Charity

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SORP 2005 & Branches

A guide for charities

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The glossary of terms in the Charities SORP 2005 (the SORP) refers to charity branches as 'entities or administrative bodies set up, for example, to conduct a particular aspect of the activities of the reporting charity, or to conduct the activities of the reporting charity in a particular geographical area. They may or may not be legal entities which are separate from the reporting entity' (GL4.1). How a branch is accounted for under the special rules of charity accounting legislation depends on its level of administrative autonomy, based on its constitution, which determines whether or not the legislation requires it to be accounted for as a separate legal entity.

The purpose of this helpsheet is to give guidance on when, how and why you may have to account for a charity branch. The helpsheet shows how branch accounting fits in with the provisions of the SORP for group accounts in respect of subsidiary charities and other controlled entities. It also provides guidance on the interaction of different legal and regulatory requirements and considers what constitutes control by a charity of another entity or administrative body, for accounting purposes.

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Legal and regulatory requirements

The Charities Act 2011 (CA 2011) requires even the smallest of charities to account for any branches. Company law and charity law each specify the form and content of accruals accounts, requiring them to show a true and fair view of the reporting entity (i.e. also including any branches and, for any group consolidated accounts, other controlled undertakings).

The SORP includes recommended practice on accounting for branches (paragraphs 77 to 81) and subsidiaries (paragraphs 381 to 406). If the gross income of a charity's group exceeds £500k after consolidation adjustments, CA 2011 requires consolidated accounts to be prepared, the form and content being set out in the Charities (Accounts and Reports) Regulations 2008 unless they are already required under the Companies Act 2006 (the Companies Act).

Branches that are an administrative part of the charity

A branch that is not a separate legal entity will generally be accounted for simply as part of the reporting charity's own accounts (SORP paragraphs 77 to 81). The SORP's Glossary (Appendix 1) contains a comprehensive definition of branches at GL4 to help you decide whether or not any other charity connected with your charity is a branch.

Further considerations

Paragraph 4.2 in GL4 states that 'for the purposes of this SORP, a "branch" is (a) either simply part of the administrative machinery of the reporting charity, or (b) a fund shown in the accounts as a restricted or endowment fund. Two types of entity are covered by this second category, each of which should be treated as linked to the reporting charity for accounting purposes:

(i) a separate legal entity (being a trust or unincorporated association or other body formed for a charitable purpose) which is administered by, or on behalf of the reporting charity and whose funds are held for specific purposes which are within the general purposes of the reporting charity … ; or

(ii) in England and Wales, a separate legal entity not falling within (i) over which the Charity Commission has, by agreement with the trustees, issued a 'uniting direction' to 'link' it on the online Register of Charities with the reporting charity for reporting purposes (see below). (It is also possible for the Charity Commission to issue a 'disuniting direction' to make a controlled charity separately accountable in the public interest.)

Overseas branches

If your charity has set up an overseas branch as an autonomous legal entity under local law, it may be separately accountable in that territory but not in England and Wales. In so far as it is not registrable with the Commission as a separate charity (nor excepted as such), the Commission will not be able to issue a uniting direction for it. Such an entity, not being accounted for as a branch of your charity, can then only be properly accounted for under CA 2011or the Companies Act by group accounting.

Special trusts

Section 287, CA 2011 defines a special trust as property that is held and administered by or on behalf of a charity for any special purposes of the charity and that is so held and administered on separate trusts relating only to that property. CA 2011 provides that a special trust does not, by itself, normally* constitute a charity for the purposes of Part 8, CA 2011 (charity accounts, report and returns), but instead is to be included in the accounts of the charity it is set up to support. This would be as a restricted fund (capital or income,
according to their terms of trust in each case) of the reporting charity. A common example is a special-purpose endowment or a school's prize fund. (*However, s12(1)(b) CA 2011 allows the Commission to issue a disuniting direction, which will then make the special trust publicly accountable as a separate charity after all.)

Charitable companies themselves can never be special trusts (see below), but many of them, in addition to their own corporate reserves (funds) do have charitable trust funds to administer (i.e. to control) or have the benefit of special trusts administered by other trustees. Because the entity accounts of charitable companies are prepared in accordance with the Companies Act, trust accounting in accordance with the SORP is best practice for giving a true and fair view rather than mandatory.

