

Annex

Response to the ASB's consultation on the 'Exposure Draft of the Financial Reporting Standard for Public Benefit Entities' from the Charity Commission and Office of the Scottish Charity Regulator in their capacity of the Joint SORP-making Body for UK charities

1. Definition of a public benefit entity

Q1: Is the definition of a public benefit entity and the accompanying application guidance sufficiently clear to enable an entity to determine if it is a public benefit entity? If not, why not?

1.1. In our view the definition is adequate.

1.2. We have pointed out in our past consultation responses our concerns over the use of the term 'public benefit entities' to describing the category of entities included in the scope of this proposed standard. In the UK the term has particular legal meaning in charity law as a defining attribute of a charitable purpose. We are concerned that the terminology used will blur the legal distinction between charities and the wider range of entities that this standard seeks to address.

2. Effective date

Q2: The ASB is proposing an effective date of 1 July 2013 which is consistent with the effective date of the FRSME. Early adoption will be permitted except for entities subject to a SORP, whereby they will be required to follow the SORP until the effective date of the [draft] FRSPBE. Do you agree with:

- (a) the proposed effective date; and**
- (b) the restriction on early adoption?**

If not, what would be your preferred date, and why?

2.1. An effective date of accounting periods commencing on or after 1 July 2013 would only be practical assuming that there are no significant changes to this exposure draft as a result this consultation or to the earlier consultation on FRED 43 and FRED 44. We have noted the ASB's tentative decision to remove from FRED 43 and FRED 44 the requirement to prepare accounts under EU-adopted IFRS where a legal requirement does not currently require their application. We assume that this decision and other tentative decisions made at the ASB's meeting of 16 June is likely to create the need for further consultation which will make an implementation date of 1 July 2013 impractical. Our response is based on the FRED 45 consultation as published and therefore certain of our responses will need to be read in that context.

2.2. As recognised by the ASB an 18 month transition period from the publishing of the final versions of the FRSME and FRSPBE and their application to UK charities is essential. The Charities SORP can also only be finalised and consulted on once these standards are in place. Also the legal framework for charity reporting in England, Wales and Scotland is linked to existing UK GAAP and necessary amendments to accounting regulations will require a separate consultation. We would

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therefore ask the ASB to give very careful consideration to the revised implementation date of 1 January 2014 to ensure the commitment for an 18 month transition period can be maintain should further consultation be needed.

- 2.3. We agree with the restricted early adoption of the FRSPBE where entities are subject to a SORP. In our view, it would not be desirable for UK charities to apply either the FRSME or FRSPBE until a revised Charities SORP is in place and more importantly it would not be legally possible for many charities to do so until existing charity accounting regulations are amended.

3. Concessionary loans

Q3: Do you agree with the proposals for concessionary loans in public benefit entities? If not, what alternative accounting treatment and/or disclosures do you consider appropriate?

- 3.1. We agree with the proposed treatment of concessionary loans. However, we note that the proposed alternative treatment is only available to Public Benefit Entities. It would be helpful if this option was available to other entities that are part of a PBE group to ensure consistent accounting policies within a PBE group and to limit consolidation adjustments.

4. Property held for the provision of social benefits

Q4: Do you agree with the proposals for property held for the provision of social benefits? If not, why not?

- 4.1. We agree with the proposed treatment of property held for social benefit. We would suggest that the standard should also allow for the presentation of such property as a separate line item on the face of the statement of financial position as the nature of property held for social benefit is fundamentally distinct from other property such as offices occupied by the entity.

5. Entity combinations

Q5: Do you agree with the proposals for combinations that are in substance a gift and combinations which are in substance a merger?

- 5.1. We are in full agreement with the proposals for combinations that are in substance a gift. We would suggest that the gain or loss should be presented as a separate line in the statement of comprehensive income.

