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Consultation on FRED 82 Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland and other FRSs – Periodic Review

My focus in this response is on Public Benefit Entities (PBEs). I have been a member of the Charity SORP Committee for over 20 years and led the Social Purpose and Non Profit teams at BDO Binder Hamlyn, Arthur Andersen, Deloitte and Crowe. I am Special Advisor to the Charity Finance Group and Chair their Technical Accounting Forum. I am also a member of the Practitioner Advisory Group working with international standard setters developing the world's first Internationally applicable Financial Reporting guidance for non-profit organisations.

I continue to work with PBEs of all sizes as a board member and professional advisor and although charities in UK are precluded from following IFRS I have worked extensively with PBEs outside the UK that follow IFRS. My comments below are informed by my work with many PBEs and reflect the challenges that I have seen as PBEs try to interpret IFRS that are written primarily with 'for profit' and private sector entities in mind. This can be easily addressed by clarifying how different aspects should be applied by PBEs.

A response of this nature focuses on the areas with suggestions for improvement and consequently might appear to be over critical. I would like to acknowledge the FRC's efforts and initiatives that have been taken and are underway to improve financial reporting.

Question 1: Disclosures

Charities are not allowed to use FRS105, and the Charity SORP requires additional disclosures that are relevant for charities in a number of important areas. For example, trustee benefits, grant payments, fund accounting etc. However, there is a real concern that some disclosure requirements create unnecessary clutter that detracts from important areas. In particular, the requirement to provide comparative information in respect of the preceding period for all amounts presented in the current period's financial statements is seen as creating unnecessary clutter.

Paragraph B3.3 of FRS102 explains that "A small number of respondents to the triennial review 2017 outreach queried whether comparatives are always necessary for disclosures required only by a SORP (i.e., disclosure that is not required by FRS 102). Comparatives are intended to provide useful information to users, and FRS 102 only provides an exemption from comparatives in limited circumstances reflecting historical company law exemptions.".

I am aware from comments made by the Charity Finance Group, that Charity SORP Committee and many charities that more than a "small number" of charities believe that their financial statements would be better presented and more useful without having to provide comparatives in some areas for disclosures required only by the SORP.

Question 2: Concepts and pervasive principles

FRED 82 uses the terms 'economic resource' and 'economic benefit'. The Glossary defines economic resource as 'a right that has the potential to produce economic benefits.' Economic benefits are not defined in the FRED or in FRS102. However, we did define this in the Charities SORP as "Economic benefits refers to the value derived from an asset in terms of cash flows generated, its cash flow generating capacity, or the service potential created, or costs saved or avoided by having control over the asset." (A similar construction can apply for a liability when considering fulfilment value.)

Reading the examples in the FRED it would appear that economic benefit is seen as analogous to financial benefit. For PBEs the benefit may be in furthering the objects of the PBE. In explaining economic benefit in this context, it would be useful to highlight the concept of service potential. This is relevant to the discussion on Fair Value discussed below.

Question 3: Fair Value

In general, the correct concepts are addressed but the way they are presented in FRS102 and FRED82 can lead to readers not fully considering the relevant nuances for PBEs.

FRED 82 states:

“2A.2 The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell an asset or to transfer a liability would take place between market participants at the measurement date.

2A.3 Fair value is a market-based measurement, not an entity-specific measurement. Therefore, it is measured using the assumptions that market participants would use when pricing the asset or liability. An entity’s intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.”

And

“2.80 Current value measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Current value measurement bases include:

(a) fair value;

(b) value in use for assets and fulfilment value for liabilities; and

(c) current cost.

“2.81 Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. Because fair value is not derived, even in part, from the price of the transaction or other event that gave rise to the asset or the liability, fair value is not increased by transaction costs incurred when acquiring the asset and is not decreased by transaction costs incurred when the liability is incurred.

“2.82 Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability. Because value in use and fulfilment value are based on future cash flows, they do not include transaction costs incurred on acquiring an asset or taking on a liability.

“2.83 The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date.”

FRS102 defines value in use as “The present value of the future cash flows expected to be derived from an asset or cash-generating unit.”

There is wide recognition that for PBEs the present value of cash flows may not be the appropriate measure and value in use may need to focus on service potential and while FRS102 does address this there is scope for it to be signposted in section 2 and for the definition of value in use to reflect the position for PBEs.

The Charity SORP explains that “The method used to determine the ‘value in use’ of an asset held by a charity will depend on whether the asset is primarily held to generate cash as a commercial return or for its service potential to the charity’s beneficiaries.” It would be useful for FRED82 to clarify this.

FRS102 and the Charity SORP defines service potential as “The capacity to provide services that contribute to achieving an entity’s objectives. Service potential enables an entity to achieve its objectives without necessarily generating net cash inflows.”

These aspects are important and particularly relevant for PBEs. For example, PBEs often receive gifts of assets and usually they would be reported at open market value. However, the paramount concept is the value to the PBE and in some cases this may not be the open market value.

The concept of value to the PBE is the value that PBE would be prepared to pay. Consider a PBE that is given a property that requires updating / conversion before it can be used and also has restrictions on the use of the property. The PBE must consider the value to the PBE and this would involve consideration of its risk appetite, how much money it was willing to spend on the renovations, the likelihood of obtaining the planning consents and then the PBE could arrive at a figure that it would be willing to pay for the property.