Although there is no such specific requirement in the Companies Act, the Charity Commission takes the view that all charitable companies, even the smallest, do need to include any charitable trusts for which they have public accountability under Part 8 of CA 2011, in order to give a true and fair view as a charity of the company's financial position.

and financial activities. (Non-beneficial trusts are disregarded in determining 'parent and subsidiary undertaking', as paragraph 6 of Schedule 7 to the Companies Act 2006 says: 'Rights held by a person in a fiduciary capacity shall be treated as not held by him'.)

This interpretation is reinforced by *Practice Note 11 The Audit of Charities in the UK (Revised)* issued by the Auditing Practices Board (now the FRC Audit and Assurance Council), which states that compliance with the Charities SORP is normally unavoidable for a charity's accounts to be able to show a true and fair view.

The law requires that charitable companies' group accounts must include any material, beneficially controlled charities. This means that any 'branch' charitable trusts not already included in their company's entity accounts will be caught.

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Uniting directions issued by the Charity Commission

The Charity Commission can use its statutory powers to give uniting directions, easing the administrative burden on connected charities for which separate annual reports and returns would otherwise have to be produced and filed, as well as, for non-company charities, separate statutory accounts and audit/examination reports. A uniting or linking direction can be made where two or more charities share the identical trustee body, or where their purposes and activities are so closely related that they can be publicly accounted for as a single charity. This enables a single set of accounts to be produced by one of the charitable trusts with the other trust being a restricted fund.

However, the two charities still remain separate legal institutions, each with their own governing document. A fuller explanation of uniting directions can be found in the Charity Commission's publication RS4 – Collaborative working and mergers, pages 20 and 68. Charity Commission policy and practice on 'linking' charities is set out in Operational Guidance OG555.

Branches that may have to be accounted for as subsidiaries

Generally, where a charity's local branch is separately constituted in law, unless it is a special trust (see above) separate statutory annual reports and accounts will have to be prepared, as its own trustees will be publicly accountable for it as a distinct charity.

These accounts must then be consolidated in group accounts if there is a parent charity that is able both to direct and benefit from the local charity. Benefit to a parent charity may arise if, say, the subsidiary provides services which contribute to the objectives of the parent charity. If the benefit test is not met the accounts should not be consolidated (see SORP paragraph 386).

Further considerations

Charities under common control

To see whether two charities are under common control, you can use the SORP's related party definition in its Glossary GL50, which says this is where the same person(s) 'have the right to appoint a majority of the charity trustees of both … charities or hold a majority of the voting rights in the administration of both … charities'. GL50 goes on to explain that 'persons who are related with each other through family or business relationships should be treated as the same person …'

If such a connected charity is not included in the reporting charity's entity accounts as its charity branch, but it is controlled beneficially by the reporting charity, it will have to be considered for inclusion as a subsidiary undertaking in any group consolidated accounts the reporting charity prepares.

Transactions between funds

Care is needed to ensure that any intra-group transactions between two distinct trust funds are disclosed in order to show the proper application of each of those charitable trust funds. While the consolidated balance sheet will need to reflect the net position (for example, only extra-group debtors and creditors), the notes will need to reflect the transactions between the different funds (for example, the inter-fund debtors and creditors will need to be disclosed in the net assets held by funds.

Other branches

As the SORP's Glossary GL9 puts it: 'Connected charities are those which have common, parallel or related objects and activities; and either: (a) common control or; (b) unity of administration. Within this category may be charities which come together under one umbrella organisation or are part of a federal structure.' Many local and some special purpose charities have a connection with a national umbrella charity that is easy to identify by the close liaison between them.

However, unless they are special trusts of the latter or (by mutual agreement) they have been linked on the Commission's online Register of Charities or there is a parent–subsidiary relationship (as discussed above) there will be no accounting implications although related party disclosure obligations may arise.

Consolidated accounts rules for charity groups
The SORP's requirements for the consolidation of subsidiaries are collected together in paragraphs 381to 406. It requires a line-by-line consolidation of the charitable and non-charitable activities of the group for all subsidiaries.

Paragraph 383 of the SORP states that a parent charity must prepare consolidated accounts including all its subsidiary undertakings where the combined gross income of the parent charity and its subsidiary undertakings exceeds £500k, or where group accounts are required by the Companies Act.