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5.2. We would question the need for the disclosures required by paragraph 4.7 (c) and (d) where a combination is in substance the gift of the net assets and undertakings of one charity to another. The disclosures would require the charity that is in receipt of the gift to prepare a balance sheet at the date of the gift and also to disclose the key components of its income and expenditure before and after the gift. We question the value of this information to general users of financial statements. It is quite common for a charity to gift its assets to another, often prior to its winding-up, and we question why in such circumstance the net assets and results of the recipient charity needs to be established and disclosed. In our view, it would be sufficient for the value of the net assets that are gifted to be recognised as income in the statement of comprehensive income and for the notes to the financial statements to disclose the nature of transaction and to provide a summary of the assets and any liability assumed by the recipient of the gift.

6. Merger accounting

Q6: Do you agree with the criteria set out for merger accounting? If not, what criteria in addition to or instead of those suggested should be included in the draft Standard?

6.1. The criteria set out in paragraph 4.9 (b) are too restrictive. A merger may involve a review of the strategy of the combined entities. This could for example involve a widening of the beneficiary class and new strategies for delivery of services to beneficiaries. We do not see why a merger necessitates the need for the new entity to be moribund in terms of its beneficiaries and services it provides in the future.

7. Impairment of assets: public benefit considerations

Q7: Do you agree with the proposed alternative method of determining value in use for assets held for their service potential? If not, what alternative method would you suggest and why?

7.1. We concur with the proposed alternative method put forward. However, we note that the glossary defines value in use only by reference to cash flows which is contradictory to the text in the body of the draft standard. Value in use is often the same as "value to the charity" being the amount that the PBE would be ready to pay for the asset.

8. Funding commitments

Q8: Do you agree with the recognition criteria and measurement and disclosure requirements set out in the proposals? If not, what further criteria and/or disclosure requirements should be included and why?

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- 8.1. Grant payments whilst not contractually enforceable can create a constructive obligation resulting in the recognition of a liability. In our view, both section 6 and its appendix need to approach the issue of funding commitments explicitly (rather than implicitly) from the perspective of whether or not a constructive obligation is created by an event. The obligating event, for a charity, would generally be the communication in writing of an offer of funding by the donor to the recipient of the funding. A liability would be recognised unless the donor charity attached conditions to the payment that remained within its control. This approach would be more consistent with the draft FRSME, the Charities SORP and Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting. We also note that the wording in paragraph 6.2 of the FRSPBE is subtly different from the criteria for recognising a liability in paragraphs 2.20 and 2.39 of the FRSME. We believe the FRSPBE should not lose sight of the fundamental definition of a liability as set out in the FRSME which recognises the concept of a constructive obligation and the need to consider the probability of the transfer of economic benefit.
- 8.2. We would also recommend that the statement made in paragraph 6A.1 that 'in most cases there is no liability, because entities rarely make irrevocable commitments without requiring future performance from the recipient' is removed from the final text as we are not aware of any empirical evidence supporting of this statement. Grants may be made for the general purposes of a charity, and grants may be made to support a particularly purpose of a charity without a performance-related condition attaching to payment of the grant.
- 8.3. We also have significant concerns with the statement in paragraph 6A.2 that 'an undertaking to provide cash made on the expectation of future income will not give rise to a liability if the entity cannot be required to fulfil it if future income is not received'. Whilst such 'conditions' are not uncommon, they are in practice seldom invoked due to reputational risks faced by an institutional funder withdrawing funding.
- 8.4. We are concerned that the guidance in paragraph 6A.2 reflects the legal form of an agreement rather than sector practice and the valid expectations of grant recipients. If the focus is on legal form then a charity wishing to avoid recognising a liability might simply add a 'condition' to their grant offer stating that the award is made on the 'expectation of future income' and so avoid recognising a liability that is their intention to met. The guidance will result in inconsistent accounting, for example where two charities intend to make a grant and both communicate the award to the recipient then one charity might book a liability and the other might not based simply on a clause or 'condition' in the offer that may have no substance. The result of this may well be a return to cash accounting by grant making entities. Moreover, even if

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such a term were inserted into a grant award, in our view, a provision should be booked where as a result of an event (communication of the award), it is probably there will be a required outflow of economic benefits and that amount can be estimated reliably.

