



**THE  
CHARTERED  
INSTITUTE OF  
TAXATION**

**CIOT/ATT East Midlands Branch**

**“Charity Update – Accounts, Law & Tax”**

**Presented by Rebecca Benneyworth BSc FCA**

**Date:** Tuesday 10 February 2009

**Venue:**

The Novotel – Notts/Derby  
Bostock Lane, Long Eaton  
Nottingham

**Timetable:**

4pm – Refreshments and registration\*  
4.30pm – Lecture begins  
6pm – Break for refreshments\*  
6.30pm – Lecture begins  
7.45pm - Questions  
8pm – Close

**CPD Hours: 3**

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*CIOT – East Midlands Branch*

## **Charity Update**

**Accounts, law & tax**

**February 2009**



**Rebecca Benneyworth  
Training Consultants**

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## **1. CHARITIES ACT 2006**

The Charities Act 2006 finally achieved Royal Assent in late 2006 when the Charities Bill 2005, which replaced the 2004 Bill lost for the General Election was passed. The Act will be implemented over the next 1 to 2 years, and effects a number of quite significant changes on the sector.

### **1.1 New Charitable purposes**

The Act includes a new definition of a charity, and a definition in statute for the first time of charitable purposes, which have previously largely been determined according to case law. Section 1 of the Act defines a charity as an institution which is established for charitable purposes only and falls to be subject to the control of the High Court in the exercise of its jurisdiction with respect to charities. This definition applies in England and Wales only.

The new range of charitable purposes wider than the existing law – running to 12 specific purposes forms part of the definition of charitable purposes, but is qualified by the requirement that the purpose is for the public benefit as defined by Section 3 of the Act. Thus, all charities will in future have to satisfy a “public benefit” test, rather than certain purposes being deemed to be for the benefit of the public as now.

The new range of purposes is :

- (a) the prevention or relief of poverty;
- (b) the advancement of education;
- (c) the advancement of religion;
- (d) the advancement of health or the saving of lives;
- (e) the advancement of citizenship or community development;
- (f) the advancement of the arts, culture, heritage or science;
- (g) the advancement of amateur sport;
- (h) the advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity;
- (i) the advancement of environmental protection or improvement;
- (j) the relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;
- (k) the advancement of animal welfare;
- (l) the promotion of the efficiency of the armed forces of the Crown, or of the efficiency of the police, fire and rescue services or the ambulance services.

### **1.2 The public benefit test**

Every purpose listed above must also be tested to ensure that the purpose is for the public benefit in the way the charity applies it. This means that many existing charities, which exist for the purposes of

- The relief of poverty
- The advancement of education or
- The advancement of religion

will no longer automatically be granted charitable status on the basis of their aims alone. All charities will have to satisfy the public benefit test, and demonstrate the nature of the benefit and the breadth of likely beneficiaries to achieve charitable status.

The determination of whether public benefit is satisfied rests with the Charity Commission, which is required by the Act to produce guidance on the operation of the public benefit test under Section 4 of the Act. The guidance will thus have statutory effect, and adequate public consultation is necessary before the final guidance is issued or revised. Trustees are required by Section 4(6) to have regard to such guidance when exercising any powers to which the guidance is relevant.

It is clear that some charities are considering whether meeting the public benefit test is in their best interests and whether, in fact they may lose charitable status and start to operate as a commercial concern. This particularly applies to some fee paying schools, who may find it difficult to meet the test.

#### 1.2.1 Guidance on public benefit

Guidance has been issued by the Charity Commission on public benefit, which is designed to support trustees in meeting the requirements. This guidance has statutory force, as it is required to be available under the Act. A summary of the key points follows :

There are two key principles of public benefit and, within each principle there are some important factors that must be considered in all cases. These are:

#### **Principle 1: There must be an identifiable benefit or benefits**

Principle 1a It must be clear what the benefits are

Principle 1b The benefits must be related to the aims

Principle 1c Benefits must be balanced against any detriment or harm

#### **Principle 2: Benefit must be to the public, or section of the public**

Principle 2a The beneficiaries must be appropriate to the aims

Principle 2b Where benefit is to a section of the public, the opportunity to benefit must not be unreasonably restricted:

- by geographical or other restrictions; or
- by ability to pay any fees charged

Principle 2c People in poverty must not be excluded from the opportunity to benefit

Principle 2d Any private benefits must be incidental

The principles of public benefit apply to all charities, whatever their aims. Each charity must be able to demonstrate that its aims are for the public benefit. Public benefit decisions are about whether an individual organisation is a charity and not about whether particular types of charity or groups of charities, as a whole, are for the public benefit.

### **Principles of Public Benefit**

#### **Principle 1: There must be an identifiable benefit or benefits**

##### **Principle 1a It must be clear what the benefits are**

It must be clear what benefits to the public arise from carrying out a charity's aims. Examples of different sorts of benefit include providing housing for the homeless or giving medical care to the sick. It should be possible to identify and describe the benefits provided but that doesn't mean they must be able to be quantified or measured; non-quantifiable benefits will be taken in account as long as it is clear what they are.

Most benefits are self evident but sometimes we may need evidence depending on the type of benefit provided. Sometimes benefit can be shown by a consensus of objective and informed opinion. In some cases we may ask for evidence of independent, expert opinion from someone suitably qualified. It will usually be for the organisation's trustees to provide evidence that their organisation's aims are for the public benefit but we may sometimes need to check evidence from other sources.

##### **Principle 1b The benefits must be related to the aims**

Benefits must be related to the charity's aims, so benefits which arise from the charity's work that are not related to its aims will not be taken into account. Where a charity has more than one aim, each of those aims has to meet the public benefit requirement; it will not be enough if only some do.

##### **Principle 1c Benefits must be balanced against any detriment or harm**

Finally, benefits must be balanced against any detriment or harm which arises. Examples of detriment or harm could include something that is damaging to the environment or mental or physical health or encourages hatred towards others. In judging whether this detriment occurs, we would need to see real evidence; we will not just assume it. Where there is more detriment than benefit, or where the organisation has aims that are illegal or is a sham, it would not be charitable.

**Principle 2: Benefit must be to the public, or section of the public**

**Principle 2a The beneficiaries must be appropriate to the aims**

While this sounds like a statement of the obvious, who constitutes the ‘public’ or ‘a section of the public’ varies according to the charitable aims. Sometimes a charity’s aims are intended to benefit the public generally, sometimes a specific section of it. Who benefits, and how, will depend on the organisation’s aims. Considering who the charity’s aims are mainly intended to benefit is important when deciding whether the public benefit requirement is met.

It is not a simple matter of numbers, but the number of people who can potentially benefit must not be insignificant. The ‘class’ of people who can benefit must be sufficiently large or open given the charitable aim being carried out. The actual number of people who can benefit at any one time can be quite small as long as anyone who could qualify for the benefit is eligible. So, for example, it is fine to offer only a small number of rooms in a care home as long as anyone who is eligible to apply can be considered for those limited places.

It is important that the opportunity to benefit is not unreasonably restricted given the nature of the charity’s aims and the resources it has. If the benefit is to a ‘section of the public’, rather than the public generally, then the restrictions must be reasonable and relevant to the charity’s aims. If they are not, this will affect public benefit.

**Principle 2b Where benefit is to a section of the public, the opportunity to benefit must not be unreasonably restricted:**

- **by geographical or other restrictions; or**
- **by ability to pay any fees charged**

Ways in which restrictions might apply to the ‘class’ of people who can benefit include geographical restrictions, those involving charitable need, such as poverty, age or ill-health, and those involving personal characteristics, such as gender, race or religion for example. We will consider the circumstances in each case when deciding whether that restriction is reasonable. At the extreme, charities must not be seen as ‘exclusive clubs’ that only a few can join. So, where the aims of a charity are more closed, inward-looking and exclusive, greater justification for the restriction may need to be provided.

Many different sorts of charities can, and do, charge for their services or facilities. Charities can charge fees that more than cover the cost of those services or facilities, provided that the charges are reasonable and necessary to carry out the charity’s aims, for example, in maintaining or developing the service provided. However, where, in practice, the charging restricts the benefits only to people who can afford to pay the fees charged, this may result in the benefits not being available to a sufficient section of the public.

## **Principle 2c People in poverty must not be excluded from the opportunity to benefit**

The fact that the services will be charged for and therefore provided **mainly** to people who can afford to pay does not necessarily mean the organisation's aims are not for the public benefit. However, if an organisation excluded people from the opportunity to benefit because they could not pay the fees, then its aims would not be for the public benefit. In particular, people in poverty must not be excluded from the **opportunity** to benefit. So it would not, for example, be enough to reduce very high fees slightly to enable more 'middle income' people to benefit, if people in poverty were still excluded from the opportunity to benefit.

In general, the lower the fees that are charged, the greater the opportunity there is likely to be for most people to have the opportunity to benefit. But where the fees charged are, of necessity perhaps, very high, then trustees of those charities will have to think about other ways in which people who cannot afford those fees can benefit in some material way related to their charity's aims. This does not mean charities have to offer services for free, or offer concessions on fees, although clearly that would help. There could be other ways of benefiting people who cannot afford the fees in a way that is related to the aims. For example, one way of doing this might be an independent school working in partnership with a local state school, or an arts charity might broadcast concerts or operatic performances via TV or radio to a wider audience. What matters is that people unable to pay are not excluded from the opportunity to benefit, whether or not they actually choose to take up the opportunity.

## **Principle 2d Any private benefits must be incidental**

Where people or organisations benefit from a charity, other than as a beneficiary, then those sorts of 'private' benefits must be incidental, which means they are a necessary result, or by-product, of carrying out the charity's aims. Where private benefits are more than incidental this might mean the organisation is set up for private, rather than public, benefit and so might not be charitable.

### 1.2.2 Reporting on your charity's public benefit

Charity trustees have a new duty to report in their Trustees' Annual Report on their charity's public benefit. The level of detail you will need to provide in your public benefit report will depend on whether your charity is above or below the audit threshold. An audit is required when a charity's gross income in the year exceeds £500,000, or where income exceeds £100,000 and the aggregate value of its assets exceeds £2.8 million. Most charities already explain their activities in their Trustees' Annual Report and so this information now needs to be set in the context of the charity's aims to show how in practice the aims have been carried out for the public benefit.

Trustees will also need to confirm that they have had regard to our public benefit guidance where relevant

**For smaller charities**, below the audit threshold, trustees are required to include a brief summary in their Trustees' Annual Report of the main activities undertaken in order to carry out the charity's aims for the public benefit. Trustees can, of course, provide fuller public benefit statements if they wish.

**For larger charities**, above the audit threshold, trustees are required to provide a fuller explanation in their Trustees' Annual Report of the significant activities undertaken in order to carry out the charity's aims for the public benefit, as well as their aims and strategies. They are required to explain the charity's achievements, measured by reference to the charity's aims and to the objectives set by the trustees.

It is up to the charity's trustees to decide how much detail they want to provide to clearly illustrate what their charity has done in the reporting year to meet the requirement; the Commission will not be prescriptive about the number of words or pages needed. But a charity that said nothing on public benefit in its Trustees' Annual Report, or produced only the briefest statement with no detail, would be in breach of the public benefit reporting requirement.

### 1.2.3 Assessing public benefit

The Charity Commission will assess whether the aims of all organisations applying to register as charities are for the public benefit. Charities that are already registered have to continue to meet the public benefit requirement. We will do this by carrying out research studies on the extent to which different types of charity are meeting the requirement and by working with representative professional and umbrella bodies and with users of those charities.

In some cases we may need to carry out detailed assessment of individual charities. Where that needs to happen we will advise the trustees on what needs to change in order to meet the public benefit requirement, and give clear reasons and advice on what happens next where it is not possible for the organisation to meet the requirement. No charity will be expected to make changes overnight and we will take reasonable account of how much time and resources might be needed by a charity that needs to make changes in order to meet the requirement. A charity or anyone affected by one of our public benefit decisions, that disagrees with it, can seek a review of that decision using our internal decision review procedures and, if they consider it necessary, can make a further appeal to the new Charity Tribunal and, ultimately, to the courts. However, by working constructively with charity trustees and undertaking extensive public consultation on our public benefit guidance, we would hope such circumstances would be rare.

## 1.3 Charity Commission

The Act establishes the Charity Commission as a statutory body, and sets out the objectives and powers of the Commission. The various statutory duties of the Commission are described in detail, and a wide range of specific powers that may be exercised by Charity Commissioners.

#### **1.4 The Charity Tribunal**

The Act also establishes a statutory appeal body called the Charity Tribunal. Charities may appeal to the Tribunal on a range of issues, and the powers and operation of the Tribunal are governed by Section 8 of the Act which inserts new Sections 2A to 2D in the 1993 Act.

Schedules 3 and 4 of the Act set out the matters on which charities may appeal to the Tribunal, which are essentially the exercise of most of its statutory powers by the Charity Commission. Most Orders of the Commission and Decision of the Commission under existing and new charity statute can be appealed to the Charity Tribunal.

The Tribunal does have the power to award costs, but under new Section 2B(6) and (7). Generally speaking costs will only be awarded when any party to the proceedings has acted vexatiously, frivolously or unreasonably. Costs may also be awarded against the Commission if the decision, direction or order of the Commission before it is held to be unreasonable.

#### **1.5 Registration of charities**

The sections in Charities Act 1993 with regard to the registration of charities are replaced in toto by new sections in the Act, forming Section 9 of this Act, and replacing Section 3 of the 1993 Act with new Sections 3, 3A and 3B.

The exemption allowing small charities not to be registered if they so choose is extended to charities with gross income of less than £5,000. The present requirement that such a charity does not have the use or occupation of land is dropped. The sum set may be revised by Order designed to reflect inflation, or to extend the exemption. It is also possible for the original legislation to reflect the new limit by Order before the commencement of this part of the Act. This measure is **already in force** applying to charities seeking registration with effect from 23 April 2007.

#### **1.6 Exempt charities**

The Act changes the list of exempt charities in Schedule 2 of the 1993 Act, but more importantly introduces additional regulation on exempt charities through Schedule 5 to the 2006 Act. This Schedule largely extends to exempt charities some of the powers of the Commission to act for the protection of charities in existing law (the 1993 Act). Certain powers, such as the power to call for documents in Section 9 of the 1993 Act specifically exclude exempt charities. The following powers in the 1993 Act are amended so that they apply in full or in part to exempt charities for the first time :

- Power to require change of name under Section 6
- Power to institute enquiries
- Power to call for documents

- Concurrent jurisdiction of the Commission with the High Court under Section 16
- Power to act for the protection of charities under Section 18
- Powers to give directions about dormant bank accounts under section 28
- Other powers under Section 33 (proceedings by persons other than the Commissioners) and 74 (power to order disqualified persons to repay sums received from the charity).

However, the Charity Commission must consult the principal regulator of the exempt charity before exercising any power in relation to an exempt charity. The Act places a statutory obligation on the principal regulator to do all that it can reasonably do to promote the compliance objective (set out in Section 13(3) of the 2006 Act.

The compliance objective is to promote compliance by the charity trustees with their legal obligations in exercising control and management of the administration of the charity.