The key to determining whether an entity is a subsidiary is whether it has a parent undertaking, and paragraphs 388 to 392 of the SORP give guidance on determining whether a charity is a subsidiary undertaking i.e. meets the tests for control (the parent's ability to direct and benefit). Paragraphs 383 and 384 explain the circumstances where consolidation is not required. One such exception is where the subsidiary is not a company and, by virtue of being a special trust or a linked charity (i.e. one that is subject to a uniting direction under CA 2011 – see above), has had its accounts aggregated with those of the reporting charity in the latter's entity accounts.

The accounting treatment for non-subsidiaries is set out in paragraphs 413 to 416 of the SORP without any charity-friendly modification of FRS9's distinction between sole and shared control, despite the inapplicability to charities of the commercial ring fencing of distributable profits.

Associates (Paragraph 413)
The charity's net interest in the results for the year in the associates should be shown as a separate row after the 'net incoming resources/(resources expended) before transfers' row in the statement of financial activities (SOFA). In the balance sheet, the net interest in associates should be shown as a separate row within fixed-asset investments.

Joint Ventures (Paragraph 414)
Joint ventures should be accounted for on a gross equity method. Gross incoming resources from joint ventures should be included under the appropriate headings on a line-by-line basis with an additional row showing the total share of gross incoming resources from joint ventures as a reduction in total incoming resources. (This means that the elements of incoming resources are reflected in the SOFA, but with a net effect on the total incoming resources of zero.

In addition, a row showing the net interest in the results for the year in the joint venture should be included in a separate row after the 'net incoming resources/ (resources expended) before transfers' row in the SOFA. The figure may be combined with that arising from any associates). In the balance sheet the share of the gross assets and the gross liabilities should be shown in a linked presentation within fixed-asset investments.

Joint arrangements
Normally, the charity's gross share of the incoming resources and resources expended and the assets and liabilities should be included in the same way as for a branch.

Further considerations

A situation now becoming increasingly common, if only for risk management reasons, is for a charity to use the public benefit activities of a non-charitable subsidiary (for example, a social enterprise) to further its own objects. If the control test is met, the non-charitable subsidiary's results should be consolidated in the group accounts.

If the control test is not met then there is not a parent subsidiary relationship. This might arguably be the case if, for example, all the ordinary voting shares in a trading company were non-participating and owned by a charity holding them on trust as an inalienable endowment in specie, with all the equity in the company being held by external non-voting shareholders, either the descendants of a founding entrepreneur or possibly a private trust for the present employees of the trading company.

However, without such an inalienability the charity would be unable to refute the counterargument that under the Trustee Act 2000 it should consider selling its control shares in the open market and replace them with a diversified portfolio of investment securities carrying rights to equity participation (rather than, as tends to be the case, depending on the generosity of the subsidiary's board for annual donations to fund charitable activities).

Exemptions from consolidation

The SORP'S 'Small Group' total exemption from consolidation
The SORP and its related 2008 Regulations (SI 2008/629) only require the parent to produce consolidated financial statements if gross income exceeds £500,000 for either the parent individually or for the group.

CA 2011's blanket consolidation exemption for all sub-groups (s139(1), CA 2011) – unlike that of the Companies Act – is only where the reporting parent charity is a subsidiary of another charity. However, Regulation 19 of SI 2008/629 does mirror the Companies Act's surviving four categories of specific exemptions: (i) immateriality; (ii) severe long-term restrictions on the exercise of parental control; (iii) disproportionate expense or undue delay; and (iv) subsidiaries held as current assets for disposal.

The 'immaterial results' exemption

Regulations made under CA 2011 allow exemption from consolidation where the inclusion of a subsidiary undertaking is not material for the purposes of giving a true and fair view. The exemption here is for any subsidiaries that are (in aggregate) immaterial for a true and fair view of the group to be given. Testing for immateriality involves comparing the charity's entity accounts with its proposed group accounts in respect of the effect of including in the latter the subsidiary's income, expenditure, assets and liabilities.

The 'severe long-term restrictions' exemption

As explained in paragraph 384 of the SORP, FRS 2 allows subsidiaries to be excluded from consolidation where there are severe long-term restrictions which substantially hinder the exercise of the parent undertaking's rights over the subsidiary undertaking's assets or management. The restrictions must be actual – not just potential. However, the SORP suggests that it is unlikely that these exclusions will generally apply to a charitable group.

