

**Consultation response:  
FREDs 46, 47 & 48  
The Future of Financial  
Reporting in the UK and  
Republic of Ireland**

Charity Finance Group

April 2012

Contact: [Katherine.smithson@cfg.org.uk](mailto:Katherine.smithson@cfg.org.uk)

## 1. Executive summary

- The responsiveness of the Accounting Standards Board to recommendations made by the Public Benefit Entity (PBE) sector at previous stages of this process has been encouraging. However, we feel that there is more that needs to be done to merge the positive aspects of the FRSPBE (FRED 45) with the draft FRS 102. There are significant drafting issues which will majorly alter the way charities report.
- The definition of a 'performance condition' and a 'restriction' in the draft FRS 102 is inconsistent with charity law and the Charity Statement of Recommended Practice (SORP). The proposed definitions will lead to a situation where much of the income currently recognised when receivable as restricted, will be deferred. CFG would like the ASB to alter these definitions and recommends the wording outlined in the current Charities SORP is used so as not to dramatically change the recognition of donated income.
- The draft FRS 102 has a separate section for income recognition from grants. It is not clear as to what the technical difference between a grant and a donation (non-exchange transaction) is. CFG believes that the section should be clarified so that it is clear that it only applies to multi-year grants which are dependent on performance conditions. The option for using the accruals method here could also lead to significant inconsistency among charities and in the way similar types of income are recognised within the same organisation. The ASB should make it possible for the Charities SORP to dis-apply this option.
- There are strong questions as to the benefits of having a separate section on recognising funding commitments. While this may be an area for further review, we recommend that it is removed as it does not add new information and confuses the standard. The current wording in this section is contradictory to the body of the FRS, creating a situation where income transfers are accounted for differently by the funder and the funded. If the section is retained the wording should be changed so that the recognition of commitments is not based on legal enforceability but considers wider contextual factors.
- Many charities receive donations in the form of goods and services. The draft FRS 102 requires these donations to be valued at fair value. CFG believes that this is an inappropriate measurement for charities which are rarely in a position where goods donated for use could be sold or services would have been purchased for the comparable market rate. Charities should be permitted to value the item at the 'value in use', or value to the charity.
- The criteria for merger have been adapted since the ASB consulted on FRED 45. However, the criterion which states that there should not be a significant change to the class of beneficiary or the purpose of the activity remains too restrictive. It is also not clear what purpose this criterion fulfils within the accounting standard as use of funds in merger situations is covered by charity law and is managed by regulation.
- CFG urge the ASB to extend the section on 'concessionary loans' to non-PBE entities when they are subsidiaries to a PBE.

## 2. Introduction

Charity Finance Group (CFG) is the charity that champions best practice in finance management in the voluntary sector. With more than 1,800 members, managing over £19 billion, we are uniquely placed to comment on and challenge regulation which affects the use of charity funds. Our training and development programmes enable finance professionals to give the essential leadership on finance strategy and management that their charities need.

CFG runs a Technical Accounting Forum. This brings together senior finance professionals in the voluntary sector and professional accounting and audit service providers specialising in the voluntary sector. This forum of experts informs CFG consultation responses and surrounding work relating to charity accounting and financial management. The forum has been heavily engaged as the Accounting Standards Board (ASB) has gone through the consultation process in order to move UK GAAP into a position which is more in line with International Financial Reporting Standards (IFRS). In particular, we are concerned to ensure that the resulting standards are fit for purpose for the complexities of charity accounting, and that the resulting standards support transparency and accountability of UK charities to their donors and beneficiaries.