### **1.7 Audit and Independent Examination**

The Act provides for changes to the requirements for audit or examination of the accounts of charities which are not companies as follows :

- (a) The audit threshold rises to gross income of £500,000, and the test is performed on a single year basis. There will also be a mandatory audit if the income is below £500,000 but over the accounts threshold (previously £100,000) and the gross assets of the charity exceed £2.8 million.
- (b) The requirement for accounts to be examined by an independent examiner remains where the charity's gross income in the year exceeds £10,000;
- (c) Independent examiners for charities with gross income of over £250,000 will have to be an independent person who is a member of a body specified in Section 249D(3) of the Companies Act 1985 as a reporting accountant, or a member of CIPFA, or a fellow of the Association of Charity Independent Examiners.

The Act also amends the requirements on charitable companies regarding audit or reporting accountant's report in Section 32 as follows :

- (a) The requirement for an accountant's report will apply to companies with turnover below £500,000 but over £90,000, and the balance sheet total test has been revised from £1.4 million to £2.8 million.
- (b) Section 33 of the Act inserts a "whistle blowing" obligation for auditors of charities which are companies. This imports the requirements detailed below, which now form Section 44A of the 1993 Act into the company environment. There is no such requirement to report for reporting accountants under Section 249B.

These new limits are **already in force** having come into effect for accounting periods commencing on or after 27 February 2007.

### **1.8 Reporting obligations : auditors and examiners**

Anyone reporting under Section 43 of the 1993 Act as either an auditor or independent examiner under that section, has an obligation to report certain matters to the Commission. This new section 44A supplements the requirements of the 1993 Act with regard to what is commonly known as “whistleblowing”.

If in the course of acting in his capacity as auditor or independent examiner the person becomes aware of any matter :

- (a) which relates to the activities or affairs of the charity or of any connected institution or body, and
- (b) which he has reasonable cause to believe is likely to be of material significance for the purposes of the exercise by the Commission of its functions under Sections 8 or 18 ,

he must immediately make a written report on the matter to the Commission.

If such a person, in the course of acting in his capacity above becomes aware of any matter :

- (a) which does not appear to him to be one that he is **required** to report as above, but
- (b) which he has reasonable cause to believe is likely to be relevant for the purpose of the exercise by the Commission of any of its functions

he may make a report of the matter to the Commission.

The requirement or power to report does not cease when the auditor or examiner ceases to act, provided the matter came to his attention in the course of exercising his duties while still engaged.

### **1.9 Group Accounts**

Schedule 6 of the Act sets out requirements as regards group accounts, introducing new Schedule 5A into the 1993 Act. This is expected to commence later in 2007.

Paragraph 3 of the Schedule requires the preparation of group accounts by the trustees of any charity which is a parent charity as defined. A parent charity is one which would be treated as a parent undertaking by company law (specifically section 258 of and Schedule 10A to the Companies Act 1985), were it a company, but is not a company. Thus the schedule requires the preparation of group accounts by unincorporated charities.

Group accounts are defined by paragraph 3(3) as consolidated accounts relating to the group and complying with such requirements as to form and content as are specified in Regulations which are yet to be issued. Group accounts will be required in addition to accounts of the parent charity as an entity, and accounts comprising receipts and payments accounts and a statement of assets and liabilities will not be acceptable for a parent charity, irrespective of the amount of gross income of that charity.

Paragraph 4(2), however permits there to be an exemption from the preparation of group accounts for a charity when the aggregate gross income of the group does not exceed a specified sum (as yet not determined). Regulations will also prescribe circumstances in which a subsidiary undertaking may or must be excluded from the group accounts so prepared.

Regulations will set gross aggregate income limits which will require the audit of group accounts of charities. An audit of the group accounts will also be required if the gross income of the parent charity exceeds the individual charity audit threshold, irrespective of the amount of the aggregate gross income and the threshold applying to this amount. Where there is a group accounts audit requirement, this will in turn trigger a requirement for the parent charity accounts to be audited, even where there is no such requirement by reference to the gross income of the parent charity. Group accounts auditors have the same reporting responsibilities as the charity auditors or examiners.

### **1.10 Charitable Incorporated Organisations**

This new entity is to be known as a CIO, and is dealt with by Schedule 7 of the Act. The idea is to allow for an alternative method of incorporation, rather than registering as a company under the Companies Acts. Companies registered under the Companies Acts, and Registered Industrial and Provident societies will be able to convert to CIO status by going through an application process. Currently registered charities will also be able to change status, by transferring their property to a CIO.

### **1.11 Remuneration of trustees**

For the first time the Act includes statutory powers to permit the payment of trustees who provide services to a charity. Section 36 inserts Section 73A into the 1993 Act, controlling payment under these circumstances. This requires remuneration paid to a charity trustee or person connected to a charity trustee to meet four conditions, A to D :

- A The amount or maximum amount of the remuneration
  - (a) is set out in an agreement in writing between the charity or its trustees and the relevant person, under which the relevant person is to provide the services in question to or on behalf of the charity, and
  - (b) does not exceed what is reasonable in the circumstances for the provision by that person of the services in question.

- B Before entering into the agreement the charity trustees decided that it would be in the best interests of the charity for the services to be provided by the relevant person to or on behalf of the charity for the amount or maximum amount of remuneration set out in the agreement.
- C If immediately after the agreement is entered into there is in the case of the charity more than one trustee, and is
- (a) a person in respect of whom such an agreement is in force, or
  - (b) a person who is entitled to receive remuneration from the charity other than under such an agreement, or
  - (c) a person connected with such a person
- then the total number of them constitute a minority of the persons holding office as a trustee of the charity at that time.
- D The trusts of the charity do not contain any express provision that prohibits the relevant person receiving the remuneration.

Trustees covered by such an agreement may not vote on or otherwise act in respect of any decision in relation to the agreement. Essentially the above is intended to create a statutory basis for a professional charging clause or similar, rather than charities having to seek individual approval from the Commission to make such provision in their Governing Document. This provision, in particular, cannot be used to pay trustees remuneration as employees of the charity.

### **1.12 Commencement dates**

The Charity Commission has released an implementation timetable for the main provisions of the Act, as follows :

#### **First Commencement Order – early 2007**

The main provisions that will be commenced by this Order will be:

- The new Charity Commission, its objectives, functions and duties (*sections 6 & 7, schedules 1 & 2*).
- The requirement for the Commission to develop guidance and consult on the public benefit test (*section 4*).
- Interim changes to the registration threshold for small charities – which will be followed by an order to increase the threshold to £5,000 annual income (*section 10*).
- The relaxation of publicity requirements relating to schemes (*section 22*).
- The participation of Scottish and Northern Irish charities in Common Investment and Deposit Funds (*section 23*).
- Changes to the audit thresholds for unincorporated and incorporated charities (*sections 28 & 32*).
- The power for the Commission to determine the membership of a charity, and the power for the Commission to enter premises and seize documents under a warrant (*sections 25 & 26*).

- Changes to the restrictions on mortgages of charity land (*section 27*).
- Waiver of trustee's disqualification and the power for the Commission to relieve trustees and auditors from liability for breach of trust or duty (*sections 35 & 38*).
- The ability for charities to purchase trustee indemnity insurance (*section 39*).
- The power for unincorporated charities to modify powers or procedures (*section 42*).
- The reserve power to control fundraising by charitable institutions (*section 69*).
- Powers for Secretaries of State, the Minister for the Cabinet Office, and the National Assembly for Wales to give financial assistance to charitable, philanthropic or benevolent organisations (*sections 70 & 71*).

### **Second Commencement Order – second half of 2007**

The main provisions that will be commenced by this Order will be:

- Provisions relating to mergers of charities (*section 44*).
- Statements indicating benefits for charitable institutions, professional fundraisers, and commercial participators (*sections 67 & 68*).
- Provisions relating to audit and accounting for charities, including group accounts and changes to the accounting regime for small charitable companies (*sections 29, 30, 31, 33, and an order under section 77, and schedule 6*).

### **Third Commencement Order – early 2008**

The main provisions that will be commenced by this Order will be:

- The new definition of charity and the public benefit requirement (*sections 1, 2, 3, and 5*).
- The Charity Tribunal (*section 8 and schedules 3 & 4*).
- New powers for the Charity Commission – to remove or suspend trustees from membership of a charity, to give specific directions for the protection of charity property, to direct the application of charity property, and to give advice and guidance (*sections 19, 20, 21 and 24*).
- Remuneration of trustees providing services to a charity (*sections 36 & 37*).
- Powers for unincorporated charities to transfer all property, to replace purposes or to spend capital (*sections 40, 41 & 43*).
- The Charitable Incorporated Organisation (*section 34 and schedule 7*).
- Changes to Cy Pres occasions and Schemes (*sections 15 to 18*).

## **Exempt and Excepted Charities**

Provisions relating to the registration of certain 'excepted' charities, and provisions relating to 'exempt' charities, are not expected to come into force before 2008. This will enable those charities, the proposed principal regulators of exempt charities, and the Charity Commission, time to prepare for the changes (*parts of section 9, sections 11 to 14, and schedule 5*).

While the Charity Commission is registering the large numbers of formerly excepted and exempt charities that it will have to register, the current law which enables the Charity Commission to exercise its discretion in relation to applications for voluntary registration will continue in force. Once those excepted and exempt charities that are required to register have been registered, the provision in the Act requiring the Commission to register charities that apply for voluntary registration will be commenced.

## **Other commitments**

There were several other commitments made during the passage of the Charities Bill:

- Preparation of a plain English guide to the Act, aimed particularly at small charities. We are working closely with the Charity Commission to produce this, and expect to publish it early in 2007.
- Consolidation of charity law will be a matter for the Law Commission. While we can't speak for the Commission we understand that it has accepted into its work programme the consolidation of charity statute law. We anticipate that much of the preparatory work will be done during the current session of Parliament but that the consolidation Act or Acts probably won't be enacted until the next session.
- A review of the financial thresholds in the Charities Acts, to take place within a year of Royal Assent. The aim of the review will be to determine what scope there is for raising or simplifying existing thresholds. The thresholds can be changed by an order made by the Minister.
- A review of existing Secondary Legislation under the Charities Acts 1992, and 1993, with a view to identifying whether any existing regulations can be simplified.
- A review of the impact of the public benefit requirement within three years of the public benefit requirement coming into force.
- An evaluation of the impact of the Charities Act 2006 within five years of Royal Assent is required by section 73. Ministers would appoint the person to undertake the review, which would report to Parliament on the impact of the Act.

## **2. CHARITY ACCOUNTS - REFRESHER – LEGISLATIVE BACKGROUND**

### **2.1 Legislative provisions**

The law regulating accounting and audit of charities is contained in Sections 41 to 49 of the Charities Act 1993 (as modified by the 2006 Act). These sections were amended almost on the introduction of the 1993 Act, by some deregulatory changes; these are noted in the text below. Most of this law does not apply to charitable companies (details below) and exempt charities are not subject to the standard accounting and reporting regime.

The detailed Regulations in this area are The Charities (Accounts and Reports) Regulations 2005 (SI 2005 No 572) which give more information on form and content of accounts, appointment and removal of auditors and wording of the audit report.

### **2.2 Annual accounts (S42)**

The trustees are required to prepare an annual statement of accounts in respect of each financial year of the charity, and this statement of accounts must comply with the form and content requirements included in regulations. This requirement is contained in Section 42(1), and these accounts are often referred to by this statutory reference. For the purposes of this course these accounts will be referred to as “full accounts”, to distinguish them from “cash accounts” described in the next paragraph.

Trustees of small charities with gross income in a financial year of less than £100,000 may alternatively elect to prepare :

- (a) a receipts and payments account, and
- (b) a statement of assets and liabilities,

rather than full accounts as required by the regulations. These accounts will need to comply with the Charity SORP in principle, but there is good guidance explaining how the SORP should be applied in these cases, with a separate publication available to assist. As regards legal “form and content” there is none, other than the wording set out above : the regulations do not deal with accounts in this form at all. Compliance with the law for charities preparing accounts under Section 42(3) is therefore a matter of being entitled to and then preparing the statements required.

## **2.3 Audit of accounts (S43)**

### **2.3.1 Accounting periods commencing before 27 February 2007**

The accounts of a charity must be audited if the charity exceeds the income and expenditure thresholds in any of **the current or the two preceding** financial years.

The thresholds are described as "gross income or total expenditure", and the threshold is £250,000. The audit must be carried out by a person who is authorised as a company auditor (that is, a registered auditor), but regulations may also specify holders of alternative qualifications eligible to act as charity auditors.

Where a smaller charity is outside the income and expenditure thresholds, the trustees may elect for the accounts to undergo an independent examination rather than an audit. In such a circumstance the examiner must be "...an independent person who is reasonably believed by the trustees to have the requisite ability and practical experience to carry out a competent examination of the accounts." It is important to note that the requirement for audit applies irrespective of the financial limits, but trustees of smaller charities may "opt out" of audit by deciding to go for independent examination. Thus charities which are below the legal requirement for audit but are still audited (whether as a requirement of their governing document or otherwise) are audited on the same terms as larger charities. There are therefore very few non statutory audits of unincorporated charitable bodies.

The Charity Commissioners may require accounts of a smaller charity to be audited if they consider it desirable, and may appoint auditors if the trustees fail to do so, in which case the trustees become personally liable for their fees.

### **2.3.2 Accounting periods commencing on or after 27 February 2007**

The amended provisions of the Charities Act 2006 have been implemented. This means that an audit is required if :

- Gross income exceeds £500,000, or
- Gross assets exceed £2.8 million and gross income exceeds £100,000.

The test is performed on a single period basis, unlike the position before the change.

If no audit is required then the accounts may alternatively be examined, but when the gross income exceeds £250,000 this must be done by a professional accountant (see details above).

## **2.4 Annual report (S45)**

The trustees must prepare and file with the Charity Commissioners an annual report in respect of each financial year of the charity. This must be filed within 10 months of the year end.

The report must contain :

- "(a) such a report by the trustees on the activities of the charity during the year, and
- (b) such other information relating to the charity, to its trustees or officers,

as may be prescribed by regulations.."

The annual report must have attached to it the statements of accounts prepared under section 42 (whichever option is followed), together with an auditors report on the accounts or statements, if they have been audited, or the report of the independent examiner on those statements.

Charitable companies must include accounts prepared under the Companies Act 1985 and the report of the auditor on those accounts in place of accounts prepared and audited or examined under the Charities Act.

## **2.5 Exemptions and exceptions**

### **2.5.1 Exempt Charities (S46)**

Exempt charities are not required to comply with any of the above. Section 46 requires that the trustees "..keep proper books of account with respect to the affairs of a charity."

If not required by any other authority, trustees of exempt charities must prepare consecutive statements of account consisting on each occasion of an income and expenditure account relating to a period of not more than 15 months and a balance sheet relating to the end of that period.

### **2.5.2 Excepted charities**

Charities excepted from registration by S3(5) of the 1993 Act and not registered need not prepare and file an annual report unless directed to do so by the Charity Commissioners.

### **2.5.3 Very small charities**

Under a deregulatory measure introduced after the Act was finalised, charities with income and expenditure below £10,000 need not be audited or examined, nor need they prepare a full annual report. No accounts are filed with the Charity Commission unless these are requested. Small charities should, however prepare accounts, and follow the necessary guidance issued by the Charity Commission on Receipts and Payments accounts. From 27 February 2007 (accounting periods commencing), Charities Act 2006 amended this exemption to apply only to income of £10,000. So charities with income below £10,000 in any period will not need to file accounts.

