

Consultation response:

Accounting standards for small entities: Implementation of the EU Accounting Directive

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1. About Charity Finance Group (CFG)

- 1.1 Charity Finance Group (CFG) seeks to inspire the development of a financially confident, dynamic and trustworthy charity sector. CFG promotes best practice and works to improve standards in financial management and reporting across the sector. We also have a role in ensuring an effective and proportionate regulatory system for charities of all sizes. CFG engages with finance professionals to enable them to give the essential leadership on finance strategy and management that their charities need; promoting best practice in charity finance, driving up standards, campaigning for a better operating environment and ensuring every pound given to charity works harder and that the trust of charity donors is maintained. CFG has more than 2,200 members, all senior finance professionals working in the sector and collectively our members are responsible for the management of over £19 billion in charitable funds.
- 1.2 CFG welcomes the opportunity to comment on the consultation paper *'Accounting standards for small entities: Implementation of the EU Accounting Directive'* published by the Financial Reporting Council on 1 September 2014.

2. About our response and key issues

- 2.1 We support the FRC's proposal to bring small companies and other entities into the FRS 102 framework and to issue a separate accounting standard for micro-entities. There are significant advantages in achieving consistency in the 'recognition and measurements' bases used by entities of all sizes with appropriate accounting and disclosure exemptions for small and micro-entities. This approach will enhance consistency and comparability and allow charities, as they grow, to move with greater ease between the reduced disclosure framework of FRS 102 to the full disclosure requirements of that standard.
- 2.2 However, it is important to note that the Recital 5 to the EU Accounting Directive specifically excludes not-for-profit undertakings from its scope. The proposed revision of FRS 102 for small entities needs to be transparent on this point and provide a clear statement as to the ongoing role of the Charities SORP in relation to identifying approaches to presentation and disclosures that are relevant in the context of charity reporting.
- 2.3 It is also important to note that charitable companies are currently precluded by company law from adopting the micro-entity framework and therefore the micro-entity standard that is proposed. Whilst there are good reasons for this exclusion stemming from the need for greater accountability within the charity sector, this issue could be overcome with a relatively simple modification to the legal framework as it applies to charities. The EU Accounting Directive does not apply to charities and therefore the micro-entity framework provided in company law could be modified to meet the need for greater accountability from charities. We appreciate that the requirements of company law are not within the remit of the FRC but it is important that the FRC are aware of the flexibilities available as a result of charities and other not-for-profit entities being outside the scope of the EU Accounting Directive and to remain mindful of the opportunities given by this exclusion in their on-going liaison with BIS.

CFG Response to the consultation

QUESTION 1

Do you agree with the proposal to develop a new accounting standard, the Financial Reporting Standard for Micro-entities (FRSME), for entities taking advantage of the micro-entities regime (see paragraph 2.4 of the consultation)? If not, why not?

- 3.1 We agree that there is a need for accounting standards to set out the 'recognition and measurement' bases applicable to micro-entities and therefore support the development of this new accounting standard.
- 3.2 As the micro-entity regime provided by company law does not currently apply to charities or to parent entities that choose to prepare consolidated accounts and their subsidiaries, it will be important for this fact to be clearly stated in the proposed standard. Charities may also prepare consolidated accounts under the provisions of charity law in the UK and it will therefore be important that there is clarity that charities, however constituted, and their subsidiary companies, are scoped out of the proposed Financial Reporting Standard for Micro-entities (FRSME).
- 3.3
- 3.4 However, as highlighted in our introductory remarks, the micro-entity framework could be made suitable for micro-entity charitable companies with relatively simple modifications to the legal framework as it applies to charities. The EU Accounting Directive does not apply to charities and therefore the micro-entity framework provided in company law could be modified to meet the need for greater accountability from charities for example by allowing for additional note disclosures and alternative formats which could be specified in relevant SORP.

Question 2

Do you agree with the proposed recognition and measurement simplifications that are being considered for the FRSME (see paragraph 2.6(b) of the consultation)? If not, why not? Are there any further areas where you consider simplifications could be proposed for micro-entities?

- 3.5 Whilst we have some concerns that relevant note disclosures will not be made in relation to certain assets and liabilities not recognised in simplified accounts, such as post-employment benefit pension schemes and certain financial instruments, we are in general agreement with the proposed simplifications. As highlighted in our response to question 1 of your consultation, it is vital that there is absolute clarity that the FRSME does not currently apply to charities however they are constituted.

