclosures. We have been informed that the aim of this is to ensure the risks of doing so have been assessed and managed appropriately.

Feedback from members has highlighted the difficulties and impracticalities of knowing whether relevant financial instruments are held when portfolios are complex and/or not managed in-house. It may be unreasonable to expect foundations – particularly smaller ones with limited capacity – to offer the additional disclosures.

We also question the use of language in the paragraph that is to be inserted. The draft Update Bulletin 2 states that charities are 'encouraged' to make additional disclosures and that they 'may be required'. This choice of phrasing is somewhat ambiguous and does not offer certainty as to whether the disclosures are mandatory, best practice, or optional (following standard sector practice around the use of 'must', 'should' and 'may').

3. Investment property

Regarding the proposed change to accounting for investment property, a member commented:

"The option to show investment properties at cost rather than market value may be at odds with the use of the property. In most instances, where a charity is renting to another group entity, I would expect the other entity to be making some kind of return (which is used to pay the rent charged by the charity). It feels like treating these transactions in the same way we do other investment properties would give users of the accounts the clearest understanding.

I would expect some charities to run into difficulty once the 'undue cost and effort exemption' is removed for valuing the components mixed use properties. This is the case where a charitable activity is undertaken from a building which also provides commercial returns, particularly where the space used for the charitable and commercial components overlap. For example, imagine a café staffed by people living with disabilities, which serves to provide both investment income and employment opportunities. I would be interested to know how a professional valuer would split the property."

Additional comments

Although not included in the current consultation, we wish to use this opportunity to draw attention to the needs of foundations taking a total return approach to their investments. A total return approach permits trustees to spend any part of the investment return from the endowment including income, dividend and capital growth. The current charities SORP does not allow foundations to show the amount of capital that trustees have converted to income that year clearly in the total income column. Current requirements risk giving the misleading impression that expenditure is disproportionately high compared to income and that the charity is mismanaged. We suggest that these paragraphs might be reviewed to clarify how charities with investments might better show the conversion of capital gains in the endowment to income available for expenditure.

We are grateful for the opportunity to comment on the Update Bulletin, and hope the joint SORP-making body and the SORP Committee takes on board the above feedback from foundations.

We'd like to reiterate our desire to engage with the joint SORP-making body and the SORP Committee not only with regards to technical amendments but on the wider purpose, content and structure of the charities SORP, and we look forward to continuing conversations beyond this consultation period.

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