#### 2.5.4 Charitable Companies

Charities which are registered as companies under the Companies Act 1985 are subject to company law instead of most of the foregoing. The only extra requirement on companies over and above the requirements of company law is the filing of the annual report with the Charity Commission, as required by Section 45 of the Charities Act 1993.

For accounting periods starting on or after 1 April 2008, charitable companies can instead choose to be subject to independent examination. Charitable companies are only subject to audit under company law if they exceed the Companies Act thresholds. Instead the scrutiny rules applying to charities apply to companies under the audit threshold in the Companies Acts. So a company charity will need an audit under charity law if it exceeds the charity law thresholds of :

- Gross income over £500,000, or
- Gross assets over £2.8m and gross income over £100,000.

Where an audit is not required under the Companies Act the directors must provide a specific statement that says that the company is exempt from the requirements for a Companies Act audit. Companies House offers guidance about the format the statement should follow.

Unless the Articles of Association specifically require an audit, charitable companies may have an independent examination instead of an audit for accounting periods beginning on or after 1 April 2008 where:

- gross income does not exceed £500,000; and
- where gross income exceeds £100,000, the charity's gross assets do not exceed £2.8m.

The Companies Act 2006 introduced provisions that harmonise the accounting and independent examination regimes for company and non-company charities. In particular, small charitable companies and groups, as defined by the Companies Act 2006, are subject to the external scrutiny provisions of the 1993 Act for accounting periods beginning on or after 1 April 2008.

Charitable companies which have either charitable or non-charitable subsidiaries must prepare group accounts under the 1993 Act where the aggregate income of the group, after the elimination of all group transactions from income for the year exceeds £500,000 and those group accounts will be subject to audit under charity law. Where the group income exceeds the small company thresholds, group accounts must be prepared and audited under company law.

Unless the charitable company or charitable group is subject to the small companies regime, the charity must also prepare a business review as required by company law as part of its director's report.

### **3. THE CHARITY SORP 2005**

#### **3.1 Introduction**

The SORP was finalised in March 2005 after an exposure period lasting 10 months. The SORP is effective for accounting periods beginning on or after 1 April 2005.

#### **3.2 Application of the SORP**

The accounting recommendations of the SORP apply to all charities in the United Kingdom that prepare accounts on the accruals basis to give a true and fair view of a charity's financial activities and financial position regardless of their size, constitution or complexity. (*Para 3*)

The SORP applies to all charities unless a more specialised SORP applies. Departures from the SORP should be disclosed and explained, both in the notes to the accounts and the Trustees' Report, although the SORP dispenses with the need to disclose departures on a true and fair override in the Trustees Report and requires only disclosure in the accounting policy notes. The Charity Commissioners may use non-compliance with the SORP as grounds for commencing an investigation into the charity. In addition they warn that non-compliance may be taken into account in assessing the trustees' responsibilities in subsequent difficulties.

As far as company charities are concerned, although these are governed by the Companies Act 1985, the SORP provides guidance on how to interpret "true and fair" in the charity sector, and therefore is supplemental to the Companies Act requirements. Paragraphs 419 – 429 of the SORP give detailed guidance on the application of the SORP in relation to charitable companies and this is considered in detail in below.

The SORP now makes clear that the 2005 version does not provide any guidance on the preparation of cash based (receipts and payments) accounts. (*Para 6*) It suggests that the "activity based" approach could be adopted in cash based accounts. The concessions available to smaller charities are summarised as Appendix 5.

### **3.3 Content of Accounts**

Charity accruals accounts prepared following the SORP should comprise (Scottish charities differ): (*Para 30*)

- (a) A statement of Financial Activities (SOFA) for the year;
- (b) A separate summary Income and Expenditure Account only where this is a legal requirement. The SORP makes this clear that this will apply to Scottish charities and to certain charitable companies. It further clarifies that in many cases the SOFA will meet the legal requirements for the Income and Expenditure account and in this case they should be combined and the heading amended appropriately. Paragraphs 423 - 427 of the SORP provide specific guidance on this subject;
- (c) A Balance Sheet;
- (d) A cashflow statement where required in accordance with accounting or reporting standards, and
- (e) Notes to the Accounts.

Corresponding figures will also be required, as will the duration of the current and previous accounting periods. Items (a) to (d) above are all described by the SORP (para 32) as primary statements. These must be given equal prominence and none of them relegated to the notes.

## **4. TRUSTEES' ANNUAL REPORT**

### **4.1 Form of report for a charitable company**

Where a charity is also a company registered under the Companies Act 1985 it will need to file a directors' report at Companies House in addition to the Trustees' annual report. The SORP indicates that only one report should be prepared showing the information required under both sets of requirements. Companies must therefore adopt suitable titles to deal with this situation, and ensure that any compliance checklists used to check completeness of the directors' report also covers the requirements of the SORP for a charity.

### **4.2 Distribution of annual report**

The Trustees' annual report must be attached whenever a full set of accounts of the charity are distributed.

### **4.3 Timing of preparation**

The trustees annual report must be completed before the audit or examination of the accounts can be concluded, as in both cases, where full accounts have been prepared, the auditor or examiner must consider whether there are any material inconsistencies between the accounts and the trustees' report.

### **4.4 SORP 2005 requirements - Trustees Report**

Paragraphs 35 to 59 of SORP 2005 outline the responsibilities for preparing the Annual Report and the importance of the report to readers, and provide detail about preparation and approval of the report. Paragraphs 41 to 59 then set out the required content of the Trustees' Annual Report as follows :

#### **4.4.1 Reference and Administrative Details of the Charity, its Trustees and Advisers**

The report should provide the following reference and administrative information about the charity, its trustees and advisers:

- (a) The name of the charity, which in the case of a registered charity means the name by which it is registered. Any other name by which a charity makes itself known should also be provided.
- (b) The charity registration number (in Scotland the Scottish Charity Number) and, if applicable, the company registration number.
- (c) The address of the principal office of the charity.
- (d) The names of all of those who were the charity's trustees on the date the report was approved or the names of at least 50 of those trustees (including all the officers of the charity, e.g. chair, treasurer etc and custodian trustees) where there are more than 50 trustees; where the charity trustees are incorporated this should include the name of the corporate body.

- (e) The name of any other persons who served as charity trustees or custodian trustees in the financial year in question; where the charity trustee is a company or corporate body, the names of its current directors or other persons managing it.
- (f) The name of any Chief Executive Officer or other senior staff member(s) to whom day to day management of the charity is delegated by the charity trustees.
- (g) The names and addresses of any other relevant organisations or persons. This should include the names and addresses of those acting as bankers, solicitors, auditor (or independent examiner or reporting accountant) and investment or other principal advisers.

Where the disclosure of the names of any charity trustees, or senior staff member, or persons with the power of appointment, or of the charity's principal address could lead to that person being placed in personal danger the trustees may dispense with the disclosure provided that (for charities in England and Wales) the Charity Commission has given the trustees the authority to do so. It is recommended that the reasons for such non-disclosure should be given in the report. The directors of charitable companies should note that there is no corresponding dispensation in relation to the disclosure requirements for the statutory Directors' Report.

Charities which are not subject to statutory audit may omit the disclosures in paragraphs (f) and (g) above, but disclosure is encouraged as a matter of good practice.

#### 4.4.2 Structure, Governance and Management

The report should provide the reader with an understanding of how the charity is constituted, how its trustees are recruited and trained and how the charity's decision-making processes operate. In particular, the report should explain:

- (a) The nature of the governing document (e.g. trust deed; memorandum and articles of association; Charity Commission Scheme; Royal Charter; etc) and how the charity is (or its trustees are) constituted (e.g. limited company; unincorporated association; trustees incorporated as a body; etc).
- (b) The methods adopted for the recruitment and appointment of new trustees, including details of any constitutional provisions relating to appointments, for example, election to post. Where any other person or body external to the charity is entitled to appoint one or more of the charity trustees this should be explained together with the name of that person or body (subject to an exclusion where disclosure of a person's name could lead to personal danger).
- (c) The policies and procedures adopted for the induction and training of trustees.
- (d) The organisational structure of the charity and how decisions are made. For example, which types of decisions are taken by the trustees and which are delegated to staff.

- (e) Where the charity is part of a wider network then the relationship involved should also be explained where this impacts on the operating policies adopted by the charity.
- (f) The relationships between the charity and related parties, including its subsidiaries and with any other charities and organisations with which it co-operates in the pursuit of its charitable objectives.

A statement should be provided confirming that the major risks to which the charity is exposed, as identified by the trustees, have been reviewed and systems or procedures have been established to manage those risks.

Charities that fall below the audit threshold may limit their disclosures within this section to those set out in subparagraphs (a) and (b) above only. The additional disclosures of this section are encouraged as a matter of good practice.

#### 4.4.3 Objectives and Activities

The report should help the reader understand the charity's objectives, strategies and activities undertaken to achieve them. Where activities are undertaken through subsidiary undertakings, details should be provided in the report. In particular the report should provide:

- (a) A summary of the objects of the charity as set out in its governing document.
- (b) An explanation of the charity's aims including the changes or differences it seeks to make through its activities.
- (c) An explanation of the charity's main objectives for the year.
- (d) An explanation of the charity's strategies for achieving its stated objectives.
- (e) Details of significant activities (including significant programmes, projects, or services provided) that contribute to the achievement of the stated objectives.

The details of significant activities provided should focus on those activities that the charity trustees consider to be significant in the circumstances of the charity as a whole. The details of activities should, as a minimum, explain the objectives, activities, projects or services identified within the analysis note accompanying charitable activities in the Statement of Financial Activities (see paragraphs 191 to 194 of the SORP).

Where the charity conducts a material part of its activities through grantmaking, a statement should be provided setting out its grantmaking policies. Where social or programme related investment activities are material in the context of charitable activities undertaken, the policies adopted in selecting such investments should be explained.

Where a charity makes significant use of volunteers in the course of undertaking its charitable or income generating activities this should be explained. Whilst measurement issues, including attributing an economic value to such unpaid voluntary contributions, prevents the inclusion of such contributions within the Statement of Financial Activities, it is nevertheless important for readers to be provided with sufficient information to understand the role and contribution of volunteers. Such information may, for example, explain the activities that volunteers help provide, quantify the contribution in terms of hours or staff equivalents, and may present an indicative value of this contribution.

Charities below the audit threshold may limit their disclosures within this section to that set out in the first paragraph sub point (a) only above, together with providing a summary of significant activities undertaken in relation to those objects. The additional disclosures of this section are encouraged as a matter of good practice.

#### 4.4.4 Achievements and Performance

The report should contain information that enables the reader to understand and assess the achievements of the charity and its subsidiary undertakings in the year. It should provide a fair review of its performance against objectives that have been set. The report is likely to provide both qualitative and quantitative information that helps explain achievement and performance. It will often be helpful to identify any indicators, milestones and benchmarks against which the achievement of objectives is assessed by the charity. In particular, the report should contain:

- (a) A review of charitable activities undertaken that explains the performance achieved against objectives set. Where qualitative or quantitative information is used to assess the outcome of activities, a summary of the measures or indicators used to assess achievement should be included.
- (b) Where material fundraising activities are undertaken, details of the performance achieved against fundraising objectives set, commenting on any significant expenditure for future income generation and explaining the effect on the current period's fundraising return and anticipated income generation in future periods.
- (c) Where material investments are held, details of the investment performance achieved against the investment objectives set.
- (d) Comment on those factors within and outside the charity's control which are relevant to the achievement of its objectives; these might include relationship with employees, users, beneficiaries, funders and the charity's position in the wider community.

Charities below the audit threshold may limit their disclosures within this section to providing a summary of the main achievements of the charity during the year. The additional disclosures of this section are encouraged as a matter of good practice.

#### 4.4.5 Financial Review

The report should contain a review of the financial position of the charity and its subsidiaries and a statement of the principal financial policies adopted in the year. In particular, the report should explain the charity's:

- (a) Policy on reserves stating the level of reserves held and why they are held. Where material funds have been designated, the reserves policy statement should quantify and explain the purpose of the designations and, where set aside for future expenditure, the likely timing of that expenditure.
- (b) Where any material fund is in deficit, the circumstances giving rise to the deficit and details of the steps being taken to eliminate the deficit.
- (c) Principal funding sources, including any borrowings, and how expenditure in the year under review has supported the key objectives of the charity.
- (d) Where material investments are held, the investment policy and objectives, including any ethical policy adopted in the selection of investments.

Charities below the audit threshold may limit their disclosures within this section to paragraphs (a) and (b) above only.

#### 4.4.6 Plans for Future Periods

For Charities above the audit threshold, the report should explain the charity's plans for the future including any key objectives it has set for future periods, together with details of any activities planned to achieve them. For Charities below the audit threshold disclosure of this matter is encouraged as a matter of good practice.

#### 4.4.7 Funds Held as Custodian Trustee on Behalf of Others

Where a charity is, or its trustees are, acting as custodian trustees, the following matters should be disclosed in the report:

- (a) A description of the assets which they hold in this capacity.
- (b) The name and objects of the charity (or charities) on whose behalf the assets are held and how this activity falls within their own objects.
- (c) Details of the arrangements for safe custody and segregation of such assets from the charity's own assets.

## **5. STATEMENT OF FINANCIAL ACTIVITIES : SOFA**

### **5.1 Format of the statement**

The purpose of the SOFA is to show all incoming resources for the period and all resources expended by the charity, and to reconcile all changes in funds. The statement should comprise a single set of accounting statements presented in columnar format if there is more than one type of fund, distinguishing between those belonging to the charity's unrestricted funds, its restricted income funds and its endowment funds. Each column of the statement will then be totalled to show the net movement in the charity's funds for the year. The statement thus contains a summary of the movements on all of the funds held or operated by the charity.

Corresponding amounts for the previous year would normally only be needed for the total movements, although they should be provided wherever separate supporting movement statements are provided for any of the underlying funds.

Any incoming resource or expenditure heading should be expanded as appropriate to convey the nature of an individual charity's activities. For example, a residential care home whose main source of income is in the form of fees received would show its gross fee income as "Residential Care Fees" under Incoming resources from charitable activities, and gross expenditure as "Residential Care Costs" under resources expended on charitable activities respectively. A charity might also find it helpful if an additional column is provided to highlight the impact of a particular activity.

Headings should be omitted where there is nothing to report in either of the current and preceding periods. In addition, the provision of extra sub headings may be helpful to some charities – this is permitted provided the overall structure of the statement is not changed.