## 3. Putting the proposals in the context of the charity sector

Since the ASB released the first consultation on the future of UK GAAP, a number of issues have been raised by the charity, and wider public benefit entity (PBE) sector. Overall, CFG is encouraged by the ASB's response to the concerns that have been raised. Some of the key considerations that have arisen are as follows:

- Most charities would be eligible to follow the FRSSE; however, the future of the FRSSE was not clearly laid out (as still remains the case), bringing the suitability of this arrangement into question. We understand that this is likely to be the subject of further consultation and would urge the ASB to publish potential proposals as soon as possible so as to clarify the situation with the FRSSE in a timely manner.
- Certain aspects of the FRSME were not suitable for PBEs. In particular, the re-valuation of property, plant and equipment and the capitalisation of borrowing costs were prohibited by the standard despite being allowed under full IFRS. This sparked considerations as to the ability, or incentives, for charities to pick and choose from the tiers and whether this would be desirable in terms of consistency within sectors.

The specific issues of borrowing costs and re-valuation of property, plant and equipment have now been resolved. It is also now our understanding that there is not likely to be a change in the law which would allow charities to follow full-IFRS. Exploring options in the future for international standards which are specific to public benefit entities would be of great interest to our members - in particular, to entities in the international sector, where comparability within an international cohort is of relevance to them.

- It was not clear whether some charities could fall under the definition of ‘publicly accountable’ and so would be required to follow full IFRS – potentially causing issues with company law. The removal of the tier 1 requirements has removed this issue.
- The importance of the sub-sector-specific SORPs was emphasised by all in the PBE sector and the ASB confirmed that they would remain in place. However, there were concerns around the time frame for developing a SORP (which would be required in a modular format well before the implementation date), the scope of the SORP to interpret and provide more detailed guidance in certain areas of accounting, and continuing discussions around inconsistency of accounting treatment between PBE sub-sectors.

It remains important that the ASB releases the final version of the new Financial Reporting Standards in a timely manner in order to ensure that sub-sectors are able to develop SORPs in good time before implementation.

- In summer 2011, the ASB consulted on a new FRS for PBEs, the FRSPBE. This would be an add-on to the FRSME and would not over-ride it. This was a positive step from the ASB to recognise the specific issues for the PBE sector and to ensure that the new framework was suitable. CFG suggested that this standard be incorporated into the overall standard’s document so as to reduce the number of reference publications. The ASB has taken this on board and has started the process of integration. However, there are some concerns that this may not be done appropriately as it currently stands. There are still some drafting issues for PBEs.

There was also significant concern raised by the sector around plans from the ASB to insist upon valuation of donated stock within charity shops. CFG felt that this was not only impossible in practice, but would give unreliable and non-material information to the users of the accounts. The ASB has now changed this requirement, meaning that this is only necessary in particular circumstances when practical and reliable, and after considering the cost/benefit of the activity.

#### **4. FREDs 46, 47 & 48**

In our response to the ASB, CFG is concentrating on the issues of primary concern to public benefit entities and in particular those that will be making use of the Charities SORP.

#### **Income recognition from non-exchange transactions**

As currently worded, the new exposure draft would significantly change the way in which charities recognise a large proportion of their income. The definition of ‘restricted’ income and ‘performance conditions’ rests on whether or not there is a possibility of repayment. By requirements in charity law, restricted income, which is not expended in line with the restriction, is potentially repayable to the donor. The definition in the draft FRS applies this criterion only to performance conditions and not to restrictions. This would mean that much of the income currently recognised as restricted income will now be deferred and not recognised until it is spent,

the point at which it would never be repayable, and so the definition of a performance condition is met.

At the same time the standard requires a liability to be recognised at the point that repayment of a donation becomes 'probable'. This treatment accords with existing practice. However, having two accounting treatments presents a conundrum for charities receiving funding to which conditions apply as defined by the draft standard. Income for which there is no repayment clause will be recognised as income and not deferred and will be recognised even if the money was paid in advance of the activity, whereas it would not be repayable but deferred if there is a repayment clause (which is most likely in the case of restricted income).

The 'funding commitments' section of the new standard also contradicts the treatment for income recognition. It states that a 'mere restriction on the specific purpose for which funds are to be used does not in itself constitute a performance-related condition'. No reference is made here to repayment, and so this means that there will be inconsistency between the way that the funder and the funded account for the same income transfer.

