

ICAEW REP 21/05

STATEMENT OF PRINCIPLES FOR FINANCIAL REPORTING: PROPOSED INTERPRETATION FOR PUBLIC BENEFIT ENTITIES

Memorandum of comment submitted in November 2005 by the Institute of Chartered Accountants in England and Wales, in response to the Accounting Standards Board’s exposure draft ‘Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities’, published on 11 August 2005.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft *Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities*, published by the Accounting Standards Board on 11 August 2005.

WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 125,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR POINTS

Overall

4. We welcome the Draft Interpretation, which builds helpfully in many areas on the 2003 Discussion Paper. However, we found too much of the Draft Interpretation difficult to understand, to the extent that in many critical areas we believe that there is scope to reach different conclusions about the effects of applying the principles to Public Benefit Entities (PBEs). As set out in the body of our response below, there are areas where further thought and development are necessary. We believe that further exposure of the issues will be required before the interpretation can be finalised.

Primacy of legislation

5. The Draft Interpretation makes no reference to the primacy of legislation and/or regulation in pervasive accounting concepts. This can be critical in the public sector, and needs to be recognised in the Draft Interpretation.

Statements of Recommended Practice (SORPs)

6. There are a number of current SORPs that will be affected by implementation of the Interpretation. Some analysis of these effects, with the Board's expectations as to timing of adoption, would be helpful.

Funders and financial supporters as the defining class of user

7. We are broadly content with ‘funders and financial supporters’ standing as a proxy for a defining class of user of PBE financial statements. However, in our view, the Interpretation should acknowledge that the information needs of a wider group of stakeholders, including beneficiaries, regulators and also elected representatives in the public sector, should also be considered.

The information required by funders and financial supporters

8. While we do not disagree that all the information set out in paragraphs 1.17 to 1.23 is needed by funders and financial supporters, it must be made clear that much of it can only be provided in narrative reports such as the Operating and Financial Review rather than in the financial statements themselves. For example, while we agree with the proposition in the first sentence of paragraph 1.19 (‘An entity’s financial position encompasses the economic resources it controls, its financial structure, its liquidity and solvency, its risk profile and risk management approach, and its capacity to adapt to changes in the environment in which it operates.’), it is worth pointing out that this information cannot all be discerned from the financial statements.

Elements of financial statements

9. We have no specific comments on the elements of financial statements, being generally in agreement with the Board’s view that a common set of principles should underlie financial reporting by all entities.

Assets

10. We agree that ‘in principle, all items meeting the definition of an asset should be recognised’ (paragraph 4.12). However, we do not think that the discussion of assets is sufficient to provide clear principles on which the treatment of gifts, for example, can be based. Instead, the Draft Interpretation merely provides two examples (historic assets and inalienable assets). This, presumably, is for the avoidance of doubt, because these examples do not throw further light on the principles (why wouldn’t they be assets?) We suggest that they should be omitted. Alternatively, other examples should be given, such as infrastructure assets. Discussion of the distinction between operational and non-operational assets (in terms of relevance to the entity’s strategy) would also be useful.
11. Overall, we discern a bias towards charities in the consideration of assets, at the expense of the public sector.

Liabilities

12. The Draft Interpretation appears to assume that all public benefit transactions are exchange transactions, and should therefore be treated as executory contracts. Such transactions therefore fall outside the scope of the requirements for recognising liabilities under FRS 12. We disagree with this proposition.

13. We accept the position outlined in paragraph 4.36 (a), that where a specific commitment is made that requires something specific in return, it is correct not to provide except as performance occurs. This is simply the equivalent of a commercial contract. However, where the funds are committed and there is no specific performance requirement, as in the case of a general donation or an unfettered grant, we believe that this gives rise to a liability under FRS 12 if the donor is not in a position to avoid making the payment. We specifically reject the idea in 4.36(b) that in such cases an executory contract exists in substance because the donor is receiving the furtherance of its objectives in return for the resources it is donating.
14. A better approach would be to look to the substance of the contract or arrangement, to determine when a legal or constructive obligation arises according to the principles of FRS 12. In our view, under FRS 12 a legal obligation will arise once the contract is signed or the funding is otherwise committed; this will require immediate provision. We suggest that many of the specific commitments considered in paragraph 4.31(b) will require similar treatment. This would also accord with the notion in paragraph 4.21 and elsewhere that an obligation occurs where the entity is not free to avoid the outflow of economic resources.
15. One example is an amount designated by a Local Authority to provide home improvement grants. We accept that this earmarking of funds does not constitute an obligation that should be provided until valid applications for the grant are submitted. However, we believe that the liability should be provided at that point, rather than on performance by the home owner.
16. The Draft Interpretation should include additional explanations and examples of executory contracts. The Draft Interpretation does not address the wide range of executory contracts entered into by different sorts of PBE. The single example provided (the purchase of new office furniture) is simplistic and inadequate. The 'definition' of an executory contract as an obligation to make a future exchange between two parties which is still equally unperformed by both sides is unhelpful in the context of PBEs, particularly in view of the assertion that one side of the exchange may simply be the achievement of the donor's objectives. We would like to see a table setting out different types of arrangement across the different sectors with an explanation of how each would be treated under the Principles.
17. We note also that the Draft Interpretation does not appear to be entirely consistent in its use of the terms commitment, obligation and liability. Closer adherence to the terms and principles of FRS 12 is essential if the Board is to avoid creating a PBE GAAP that is inconsistent with current GAAP.
18. If promulgated in their present form, the Principles will be inconsistent with GAAP and, therefore, with some existing SORPs. We put forward the real-life example of a commitment by a corporate entity to make a charitable donation shortly before its year end, and with some or all of the payment subsequent to the year end. If this were to be made through the corporate entity, it would properly be provided in the accounts. However, according to the Draft Interpretation, if the donation were made through a charitable trust of the entity, it would not be provided in the Trust accounts.