## **STATEMENT OF FINANCIAL ACTIVITIES – SORP 2005**

### **INCOMING RESOURCES**

- Incoming resources from generated funds
  - Voluntary income
  - Activities for generating funds
  - Investment income
- Incoming resources from the charitable activities
- Other incoming resources

### **(TOTAL : INCOMING RESOURCES)**

### **RESOURCES EXPENDED**

- Costs of generating funds
  - Costs of generating voluntary income
  - Fundraising trading : cost of goods sold and other costs
  - Investment management costs

### **(OPTIONAL SUBTOTAL : NET INCOMING RESOURCES AVAILABLE FOR CHARITABLE APPLICATION)**

- Charitable activities
- Governance costs
- Other resources expended

### **(TOTAL : RESOURCES EXPENDED)**

### **SUBTOTAL : NET INCOMING/OUTGOING RESOURCES BEFORE TRANSFERS**

### **TRANSFERS**

- Gross transfers between funds

### **(SUBTOTAL : NET INCOMING RESOURCES BEFORE HOLDING GAINS AND LOSSES)**

- Other recognised gains or losses
  - Gains on revaluation of fixed assets for charity's own use
  - Gains/losses on investment assets
  - Actuarial gains/losses on defined benefit pension schemes

### **SUBTOTAL : NET MOVEMENT IN FUNDS**

- Reconciliation of funds

### **TOTAL FUNDS BROUGHT FORWARD**

### **TOTAL : TOTAL FUNDS CARRIED FORWARD**

## **6. INCOMING RESOURCES**

### **6.1 Recognition of incoming resources : general points**

All incoming resources should be recognised in the Statement of Financial Activities as soon as it is prudent and practicable to do so. Resources should not be recognised until the conditions for receipt have been met and there is reasonable assurance of receipt. This will usually be when the particular resource is receivable or the charity's entitlement to it becomes legally enforceable.

The new SORP takes a different approach in a substantially amended section on the recognition of incoming resources, setting out the criteria for recognition should be when a transaction or other event results in an increase in the charity's assets. However, it retains the approach adopted first in SORP 2000 of using three factors to judge this :

- Entitlement – normally arises when there is control over the rights or other access to the resource, enabling the charity to determine its future application;
- Certainty – when it is virtually certain that the incoming resource will be received;
- Measurement – when the monetary value of the incoming resource can be measured with sufficient reliability.

All incoming resources should be reported gross, whether raised by the charity or its agents.

#### **6.1.1 Contractual arrangements - recognition of income**

The SORP introduces new guidance (*Paras 98 to 103*) on income arising from contractual arrangements entered into by charities. In general, where the charity earns income by charging for goods or services as part of their charitable activities, and normally such incoming resources will be recognised when the services are provided. Where the incoming resources are received in advance then a charity may not have entitlement to these resources until the goods or services have been provided, in which case, the incoming monies received in advance should be deferred until the charity becomes entitled to the resources.

Certain grant funding arrangements may contain conditions that closely specify the service to be performed by the charity. The terms of such funding may be set out in a service level agreement where the conditions for payment are linked to the performance of a particular level of service or units of output delivered, for example, number of meals provided or the opening hours of a facility used by beneficiaries. Entitlement to the incoming resources derived from such performance-related grants may be conditional upon the delivery of the specified level of service and in such circumstances should be recognised to the extent that the charity has provided the services or goods.

Simply because a grant is restricted to a particular purpose of the recipient charity does not mean it should necessarily be recognised as a performance related grant. For a performance related grant entitlement to the incoming resource only arises with the performance of a specific output identified as a condition for the grant. Entitlement to the grant in such cases only arises as the performance conditions are met. This can be contrasted with a restriction that whilst limiting how a charity may expend funds to particular purposes does not require a specific and measurable output to be delivered by the recipient charity as a condition of a charity's entitlement to the funds. Such restricted grants are recognised on the basis set out in paragraphs 104 to 111

Where charities receive membership subscriptions, these may be in the nature of a gift, or they may effectively buy services or access to certain privileges. Where the substance of the subscription is that of a gift, the incoming resource should be recognised on the same basis as a donation. If the subscription purchases the right to services or benefits, the incoming resource should be recognised as the service or benefit is provided. If the subscriber receives rights to such benefits evenly over the period of membership then recognising such membership income on a pro-rata basis for the period of time covered by the subscription may be an appropriate estimation technique for income recognition.

## **6.2 Recognition of Grants and Donations Receivable**

A pre-requisite of recognition of a promised grant or donation is evidence of entitlement. Evidence will normally exist when the grant is formally expressed in writing. Where entitlement is demonstrable, and no conditions are attached, such promises should be recognised once the criteria of certainty and measurability are met.

### **6.2.1 Grants and donations with conditions attached**

Charities often receive grants or donations with conditions attached that must be fulfilled before the entity has unconditional entitlement (control) of the resources. Meeting such conditions may be either within the recipient charity's control or reliant on external factors outside its control. Where meeting such conditions are within the charity's control and there is sufficient evidence that the conditions will be met, then the incoming resource should be recognised. Where uncertainty exists as to whether the recipient charity can meet conditions within its control, the incoming resource should not be recognised but deferred as a liability until certainty exists that the conditions imposed can be met. For example, a grant may be conditional on a charity obtaining matched funding, or subject to a successful planning consent. Meeting the conditions attaching to such grants would not be either certain or wholly within the control of the recipient charity. The charity would not therefore have unconditional entitlement (control) of the incoming resource until these conditions were met. The incoming resource and corresponding asset should not be recognised until the conditions set have been met.

Conditions such as the submission of accounts or certification of expenditure can be seen as simply an administrative requirement as opposed to a condition that might prevent the recognition of incoming resources.

Incoming resources may also be subject to donor imposed conditions that specify the time period in which the expenditure of resources can take place. Such a pre-condition for use limits the charity's ability to expend the resource until the time condition is met. For example, the receipt in advance of a grant for expenditure that must take place in a future accounting period should be accounted for as deferred income and recognised as a liability until the accounting period in which the recipient charity is allowed by the condition to expend the resource.

Where the existence of a condition prevents the recognition of an incoming resource, a contingent asset should be disclosed where it is probable (but not virtually certain) that the condition will be met in the future. In all cases where income is deferred, the treatment should be explained and the amounts brought forward and carried forward explained in the notes to the accounts.

#### 6.2.2 Donations for future expenditure

Charities are normally entitled to incoming resources when they are receivable. Recognition of a grant or donation without pre-conditions should not be deferred even if the resources are received in advance of the performance of the activity funded by the grant or donation. In such cases the charity has entitlement to the resource with the timing of the expenditure being within the discretion of the charity. Incoming resources cannot be deferred simply because the related expenditure has not been incurred.

#### 6.2.3 Donations to fund the purchase of fixed assets for use by the charity

Where either incoming resources are given specifically to provide a fixed asset or a fixed asset is donated (a gift in kind), the charity will normally have entitlement to the incoming resources when they are receivable. At this point, all of the incoming resources should be recognised in the Statement of Financial Activities and not deferred over the life of the asset. Once acquired, the use of the asset will either be restricted or unrestricted. If its use is unrestricted the trustees may consider creating a designated fund reflecting the book value of the asset. The relevant fund will then be reduced over the useful economic life of the asset in line with its depreciation. This treatment accords with the requirements under accounting standards for the recognition of assets and liabilities and provides the most appropriate interpretation of SSAP 4 for charities.

#### 6.2.4 Donations for restricted purposes

The fact that a grant or donation is for a restricted purpose does not affect the basis of its recognition within the Statement of Financial Activities. There is an important difference for accounting purposes between restrictions placed on the purposes for which a particular resource may be used and conditions which must be fulfilled prior to entitlement or use by the charity. The existence of a restriction does not prevent the recognition of the incoming resource as the charity has entitlement to (control of) the resource and is simply limited by the restriction as to the purposes to which the resource can be applied.

Funds received for the restricted purpose of providing fixed assets should be accounted for immediately as restricted funds. The treatment of the fixed assets provided with those funds will depend on the basis on which they are held. The terms on which the funds were received may either require the fixed assets acquired to be held in a restricted fund or the fixed assets' acquisition may discharge the restriction and the asset will be held in the unrestricted funds. Where assets are re-allocated from one fund to another this should be reflected as a transfer between the relevant funds.

#### 6.2.5 Do the resources belong to the charity?

SORP 2000 deals with the question of funds received by the trustees as agent (and not as custodian trustees) and where they are legally bound to pay them over to a third party and have no responsibility for their ultimate application. In these circumstances the intermediary charity should not recognise the resources in the SOFA. The guidance is unchanged in SORP 2005.

However trustees need to distinguish whether in such circumstances they own the resources prior to the transfer to the third party. Examples may include where the trustees have applied for the grant of resources or are able to direct how the grant should be used by the third party or both.

Alternatively the funding may require the trustees to accept legal responsibility for ensuring the charitable use of the funds. In such cases the incoming resources and their application should be recognised within the SOFA.

Where a charity has held resources for a third party not included in the SOFA, the notes should analyse the movements, relating to each party or type of party. Since the party may be a related party, the additional disclosures required by this section of the SORP need to be considered.

### **6.3 Incoming resources – classification**

Incoming resources should be analysed according to the activity that produced the resources. The analysis adopted should follow that given in the proforma, in particular grouping separately those resources generated by charitable activity from those activities aimed primarily at generating funds. In most cases it will be clear which activity generated a particular resource. When the resources are generated from several activities then it is permissible to apportion the resources between the activities on a reasonable, justifiable and consistent basis.

### **6.4 Voluntary income**

This heading covers income received from the following :

- gifts and donations, including legacies given by the founders, patrons, supporters, the general public and businesses;
- grants which provide core funding or are of a general nature provided by government and charitable foundations but will not include those grants which are specifically for the performance of a service or production of charitable goods, for instance a service agreement with a local authority;
- membership subscriptions and sponsorships where these are, in substance, donations rather than payment for goods or services;
- gifts in kind and donated facilities and services.

### **6.5 Legacies**

Legacies should be included in the Statement of Financial Activities unless they are incapable of financial measurement. Where the charity has entitlement to material legacies which have not been included in the accounts, this fact and an estimate of the amounts receivable should be disclosed in the notes to the accounts.

The SORP gives detailed guidance on when to recognise legacies (*Paras 123 to 127*). It confirms that it is good practice to monitor legacies but the charity should not regard a legacy as receivable simply because it has been told about it. It should only include it if the legacy has been received or there is sufficient evidence to provide the necessary certainty that the legacy will be received and the value of the incoming resource can be measured reliably. In practice, it is unlikely that this certainty can be demonstrated before the receipt of a letter from the personal representative advising of an intended payment or transfer. Even then receipt of such a letter will not necessarily result in the legacy being included in the SOFA, if there are conditions associated with the legacy e.g. the death of a life tenant. The SORP confirms that where a letter is received after the year end and it is clear that had been agreed before the year end it should be accrued in the SOFA since it provides evidence of conditions existing at the balance sheet date (SSAP 17). Where the charity has been notified of material legacies which have not been included in the SOFA, that fact and an estimate of the amount should be disclosed by way of note.

## **6.6 Gifts in kind**

Assets given for distribution should be included in the statement as voluntary income when distributed. The value of assets on hand at the balance sheet date should be estimated and disclosed by way of a note to the accounts if material. Assets given for use by the charity should be recognised when receivable.

Gifts donated for resale should normally be recognised as received, but this is not practical in all cases, in which case they should be included when sold. They will not be categorised as voluntary income, as although they are legally donations, the operation of a charity shop to convert such donations into cash is really an “activity for generating funds” and should be disclosed as such.

## **6.7 Donated services and facilities**

A charity may receive assistance in the form of donated facilities, beneficial loan arrangements, donated services or services from volunteers. Such assistance is generally referred to as “intangible income”.

Such incoming resources should be included in the Statement of Financial Activities where the benefit to the charity is reasonably quantifiable and measurable. The value placed on these resources should be the estimated value to the charity of the service or facility received: this will be the price the charity estimates it would pay in the open market for a service or facility of equivalent utility to the charity.

Donated services and facilities recognised in financial statements would include those usually provided by an individual or entity as part of their trade or profession for a fee. In contrast, the contribution of volunteers should be excluded from the Statement of Financial Activities as the value of their contribution to the charity cannot be reasonably quantified in financial terms. Commercial discounts should not be recognised as incoming resource except where they clearly represent a donation.

Where donated services or facilities are recognised, an equivalent amount should be included as expenditure under the appropriate heading in the Statement of Financial Activities.

## **6.8 Activities for generating funds**

Activities for generating funds are the trading activities carried out by a charity to generate incoming resources which will be used to undertake its charitable activities. This category will include:

- (a) fundraising events such as jumble sales, firework displays and concerts (which are legally considered to be trading activities);
- (b) those sponsorships and social lotteries which cannot be considered as pure donations;
- (c) shop income from selling donated goods and bought in goods;
- (d) providing services other than for the benefit of the charity's beneficiaries;

- (e) letting and licensing arrangements of property held primarily for functional use by the charity but temporarily surplus to operational requirements.

Ancillary trades where the principal aim (whilst still providing a service to the beneficiaries) is to generate incoming resources to support or contribute to the funding of charitable activities, should also be included in this section.

It may be possible to segregate the incoming resources and resources expended for each different type of activity (this may have to be done for tax purposes) but an enterprise carrying on a mix of activities will often be viewed as a single economic unit. Charity trustees should consider the balance of the activities being undertaken to determine the most appropriate place to include the incoming resources from such enterprises but having done this the mix of incoming resources need not be segregated further. This may include trading in furtherance of the charity's objects where this is not material. For instance a shop may mainly sell donated and bought in goods, but it may also sell a small amount of goods made by its beneficiaries and incidentally provide information about the charity. It would be acceptable to class all the incoming resources from the shop as "shop income" under "other activities for generating funds".

## **6.9 Investment income**

Investment income includes incoming resources from investment assets, including dividends, interest and rents but excluding realised and unrealised investment gains and losses.

Where a charity has subsidiary undertakings:

- (a) all payments to the charity by its subsidiary undertakings and all dividend entitlements from them, other than amounts receivable by the charity for the provision of goods and services to subsidiaries, should be separately recognised as incoming resources and appropriately described under investment income in the parent charity's accounts.
- (b) The exact amount of a gift aid payment from a subsidiary undertaking relating to a financial year can often only be precisely determined subsequent to the year end, for example with the calculation of taxable profits. Provided that a liability for the gift aid payment existed at the year end, the amount of the liability should be adjusted where calculations subsequent to the year end provide greater accuracy
- (c) Gift aid payments from subsidiary undertakings should be separately disclosed in the charity's Statement of Financial Activities within investment income, or, if not material, in the notes to the accounts. The subsidiary undertakings themselves will only be accounted for by the charity in its consolidated Statement of Financial Activities of the group.

### **6.10 Incoming resources from Charitable Activities**

This category includes any incoming resources received which are a payment for goods and services provided for the benefit of the charity's beneficiaries. It will include trading activities undertaken in furtherance of the charity's objects and those grants (although legally donations) which have conditions which make them similar in economic terms to trading income, such as service level agreements with local authorities.

This category will not include grants which are for core funding or do not have particular service requirements or are in response to an appeal. Such grants should be included in the section for voluntary income.

Incoming resources from charitable activities should include:

- (a) the sale of goods or services as part of the direct charitable activities of the charity (known as primary purpose trading);
- (b) the sale of goods or services made or provided by the beneficiaries of the charity;
- (c) the letting of non-investment property in furtherance of the charity's objects;
- (d) contractual payments from government or public authorities where these are received in the normal course of trading under (a) to (c), e.g. fees for respite care;
- (e) grants specifically for the provision of goods and services to be provided as part of charitable activities or services to beneficiaries;
- (f) ancillary trades connected to a primary purpose in (a) to (e).

