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Your Ref:
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Date: 4 May 2012

Dear Jenny,

Consultation – Revised Financial Reporting Exposure Drafts (FREDs 46, 47 and 48)

The Charity Commission and the Office of the Scottish Charity Regulator act together as the joint SORP-making body for UK charities and our response to your consultation is made in that capacity. Your consultation and revised exposure drafts have been considered by our SORP Committee and our response incorporates the views and advice that we have received from that Committee.

We welcome the development of this suite of proposed standards that will provide the future framework for a new GAAP in the UK. Overall, we see the general reporting framework provided by these standards as being proportionate to the reporting needs of both medium-sized and large charities. We appreciate the work undertaken by the Board in addressing the reporting needs of charities and other PBEs within this framework and the pragmatism shown in addressing many of the concerns raised in last year's consultation on FRED 45 (FRS for PBEs).

However, the proposals in FRS 102, as they stand, will introduce a radical change to the way in which restricted income and funding commitments with repayment conditions are recognised in charity accounting. We do not believe that this was the Board's policy intention but rather a result of definitional and drafting issues in the proposed text of FRS 102. In particular, we are concerned that restricted income may often be construed as being subject to a performance condition resulting in the deferral of income despite the charity having both control over, and a right to, the gifted resource. We have met with the Project Directors taking forward the proposals and have been encouraged by their recognition of our concerns and their willingness to give further consideration to them.

The recognition of both income and commitments resulting from non exchange transactions are central to PBE accounting and were very thoroughly considered and resolved in the Board's development of the Interpretation of the Statement of Principles for Public Benefit Entities which we regard as an exemplary piece of work. In developing the final text of FRS 102 relating to PBEs, we would encourage the Board to ensure consistency with the recognition criteria developed in the context of their earlier work on Interpretation of the Statement of Principles for Public Benefit Entities.

We have set out in annex A to this letter what we consider to be the essential amendments to the text of FRS 102 to ensure consistency with sector accounting practice, the concepts and pervasive principles set out in FRS 102, the interpretation and the Charities SORP. If these drafting issues are addressed it will enable charities and other PBEs to account appropriately for income and commitments subject to a restriction and/or conditions.

We have also set out in annex B to this letter our comments on the specific questions raised by your consultation.

We would welcome continued liaison with the Project Directors taking forward the PBE aspects of the new standards and in particular the recognition bases applying non exchange transaction where gifts are subject to restrictions and/or conditions.

Yours sincerely,

Sam Younger
Joint Chair of Charities SORP Committee
Chief Executive, Charity Commission

Laura Anderson
Joint Chair of Charities SORP Committee
Head of Inquiry & Investigation, OSCR

Annex A - Drafting amendment to FRED 48 (Draft FRS102) **Charity Commission and Office of the Scottish Charity Regulator response as the Joint SORP-making Body for UK Charities to the ASB's consultation on the 'Revised Financial Reporting Exposure Drafts'**	
Suggested re-draft	**Why amendment is necessary**

Glossary p.280 – Restrictions		
1.	**Restrictions:** A requirement that limits or directs the purposes for which a resource may be used. ~~but does not require that resource to be returned to the donor if the resource is not used as specified~~.	• A restricted gift should not be defined by the presence or absence of a repayment clause. • Unless the definition is changed, all restricted resources received with a repayment clause would be deferred until the gifted resource was expended even if it was probable that the resources would be used in line with the restriction. The recognition of restricted income should only be deferred if repayment is probable which, we believe, is the intention behind paragraph PBE34.69. • The existing definition if not amended would result in restricted income subject to a repayment clause being treated as a gift subject to a performance condition and this would result in income only being recognised as the resource was expended. • The amendment ensures a clear distinction is made between a restriction, which limits or directs the purposes for which a resource may be used and a condition that must be overcome before there is entitlement to the gift. • The amendment proposed also ensures paragraph PBE34.66 to work as intended i.e. to ensure a restriction does not prevent recognition of a donated resource.