There is no hard and fast rule or objective basis that may be applied by the PBE when deciding on what they may pay as the risk appetite may differ between PBEs and dependant on the circumstances. For example, if two identical assets were gifted to two PBEs one may conclude that the value to it was £x (i.e. they would pay £x) whereas the other may be willing to pay £y. In such circumstances £x or £y would be their considered value to the different PBEs. (Contrast this with FRED 2A3, cited above that states that “fair value is a market-based measurement, not an entity-specific measurement”.)

In some cases, value to the PBE may be based on the economic potential - i.e. discounted cash flows but in many cases this is inappropriate. PBE assets may or may not be held to derive income streams. In some cases income streams may not be maximised due to the very nature of what the PBE is trying to achieve.

This is recognised and discussed when considering impairment. In such cases, an alternative measure of its service potential may be more relevant, such as the intrinsic worth of the service delivery or the replacement cost of the asset. Each PBE can and should determine its own measure of service delivery, but this must be reasonable, justifiable and consistently operated.

For example, consider a hospice, place of worship or a visitor attraction. The PBE could decide its value in use based on the numbers using or visiting it. This is a difficult concept, the PBE could decide that small numbers using it provided value it would be difficult to say that there should be more individuals using it or alternatively that they had to lower the carrying value. This is a well supported principle and there is much agreement that with PBEs money may be a poor proxy for value.

The concept of value in use or value to the business was discussed in some detail in the Interpretation of the Statement of Principles for Public Benefit Entities which was published by the Accounting Standards Board in May 2007. The interpretation explains that:

"Many public benefit entities have assets that are specialised in nature, where there may be no viable market for the asset's sale. As a result, assets are infrequently valued on the basis of net realisable value because it is often artificially low as a result of the lack of an active market."

In addition, PBEs use their assets to deliver their objectives and the cost of producing the asset may be more than the market value calculated on a conventional basis. This needs to be recognised when valuing such assets. The Statement of Principles also explained that "value in use may be difficult to calculate in practice. Many assets do not generate cash flows at a market rate because they are involved in the production of goods and services that are provided at a subsidised rate or for free. In such cases, assets should be stated at the replacement cost of the assets service potential."

It would be helpful if this thinking can be clearly reflected.

Question 6: Leases

The proposed changes would have a significant impact on PBEs that have a large number of leases. Having said that I recognise that this is the accepted direction of travel.

FRS105 exempts smaller companies from these requirements but charities cannot avail of these exemptions, and this should be reconsidered by creating a specific opt out for smaller charities.

FRED 82 refers to leases that have an element of non-exchange transaction, which includes those under market value or with minimal cost where there is otherwise no 'market'. Many PBEs are provided with "free" office space usually this involves a licence to occupy rather than a formal lease. In other jurisdictions this has led to confusion as to whether the asset meets the wider definition of a right to use asset, and this should be clarified.

Question 7: Revenue

In general, I support the proposals. However, there are nuances for PBEs that need to be considered. I have seen these areas create confusion with PBEs that have tried to adopt IFRS.

FRED 82 includes the following definitions.

Contract: "An agreement between two or more parties that creates enforceable rights and obligations."

Customer: "A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."

Many PBE contracts and similar arrangements do not create "enforceable rights and obligations". This has been considered in the Charity SORP which explains in the case of liability recognition "For example, a term in a grant offer that seeks to relieve the donor charity from a future obligation in the event of a lack of funds at a future settlement date would not normally prevent the recognition of a liability if payment is probable."

Further clarity should be provided to take account of PBE's when considering 'enforceable rights and obligations'. There have been examples of difficulties relating to the definition of a customer as "a party that has contracted with an entity to obtain goods or services." It is common in the PBE sector for one party to contract with another party to deliver goods or services to a third party. There should be benefit in clarifying that the party that is contracting for the goods or service to be delivered need not be the same as the party who is receiving the goods or service.

In addition, the revised revenue recognition model requires that it is used only when certain criteria are met. These include that the contract has 'commercial substance'. The term is not defined and the issues for PBEs are similar to the consideration of other terms such as 'economic benefit' which has been discussed earlier.

It is useful that Appendix B relating to income recognition by PBEs has been included in the body of Section 34. In particular, we continue to see some auditors requiring PBEs to recognise legacies when probate is received rather than waiting to ensure that "the executor(s) of the estate has established that there are sufficient assets in the estate, after settling liabilities, to pay the legacy." The option for using a portfolio basis is useful but it is important that this continue to be seen as an option and not a requirement.

It is disappointing that, yet again, the FRC has not taken the opportunity to endorse the principles based approach that would focus on income recognition and the definition of an asset or liability as being the basis for accounting for all grants. This issue was highlighted in the Statement of Principles in 2007 and it is a retrograde step that FRED 82 has failed to grasp this nettle. There continues to be the anomaly that that different accounting treatments are allowed for income recognition with grants depending on the source of the grant rather than whether the underlying terms and conditions of the grants are different.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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