## **7. RESOURCES EXPENDED**

### **7.1 Recognition of expenditure**

Expenditure should be recognised when and to the extent that a liability is incurred or increased without a commensurate increase in recognised assets or a reduction in liabilities. In accounts prepared on the accruals basis liabilities are recognised as soon as there is a legal or constructive obligation committing the charity to the expenditure as described in Financial Reporting Standards 5 and 12. A liability will arise when a charity is under an obligation to make a transfer of value to a third party as a result of past transactions or events.

#### **7.1.1 Contractual Arrangements**

Where a charity enters into a contract for the supply of goods or services, expenditure is recognised once the supplier of the goods or services has performed their part of the contract, for example, the delivery of goods or the provision of a service. Certain grants made may contain specific conditions that closely specify a particular service to be performed by the recipient of the grant. The terms of such grants may be set out in a service level agreement where the conditions for payment are linked to the performance of a particular level of service or units of output delivered, for example, number of meals provided or the opening hours of a facility used by beneficiaries. Often, in such cases, the grant maker will have negotiated the services to be provided to it or its beneficiaries. Expenditure on such performance-related grants should be recognised to the extent that the recipient of the grant has provided the specified service or goods.

A grant that is merely restricted to a particular purpose of the recipient does not create a performance related grant unless the grant also includes specific performance terms that meet the criteria set out above. Similarly, certain restricted grants may fund a programme of work to be undertaken over a number of years by the recipient. Again, this does not mean it should necessarily be recognised as a performance-related grant simply because of the period of the funding commitment or because the grantor is involved in monitoring or influencing the focus of the work as part of its grantmaking procedures

For example, a grantmaking charity may fund a three year research programme enabling the recipient to undertake a programme of work identified by the recipient as necessary to meet its own objectives or that adds to the stock of knowledge on a topic. In order to provide funding, the work undertaken will need to be consistent with the legal objects of the grantmaker which may also, as part of its own grant approval processes, be involved in monitoring or influencing the focus of the work. Such an arrangement would not create a performance-related grant if the funding is not directed at providing a specified service to the grantmaker or its beneficiaries as a condition of payment. Grants without such performance conditions that are directed at enabling the recipient to follow its own programme of work or increasing the pool of knowledge in an area of work should be recognised as a liability where a constructive obligation arises to make the grant payment.

### 7.1.2 Grants Payable and Constructive Obligations

In the case of grants (other than performance-related grants) and certain other expenditure relating directly to charitable activities, an exchange for consideration does not arise. Such expenditure is incurred to further the charity's objects but without creating a contractual or quasi-contractual relationship with the recipient of the grant or the charity's beneficiaries. Nevertheless, the charity may still have a liability which needs to be recognised.

Liabilities may arise from a constructive or a legal obligation. A constructive obligation arises under FRS12 where events have created a valid expectation in other parties that the charity will discharge its obligations. Determining whether a valid expectation has been created will be evidenced by the charity's current and past practice in discharging such obligations and the specific communication of a commitment to the recipient. A constructive obligation always involves a commitment to another party that has been communicated to those affected in a sufficiently specific manner to raise a valid expectation on the part of the recipient that the charity will discharge its obligations.

Charities may on occasions make general or policy statements of their future intentions, for example, of an intention or aim of relieving famine in a particular location or to improve the quality of care provided to a particular group of people. Such statements can be communicated in a variety of ways including mission statements, setting out future plans in a Trustees' Annual Report or simply by making a general policy statement. Statements such as these do not create a constructive obligation as discretion is retained by the charity as to their implementation.

A constructive obligation is likely to arise where:

- (a) a specific commitment, or promise to provide goods, services or grant funding is given, and
- (b) this is communicated directly to a beneficiary or grant recipient.

In such circumstances, the charity is unlikely to have a realistic alternative but to meet the obligation. However, the recognition of any resulting liability will be dependent on any conditions attaching to such commitments.

A charity may enter into commitments which are dependent upon explicit conditions being met either by itself or by the recipient before payment is made or upon future reviews. A liability, and hence expenditure, should be recognised once such conditions fall outside the control of the giving charity. If the conditions set remain within the control of the giving charity, then the charity retains the discretion to avoid the expenditure and therefore a liability should not be recognised.

By way of illustration, where a charity makes a specific commitment to grant fund a project over a three year period, the following situations may arise:

(a) If the multi-year grant obligation:

- (i) is conditional on an annual review of progress that determines whether future funding is provided; and
- (ii) discretion is retained by the giving charity to terminate the grant

then provided evidence exists (e.g. from past review practice) that the discretion retained by the charity has substance, this amounts to a condition and an immediate liability arises only for the first year of the funding commitment. If the annual review process, although set out in the conditions of the grant, is not in practice used to determine whether funding is provided in the subsequent years of the commitment, then the review stipulation should not be interpreted as a condition and a liability for the full three years of the grant should be recognised.

(b) If there is no condition attaching to the grant that enables the charity to realistically avoid the commitment, the liability for the full three years of the funding should be recognised.

Commitments may contain conditions that are outside the control of the giving charity. For example, a charity may promise a grant payment on the condition that the recipient finds matching funding. As the condition falls outside the control of the giving charity, a liability arises and expenditure should be recognised.

### 7.1.3 General Issues

Where a liability is not accrued, because conditions have not been met, such a commitment should normally be treated as a contingent liability. The trustees may wish to designate some of the charity's income funds to represent contingent liabilities and other planned expenditure which may not have created a liability.

Where later events make the recognition of a liability no longer appropriate, the liability should be cancelled by credit against the relevant expenditure heading in the Statement of Financial Activities. The credit should mirror the treatment originally used to recognise the expenditure for the liability and should be disclosed separately.

## 7.2 Support Costs

In undertaking any activity there may be support costs incurred that, whilst necessary to deliver an activity, do not themselves produce or constitute the output of the charitable activity. Similarly, costs will be incurred in supporting income generation activities such as fundraising, and in supporting the governance of the charity. Support costs include the central or regional office functions such as general management, payroll administration, budgeting and accounting, information technology, human resources, and financing.

Support costs do not, in themselves, constitute an activity, instead they enable output-creating activities to be undertaken. Support costs are therefore allocated to the relevant activity cost category they support on the bases set out below. This enables the total cost of an activity category to be disclosed in the Statement of Financial Activities and for the cost of the constituent sub-activities to be presented at a service, programme or project level within the notes to the accounts. There is nevertheless legitimate user interest in both the level of support costs incurred and the policies adopted for their allocation to the relevant activity cost categories that should be addressed through relevant note disclosures.

### **7.3 Allocation of expenditure**

In attributing costs between activity categories, the following principles should be applied:

- (a) Where appropriate, expenditure should be allocated directly to activity cost category.
- (b) Items of expenditure which contribute directly to the output of more than one activity cost category, for example, the cost of a staff member whose time is divided between a fundraising activity and working on a charitable project, should be apportioned on a reasonable, justifiable and consistent basis.
- (c) Depreciation, amortisation, impairment or losses on disposal of fixed assets should be allocated in accordance with the same principles.
- (d) Support costs may not be attributable to single activity but rather provide the organisational infrastructure that enables output producing activities to take place. Such costs should therefore also be apportioned on a reasonable, justifiable and consistent basis to the activity cost categories being supported.

There are a number of bases for apportionment that may be applied. Examples include:

- (a) usage - e.g. on the same basis as expenditure incurred directly in undertaking an activity;
- (b) per capita - i.e. on the number of people employed within an activity;
- (c) on the basis of floor area occupied by an activity.
- (d) On the basis of time (e.g. where staff duties are multi activity)

The bases for apportionment adopted by a charity should be appropriate to the cost concerned and to the charity's particular circumstances and selected to enable its accounts to give a true and fair view. The bases adopted for apportionment will normally be consistent between accounting periods. The SORP provides a Table to illustrate how the disclosures might be made.

Table 4. Example of Support Cost Breakdown by Activity

Support Cost (Examples)	Fund-raising	Activity 1	Activity 2	Activity 3	Activity 4	Activity 5	Basis of allocation
Management	£x	£x	£x	£x	£x	£x	Text describing method
Finance	£x	£x	£x	£x	£x	£x	Text describing method
Information Technology	£x	£x	£x	£x	£x	£x	Text describing method
Human Resources	£x	£x	£x	£x	£x	£x	Text describing method
Total	£x	£x	£x	£x	£x	£x	

Particular issues arise where a charity provides information about its activities in the context of a fundraising activity. Information about the aims, objectives and projects of a charity is frequently provided in the context of mail shots, collections and telephone fundraising. In determining whether a multi-purpose activity arises, and therefore a need to apportion costs, a distinction should be drawn between:

- (a) publicity or information costs involved in raising the profile of a charity which is associated with fundraising (costs of generating funds); and
- (b) publicity or information that is provided in an educational manner in furtherance of the charity's objectives (charitable expenditure).

In the context of a fundraising activity, for publicity or information to be regarded as charitable expenditure, it must be supplied in an educational manner. To achieve an educational purpose, information supplied would be:

- (a) targeted at beneficiaries or others who can use the information to further the charity's objectives; and
- (b) information or advice on which the recipient can act upon in an informed manner to further the charity's objectives; and
- (c) related to other educational activities or objectives undertaken by the charity.

Where information provided in conjunction with a fundraising activity does not meet these criteria, it should be regarded as targeted at potential donors and therefore relating wholly to the fundraising activity.

For example, a health education charity that targeted high-risk beneficiary groups or the medical profession supplying information as to health risks or symptom recognition and advising on steps that should be taken. Such information would fall within charitable expenditure in that it is targeted at beneficiaries, advises on steps that can be taken and is likely to link to the charity's activities or objectives in health education. Therefore when such information is provided in the context of a fundraising activity, a joint cost would arise with costs apportioned between the fundraising and charitable activities.

## **7.4 Costs of generating funds**

These are the costs which are associated with generating incoming resources from all sources other than from undertaking charitable activities. The main components of costs within this category are:

- (a) costs of generating voluntary income;
- (b) costs of fundraising trading, including cost of goods sold and other associated costs; and
- (c) costs of managing investments for both income generation and capital maintenance.

Costs of generating funds should not include:

- (a) costs associated with delivering or supporting the provision of goods and services in the furtherance of the charity's objects; nor
- (b) the costs of negotiating the terms of a contract or performance-related grant relating to the provision of such services.

### **7.4.1 Costs of Generating Voluntary Income**

Costs of generating voluntary income are defined in the Glossary to the SORP. All such fundraising costs, including agents' costs where fundraising agents are used, should be included within this category. In the case of consolidated accounts any such costs incurred by any subsidiary companies or other entities should be consolidated on a line-by-line basis.

Some fundraising costs may be incurred in starting up a new source of future income such as legacies, or in developing a supporter database.

- (a) Start-up costs of a new fundraising activity should be dealt with in accordance with UITF 24 - Accounting for Start-up Costs. In most cases, it will be inappropriate to carry forward start-up costs as prepayments or deferred expenditure as the future economic benefits that may be derived are usually not sufficiently certain.
- (b) Data capture costs of internally developed databases may only be capitalised where future benefit can be demonstrated and the resulting database has a readily ascertainable value ;

The start-up costs of a new fundraising activity may be material in the context of the overall fundraising activity and may, because of their exceptional size or incidence, require separate disclosure to explain performance.

#### 7.4.2 Fundraising trade – cost of goods sold and other costs

This category should include all those costs that are incurred by trading for a fundraising purpose in either donated or bought-in goods or in providing non-charitable services to generate income. This includes:

- (a) the cost of goods sold or services provided;
- (b) other costs related to the trade, including staff costs, premises costs and other costs incurred in the activity including allocated support costs; and
- (c) costs related to the licensing of a charity logo.

In consolidated accounts this category will include the costs incurred by both the charity and any subsidiaries or other entities consolidated on a line-by-line basis.

#### 7.4.3 Investment management costs

Investment management costs are defined in the Glossary. Where investment management fees are deducted from investment income by investment managers, the charity should show as investment income the gross investment income before fees and report the fees within this cost category. Investment management costs associated with endowment fund investments should generally be charged to the endowment fund in the Statement of Financial Activities. Investment management costs are defined in the Glossary to the SORP. Investment management costs associated with endowment fund investments should generally be charged to the endowment fund capital.

### 7.5 Charitable activities

Resources expended on charitable activities comprise all the resources applied by the charity in undertaking its work to meet its charitable objectives as opposed to the cost of raising the funds to finance these activities and governance costs. Charitable activities are all the resources expended by the charity in the delivery of goods and services, including its programme and project work that is directed at the achievement of its charitable aims and objectives. Such costs include the direct costs of the charitable activities together with those support costs incurred that enable these activities to be undertaken.

Charities may carry out their activities through a combination of direct service provision and grant funding of third parties to undertake work that contributes to the charity's objectives or programme of work. In such cases, the total cost of the activity involves both costs incurred directly by the charity and funding provided to third parties through grantmaking activities.

Where incoming resources are received either under contract or by a restricted grant to provide a specified service, further analysis of charitable activities expenditure may be provided in the notes to the accounts to demonstrate the link between the incoming resource and the charitable activity that it funds.

An analysis should be provided to inform readers of the accounts how resources have been deployed between the charity's main areas of work. The activities disclosed should be consistent with those disclosed for incoming resources. The SORP suggests a tabular approach (*Para 194 – Table 5*) may once again be appropriate, using the following format :

Activity or Programme	Activities undertaken directly £	Grant funding of activities £	Support costs £	Total £
Activity 1				
Activity 2				
Activity 3				
Total				

## 7.6 Grants Payable

Costs associated with grantmaking activity include the grants actually made and the support costs associated with the activity. Grantmaking charities may undertake their entire programme of work through grantmaking activities, whilst other charities may undertake their activities through a combination of direct service provision and grant funding of third parties. In either case, further analysis of grantmaking, where material, should be provided.

Grantmaking will be material if in any accounting year a charity makes grants totalling at least 5% of its total resources expended in that year. The analysis of grants payable should differentiate between grants made to individuals and those payable to institutions. An individual grant is one that is made for the direct benefit of the individual who receives it, for example, to relieve financial hardship. All other grants should be regarded as institutional. For example, a grant which is made to an individual to carry out a research project should be regarded as a grant to the institution with which the individual is connected rather than as a grant to the individual.

Support costs related to grantmaking will include:

- (a) costs incurred before grants are made (pre-grant costs) as part of the decision making process;
- (b) post-grant costs e.g. monitoring of grants; and
- (c) costs of any central or regional office functions such as general management, payroll administration, budgeting and accounting, information technology, human resources, and financing.

### 7.6.1 Disclosures – grant making

The analysis and explanation should help the reader of the accounts understand how the grants made relate to the objects of the charity and the policy adopted by the trustees in pursuing these objects. The notes to the accounts should identify the amount of support costs associated with grantmaking activities.

The analysis and explanation in the notes should provide details, with amounts that reconcile with the total of grants payable of:

- (a) the total number and total amount of grants analysed between grants to individuals and grants to institutions;
- (b) an analysis of the grants by purpose.

This statement may, for example, be structured as follows: (*Table 6 – para 204*)

Analysis	Grants to institutions		Grants to individuals	
	Total number	Total amount £	Total number	Total amount £
Activity / Project 1				
Activity / Project 2				
Activity / Project 3				
Total				

The analysis of grants by their purpose should relate to the charity's objectives, for example, categories may be social welfare, medical research, the performing arts, welfare of people in financial need, help to people seeking to further their education, etc, depending on the nature of the charity. Some charities may decide that it is appropriate to provide further or alternative levels of analysis perhaps for example, showing a geographical analysis of the number and value of grants made.