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Suggested re-draft	**Why amendment is necessary**

	Glossary p.278 - Performance condition	
2.	**Performance condition:** ~~A requirement that specifies that the resource is either to be used by the recipient as specified, or if not so used, to be returned to the donor.~~ <u>A term that requires an entity to provide a specified level of service (or provision of goods) with payment/entitlement being conditional on that specified service (or goods) being provided.</u> <u>Or</u> <u>A term that requires the performance of a particular level of service or units of output to be delivered with payment/entitlement conditional on that performance.</u>	• As with any other condition, a performance condition needs to be met (or overcome) before there is unconditional entitlement to the resource received. It is the conditionality of the gift that needs to be the focus of the definition not the presence or absence of a repayment clause. • At present the definition of a performance condition makes it difficult to distinguish between a restriction and a performance condition. • The existing ASB definition would change the way charities currently account for both their funding commitments and the income receivable from non-exchange transactions. • The first alternative definition offered is taken from paragraph 4.32 of the Statement of Principles – Interpretation for Public Benefit Entities. • A second alternative definition offered is taken from paragraphs 99 and 100 of the Charities SORP and is more specific.

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	Suggested re-draft	**Why amendment is necessary**
	Addition to glossary – 'Condition'	
3.	<u>**Condition:** A condition specifies an uncertain future event which must occur or fail to occur before the recipient of a resource has an unconditional right to the resource.</u>	• Necessary to clarify term used in PBE34.69 • Establishes that conditions other than 'performance conditions' may affect entitlement to a resource.
	Income from non-exchange transactions p252	
4.	**PBE34.69** An entity shall recognise a liability for any resource <u>*received*</u> ~~with specified performance~~ if<u> as a result of a failure to meet restrictions or </u>conditions <u>attached to it, </u>~~that becomes repayable due to non-compliance with the performance conditions, when that~~ repayment becomes **probable**.	• Repayment may arise when the conditions attaching to a conditional gift are not met. • Conditions that could trigger repayment are wider than just performance conditions. • Therefore we need to define a 'condition' so that this paragraph applies to any repayment that arises through the failure of a condition attaching to a gift being met. • It is the failure to meet a condition that triggers the possibility of repayment and the recognition of a liability. • The proposed amendment also creates consistency with Paragraph PBE34.72(b) which is drafted to included 'conditions and contingencies' and not limited to 'performance conditions' • This amendment also necessitates defining a 'condition' in the glossary.

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Suggested re-draft	**Why amendment is necessary**

	Guidance on Incoming Resources from Non-exchange Transactions p.258	
5.	**PBE34B.13** Some resources are given with performance conditions attached which require the recipient to use the resources ~~for~~ to provide a specified level of service ~~a particular purpose~~ in order to be entitled to retain the resources. An entity will not recognise income from those resources until these performance conditions have been met.	• This paragraph muddles the definition of a restriction and a performance condition. • Restrictions, not conditions, limit the purpose for which resources can be used. • Re-draft needed to be consistent with the suggested revisions to definitions.
	Guidance on Incoming Resources from Non-exchange Transactions A p.258	
6. 6a	**PBE 34B.15** Paragraph PBE34.71 requires resources received to be measured at their fair value. These fair values are usually the price that the entity would have to pay on the open market for an equivalent item. In the case of goods that are expected to be sold, market value may be derived from the estimated resale value (which may reflect the amount actually realised) after deducting the cost to sell the goods. **PBE34B.16** On occasions, due to a restriction, condition or term attaching to a gift, it may not be practical for goods or facilities donated to a PBE for its own use to be resold. In such instances, a value may be derived from the amount that the recipient of the donation would have to pay in the open market for goods or facilities providing the same service potential.	• Goods and facilities may be donated to a charity with expectation of their use by the charity or for their distribution to beneficiaries in furtherance of purposes. • Where restrictions or conditions attaching to a gift make it impractical for the good or service to be sold then a notional market value may overstate the gift's value to the recipient particularly where goods or facilities of a lower specification would meet the service needs of the recipient. • In the view of the SORP Committee, these circumstances are not as rare as envisaged in the ASB explanation in paragraphs 10.31 and 10.32 of Part Three of its consultation pack. • The amendments suggested would also mean that the cost of purchasing an asset or facilities with the same service potential would only arise when it was impractical

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	Suggested re-draft	Why amendment is necessary
	~~When there is no direct evidence of an open market value for an equivalent item a value may be derived from sources such as:~~ ~~(a) the cost of the item to the donor; or~~ ~~(b) in the case of goods that are expected to be sold, the estimated resale value (which may reflect the amount actually realised) after deduction the cost to sale the goods.~~	for the recipient to re-sell the goods or facilities it has received. This approach should therefore ameliorate the ASB concerns as to the cost, subjectivity and risks of undervaluation.
	Funding Commitment p.251	
7.	**34.57 (a)** the obligation (which may be **<u>a constructive obligation)</u>** is such that the entity cannot realistically withdraw from it; and…	• Important that it is clearly understood that recognition is based on the existence of a constructive liability. • Non-exchange transactions and indeed many grants are not contractual hence it is vital that we establish clearly that it is the existence of a constructive obligation that drives recognition.