Omission of the entity SOFA in consolidated accounts

The Charity Commission is prepared to accept statutory consolidated accounts that omit the SOFA for the parent company provided that the gross income/turnover and results of the parent charity are clearly disclosed in the notes. However, the Charity Commission retains the power to require the production and filing of the parent charity's individual SOFA and similarly members of the public have a legal right to request this statement (SORP paragraph 397).

Further considerations

Strictly speaking, non-company parent charities do not have a special dispensation such as provided to company charities by the Companies Act that allows them to omit their entity SOFA in favour of a consolidated SOFA covering the parent's group interests. However, the Commission's policy is to accept consolidated accounts of groups headed by a non-company charity provided that the key results (gross incoming resources, costs of generating funds, charitable activity costs, governance costs, also gains/losses) of the parent charity are clearly disclosed in the notes.

Cross-border charities filing with OSCR

Nearly 700 ‘foreign’ charities operate in Scotland (mostly English-registered) and so are registered with OSCR and subject to the Scottish charity monitoring regime. OSCR’s policy is to accept for filing the same annual report and accounts that are filed each year with the Charity Commission, provided that they comply with Scottish law governing accounts preparation and audit or independent examination and the contents of the trustees’ annual report in accordance with the SORP’s ‘methods and principles’.

It should be noted that the SORP’s related Scottish Regulations (SSI.2006/218 as amended by SSI.2010/287), which technically overlay the Companies Act requirements for charitable companies, make no provision for dispensation where the entity SOFA is omitted from group consolidated accounts. However, OSCR normally does not reject consolidated accounts just for excluding the entity SOFA of the parent charity.

Distinguishing non-charitable trading funds in the group balance sheet

Many charities ring fence the usual taxable trading activities for tax-exemption and any high-risk charitable activities within a non-charitable subsidiary. The SORP says at paragraph 406: ‘In consolidated accounts, funds or reserves retained by subsidiary undertakings other than funds to be used in carrying out the charity’s objects should be included under an appropriate separate fund heading in the balance sheet (e.g. funds retained within a non-charitable subsidiary).’

It is not always easy to identify the amounts attributable to taxable trading activities that belong in the accounts of the non-charitable subsidiary. For non-charitable trading, the amounts can be affected by consolidation adjustments to eliminate deferred tax liabilities in the subsidiary’s accounts. If these represent timing differences arising on capital allowances, the provision can be eliminated in the group accounts in recognition of the mitigating effect on the subsidiary’s future taxable profits of a profit-stripping covenant or other binding commitment to continue donating to the parent charity under the Gift Aid scheme.

Group Trustees' Reports

Where group consolidated accounts are prepared, a group trustees' report must be prepared in accordance with Regulation 41 of SI 2008/629. This adds in narrative reporting on the aims, objectives, activities and achievements of subsidiary undertakings, on their investment policy and performance (unless immaterial to the group) and extends the statutory declaration concerning 'major risks' to cover them, too, thus supplementing all those disclosures for the parent charity itself.

The group trustees' report must also disclose the subsidiaries' organisational structure and principal sources of income and the extent to which any [revenue] reserves retained in the subsidiaries have affected the parent charity's reserves level and policy. If any subsidiary had a material opening deficit of capital and reserves in its balance sheet at the previous year end, Regulation 41 requires disclosure of the steps it has taken to eliminate the deficit.

Further considerations

The Companies Act allows companies subject to the small companies' regime to file abbreviated accounts i.e. without the directors' report or profit and loss account. This provision includes charities (entities or groups) that are below the audit threshold, so that they need not file their trustees' report (referred to in the document, for example by using a subheading, as the directors' report) or statement of financial activities (including income and expenditure account). However, the view of ICAEW is that the same annual accounts should be placed on the public records at Companies House and at the charity regulator, and as a matter of good governance/accountability and transparency we do not consider it appropriate for a company charity to file abbreviated accounts at Companies House.

However, the fact that s444, Companies Act 2006 allows companies to omit the directors' report means that a SORP-compliant trustees' report can be filed without the subheading/description 'directors' report' as 'additional information useful to accounts users'. This enables company charities to make use of the charity law (not company law) dispensation that permits a charity (e.g. a women's refuge) to omit the disclosure of its location and directors' names on risk grounds.

FOR GENERAL INFORMATION ONLY

Please note that this helpsheet is not intended to give specific technical advice and it should not be construed as doing so. It is designed to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.

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