The trustees may give further analysis and explanation of the purposes for which grants were made as part of the Trustees' Annual Report or by means of a separate publication. Such further analysis does not excuse the trustees from providing sufficient detail in the notes to the accounts as is needed to provide a true and fair view.

If a charity has made grants to institutions, the charity should disclose details, of a sufficient number of institutional grants to provide a reasonable understanding of the range of institutions it has supported. This information may be provided either in the notes to the accounts, or as part of the Trustees' Annual Report or by means of a separate publication.

The disclosure of institutional grants should give the name of the institution and the number and total value of grants made to that institution in the accounting year. Where grants have been made to a particular institution for different purposes, the number and total value of the grants made for each purpose should be disclosed. For example, a charity may have made grants to different officers or departments of a particular university for different projects. Such grants should be treated as having been made to the same institution with an analysis provided of the number and total value of grants made for each purpose.

No disclosure of institutional grants is necessary where the total value of grants given to any particular institution in the accounting year is less than £1,000. Where the total value of grants paid to any particular institution exceeds £1,000, relevant disclosures should be made although the disclosure may be limited to the 50 institutions in receipt of the largest value of institutional grant funding provided by the charity. Very exceptionally, even though the grants to a particular institution are material, it is possible that the disclosure of the details of one or more of those grants could seriously prejudice the furtherance of the purposes either of the recipient institution or of the charity itself. Situations where serious prejudice is clearly indicated include those where disclosure could result in serious personal injury. Mere unwillingness to disclose grants or inconvenience or embarrassment to one or more trustees cannot be regarded as serious prejudice. Commercial disadvantage is not of itself seriously prejudicial.

Where the circumstances amount to serious prejudice, a charity may withhold details of the recipient of any institutional grant concerned but should in such circumstances:

- (a) disclose in the notes to the accounts the total number, value and general purpose of those grants the details of which have not been disclosed;
- (b) give in writing to the charity's regulatory body:
  - (i) the full details of any grants not disclosed, and
  - (ii) a full explanation of the reasons why those details have not been disclosed in the accounts;
- (c) state in the notes to the accounts whether or not those details have been given to the charity's regulatory body.

It is unlikely in practice that all the material institutional grants of a charity would fall within this exception.

## **7.7 Governance costs**

These costs include the governance arrangements which relate to the general running of the charity as opposed to the direct management functions inherent in generating funds, service delivery and programme or project work. These activities provide the governance infrastructure which allows the charity to operate and to generate the information required for public accountability. They include the strategic planning processes that contribute to future development of the charity.

Expenditure on the governance of the charity will normally include both direct and related support costs. Direct costs will include such items as internal and external audit, legal advice for trustees and costs associated with constitutional and statutory requirements, e.g. the cost of trustee meetings and preparing statutory accounts. There should also be an apportionment of shared and indirect costs involved in supporting the governance activities (as distinct from supporting its charitable or income generation activities).

## **8. BALANCE SHEET**

The SORP 2005 moves closer towards a columnar balance sheet display. It states that the display is not mandatory but that it is preferable, and as an alternative, the same information should be provided by way of note. At this point, it is probably easier to prepare a columnar balance sheet than to provide copious notes in addition to a single column display. The new format headings appear on the following page.

### **8.1 Tangible fixed assets**

Tangible fixed assets should be split between assets held for charity's own use and heritage assets, although there may be some overlap; functional fixed assets are defined as those assets which are used for charitable purposes i.e. within the functional activities.

Tangible fixed assets should be included at cost as under FRS 15, i.e. directly attributable costs; they should be capitalised on initial acquisition and included in the balance sheet thereafter at cost or valuation. If assets are acquired in full or part from a grant, the cost should be shown in full, and donated assets should be included at the amount of the gift.

If capitalised some time after being acquired functional fixed assets should be included at original cost or at the value at which the gift was included in the SOFA, less depreciation. If the cost is not ascertainable, a reasonable estimate of the cost or current value should be used as the asset's initial carrying amount and not be treated as a revaluation.

Fixed assets should be subject to impairment write downs in line with FRS 11 if the recoverable amount is lower than carrying value.

### **8.2 Mixed Use of Fixed Assets**

It is important that where assets are held partly for investment and partly for functional purposes, the way in which they are capitalised depends on the primary purpose for holding the asset and the extent to which they are separable. There are 3 options:

- (a) Land and buildings held primarily for charity use of which a part is leased at a commercial rent should be regarded as functional fixed assets and included within tangible fixed assets provided the asset is wholly or mainly used for charitable purposes.
- (b) Land and buildings held primarily for investment purposes where the asset is wholly or mainly used for investment purposes should be included within the fixed asset investment category of the balance sheet.
- (c) Land and buildings which contain clearly distinguishable parts which are held for different purposes i.e. partly functional and partly investment and do not fall under or (b) above, should be apportioned and analysed in the balance sheet between functional and investment assets.

## **BALANCE SHEET (SORP 2005)**

### **FIXED ASSETS**

- Intangible assets
- Tangible assets
- Heritage assets
- Investments :
  - Investments
  - Programme related investments

### **TOTAL : FIXED ASSETS**

### **CURRENT ASSETS**

- Stock and work in progress
- Debtors
- Investments
- Cash at bank and in hand

### **TOTAL : CURRENT ASSETS**

### **LIABILITIES :**

### **CREDITORS : AMOUNTS FALLING DUE WITHIN ONE YEAR**

### **SUBTOTAL : NET CURRENT ASSETS OR LIABILITIES**

### **TOTAL : TOTAL ASSETS LESS CURRENT LIABILITIES**

### **CREDITORS : AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR**

### **PROVISIONS FOR LIABILITIES OR CHARGES**

### **TOTAL : NET ASSETS OR LIABILITIES EXCLUDING PENSION ASSET OR LIABILITY**

### **DEFINED BENEFIT PENSION SCHEME ASSET OR LIABILITY**

### **TOTAL : NET ASSETS OR LIABILITIES INCLUDING PENSION ASSET OR LIABILITY**

### **FUNDS OF THE CHARITY**

- Endowment Funds
- Restricted income funds
- Unrestricted income funds
  - Share capital
  - Unrestricted income funds
  - Revaluation reserve

### **TOTAL : UNRESTRICTED FUNDS EXCLUDING PENSION ASSET / LIABILITY**

- Pension reserve

### **TOTAL UNRESTRICTED FUNDS**

### **TOTAL : CHARITY FUNDS**

### **8.3 Heritage assets**

FRS 15 requires that all tangible fixed assets should be capitalised in the balance sheet. In principle this includes tangible fixed assets which are of historical, artistic or scientific importance that are held to advance preservation and conservation objectives of a charity. However, charities will not necessarily need to capitalise such heritage assets that were acquired in past accounting periods and omitted from previous balance sheets when the circumstances below apply.

To fall within the definition of heritage assets, the charity must hold the relevant assets in pursuit of preservation or conservation objectives. The objective of the charity may be specifically of a preservation or conservation nature, or the heritage assets may be integral to a broader objective such as educating the public in history, the arts or science as in the case of museums and galleries.

Newly purchased heritage assets should be initially measured and recognised at their cost.

When heritage assets were acquired in past accounting periods and not capitalised, it may be difficult or costly to attribute a cost or value to them. In such cases these assets may only be excluded from the balance sheet if:

- (a) reliable cost information is not available and conventional valuation approaches lack sufficient reliability; or
- (b) significant costs are involved in the reconstruction or analysis of past accounting records or in valuation which are onerous compared with the additional benefit derived by users of the accounts in assessing the trustees' stewardship of the assets.

FRS 15 provides details of appropriate valuation bases. However, certain heritage buildings, structures or sites may present particular valuation issues. Whilst most specialised buildings can be valued using Depreciated Replacement Cost (DRC), particular issues can arise in attempting to estimate the replacement cost of achieving the same service potential of certain historic buildings.

The uniqueness of certain structures that are associated with particular locations, events, individuals or periods in history may be irreplaceable in terms of recreating the same service potential. The same service potential in terms of its heritage value or educational benefit to the public may only be achieved through the original structure or site.

Examples of heritage assets for which a cost or valuation may be difficult to attribute include:

- (a) museum and gallery collections and other collections including the national archives;
- (b) medieval castles, archaeological sites, burial mounds, ruins, monuments and statues.

It may also be difficult or costly to attribute a cost or valuation to heritage assets which are donated where such assets are rarely sold on the open market. Where assets are purchased by a party who then shortly afterwards donates the asset to the charity, the purchase price should be considered as reliable cost information and could be used as a reference point for the fair value of donations of similar assets. Where an asset is partly purchased by the charity and partly donated, a reasonable estimate of the cost or value to the charity should be able to be made. Gifts on death or lifetime transfers of significant value may also carry valuations for inheritance tax purposes that may provide sufficient reliability. Heritage assets should be included in a separate row in the balance sheet and can be further analysed, in the notes to the accounts, into classes appropriate to each charity e.g. collections, artefacts, and historic houses. An appropriate depreciation policy should be applied.

Where assets of historical, scientific or artistic importance are held by a charity but not for preservation or conservation purposes, they cannot be regarded as heritage assets. Examples of assets that do not fall within the heritage assets category include situations where a charity:

- (a) holds and occupies an historic building as its administrative offices or as part of a property investment portfolio unrelated to any preservation or educational purpose;
- (b) has in its possession works of art, or a collection of historic importance, or antique furnishings within its boardroom, as a store of wealth, the retention of which is unrelated to any objectives of preservation or education;
- (c) occupies a functional property that is used to house or display a collection of heritage assets (unless the property itself is held for preservation or conservation purposes).

Charities may be required by trust law to retain an asset indefinitely for its own use/benefit and are effectively prohibited from its disposal without external consent. Normally, such inalienable assets belong to a charity's permanent endowment. Inalienability, of itself, does not preclude capitalisation of an asset.

Inalienable assets that do not fall within the definition of heritage assets, should be capitalised and disclosed in the relevant categories of balance sheet and in related notes. For example:

- (a) An investment property will be included as an investment within fixed assets, valued at open market value and disclosed as part of investment properties within the investment notes.
- (b) Functional properties used by a charity in undertaking its activities are included within tangible fixed assets and are included at cost or valued on an existing use basis unless of a specialized nature when a depreciated replacement cost valuation is adopted.
- (c) Tangible fixed assets other than properties are included at cost or valued at open market value.

Abbeys, Monasteries, Cathedrals, historic Churches and ancient centres of learning may not meet the heritage asset definition as the preservation of the buildings they occupy is unlikely to be the primary objective of the charity. Such assets might nevertheless be considered integral to the activities of the charity and this may give rise to difficulties in ascertaining an estimate of the current cost of construction of an asset that has the same service potential as the existing one. For example, a new structure could recreate the floor area and seating capacity of a medieval Cathedral but such a structure would not recreate the uniqueness of the original in terms of the religious and historical significance. In such cases a valuation of previously non-capitalised assets may be impractical and the notes should contain a statement to that effect explaining why conventional valuation techniques cannot be applied.

### 8.3.1 Disclosure

Information on heritage assets (whether or not they have been capitalised) should be given in the notes to the accounts. The notes should contain:

- (a) an analysis or narrative that enables the user to appreciate the age, scale and nature of the heritage assets held and the use made of them;
- (b) either:
  - (i) details of the cost (or value) of additions and disposals of heritage assets during the year; or
  - (ii) where details of cost or value are not available (non-capitalisation in previous periods), a brief description of the nature of the assets acquired or disposed of, together with the sales proceeds of any disposals;
- (c) accounting policy notes explaining the charity's capitalisation policy in relation to heritage assets and the measurement bases adopted for their inclusion in the accounts.

## 8.4 Programme related investments

Programme related investments are defined in the Glossary to the SORP and should be disclosed separately within the investment asset category from those investments intended primarily to generate a return for the charity.

### 8.4.1 Definition

Programme related investments (also known as social investments) are made directly in pursuit of the organisation's charitable purposes. Although they can generate some financial return, the primary motivation for making them is not financial. Such investments could include loans to individual beneficiaries (e.g. for housing deposits) or to other charities (for example, in relation to regeneration projects).

#### 8.4.2 Treatment

Programme related investments should generally be included in the balance sheet at the amount invested less any impairments (in the case of equity or loans) and any amounts repaid (in the case of loans). Impairments should be charged to resources expended on charitable activities. Where a gain is made on the disposal of a programme related investment, then the gain should either be set off against any prior impairment loss or included as a gain on disposal of fixed assets for the charity's own use and recorded under "other incoming resources".

#### 8.4.3 Disclosure

Where the use of programme related investments forms a material part of the work of the charity, or the amounts form a material part of the investment assets of the charity, the notes to the accounts should show all changes in carrying values of programme related investments, including any impairment losses, and reconcile the opening and closing carrying values of such investments.

### **8.5 Multiple funds : disclosures**

The SORP does indicate that where there are several major funds these may need to be presented on several sets of statements linked to a total summary to aid an appreciation of the information presented. Alternatively all supplementary analysis may be provided by the notes to the accounts : the trustees must decide the most appropriate way to disclose the information with clarity.

In all cases a reconciliation of the opening and closing balances on all funds of the charity must be prepared, analysed between the major types of fund, with further analysis in the notes on each major fund, disclosing the nature and purpose of each major fund.

In addition, the notes should disclose whether the way the funds are held will permit their use according to the restrictions : for example, funds which are to be spent soon should be held in short term investments or liquid funds.

The SORP suggests one clear way to show the fund reconciliation is to provide it in tabular format as follows (*Paragraph 76 – Table 2*)

<b>Fund name</b>	<b>Balance b/f</b>	<b>Incoming resources</b>	<b>Outgoing resources</b>	<b>Transfers</b>	<b>Gains &amp; losses</b>	<b>Balance c/f</b>
Major Fund 1						
Major Fund 2						
Major Fund 3						
Other Funds						
Total funds						

The specific fund disclosures required by the SORP are set out in Paragraph 75 as follows :

The notes to the accounts should provide information on the structure of the charity's funds so as to disclose the fund balances and the reasons for them, differentiating between unrestricted income funds (both general and designated), restricted income funds, permanent endowment and expendable endowment as well as identifying any material individual funds among them. In particular:

- (a) The assets and liabilities representing each type of fund of the charity should be clearly summarised and analysed (e.g. investments, fixed assets, net current assets) between those funds unless this information is presented in a columnar balance sheet (*see paragraph 248*).
- (b) Disclosure of how each of the funds has arisen (including designated funds), the restrictions imposed and the purpose of each fund should be provided. An indication should also be given as to whether or not sufficient resources are held in an appropriate form to enable each fund to be applied in accordance with any restrictions. For example, if a charity has a fund which is to be spent in the near future, it should be made clear in the notes whether or not the assets held (or expected to be received) in the fund are liquid assets.
- (c) Any funds in deficit should always be separately disclosed. An explanation should be given in the Trustees' Annual Report. Designated funds should never be in deficit.
- (d) Material transfers between different funds and allocations to designated funds should be separately disclosed, without netting off, and should be accompanied by an explanation of the nature of the transfers or allocations and the reasons for them.
- (e) Where, in relation to permanent endowment, a total return approach to investments has been adopted, the notes to the accounts should give particulars of the movements in the value of the unapplied total return for the financial year. The note should reconcile the balance held as unapplied total return at the beginning with that at the end of the financial year. (*Appendix 3 paragraphs 3(g) to 3(k)*)

## **9. RECENT TAX CHANGES AFFECTING CHARITIES**

### **9.1 ITA 2007**

The completion of the tax law rewrite project, with the issue of the Income Tax Act 2007 means that all of the statutory authority for charity tax exemptions for charitable trusts has changed. The new legislation is, as one would expect, rewritten in clear style and better laid out than before. It can be found in Part 10 of the Act, running from sections 518 to 564.