CFG would suggest that the definition of a performance condition and a restriction are re-drafted so that they are no longer determined by the presence or absence of a repayment clause. The Charities SORP and the ASB's 'Interpretation of the Statement of Principles' (2007) both have definitions that can be used. This is important so as not to result in a change of accounting treatment for income from non-exchange transactions, which we do not believe to be the intended consequence of the drafting. This could have significant consequences for charities in terms of the accounts representing a true and fair view of their financial position.

### Recognising income from grants

There are two options for recognising grant income in the new FRED. These are recognition on a performance basis or on an accruals basis. There is inconsistency in the way that grants are currently recognised and we understand that these two options have been put in place by the ASB in order to offer an interim solution. There is, however, a concern that this may lead to differences in the way that similar assets are accounted for in the same organisation. For example, capital grants could be deferred through the accruals method whereas other gifted assets would be recognised straight away as income even if they are used over several years.

It is not clear as to how the ASB defines a grant as compared with a non-exchange transaction. The fact that there is a choice of accounting method for grants and not for donations could therefore lead to a confusing situation. An asset purchased through a mixture of grant and donation could end up being accounted for in two different ways although the income is in essence the same.

The accruals method also appears to contradict paragraph 2.45 of Section 2 'concepts and pervasive principles' in the draft FRS 102 which states *'This draft does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities regardless of whether they result from applying the notion commonly referred to as the 'matching concept' for measuring profit or loss.'* This would not allow the use of matching as required by the accruals method as the deferred income would not meet the definition of a liability.

For charities, either of the two accounting treatments for grants will result in changes to

recognition as a result of the proposed definitions for performance conditions and restrictions (as explained above). This definition should be changed in order to make the performance based option work. The option of accruals based recognition would present significant differences in the case of charities and could lead to significant inconsistencies and we recommend that the Charities SORP be permitted to dis-apply this option. It would also be useful if this section clarifies that it should only be applied to grants with performance conditions and that other grants should be accounted for as non-exchange transactions.

### Funding commitments

As we have highlighted above that there is inconsistency in the way that it is suggested that the funder and the funded account for income which is transferred between them.

There is currently varied treatment of funding commitments in the charity sector and between PBE sub-sectors. This inconsistency emerges from different circumstances and views as to where there is a true liability. We understand that this section has been included in order to streamline treatment and deal with some of the inconsistency. However, the current wording implies legal enforceability as the main determining factor as to whether a liability exists. The main sections of the FRED, in line with the Charities SORP, looks at other contextual factors which imply an accounting liability even when there is not a legal one.

The wording in the draft FRS 102 refers to a liability only being recognised when *‘an entity cannot realistically withdraw from its obligation’* and *‘entitlement of the other party to the resources does not depend on the satisfaction of performance conditions’*.

The draft also makes clear that these ‘performance conditions’ include the promise to provide cash being conditional on the receipt of future income. Many organisations have such clauses in their funding agreements but in reality these are rarely exercised and therefore the liability is material to the user of the accounts. The ASB should remove this sentence from the standard as it may create a situation where commitments that would be material are not recognised as liabilities despite the fact that it would be extremely unlikely for the commitment not to be met. In effect, we believe that this sentence is contrary to the main body of the FRED.

There is a significant issue here for the common circumstances where income is paid to the recipient organisation before there is related expenditure, therefore before performance conditions are met. The ASB should review this section of the draft, reconsidering the definition of a ‘performance condition’ in line with comments we have made in the sections above.