Question 3

The accounting standard that is applicable to small entities (not just small companies) (i.e. currently the FRSSE) is being revised following changes to company law. Company law, which will limit the disclosures that can be made mandatory, may not apply to entities that are not companies. Do you agree that the accounting standard for small entities should continue to be applicable to all entities meeting the relevant criteria, not just companies? This will have the effect of reducing the number of mandatory

disclosures for all small entities, not just small companies (see paragraph 3.11). If not, why not?

- 3.6 Yes, we agree that the proposed financial reporting standard for small entities should to be available to all entities that meet the relevant size and other criteria and not just for companies. It is important that a consistent framework applies to charities however establish.
- 3.7 However, it is important to note that the Recital 5 to the EU Accounting Directive specifically excludes not-for-profit undertakings from its scope and to recognise that this exclusion is in line with point (g) of Article 50(2) of the Treaty on the Functioning of the European Union (TFEU). It would therefore be inconsistent with the intentions of the directive and its likely implementation in the UK for the proposed standard to limit the note disclosures provided by a charity. It would therefore, in the context of charities, be incorrect to say that neither the law nor standards may add to the disclosures specified in the directive as stated in the consultation document.
- 3.8 Charities need to report and present information in a way that is relevant to their stakeholders (including donors, beneficiaries and the public). For example, charities need to provide notes to their accounts to explain their charitable and fund-raising activities, the nature of the funds they hold and provide information about private benefits. Charities also adapt the format of their accounts to present their income and expenditure relating to the activities they undertake and the charitable funds they hold. It is vital for accountability and stewardship reporting that this flexibility continues to be available in accounting standards. We appreciate that additional disclosures must be provided to present a 'true and fair' view and therefore would suggest that this fact must also be clearly explained in the proposed standard.
- 3.9 It is also important that the proposed standard makes clear reference to the role of Statements of Recommended Practice (SORPs) so there is absolute clarity as to their on-going application to charities. For example, a statement along the lines of paragraph 5 to 8 of the Application of Financial Reporting Standards (FRS 100) would be particularly helpful in highlighting that SORPs will apply in the circumstances explained in the standard. Similarly, the requirements of charity law will apply when accounts are prepared under that framework and again there is no prohibition on UK law, standards or SORPs specifying additional disclosure requirements for charities. For example there would be advantages in applying the 'PBE' disclosures requirement of section 34 of FRS 102 to charities adopting the proposed standard.
- 3.10 Our preferred approach would be for the proposed standard to apply the mandatory disclosures of the EU Accounting Directive to charities whilst also stating that additional disclosures should be provided where required by a relevant SORP or by the 'PBE' sections of FRS 102.
- 3.11 Without the matters set out above being specifically addressed in the proposed standard there is a significant risk that the level of accountability provided to donor, beneficiaries and the public by charities will be unacceptably diminished.
- 3.12 Subject to these matters being addressed in the proposed standard for small entities, we agree that the standard should continue to be applicable to all entities meeting the relevant criteria, not just companies. In the context of charities that prepare an income and expenditure account, the turnover criteria should also be replaced with a gross income threshold as major sources of income including donations, legacies and certain grants fall outside of the definition of turnover in company law.
- 3.13 Finally, if the small entities standard is to be incorporated as a new section to FRS 102, it will be important for this new section to be given due prominence in the standard and for

this addition to the standard to be clearly identified early in the text to reflect the ‘think small first’ principle.

Question 4

Do you agree that the FRSSE should be withdrawn and small entities should be brought within the scope of FRS 102, so that they apply recognition and measurement requirements that are consistent with larger entities, but with fewer mandatory disclosures (see paragraph 3.15 of the consultation)? If not, are there any areas where you consider there should be recognition and measurement differences for small entities and why?