The new legislation does not change existing charity law, but the most recent direct tax changes affecting charities can now be incorporated into the legislation – in particular those changes introduced in Finance Act 2006.

The following notes provide a rounded view of non charitable expenditure, and reflect the overall position, including the changes, which are noted.

### **9.2 Treatment of trading profits – outline**

In ITA 2007 the exemption for trading income is set out in Section 524 and 525 and excludes from total income the profits of a charitable trade. Section 525 defines a charitable trade for these purposes.

“For the purposes of this Part a trade carried on by a charitable trust is a charitable trade in relation to a tax year if throughout the basis period for the tax year—

- (a) the trade is exercised in the course of carrying out a primary purpose of the charitable trust, or
- (b) the work in connection with the trade is mainly carried out by beneficiaries of the charitable trust.

This exemption is unchanged from the terminology in TA 1988, S505.

However, ITA 2007 deals more directly with the changes introduced by Finance Act 2006, which segregates as separate trades activities which relate partly to the primary purposes of the charity and partly not, and similarly in relation to the “work carried out by beneficiaries” test.

The effect of this separation is to provide full tax exemption on the aspects that meet the primary purpose test or the work carried out by beneficiaries test, and to potentially bring within the charge to tax activities which do not meet these tests. The profits arising may, however, be exempt under the exemption for small scale trades. Where such a separation is required, the expenses and receipts of the trade must be allocated between the two activities using a just and reasonable apportionment.

Section 526 then provides the tax exemption applying to small scale trades which was introduced in Finance Act 2000, and Section 529 deals with profits from fund-raising events previously exempt by concession. More details on these are given below.

### 9.2.1 Trades which are not wholly primary purpose trades

In some cases, a trade may amount, in part, but not wholly, to a primary purpose trade. For example, the trade might offer a range of goods or services, only some of which are within a primary purpose, or the trade might serve some customers who are not beneficiaries or patrons of the charity, as well as those who are.

Examples of such trades are :

- a shop in a museum, selling a range of goods, some of which are related to a primary purpose of the charity (i.e. education and the preservation of property for the public benefit). In this case, the sale of direct reproductions of exhibits and catalogues would be related to the primary purpose, but the sale of promotional pens, mugs, tea towels, stamps etc, would not;
- a school or college letting accommodation to students (the beneficiaries of the charity) in term- time, and to tourists out of term- time;
- a theatre restaurant selling food and drink to the theatre audience (the beneficiaries of the charity), but also to the general public.

It is under these circumstances that Section 525(2) ITA 2007 requires that the trades now be treated as two separate trades. This rule was introduced in Finance Act 2006 in relation to periods beginning after 22 March 2006.

### 9.2.2 Exemption for small trades

Section 46 of the Finance Act 2000 provided a blanket exemption from tax for moderate income from small trading activity. The current tax exemption for charitable trusts is now included in Section 526 ITA 2007, and covers post cessation receipts and adjustment income in the same way as routine trading profits.

The measures exempt from tax under Schedule D Cases I or VI income (referred to in ITA 2007 as trading and miscellaneous incoming resources) which is subject to a claim for exemption by the charity, and satisfies :

- It is applied for charitable purposes only
- The charity's gross income for the chargeable period does not exceed the requisite limit for the tax year(see below), **or**
- The charity had at the beginning of the period, a reasonable expectation that its gross income for the period would not exceed that limit.

(Section 528(1) ITA 2007)

The trading incoming resources are defined as the incoming resources required to be taken into the account in calculating the profits or losses in the basis period of any non exempt trade carried on by the charitable trust, plus adjustment income and post cessation receipts relevant to that basis period. (Section 528(2))

The requisite limit is the greater of :

- £5,000, and
- the lower of £50,000 and 25% of the charity's incoming resources for the period.

(Section 528(6))

Gross income for these purposes is the income that would otherwise be taxable under Schedule D cases I or VI, apart from the new relief, **before** any deductions for costs. When the chargeable period is less than 12 months, these limits are reduced pro rata.

### 9.2.3 Exemption for profits from fund raising events

This was previously covered by Extra Statutory Concession, and is now the subject of statutory exemption for charitable trusts. The concession still applies to company charities.

Where a fundraising event qualifies under the VAT rules as an exempt event, the profits from that event will be exempt from direct tax provided that they are applied for charitable purposes. The exemption from VAT is considered below in some detail.

Section 529 ITA 2007 expresses the exemption as applying to profits of a trade carried on by a charitable trust so far as they arise from a VAT-exempt event, cross referring to the relevant VAT legislation in Group 12 of Schedule 9 to VATA 1994.

## 9.3 Application of funds for charitable purposes only

The reliefs available depend upon the application of the profits that would otherwise be assessable for a charitable purpose only. The use of profits for non charitable purposes or the accumulation of profits may preclude the charity from claiming tax exemption on some or all of its income.

### 9.3.1 Establishing application for a charitable purpose

The use of profits or income received in fulfilling the objects of the charity within the accounting period, clearly constitute application for a charitable purpose. However, the actual application of funds may well be delayed, because a particular project is dependant upon a large amount of funds being available at one time. Provided the application of the funds to the charitable purpose is within the foreseeable future there is unlikely to be a problem in this respect.

The donation of charitable income that would otherwise be taxable to another charity in fulfilment of that first charity's objects is an application for charitable purpose by that first charity, but that income would become a taxable receipt in the second charity's hands unless applied for a charitable purpose. The contention that such a receipt is of a capital nature for tax purposes is not acceptable.

The payment of funds to an overseas body will only be acceptable if the charity has taken reasonable steps to ensure that the sums paid over are, in fact applied for charitable purposes. Reckless payments of amounts overseas would probably result in tax being deducted from income in respect of those payments.

### 9.3.2 Application for non charitable purposes

The use of funds to pay the administrative expenses of the charity is not application for a charitable purpose in the strict sense. However, recognising that charities could not function and fulfil their objectives without staff and other administrative costs being incurred, the Revenue will not challenge a charity on this point provided the administrative costs are not excessive. The straying over an acceptable level of costs is likely to attract attention both from the Revenue and the Charity Commissioners, under their powers outlined above.

The application of funds to which the charity may believe are charitable purposes, but which are held to be political or other banned activities can have serious consequences for the charity and every effort must be made to distance the charity from such activities, by the formation of a separate company to which no support is provided by the charity.

There are also specific tax provisions which designate certain expenditure as “non charitable expenditure” which would also give rise to the withdrawal of tax relief on those amounts. This is primarily relevant in the context of major donors and transactions with major donors, which anti avoidance legislation was introduced in Finance Act 2006. This is dealt with in detail below.

## 9.4 Loss of tax exemption

Section 539 of ITA 2007 provides the restriction on the tax exemptions provided elsewhere in Part 10 of the Act if the charitable trust has a “non exempt amount” for a tax year. The definition of a non exempt amount is given in Section 540. Section 539(2) eliminates all exemptions hitherto applying to the income of the charity in so far as any income of the charity is attributed by Section 541 to the non exempt amount.

### 9.4.1 The non exempt amount

This is defined for charitable trusts by Section 540 ITA 2007, which structure also applies to companies covered by Section 503 ICTA as amended by FA 2006.

A charitable trust has a non-exempt amount for a tax year if it has :

- (a) non-charitable expenditure for the tax year (amount A), and

(b) attributable income and gains for the tax year (amount B).

The non-exempt amount for the tax year is the lower of amounts A and B.

Section 540 further defines a charitable trust's "attributable income" for a tax year as the charitable trust's income for the tax year that is exempt from income tax as a result of any of the exemptions given by Part 10 of ITA 2007, and a charitable trust's "attributable gains" for a tax year as any gains accruing to the charitable trust in the tax year that as a result of the exemption given by section 261 of TCGA 1992, are not chargeable gains. The attributable income and gains is the sum of the two.

#### 9.4.2 Non charitable expenditure

This is a relatively new concept, introduced by FA 2006, and replacing the term "non qualifying expenditure". The withdrawal of the tax exemption worked in a markedly different way until 22 March 2006, and was tightened up as a result of marketed tax avoidance schemes aimed at major donors. The new definition now appear in Section 543 ITA 2007.

A charitable trust's non-charitable expenditure for a tax year is:

- (a) any loss made in the tax year in a trade carried on by the charitable trust unless :
  - (i) the trade is a charitable trade in relation to the tax year, or
  - (ii) the trade is not a charitable trade in relation to the tax year but profits of the trade arising in the tax year would be exempt from income tax as a result of one of the exemptions in sections 526, 529 or 530,
- (b) any payment made in the tax year by the charitable trust in connection with a trade in circumstances where relief is available under section 96 (post-cessation trade relief) unless :
  - (i) the trade was a charitable trade in relation to the tax year in which the cessation occurred, or
  - (ii) the trade was not a charitable trade in relation to that tax year but profits of the trade arising immediately before the cessation would have been exempt from income tax as a result of one of the exemptions in sections 526, 529 or 530,
- (c) any loss made in the tax year in a trade, or in a UK property business or an overseas property business, carried on by the charitable trust, if:
  - (i) the loss relates to land, and
  - (ii) profits of the trade, or income of the business, generated from the land in the tax year would not be exempt from income tax as a result of the exemptions in section 531,
- (d) any payment made in the tax year by the charitable trust in connection with a trade or UK property business in circumstances where relief is available under section 96 or 125 (post-cessation trade or property relief), if :
  - (i) the payment relates to land, and
  - (ii) profits of the trade, or income of the business, generated from the land immediately before the cessation would not have been exempt from income tax as a result of the exemptions in section 531,

- (e) any loss made in the tax year in a miscellaneous transaction entered into by the charitable trust otherwise than in the course of carrying out a charitable purpose,
- (f) any expenditure (including capital expenditure) incurred by the charitable trust in the tax year, not falling within paragraphs (b) or (d), which is not incurred for charitable purposes only and is not required to be taken into account in calculating :
  - (i) the profits of, or losses made in, any trade, UK property business or overseas property business carried on by the charitable trust, or
  - (ii) the profit or loss made in any miscellaneous transaction entered into by the charitable trust,
- (g) any payment made in the tax year by the charitable trust to a substantial donor which is treated under section 551(1) or (5) as non charitable expenditure,
- (h) any non-charitable expenditure treated as incurred under section 551(2) as a result of a transaction between the charitable trust and a substantial donor,
- (i) the amount of any of the charitable trust's funds that is invested in the tax year in an investment which is not an approved charitable investment (see section 558), and
- (j) any amount lent in the tax year by the charitable trust, if the loan is neither an investment nor an approved charitable loan (see section 561).

But anything which falls within more than one of the above paragraphs counts as non-charitable expenditure only once.

An amount may also be non-charitable expenditure for a tax year as a result of section 562 (excess expenditure treated as non-charitable expenditure of earlier years).

For the above purposes, none of the following is to be treated as “expenditure” :

- the investment of charitable funds
- The making of a loan
- The repayment of a loan

However, for these purposes GAAP (and therefore probably the SORP) applies to the recognition of expenditure, taking a tax year basis period. This means that expenditure on charitable commitments may well be recognised for these purposes before it is incurred in cash terms. (Section 546).

#### 9.4.3 Foreign payments

A payment to a body outside the UK is regarded as a non charitable payment under Section 547 unless the trustees have taken reasonable steps to ensure that the payment will be applied for charitable purposes only.

#### 9.4.4 Investments and loans

Where investments are realised and loans by the charity repaid during a period, the subsequent application of those monies will not be regarded as non charitable expenditure under Section 543(1) (i) or (j).

#### 9.5 Dealings with substantial donors

These measures, introduced in Finance Act 2006, restrict the dealings that charities can have with substantial donors – that is those who donate by relievable gift £25,000 or more in a single tax year, or £100,000 or more in a period of six years. (Section 549(2)). Once a substantial donor has been identified they remain within this classification for the year of the donation and a further 5 years. A relievable gift is defined in detail in section 550, but essentially extends to any sort of gift which can attract tax relief.

The rules identify the following types of “substantial donor transaction” which may give rise to non charitable expenditure :

- (a) the sale or letting of property by a charitable trust to a substantial donor,
- (b) the sale or letting of property to a charitable trust by a substantial donor,
- (c) the provision of services by a charitable trust to a substantial donor,
- (d) the provision of services to a charitable trust by a substantial donor,
- (e) an exchange of property between a charitable trust and a substantial donor,
- (f) the provision of financial assistance by a charitable trust to a substantial donor,
- (g) the provision of financial assistance to a charitable trust by a substantial donor, and
- (h) investment by a charitable trust in the business of a substantial donor.

#### 9.5.1 Non charitable expenditure

Payments made by a charity in the course of substantial donor transactions are treated as non charitable expenditure. Section 551 further provides that if the terms of a substantial donor transaction are less beneficial than arm’s length, the charity will be treated as having incurred additional expenditure sufficient to reflect an arm’s length deal, although this cannot apply in addition to create a double tax charge on a transaction.

A payment by a charitable trust of remuneration to a substantial donor is treated for the purposes of section 543 as non-charitable expenditure unless it is remuneration, for services as a trustee, which is approved by :

- (a) the Charity Commission,
- (b) another body with responsibility for regulating charities by virtue of legislation having effect in respect of any part of the United Kingdom, or
- (c) a court.

If remuneration is paid otherwise than in money, this rule applies as if it had been paid in money of an amount that would, under Part 3 of ITEPA 2003, be the cash equivalent of the remuneration as a benefit.

### 9.5.2 Exempt transactions

Certain transactions between a substantial donor and a charity will be exempt from the new rules where HMRC is satisfied that a charity engages in them for genuine commercial reasons, on terms that are no less beneficial to the charity than those that might be expected of an identical arm's length transaction, so long as the transaction is not part of an arrangement for the avoidance of tax. The exemption will apply to:

- financial assistance given to a charity by a substantial donor; or
- the sale or letting of property, or the provision of services, where the transaction forms part of the business of the substantial donor; or
- transactions that are provided by a charity to a substantial donor in furtherance of the charitable purpose of the charity and which are no more beneficial to the substantial donor than could be obtained on arm's length terms.

Where a charity takes part in any of the transactions that are not otherwise exempt, any payments made by the charity in connection with the transaction will be treated as non-charitable expenditure. Where the transaction is not on arm's length terms any difference between the actual terms and arm's length terms, so far as it favours the substantial donor, shall be treated as non-charitable expenditure and the charity will have its tax relief restricted. This commences for transactions undertaken from 22 March 2006.