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Suggested re-draft	**Why amendment is necessary**

	Guidance on Funding Commitments p.256	
8.	**34A.2 …** ~~Similarly, a promise to provide cash conditional on the receipt of future income does not give rise to a liability as the entity cannot be required to fulfil it if the future income is not received.~~	• This guidance paragraph will result in accounting for the form of an agreement rather than its substance. • It is preferable to simply rely on the definition of a constructive obligation rather than base liability recognition on a term of a funding offer that may or may not change a recipient's expectations of receipt. • It is agreed that if an economic outflow is not probable then a liability should not be booked.
	Section 24 Grants p.196	
9.	**24.1**A government grant is assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified <u>performance </u>condition relating to the operational activities of the entity. **24.2**……trading transactions of the entity. <u>Government and other grants also exclude the transfer of resources to an entity on a non-exchange basis.</u>	• In the charity sector grants are often made and received as gifts under trust law rather than under contract. The terms grant and donation are often used inter-changeably and where the substance of the transfer is that of a gift then the two terms are indistinguishable (Charities SORP GL29 & 30 pp. 68-69). We are therefore concerned that there will be uncertainty as to when a grant is accounted for as a non-exchange transaction under the PBE section of the proposed standard and when Section 24 of the proposed standard applies. • The text of Section 24 was initially written to apply only to government grant but has been expended to include 'grants made by others' and so could include corporate and charity sector donors such as trusts and foundations.

	Suggested re-draft	Why amendment is necessary
		• The definition of a government grant refers to specified conditions and that resources are transferred in 'return' for compliance with conditions. This raise the issue of distinguishing 'condition' and 'restriction' and being clear that the conditions referred to are 'performance conditions'. In addition, the specific statement that grants excludes 'non-exchange transactions' would add clarity to when section 24 applies to grants as the term is used by charities. • As you are aware, we have concerns over the application of accrual model proposed in paragraphs 24.5C to 24.5G particularly where a grant is not subject to a performance condition as resources available to spend will not be recognised in the performance statement until spent. This impacts on the transparency of charity accounts.

	Suggested re-draft	Why amendment is necessary
	Section 11 Basic Financial Instruments p.111	
10.	**11.14(a)** Debt instruments that meet the conditions in paragraph 11.8(b) shall be measured as follows: • If the debt instruments are publicly traded or their fair value can otherwise be measured reliably, the investment shall be measured at fair value with changes in fair value recognised in profit or loss. • All other debt instruments shall be measured at **amortised cost** using the **effective interest method.**	• Charities, particularly endowed charities often hold government stock and corporate bonds as part of their investments portfolios that generate income and gains to be used for their charitable purposes. • Existing practice in charity accounting is to include such investments in the accounts at their market value. • Where debt instruments such as government stocks or corporate bonds are traded on an active market then the best evidence of fair value is the quoted price of the instrument. Obtaining the quoted price is also far less onerous than calculating a proxy for fair value using the effective interest method. The concept of amortised cost has little practical use in the context of an investment portfolio. • Introducing an 'active market option' would also be a more proportionate solution than requiring charities with investment portfolios to refer to the recognition and measurement provisions of IAS 39.

Annex B: Charity Commission and Office of the Scottish Charity Regulator response as the Joint SORP-making Body for UK Charities to the ASB's consultation on the 'Revised Financial Reporting Exposure Drafts'

1. Objective of Financial Reporting Standards

Q1: The ASB is setting out the proposals in this revised FRED following a prolonged period of consultation. The ASB considers that the proposals in FREDs 46 to FRED 48 achieve its project objective: To enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and user's information needs. Do you agree?