The section on funding commitments begins with *‘When applying these paragraphs, the requirements of Section 2 ‘concepts and pervasive principles’ and Section 21 shall also be taken into consideration’*. There is a strong body of opinion that funding commitments should be accounted for under the general rules for accounting for liabilities and that a special section which appears to depart from this is not warranted. The ASB should consider that the main body of the FRS is sufficient to cover the issue of funding commitments. However, CFG accepts that this does represent an area of varied perspectives between sub-sector SORPs. In the future it may be helpful to review this overall so as to conclude whether a position of consistency can be achieved.

## Gifted goods or services for distribution or use

The draft FRS currently states that donated goods or services that are for distribution or use should be measured at fair value. CFG believes that PBEs should have the option to value such goods and services at 'value in use', put more simply as the value to the charity.

It is rare for circumstances to emerge where goods or services that have been donated for use are passed on or sold in order to re-buy at a lower cost. This includes situations where had the donation not been received, the charity would have needed to buy the product themselves they would have bought a lower value item. Often donor relationships require that the donated goods are not sold. This is an important consideration for charities and therefore in most cases the value in use would give a more indicative value of the material benefit of the donation.

Examples of circumstances where it would be highly unlikely to be appropriate to sell on the donation would be a donated lease on a property or office space provided in kind, consultancy or legal support, and donated equipment for use by charities such as tents, cars or other.

Valuing some of these services at fair value could also have the consequence of inflating the charities' operating administrative costs. It is important that charities are transparent about the true costs of running an efficient and professional organisation. While CFG do not believe that charities should in any way look to bring down perceived 'administrative' costs for the sake of it, this is a sensitive area and inflating expenditure on expensive gifted services could give a misleading view as to how resources have been expended in different service areas.

## Mergers

The continued inclusion of merger accounting for PBEs in FRS 102 is welcomed by CFG. However, in our response to FRED 45, CFG asked that the criteria for merger be changed. A small change has been made in line with the request. In the draft standard, PBE34.80(b) states *'there is no significant change to the classes of beneficiaries of the combining entities or the purpose of the benefits provided as a result of the combination.'* CFG still feels that even with this change of wording this criterion is not appropriate within the standard and could catch some legitimate mergers. Mergers often occur in order to respond to changing needs. It might be possible for the SORP to provide more detailed guidance on the application of this criterion in practice; however, the issue of use of funds in circumstances of merger could be left to be dealt with by the charity regulator, the Charity Commission.

We also believe that the disclosure requirements for combinations that are in essence a gift should not be the same as for combinations by way of acquisition.

## Concessionary loans

The provisions for concessionary loans have not been extended to subsidiaries of PBEs despite there being calls for this within the sector. In our response to FRED 45 CFG asked that the ASB extend the provision, with the exception of entities operating as financial institutions, where this is part of normal business. It was argued that otherwise the loans would be treated one way for the PBE and another for the subsidiary, only to be subsequently changed as a consolidation adjustment.

CFG still stands by this position and urges the ASB to make this change in the final publication of the standard.

## Conclusion

CFG has outlined the issues in the draft FRS 102 which are of particular significance to the PBE sector and organisations which follow the guidance outlined in the Charities SORP. Encouragingly, many of the significant issues raised at previous stages of the consultation process have been ironed out for charities. There are however, some problematic drafting issues which stand to change the accounting treatment of income significantly for charities. CFG has outlined these problems above; it is important that these changes are made so as to ensure that the new standard is fit for purpose and that charities are able to make a smooth transition.

A vast majority of charities will be eligible to follow the FRSSE. It is very important that there is a clearer picture of the future of the FRSSE and what arrangements will be put in place if the standard is to be phased out. CFG would like to see a full consultation on the future of the FRSSE as soon as possible so that the sector is able to prepare and to inform the design of the SORP.

In our response to FRED 45 CFG recommended that the ASB integrate the FRSPBE into the main standard. This was to reduce the number of reference documents and to increase the salience of PBEs when considering alterations to the standards. While we are pleased that this recommendation has been taken on board, we feel that the integration could be improved and that efforts need to be made to ensure that there is consistency between different sections of the standard and how they relate to the over-arching principles.