Residual interest

19. We agree that designated funds (unless legally restricted) do not lead to separate categories of residual interest. However, the Draft Interpretation appears to confine disclosure of such designations to ‘accompanying information’, thus excluding from the financial statements useful information about management’s intentions. We believe that the current practice of showing designated funds within the accounts can be helpful and bodies should be left with the option to make this disclosure within the accounts where it is considered appropriate. However, there should be no implication that a designation reduces the residual interest or the net assets in any way.

Voluntary gifts - services

20. We do not believe that the Draft Principles offer a practicable treatment of donated services. The proposals do not offer the simplicity of either full recognition or no recognition, and fail to provide a compromise solution that confers practical advantages. As set out in paragraphs 37 to 41 below, we believe that this area needs further consideration and development by the Board.

Business combinations

21. We do not agree with the Draft Interpretation that the majority of combinations involving public benefit entities are acquisitions in which it is generally possible to identify an acquirer. Mergers are common in the education and housing association sectors; a significant minority - at least - of combinations in the health sector are also mergers. It is important that the Principles recognise the need to retain the accounting machinery to deal with true mergers.
22. The Board notes in paragraph 76 that it believes that it may be possible to improve the accounting for true mergers by using ‘fresh start’ accounting. We agree with this, particularly in relation to PBEs in the public sector, and join the Board in looking forward to this topic being progressed internationally.

Control

23. In our view it will be necessary to retain the current treatment for common control transactions. The discussion in the draft Interpretation of whether a combination is likely to be an acquisition or a merger specifically excludes entities under common control, because they would be treated as group reconstructions. Having excluded entities under common control, the Board then concludes that the majority of combinations will be acquisitions, because an acquirer can always be identified. However, FRED 36 issued in July 2005 proposes to converge with international standards, which will require acquisition accounting in all circumstances. In our view, this will have the effect of requiring such transactions to be treated as acquisitions, which would be completely inappropriate.
24. We would also like to see a more rigorous discussion of the factors that determine control. For example, paragraph 2.11 states that ‘in the absence of any other factors, an agreement to provide funding would not be expected to constitute control.’ We disagree with this. An entity that provides most or all of the funding is likely to have

a large degree of control. There may also be other ways of conferring effective control, through, for example, powers of veto. This is common in the Registered Social Landlord (RSL) sector. The Draft Interpretation states that powers of veto are 'unlikely' to form the sole basis of control, without suggesting any such unlikely circumstances or examining the other factors in association with which a power of veto might confer control.

25. We are also concerned with the implication of paragraph 2.12 that a hospital, for example, should consolidate its charitable funds because the trustees are the same. The trustees of a charity must act for the benefit of the charity irrespective of their other responsibilities, and the objectives of the charity are complementary to those of the hospital without being the same. However, in determining the appropriate accounting treatment, bodies will need to take all relevant factors into account, including the substance of the arrangements as well as the legal obligations of the trustees.

SPECIFIC QUESTIONS

Liabilities

- (a) *Do you agree with the discussion of liabilities in the context of 'commitments to provide public benefits'? In particular:*
- (i) *Do you agree that performance-related grants are analogous to contracts? If not, why not?*
26. Yes.
- (ii) *Do you agree that, for non-performance-related commitments (similarly to assets), benefits can be obtained by achieving an entity's objectives such that a commitment to provide public benefits will have the substance of an executory contract and liabilities will not usually arise until the transfer of resources become due? If not, why not?*
27. No. See paragraphs 12 et seq above.
- (b) *Do you believe that there are circumstances where an entity has entered into a commitment in furtherance of its objectives, but nevertheless a liability has been created when the commitment was given? If so, please describe the circumstances and characteristics of such a liability?*
28. Yes, in circumstances where a specific commitment has been made to a specific beneficiary.