1.1. The final suite of standards provides a proportionate approach to aligning UK GAAP with international practice. In our view, the ASB has shown commendable pragmatism in its approach, for example in its treatment of Financial Instruments.

1.2. The framework, including the PBE SORPs, is capable of delivering high quality financial reporting provided a small number of significant issues affecting PBE accounting are addressed. We have set out in appendix A of this response what we consider to be the essential amendments to FRED 48 necessary to provide a workable financial reporting framework for charities.

2. Disclosure requirements for Financial Institutions

Q2: The ASB has decided to seek views on whether:
As proposed in FRED 47: A qualifying entity that is a financial institution should not be exempt from any of the disclosure requirements in either IFRS 7 or IFRS 13; or
alternatively: A qualifying entity that is a financial institution should be exempt in its individual accounts from all of IFRS 7 except for paragraphs 6, 7, 9(b), 16, 27A, 31, 33, 36, 37, 38, 39, 40 and 41 and from paragraphs 92-99 of IFRS 13 (all disclosure requirements except the disclosure objectives).
Which alternative do you prefer and why?

2.1. Only a small number of charities will fall within the definition of an investment institution and it will be appropriate for such charities to adopt the particular disclosure requirements that will apply to the generality of financial institutions. Where a bank or collective investment scheme is operated by a charity then it is important for that entity to meet reporting requirements required of both a financial institution and a PBE.

2.2. We also welcome the decision to update the SORP for Authorised Funds as regulations made under the Charities Act require charitable common investment funds to adopt this SORP as they provide collective investment services for other charities.

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3. Cross references to EU- adopted IFRS

Q3: Do you agree with the proposed scope for the areas cross-referenced to EU- adopted IFRS as set out in section 1 of FRED 48? If not, please state what changes you prefer and why.

3.1. We have no comments on this question.

4. The definition of a financial institution

Q4: Do you agree with the definition of a financial institution? If not, please provide your reasons and suggest how the definition might be improved.

4.1. We are uncertain whether the definition of a financial institution seeks to include entities which provide an insurance brokerage service. Charities or their subsidiaries may, on occasions, provide insurance brokerage services for their beneficiaries. In our view, it would not be proportionate to include entities undertaking retail insurance broking activities within the definition of a financial institution particularly if client assets were not held.

4.2. In furthering their charitable aims, charities operate micro credit activities overseas to assist beneficiary groups. Such initiatives are intended to develop sustainable activities and to lift beneficiaries out of debt to attain better living conditions. These micro credit activities are in furtherance of charitable purposes and we would seek their specific exclusion from the definition of a financial institution.

4.3. On occasions, charities with common trustees pool their investment funds. These internal arrangements are intended to reap economies of scale in investment rather than engage in investment business for profit and again it would not be proportionate for such arrangements to create a need to report as a financial institution.

5. Specialist activities

Q5: In relation to the proposals for specialist activities, the ASB would welcome views on:
a) Whether and, if so, why the proposals for agricultural activities are considered unduly arduous? What alternatives should be proposed?
b) Whether the proposals for service concession arrangements are sufficient to meet the needs of preparers?

5.1. We have no comment on the issues raise (a) or (b). However, we do have significant concerns relating to parts of the standard that determine the recognition basis for non-exchange transactions (grants and donations) in Public Benefit Entities. The proposals in FRS 102, as they stand, will introduce a radical change to the way in which restricted income and funding commitments with repayment conditions are recognised in charity accounting.

5.2. We have set out in appendix A of this response what we consider to be the essential amendments to the proposals in FRS 102 necessary to provide a workable financial reporting framework for charities.

6. Retirement benefit plans

Q6: The ASB is requesting comment on the proposals for the financial statements of retirement benefit plans, including:
a) Do you consider that the proposals provide sufficient guidance?
b) Do you agree with the proposed disclosures about the liability to pay pension benefits?

6.1. We have no comment on this question.

7. Related party disclosure requirements

Q7: Do you consider that the related party disclosure requirements in section 33 of FED 48 are sufficient to meet the needs of prepares and users?

7.1. We have no comment on the application of related party disclosure requirements for transactions involving for-profit entities. However, in the context of charities holding funds on trust and operating using trading subsidiaries, the disclosure of related party transactions between the subsidiary and the parent charity is important to the users of the financial statements. Research conducted by IPSOS MORI for the Charity Commission in 2010 found that donors and financial supporters want to know how the charity has spent their money and what activities the charity has undertaken. The extent to which subsidiaries are used by the charity to further its activities and the transactions between the parent charity and a subsidiary provides important information to donors on how the charity has spent their money.