- 8.5. The text in paragraphs 6A.2 to 6A.4 might be clearer without the insertion of 'only' on three occasions where it appears to be superfluous to the meaning conveyed in text.
- 8.6. We presume the intention of paragraph 6A.6 is to identify commitments not recognised because they have not been communicated to the recipients but where the payments have been approved by the entity. If that is the case, then it would be helpful for the text to be clarified along these lines.

9. Incoming resources from non-exchange transactions

Q9: Do you agree with the proposals for recognition of incoming resources from non-exchange transactions?

- 9.1. We concur with the general direction being taken but do have a number of issues regarding clarity as set out in our response to question 10 of your consultation. However, our particular concern is the impact of valuing gifts of goods received by charities for resale, for example through charity shops, on their receipt rather than on their sale.
- 9.2. As you will be aware recognising goods donated for resale on receipt will be a change in accounting practice for charity shops in the UK. Such assets are currently valued in UK charity financial statements on sale rather than when donated. In our view, the practical difficulties in valuing stock in the context of shops often run by volunteers will be significant. It is also important for charities to understand that the stock valuation only becomes an issue where such stocks are material in the context of the financial statements. We are doubtful that on a cost/benefit analysis that the additional information provided to users of the accounts from placing an estimated value on stock will generally justify the additional costs involved.
- 9.3. We also have concerns about the additional audit costs that might be placed on charities when 'stock' is potentially material. IAS 501 is likely to require the attendance of the auditor at a physical count of the stock which will add to audit costs. If costs are to be limited then it will be important that the final standard to offer flexible approaches to estimation techniques that will be supported in APB guidance to auditors.
- 9.4. We would ask the ASB to consider the cost constraint on the provision of information inherent in conceptual frameworks and allow charities to

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applying a cost/benefit test to this issue with valuation only being mandatory where the value of the information to users outweighs the costs of obtaining the information.

- 9.5. The issue is further complicated by the fact that goods are increasing sold under gift aid provisions. Under such arrangements goods are sold by a charity as the agent of a potential donor. The proceeds of the sale belong to the owner of the goods not the charity. Only following the sale of the goods does the donor confirm the gift of the net proceeds to the charity. This might mean that a charity would have to adopt accounting policy out of line with the tax treatment for gift aid purposes or alternatively adopt two accounting policies - one for the sale of donated goods and another for items sold as agent with the net proceeds being donated to the charity. This again adds to complexity but has limited information value to users of accounts. We also have doubts that the ASB's perception of the transaction as a gift which is received by a charity as stock on which it then seeks to achieve a sales margin really reflects the nature of a transaction which is simply the conversion of a gift into cash.
- 9.6. We also note that whilst FRED 45 considers income from non exchange transactions, it does not explicitly address the issue of inventories and how the test of 'lower of cost and net realisable value' is applied in the context of goods donated to a charity for resale.
- 9.7. The interpretation placed on the 'fair value' of donated resources (see paragraphs 7.7, 7A.14 and section VI paragraph 30) may result in an overstatement of income. On occasions, a charity may receive a gift with a higher specification than it requires. Where the gift is a donated services or use of facilities, the nature of the gift might not allow the service or facility to be sold. It would not, for example, be possible to sell legal advice received or to let office facilities provided to the charity for its specific use and then to buy a more basic service or facility that met the charity's operational needs. Donor relations also have to be considered. It might be potentially damaging to relations if an asset donated for a charity's ongoing use were to be sold and replaced with an asset that met the charity's basic operational requirements. Fair value in this context may therefore need to consider the cost a charity would pay for resource that meets its service potential requirements.
- 9.8. We therefore recommend words similar to those used in the charity SORP which requires that the value placed on gifts in kind or donated services and facilities 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

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- 9.9. Paragraph 7A.5 states that the criteria for legacy recognition will 'normally' be met following probate. Our view is that beneficial title is acquired at the point when the executor decide that the asset in question will not be required to satisfy claims in the estate which have a higher priority to that of the beneficiary. This perhaps needs to be stressed more than 'probate' as the point at which the recognition criteria is likely to be met. We agree that notification or estate accounts may provide evidence that the executor has determined payment can be made.
- 9.10. In relation to Paragraph 7A.10, in our view, it is unlikely that a monetary value can be attributed to general volunteers. It would remove ambiguity by simply stating that it is 'normally it is not possible' to quantify such contributions.
- 9.11. Paragraph 7.8 requires that an entity shall disclose the following:
- (a) the nature and amounts of resources received from non-exchange transactions recognised in the financial statements;
 - (b) an unfulfilled conditions or other contingencies attaching to resources from non-exchange transactions that have not been recognised in income; and
 - (c) an indication of other forms of resources from non-exchange transactions from which the entity has benefited.