Residual interest and restricted assets

- (c) *Do you agree that information should be provided in the financial statements to explain the amount and nature of any assets that are subject to restrictions over their application? If not, why not?*

29. Yes.
- (d) *Do you agree that the mere designation of a portion of the residual interest does not result in a transaction for recognition in the financial statements, but could instead be discussed in accompanying information? If not, why not?*
30. No. We agree that designation is not a transaction, but we believe that disclosure of designated funds can be useful information for users (see paragraph 19 above).

Business combinations

- (e) *Do you agree that, having taken the circumstances of business combinations between public benefit entities into account, it is likely that the majority (other than those involving entities under common control) will be acquisitions? If not, why not?*
31. No. See paragraphs 21 et seq above.

Capital contributions

- (f) *Do you agree that capital contributions (being those establishing a financial interest in the residual interest of a public benefit entity) should not be accounted for as gains, but as an increase in the residual interest? If not, why not?*
32. Yes. However, we believe that the Draft Interpretation could provide more clarity here, particularly in distinguishing between capital contributions and grants to purchase fixed assets. A glossary of terms and examples of items that fall into different categories would be helpful.
- (g) *Do you agree that any resources received from a controlling party, whether or not they are capital contributions, should be disclosed due to the impact they have on the financial performance and financial position of the reporting entity? If not, why not?*
33. Yes. However, more guidance is required on how they would be disclosed.

Capital grants

- (h) *Do you agree that capital grants should be recognised as gains when any conditions attaching to their receipt are met, and that assets financed by capital grants should be subject to an impairment test once they are ready for use? If not, why not?*
34. We agree that capital grants should be recognised as gains when any conditions attaching to their receipt are met. However, we do not agree that assets financed by capital grants should always be subject to an impairment test. Receipt of a grant is not relevant. The fact that a charity, for example, might not have chosen to acquire the asset without the grant does not invariably mean that the asset is of limited use. The decision as to whether or not the asset is impaired flows from the use of the asset

applying normal impairment indicators, and has nothing to do with how the asset was funded. The requirement to consider impairment should reflect this.

35. We note that the proposed treatment of capital grants is different from current practice in, for example, the education and RSL sectors. At present, the SORPs for these sectors recommend, in accordance with SSAP 4, deferred recognition of the grant, with subsequent release to income in line with the use of the asset. Paragraph 5.37 goes some way to addressing this issue by suggesting that explanatory material could be included in the explanatory material accompanying the financial statements. We question whether this is sufficient.

(i) *In particular, do you agree that the existence of a clause requiring the repayment of a capital grant in the event that the asset it financed is sold is not a barrier to recognising the grant as a gain? If not, why not?*

36. Yes. However, the possibility of a contingent liability would need to be considered.

Voluntary gifts

(j) *Do you agree that those voluntary services that would have been purchased, if not given voluntarily, should be recognised based on the value to the recipient (providing it can be reliably measured), but that otherwise voluntary services should not be recognised in the financial statements? If not, why not and how would you resolve any measurement issues that might arise?*

37. We do not believe that the discussion of donated services in the Draft Interpretation is sufficient to deal with the practical questions that arise. The efforts of charity volunteers, for example, make possible many activities that would not otherwise take place. No doubt the charity would undertake all of these activities if it had sufficient funds. It is unrealistic and onerous to expect the charity to consider on a case-by-case basis whether it would have purchased the service at the expense of not carrying out some other activity.

38. Even services that the charity may in some sense be obliged to acquire, legal and accounting advice for example, raise difficulties, because donated professional services often exceed what the charity would otherwise have purchased; or the charity might have sourced the service more cheaply.

39. We also question the proposed basis of valuation, which seems in effect to distinguish professional services (to which a value can be attached) and non-professional services (which are not valued). This therefore appears to be based on the concept of value of the provider rather than value to the recipient, which we find difficult to accept.

40. There is a principled case for treating donated services on the same basis as gifts, valuing them at current value to the recipient where they meet the test of being gains. This would better reflect the overall economic activity of the entity. Conversely, the current Charities SORP, for example, excludes all volunteer time. We suggest accordingly that more consideration could have been given to a disclosure solution, in which volunteer services are listed but not valued.

41. In summary, the Draft Principles appear to strike an uneasy compromise between the extremes of full recognition and no recognition, without offering a solution that confers practical advantages. This area needs further consideration and development by the Board.

Other

(k) *Do you believe that any other guidance or re-expression of the principles is needed? If so, please provide details.*

42. As set out above, we believe that further work is needed in developing the principles.

DETAILED COMMENTS

43. *Paragraph 2.2:* could 'legitimate demand' be quantified or better defined?

Paragraph 2.10: is 'investor' the appropriate term? Perhaps 'participator' would be better.

Paragraph 3.9: should comparability be restricted to similar entities?

Paragraph 5.8: is 'faithfully' the correct word, or is the test 'fairly'?