- 3.14 We agree that the FRSSE should be withdrawn and that consistent bases for recognition and measurement of assets and liabilities should apply. We agree that this is best achieved by bringing small entities within the scope of FRS 102.
- 3.15 In our view, there are significant advantages in applying the same ‘recognition and measurement’ bases to all entities including charities. Clearly, maintaining a FRSSE based on existing UK GAAP is impractical as the underlying standards on which it is based are to be withdrawn and in the longer term a consistent framework for ‘recognition and measurement’ will reduce training costs and allow charities to move between the reduced disclosure framework of FRS 102 and full application of that standard with greater ease. We do have some concerns that small entities may struggle with the use of fair value measurement techniques when accounting for non-basis financial instruments for example interest rate swaps. However, we recognise that that option of addressing this issue through disclosure may be limited by the legal framework. In these circumstances, we believe there is a need for the FRC to provide additional guidance on accounting for more complex financial instruments together with practical examples that will be accessible to smaller entities that may lack technical knowledge or experience in accounting for more complex financial instruments.
- 3.16 As highlighted in our response to question 3 of your consultation, there needs to be clarity that the limitation on placed on accounting disclosures by company law does not apply to charities however constituted. It would be completely inappropriate for the FRC to apply an accounting directive written primarily for owner-managed companies to charities without identifying that additional disclosures can be specified in law, standards or SORPs for charities. The role of SORPs and the specialised section of FRS 102 in identifying additional disclosures should be specifically stated in the proposed standard for clarity.
- 3.17 At present some small charities apply full UK GAAP but do not prepare a cash flow statement, as permitted by ‘FRS 1: Cash Flow Statements’. We note that no similar exemption is available for small entities applying FRS 102. However, this exemption will again be available from 1 January 2016 if a small charity opts to use the reduced disclosure framework of FRS 102. A small charity not wishing to prepare a cash flow would therefore be forced into two consecutive changes as they move from full UK GAAP to the FRSSE 2015, and then to the FRS 102 with reduced disclosures. This position could be avoided if a transitional exemption from preparing a cash flow statement was granted to small charities and other small entities on at least their first application of FRS 102.
- 3.18 We understand that the revision of FRS 102 for small entities may not be available until summer 2015. This will give small charities little time to prepare for the new requirements and will allow very little time for SORP-making bodies to make necessary revisions to applicable SORPs and for necessary amendments to be made to accounting regulations made under the Charities Act 2011. This issue requires careful consideration and liaison with the SORP-making bodies and the Office for Civil Society who is responsible for

making relevant regulations.

Question 5

FRED 50 Draft FRC Abstract 1 – Residential Management Companies’ Financial Statements was issued in August 2013. After considering the comments received, the FRC publicised its intention to roll this project into the work required to implement the new EU Accounting Directive. Do you agree, in principle, with adding a new sub-section to Section 34 Specialised Activities of FRS 102 to address the principles of accounting by residential management companies (RMCs) (see paragraph 3.27)? If not, do you consider this unnecessary, or would you address the issue in an alternative way?

- 3.19 If this issue needs to be addressed within standards then we agree that it is best dealt with in the specialised activities section of FRS 102.
- 3.20 If assets including service charge balances held on trust are to be excluded from the balance sheet of residential management companies, it would be preferable for a linked presentation to be provided in the balance sheet identifying the amounts held on trust with a corresponding liability to leaseholders for such funds as this will provide relevant information to leaseholders.

Question 6

FRS 102 does not currently include all of the disclosures specified in company law. Other than in relation to the new small companies’ regime within FRS 102, it is not proposed that this will change. Do you agree that FRS 102 should not include all the disclosure requirements for medium and large companies from company law (see paragraph 4.6 of the consultation)? If not, why not?

- 3.21 In the longer term, there would be considerable merit in the FRC and BIS discussing the possibility of detailed disclosures being addressed only in accounting standards as is the case where a listed company applies EU-adopted IFRS. An integrated approach that ensured compliance with the standard also resulted in compliance with the law is clearly desirable.
- 3.22 If there no possibility of delegating this matter to standards in the medium term then there is an argument for scheduling such requirement within the relevant sections of FRS 102. However, we appreciate this might need considerable adjustment to the format of the standard and would therefore suggest that this work could better be undertaken as part of the three-yearly review of the standard.

Question 7

Do you agree that, if UK and Irish company law is sufficiently flexible, FRS 101 should be amended to permit the application of the presentation requirements of IAS 1 Presentation of Financial Statements, rather than the formats of the profit and loss account and balance sheet that are otherwise specified in company law (see paragraph 5.4 of the consultation)? Do you agree that this will increase efficiency of financial reporting within groups? If not, why not? Do you foresee any downsides to this approach?

- 3.23 As charities do not prepare their accounts using EU-adopted IFRS, the proposed amendment will have no impact on charities. However, we support the concept that presentational

requirement should consistently apply within a group whenever possible and therefore can see advantages in permitting the individual accounts of group members being presented in the same format as adopted for the preparation of consolidated accounts by the parent entity. If a parent entity is permitted to present its consolidated accounts in line with IAS 1, then we support that format also being available to members of a group when presenting their individual accounts.