PBEs receive many sources of income and specific disclosure requirements are covered in the relevant SORPs. We are unclear why this level of detailed information is deemed to be necessary in the context of gifts received and why aggregate disclosure by income categories is not sufficient. The information sought in paragraph 7.8 (b) (c) would more easily be addressed through a single accounting policy disclosure rather than by listing conditions that limit income recognition within the other notes to the financial statements. We are concerned the requirements will add significantly to disclosures and length of charity financial statements. We also suggest that resources that cannot be recognised are better addressed in the management commentary provided in annual reports.

10. Clarity of guidance

Q10: Is the guidance sufficiently clear to enable an entity to understand and interpret the proposed requirements? If not, what further guidance is required?

- 10.1. We have noted the ASB's tentative decision to remove from FRED 43 and 44 the requirement for 'publicly accountable' entities to prepare accounts under EU-adopted IFRS where no legal requirement currently

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exits. This tentative decision ameliorates some of our concerns about charities being 'forced' into tier 1 reporting. However, concerns still remain about charities voluntarily adopting tier 1 reporting and indeed also tier 3 reporting. As stated in our response to the FRSME consultation, we are concerned that tier 1 and tier 3 reporting applies a framework and a set of standards that have not been developed or adapted for public benefit entities. The ASB's intention to apply that framework without mandatory application of the FRSPBE at tier 1 and tier 3 raises considerable concerns, not least the potential inconsistency in reporting by charities across the tiers and the basis upon which an auditor can discern 'a true and fair view' in the context of sector specific transactions. We recognise that the FRSPBE and the relevant SORP will apply as best practice to public benefit entities in these tiers but, in our view, it is important for charities reporting under all tiers to apply both the FRSPBE and relevant SORP to ensure accountability to their charity stakeholders and to meet the legal requirement for 'true and fair' financial reporting.

- 10.2. Further guidance is also required on accounting for government grants. Whilst it is recognised that this issue is addressed within the FRED 44 (the FRSME) further guidance is required on how 'performance conditions' limit recognition. It is important to clearly differentiate restrictions that require an asset to be use for a particular purpose of the charity from performance conditions that may limit recognition. We are firmly of the view that a restriction does not prevent recognition of a grant or gift. It is common for charities to receive gifts that must be used for a particular purpose and such gifts create assets that need to be recognised. We are concerned that grants and other donations to fund particular purposes may be inappropriately deferred unless the term 'restriction' and 'performance condition' are defined and differentiated.
- 10.3. Also in Paragraph 7.A12, the term 'performance condition' appears to be used to mean a restriction on the use of resources for a particular purpose of the entity. Restricted income creates an asset that can be expended by the entity within the purposes specified by the gift. We see no basis for the deferral of restricted income unless the charity is unable to meet the restriction and repayment is likely. This appears to be suggested by the examples in the appendix to the section but the text appears to suggest recognition is delayed until the restriction is actually met. Others might interpret 'performance conditions' as terms attaching to a gift that must be overcome before the recipient is entitled to the income. This may be the drafting intention and if so it would benefit from greater clarity in drafting.
- 10.4. Paragraph 7A.4 indicates that income is recognised when receivable. However, a promise of a donation may not be enforceable in law (except possibly to the extent costs have been incurred based on the promised

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income). It would be helpful to clarify how the concept of 'sufficient certainty' might be construed in the context of a promise.

10.5. Paragraph 7A.7 introduces the term 'portfolio approach' to describe a measurement basis that may be adopted in the context of small legacies. An explanation of what is meant by this term should be added to the glossary.