### 9.6 Carry back of excess expenditure

If a charitable trust's non charitable expenditure for a tax year exceeds its income and gains for that year, the excess amount is carried back and treated as the non charitable expenditure of an earlier year. (Section 562)

The available income and gains of the charity in a year is the total of :

- The total income of the charity for the year
- Any chargeable gains accruing to the charity in the year
- The attributable income and gains of the year (as defined above), and
- Any non taxable sums received by the charity in that year.

Section 563 allows the excess expenditure to be carried back up to six years to any year in which the available income and gains of the year is more than the non charitable expenditure for that year, taking more recent years first.

## 9.7 Examples from HMRC guidance

Guidance released in May 2007 illustrates the application of the tax charge when there is non charitable expenditure :

### **Charity A : 2006/2007**

- Charity A has gross Gift Aid income of £28,000 and gross bank interest of £3,000 in a chargeable period
- It would be entitled to tax exemption on those sources of relievable income, totalling £31,000.
- The charity spends £10,000 in charitable grants and administration, and makes a non-charitable loan of £7,000

<b>Income and expenditure</b>	<b>Amounts (£)</b>
Relievable income	31,000
Less: non charitable expenditure	7,000
Income on which relief is allowed	24,000

Tax relief is disallowed in respect of £7,000 of relievable income.

Where a charity has the tax exemptions on part of its relievable income and gains restricted it can choose which sources of relievable income and gains the restriction is applied to. The charity must notify HMRC Charities of its preference within 30 days of being notified of the restriction. If the charity does not specify a source then HMRC will do so for the charity.

If a charity has incurred non-charitable expenditure HMRC Charities will expect it to complete a Self Assessment / Corporation Tax Return for the chargeable period concerned and account for any resulting tax liability. If the return shows the relievable income and gains being allocated against particular sources of income HMRC will accept this as notice being given.

See the detailed guidance on all aspects of these provisions, including very detailed examples of the substantial donor legislation at [http://www.hmrc.gov.uk/charities/guidance-notes/annex2/annex\\_ii.htm](http://www.hmrc.gov.uk/charities/guidance-notes/annex2/annex_ii.htm)

## 9.8 Gift Aid donor benefit change

### 9.8.1 Finance Act 2007 – increased limits

The gift aid rules include limits setting the maximum benefit a donor may receive in return for a donation. These limits are intended to ensure that donations on which gift aid are claimed are really gratis gifts, and not payment for a commercial supply.

The limit applying to the largest gifts of £1,000 and over has been increased by Section 60 FA 2007, by doubling the percentage of the value of the gift from 2.5% to 5%, and increasing the absolute maximum to £500 from £250. The limits apply to both gifts by individuals and by companies, and the revised limits apply to all gifts on or after 6 April 2007. Note that the value of gifts and value of donor benefit are computed for a fiscal year for individual donors, and for an accounting period for corporate donors.

The table of maximum donor benefits now reads :

<b>Value of the gift</b>	<b>Maximum benefit</b>
Less than £100	25% of the value of the donation
£100 to £1,000	£25
Over £1,000	5% of the value of the donation; maximum £500

### **9.9 Gift Aid as an admission charge**

Following a scheme applicable only to certain charities, under which admission was granted to certain facilities in return for a gift aid donation rather than an admission charge, HMRC changed the law, and permitted a modified form of the scheme to apply more widely, while restricting the use of the scheme to a limited scenario where there was a genuine actual donation. Current guidance on using gift aid for admission to premises or facilities provides the following advice. Charities are advised to check with HMRC or their advisers before implementing a scheme.

The revised scheme involves a relaxation in the gift aid donor benefit rules when a charity allows donors to view charity property.

For the benefit of any right of admission received in consequence of a donation to be disregarded (so that the donation can be considered for Gift Aid), the following conditions must be satisfied:

Either

- a donation is made and in return the charity grants a right of admission to the donor, or the donor and his family, for a period of at least a year, at the same times at which the general public can obtain admission, or;
- a donation is made of at least 10% more than the cost of admission to the general public and in return the charity grants an equivalent right of admission to the donor, or the donor and his family.

The opportunity to make a gift and to receive a right of admission in consequence must always be available to the public. This means that the right of admission to view charity property must not be made conditional upon the donor making a Gift Aid declaration.

The right of admission must be granted by the charity for the purpose of viewing property preserved, maintained, kept or created by a charity in pursuit of its charitable purposes. Property is not restricted to land and/or buildings. It also includes:

- artefacts
- works of art (but not performances)
- plants
- animals
- scientific property.

If a visitor chooses to make a donation to a charity he can also choose to make a Gift Aid declaration. The donation will not qualify for Gift Aid treatment in the charity's hands unless an appropriate declaration is given.

### **Annual right of admission**

Charities may alternatively provide an annual right of admission to property owned by the charity whenever that property is generally open to the public in return for a donation. Under this scheme, the charity can choose to apply one of the following variants :

- accept a donation and allow free admission for all visits during the period covered (but the charity can specify up to five days when the right of free admission does not apply). A visitor who chooses to make a donation but does not complete a Gift Aid declaration must also be able to gain free admission on the same terms, or;
- accept a donation and grant a right of admission on payment of a reduced fee, which must apply for the first and all subsequent visits during the period covered. In this scenario only the initial donation will qualify for Gift Aid. The first and subsequent admission fees are not donations but are payments of a charge for admission to view the property. A visitor who chooses to make a donation but does not complete a gift aid declaration must also be able to gain the same reduced rate admission on the same terms for their first and all subsequent visits.

A charity granting annual admission in return for a donation must apply one or the other of these scenarios rather than a mixture of the two i.e. the same free or reduced rate admission must be applied for the first and all subsequent visits. For example, a twelve month admission scheme where a donation, equal to the cost of a day admission, secures one free visit and repeat visits at reduced rates does not succeed because it mixes free and reduced price admission.

Charities are free to decide what minimum level of donation they will accept before granting a right of admission for a year or more (so for example can choose to allow annual admission for a donation equal to the daily admission charge), but must always give an equivalent right of admission to all donors including those who do not make a Gift Aid declaration i.e. the right of admission must not be made conditional upon the donor making a Gift Aid declaration.

## **10% donation**

This option applies where a member of the public could purchase a right of admission, but instead chooses to make a gift that is at least 10% more than the admission charge, and in return for that donation the charity grants the equivalent admission to view charity property. The whole amount received from a donor is treated as a donation for Gift Aid purposes, not just the additional 10%.

For payments to qualify for Gift Aid, each visitor must be made aware at the time he is asked for payment that he can choose to pay the admission charge or make a voluntary donation of 10% more than the admission charge and receive the same right of admission. If the visitor is denied the right to choose to pay the standard admission charge, then payment of the extra 10% is not a freely given gift and cannot be a qualifying donation. Charities must clearly advertise their normal admission charges and make it absolutely clear to all visitors that they will be admitted upon payment of the lower admission charge if they choose not to make an additional 10% voluntary donation.

### **9.10 Finance Act 2008 : Gift Aid Supplement**

As a result of the reduction in the basic rate of income tax, charities faced losing a significant amount of income in relation to Gift Aid payments. Until charities can encourage donors to increase their net donation, in view of the reduced tax deduction, they would suffer a shortfall in donated income.

Section 53 and Schedule 19 of the Finance Act 2008 provide for additional gift aid payments as a supplement to the standard gift aid tax claims for a period of three years, giving charities time to adjust and seek more donations. Claims will, however, have to be made separately for the supplement, which is known as “gift aid supplement”. The time limit is two years from the end of the year to which the claim relates.

The legislation has been written sufficiently flexibly to allow for further variations in the basic rate of tax during the three year period (known as transitional tax years). The transitional supplement will always be 2%, so if the basic rate were to reduce further charities would not receive sufficient supplement to reinstate the 2007/08 position.

### **9.11 VAT recovery for charities**

HMRC has now published a policy change resulting from the successful appeal by the Church of England Children's Society. The Society sought recovery of VAT on certain fundraising costs, and appealed to the High Court to establish the treatment of these costs. The High Court applied a recent EC decision and held that the VAT incurred on such costs was attributable to the whole of the charity's activities and that therefore some VAT would be recoverable as the charity made some taxable supplies. Although the case was an appeal regarding VAT charged by professional fundraisers, it could apply to any costs incurred in raising funds or seeking general donations by charities which make taxable supplies. Charities should seek advice about the impact of this change in policy.

The ECJ decided in the case of Kretztechnik AG v Finanzamt Linz (Case C-465/03) that where a capital raising transaction falls outside the scope of VAT because it is neither a supply of goods nor services, then the VAT incurred on costs related to that transaction can be treated as applying to the entity as a whole, and thus attributed to the taxable supplies made by the entity (if any). Although the decision related to the raising of capital by a commercial enterprise, the High Court has now applied the principle to the raising of "capital" through securing donations for general funds by charities. In reality for many charities, these costs will be incurred on raising funds in a variety of ways – by professional fundraisers, and in seeking cash donations and legacies. The decision does not apply to the costs of raising restricted funds which are applied to a specific non business purpose.

Charities will now be able to apply a VAT recovery to those costs incurred either in raising funds for specific business activities, or on general fundraising, based on the proportion of taxable supplies made by the charity as a whole (but not by other entities such as trading subsidiaries). Where costs relate directly to the taxable activities, the full VAT incurred will be recoverable. The recovery of the VAT on general fundraising will be subject to apportionment between business/non business activities, and then between taxable and exempt supplies, and may require some charities to revise their apportionment methods – HMRC are willing both to consider new methods, and where appropriate, backdate their use. Charities affected by this decision will be able to backdate their claim by three years under general VAT principles.

<p><b>More information</b> : For more information see Business Brief 19/05, which also deals with goods donated by charities and related VAT recovery.</p>
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### **9.12 VAT - Self supply of buildings on change of use**

There were sketchy references to this in the 2007 Budget, but no detailed information on this proposal was included in the Budget Notices.

The VAT charge on the change of use of a charity building within 10 years of its construction or supply as a zero rated supply has been effectively removed. It will remain in place only where the change of use was anticipated at the outset.

Where the change of use was not anticipated, Customs will not enforce the self supply charge when the non qualifying use of the building exceeds 10% in the 10 years following the zero rated supply, but it will be enforced if the change of use was intended to occur within the 10 year period, and HMRC may well take the view that the entire supply should not have been zero rated – this would provide a more disadvantageous outcome than the present rules, as the period of qualifying use is recognised in calculating the self supply charge.

Charities which have paid a self supply charge on change of use within the last three years should now be able to reclaim the VAT they have suffered.

**Links :** A little more detail is in Revenue & Customs Brief 29/07 at <http://www.hmrc.gov.uk/briefs/vat/brief2907.htm>

### **9.13 Charity Challenge events**

VAT Notice 701/1 Charities has been updated by the issue of Update 2, which provides further clarification on the VAT treatment of charity challenge events as a new section 10 to the notice. This provides a good detailed study of the impact of VAT on charity challenge events, including more information about the need to operate the Tour Operators Margin Scheme in relation to some events.

HMRC has also issued a Revenue & Customs Brief (36/08) drawing attention to the change and identifying updates to CWL4 (Fundraising events) as a result of the revised guidance. R & C Brief 36/08 also includes details of the transitional arrangements. The revised guidance takes effect from 31 July 2008, but if a charity has signed a contract before that date in respect of an event to take place some time after that date, or already publicised an event, HMRC will accept the VAT treatment if it complied with the previous version of the guidance.

Claims may also be appropriate in respect of earlier periods.

**Links :** Revenue & Customs Brief 36/08 is at <http://www.hmrc.gov.uk/briefs/vat/brief3608.htm>

**EAST MIDLANDS CIOT & ATT – Events for 2008/2009**

<b>Date</b>	<b>Details</b>	<b>Timetable</b>	<b>Venue</b>
Tuesday 24 February 2009 6.00pm – 8.00pm <b>Cost: Free</b> CPD Hours: 1.5	<b>Your Clients' Business Protection &amp; Its Tax Implications</b> Presented by Richard Smith of Zurich & Neil Marshall – Sense Financial Solutions	6.00pm - Registration & refreshments 6.30pm - Lecture starts 7.45pm - Questions 8.00pm – Close	Best Western - Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire
Tuesday 10 March 2009 4.00pm – 8.00pm <b>Cost: £40.00</b> CPD Hours: 3	<b>Property Tax Update</b> By Brian Ogilvie FCCA CTA Freelance Tax Lecturer & Consultant	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	Best Western - Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire
Wednesday 22 April 2009 4.00pm – 8.00pm <b>Cost: £40.00</b> CPD Hours: 3	<b>The Interaction between Accounting Standards &amp; Tax</b> By Andrew Guntert MSc FCA Lecturer for Mercia	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	Premier Inn, Braunstone Lane East Leicester
Wednesday 20 May 2009 4.00pm – 8.00pm <b>Cost: £40.00</b> CPD Hours: 3	<b>Finance Bill 2009</b> Mark Morton BA ATII ATT Senior Tax Lecturer for Mercia	4.00pm - Registration & refreshments 4.30pm - Lecture starts 6.00pm - Break for refreshments 6.15pm - Lecture resumes 8.00pm – Close	Best Western - Leicester North (formerly the Comfort Inn) A46 Fosse Way Upper Broughton Leicestershire
<b>Date to be advised</b> 6.00pm – 8.00pm <b>Cost: £15.00</b> CPD Hours: 1.5	<b>Topical Tax Issues</b> Andrew Hubbard BMus PhD ATT CTA (Fellow) Tax Director, Tenon Group PLC	6.00pm - Registration & refreshments 6.30pm - Lecture starts 7.45pm - Questions 8.00pm – Close	PricewaterhouseCoopers Offices Donington Court, Pegasus Business Park, Castle Donington, Derbyshire

**The Branch Committee reserves the right to alter the above programme without prior notice.**

For more details of any of the above events or to book a place please contact the Branch Secretary, Martin Tomes at  
Greenhalgh & Co.

2A Peveril Drive, Nottingham. NG7 1DE

Telephone: 0115 985 9517 or E-mail: [martin.tomes@greenhalghco.net](mailto:martin.tomes@greenhalghco.net)



THE  
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**EAST MIDLANDS BRANCH**

**“Your Clients’ Business Protection & Its Tax Implications”  
Presented by Richard Smith of Zurich &  
Neil Marshall – Sense Financial Solutions**

**To be held at:** Best Western Hotel – Leicester North (formerly the Comfort Inn)  
A46 Fosse Way, Upper Broughton  
Leicestershire

**On:** Tuesday 24 February 2009

**Commencing:** 6.00pm (for 6.30pm) – finishing approximately 8.00pm

**Cost:** Free

**CPD hours:** 1.5

Please reserve ..... place/s for the “Your Clients’ Business Protection & Its Tax Implications” seminar on Tuesday 24 February 2009.

Name(s) of Attendees: .....

.....

.....

Name of firm: .....

Address: .....

.....

.....

.....

Telephone no: .....

E-mail address: .....

Please return this slip by **20 February 2009** to:  
Sense Financial Solutions  
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Telephone 0115 9227107  
[www.itmakessense.net](http://www.itmakessense.net)  
[register@itmakessense.net](mailto:register@itmakessense.net)

**If you do not supply an e-mail address we are unable to confirm your booking.**



**CIOT/ATT East Midlands Branch would like to thank and acknowledge the support of the sponsors who made this event possible:**



For more details of how Harper Resourcing can help you please contact:  
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