7.2. FRS 101 is to apply to the accounts of a qualifying entity which is not a financial institution. FRS 101 would apply to the individual accounts of ultimate parent charity and its subsidiaries. It is therefore important that paragraph 8 (l) of FRS 101 disapplies the disclosure exemption in relation to transactions between a parent charity and its subsidiaries. This would also ensure that FRS 101 is consistent with charity law which, in requiring the approval of a charity regulator to specified transactions between a subsidiary and a parent charity, highlights a public interest in such transactions.

Annex B: Charity Commission and Office of the Scottish Charity Regulator response as the Joint SORP-making Body for UK Charities to the ASB's consultation on the 'Revised Financial Reporting Exposure Drafts'

8. <u>Effective date</u>

Q8: Do you agree with the effective date? If not, what alternative date would you prefer and why?

8.1. We welcome both the certainty that a specific implementation date of 1 January 2015 brings and the ASB's undertaking that there will be a minimum of an 18 months transition period between the issuing of standards and the implementation of new UK-Irish GAAP. We also welcome the provision that early adoption by entities covered by a PBE SORP will not be permitted until the relevant PBE SORP has been developed in accordance with the new standards.

8.2. The future of the FRSSE is important to the charity sector as 99% of charities are eligible to use the FRSSE. The research carried out for the Charities SORP Committee (reported in December 2010) found that overall 30% of charities eligible to use the FRSSE currently opt to use the FRSSE.

8.3. The next Charities SORP will seek to address the needs of all charities whether they adopt the FRSSE or FRS 102. We are aware that new EU accounting directives that will apply to both small and micro-entities may result in the development of a revised FRSSE. We also note that a further consultation is planned on options for the FRSSE's future development.

8.4. We appreciate that the timing of any revision to the FRSSE is dependent on the adoption of new EU accounting directives into UK law. However, there would be distinct advantages in co-ordinatinating changes to UK standards if at all possible so that the implementation dates of the new FRSSE and FRS 102 were the same. As you will appreciate, a revision of the FRSSE would result in a need for changes to be made to the Charities SORP and possibly charity law regulations. Such changes would be problematic and may be seen by the charity sector as very disruptive if they were to follow shortly after the publication of a new SORP in 2014/15.

9. <u>Alternative view</u>

Q9: Do you support the alternative view, or any individual aspect of it?

9.1. We do not agree with the alternative view that the primary objective of accounts is going concern with stewardship as a secondary consideration. Stewardship reporting has particular importance in the context of financial reporting by charities. Research conducted by IPSOS MORI for the Charity Commission in 2010 found that '96% (of respondents) say it is important to them that charities provide information about how they spend their money' and '89% also say that it is important to them that charities explain in a published report what they have actually achieved.' Nor do we see the FRSSE, FRS 101 and FRS 102 being inconsistent with providing information in accessible format.

9.2. However we do agree with the alternative view that when reviewing the FRSSE, FRS 101 and FRS 102 the ASB should aim to further remove unnecessary complexity and clutter by aiming to reduce the number of disclosures required.

9.3. For example, the opportunity could be taken now to remove the disclosure requirements relating to mergers PBE34.87 (c) and (d) which require considerable analysis of limited benefit to the users of the accounts. We also agree that the reporting of defined benefit pension schemes includes extensive and detailed disclosures that is of limited value and often not understood by the user of charity accounts. Also the requirement to disclose unrecognised commitments (34.61) appears to require unnecessary details since such items are not commitments as they are not legal or constructive obligations but represent future intentions and not transactions.

9.4. Preparers might also be encouraged to avoid immaterial disclosures with a reference to materiality being added to paragraph 8.1 of FRS 102 to state that 'notes provide narrative descriptions or disaggregations of *material* items presented'.

9.5. We would welcome a full review of the disclosure requirement of UK GAAP to ensure that disclosure requirement are set in the context of an agenda of eliminating unnecessary complexity and cutting clutter. However, we would not wish to see further delay in the introduction of a new framework or until such time as the IASB has completed and published its review of the IFRS for SMEs.