10.6. The glossary currently defines 'value in use' in terms of cash generation. In the context of public benefit entities this definition also needs to consider service potential as service may be supplied free or below cost to beneficiaries.

11. Heritage assets

Q11: Do you agree with the proposals for heritage assets and in particular the proposals for recognising subsequent movements in valuation of heritage assets in other comprehensive income?

11.1. We agree with the proposals for heritage assets and in particular concur that movements in valuation should be recognised in other comprehensive income.

11.2. The SORP committee has reported some confusion in the application of the definition of heritage assets. For example, some take the view that a school building of historical importance meets the definition as it has educational attributes. It would be helpful if this issue which is partly addressed in paragraph 34.17 of section III (FRSPBE amendment to the FRSME) could be more robust making it even clearer that assets held for operational activities should be accounted for as plant, property and equipment notwithstanding historical or other heritage qualities.

12. Future development

Q12: Do you believe the future issues that may be considered following finalisation of this draft Standard as set out in paragraph 4 of Section IV are appropriate? Are there any additional matters which you believe should be included on the agenda for future updates to this draft Standard?

12.1. The introduction of a new financial reporting framework, this standard and new SORPs will present an agenda of radical change for the UK charity sector. The feedback we have received from our SORP research programme is that after change, a period of stability is valued. We therefore do not favour piecemeal development of this standard. Our preference would be for ASB to set a review period for the standard, perhaps following the IASB model for IFRS for SMEs. It is essential for

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change to be co-ordinated with any future updating of the FRSME, SORPs and charity legislation in both England & Wales and Scotland. Without careful co-ordination there is a significant risk that the application of standards will be incompatible with charity law in the UK.

12.2. The issues of narrative reporting, fund accounting and format of primary statements are already addressed in the Charities SORP. We do not perceive any urgent demand for developing an approach to fresh start accounting at present. Accounting for social benefit obligations is perhaps primarily relevant to the public sector. We recognise that issues can arise in relation to the definition of associates and where Board members may be appointed to a charity by an entity to provide a resource rather than to influence operational policy.

13. Control

Q13: Do you believe that further guidance is required to interpret the indicators of control included in Section 9 *Consolidated and Separate Financial Statements* of the draft Financial Reporting Standard for Medium sized Entities (FRSME)?

13.1. Whilst we believe there are issues arising from the particular nature of the control exercised by charity trustees, we believe these issues should be considered in the context of Phase G of the IASB's work on the application of their conceptual framework to the non-for-profit sector. Until IASB have considered this issue, we believe this matter is best addressed through relevant sector SORPs.

14. The FRSSE

Q14: Do you believe that the requirements of this draft Standard should be extended to entities that apply the FRSSE?

14.1. We recognise this standard has been developed to address specific financial reporting issues for public benefit entities which are not addressed in sufficient detail in the [draft] Financial Reporting Standard for Medium-sized Entities.

14.2. Identical issues arise in the context of charities and other PBEs applying the FRSSE. At present charities which apply the FRSSE also apply the Charities SORP and it will be important in the future for the FRSPBE to apply to charities that opt for this UK GAAP based framework.

14.3. We would therefore ask for a further amendment to the FRSSE so that the FRSPBE is applied to relevant transactions where charities report under tier 3. The vast majority of UK charities fall within the FRSSE

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thresholds and it would be anomalous for the FRSPBE to apply only to a small percentage of UK charities that must apply the FRSME.

14.4. In relation to the FRSSE more generally, it is now becoming a matter of urgency for the ASB to give an unambiguous statement as to their future intentions for this standard. Charities are already giving consideration to whether they might apply the FRSSE or FRSME and cannot make a fully informed decision without a clear understanding of whether or not the FRSSE will be retained beyond a transition period.

15. Other Matters

15.1. An issue has arisen concerning how paragraph 2.52 and 21.9 applies to insurance proceeds following the loss or destruction of an asset. Paragraph 54 of IAS 37 would appear to allow the netting of the loss and its recovery in the statement of comprehensive income. The FRSME appears to rule out this option and may as a result overstate income. It would be helpful if this anomaly could be considered when finalising the FRSME.