The Future of Accounting for 'Public Benefit Entities'

Understanding what new financial reporting standards mean for your organisation

CFDG Briefing Paper 2011

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1.0 Introduction

A new financial reporting framework

In August 2009 the Accounting Standards Board issued the consultation paper 'the future of UK GAAP' which outlined the ASB's intention to converge existing Generally Accepted Accounting Principles in the UK and Ireland (UK GAAP) with EU-adopted International Financial Reporting Standards (IFRS). This would mean that the body of literature making up UK GAAP would cease to be updated and would be superseded by new standards.

At the heart of the proposals was a new three-tiered framework for financial reporting. This was consulted on, along with the specific details of tier 2 (Financial Reporting Standard for Medium-Sized Entities or FRSME) earlier in 2011.

This framework is summarised in the table below:

Tier	**Accounting Regime**	**Details**	**Nature of entity**	**Reduced disclosures for:**
1	EU-adopted IFRS	International financial reporting standards (IFRS)	Publicly accountable	Qualifying subsidiaries
2	FRSME	Based on the IFRS for SMEs	Entities without public accountability and small publicly accountable entities that are prudentially regulated	Qualifying subsidiaries
3	Financial Reporting Standard for Smaller Entities or FRSSE	Existing standard based on the UK GAAP	Smaller entities without public accountability (turnover of less than £6.5 million, balance sheet less than £2.8 million and no more than 50 employees)	

The new framework was due to come into play for accounting periods starting on or after 1st July 2013. However, tentative decisions made by the ASB following the consultation process indicate that the Framework may now change substantially (with the removal of the requirement for publicly accountable entities to follow full-IFRS, and some changes to individual requirements under the FRSME) and that the date will now be pushed back by at least six months to 1st January 2014. This is largely in line with some of the recommendations made in the CFDG response to this consultation.

Under the current proposals, for some time at least, the vast majority of charities will be able to follow the accounting requirements of the FRSSE. They may find that their immediate financial reporting requirements change very little. However, the future plans for the FRSSE are uncertain and existing accounting standards under UK GAAP will no longer be updated and maintained.

It is likely, therefore, that in the future many more organisations will eventually need to adopt accounting standards that are based on international financial reporting requirements. Many organisations may make the choice to trade-up to a higher tier, particularly those that wish to grow. It is also the case that accountants are now only trained to know about international standards. As a result, knowledge and expertise of existing UK GAAP will diminish over time.

UK GAAP, through the sector-specific SORPs, has adapted over the years to the nuances of accounting for not-for-profit organisations. IFRS however, does not adequately deal with many of the issues specific to charities and other public benefit entities. In recognition of this the ASB have produced the ‘Public Benefit Entity Standard’ to sit within the new accounting framework.

What is the PBE Standard?

The PBE Standard (FRSPBE) will be a ‘back-filler’ to the FRSME, in order to allow for the gaps in accounting practice left by the FRSME for organisations such as charities that exist for public benefit. These are specific financial reporting requirements to be applied by PBEs.

The ASB defines a PBE as *“an entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity’s primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members.”*

Financial Reporting Exposure Draft 45 (FRED 45) has been issued to consult on the proposals for a FRS for PBEs. The closing date for this consultation is 31st July 2011.

What about the SORPs?

One of the concerns regarding the new proposals is that the SORPs may no longer act as a ‘one stop shop’ in the same way that they currently do for those sectors that have one. In recognition of the value of sector-specific SORPs, the ASB has confirmed that SORPs for the charity, housing association and higher education sectors will continue to be a key part of their accounting framework.

It is important to ensure that charities are able to interpret the new financial reporting standards. The new Charity SORP will have to take account of the new accounting framework, taking a modular format in order to deal with the requirements of the FRSSE and the FRSME.

The Charity SORP is already being drafted taking into consideration the current proposals of the ASB. A consultation on the new Charity SORP is expected in 2012. Having a Charity SORP in place in good time before convergence to international standards will put the sector in a better position to prepare for the changes.

2.0 Have your say

Most charities use the Charity SORP as the primary guidance document for their financial reporting. Although the new Charity SORP will be subject to a period of consultation, it will have to reflect the requirements of the FRSME, FRSSE and FRSPBE. The underlying standards have the potential to dramatically impact on future charity reporting. This may also have implications for the way that charities operate. **In order to influence this it is essential that charities engage now**.

Charities can contribute to the CFDG submission to the ASB on the FRSPBE by contacting CFDG in response to this briefing paper – **please send comments to CFDG by 12th July 2011**. However, it is also very important that as many charities respond as possible – numbers count! **We therefore encourage charities to put forward their own representations to the ASB**, particularly on specific issues that will have an impact for them.

Responses can be sent to the ASB at asbcommentletters@frc-asb.org.uk, or as a hard copy to:

Joanna Spencer
Accounting Standards Board
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

The closing date is **31st July 2011**.

Section 1, 'Invitation to Comment', of the draft FRSPBE outlines 14 specific questions. General comments can also be made.

When responding:

- Concentrate first and foremost on sound technical reasons as to why a proposed accounting treatment is not appropriate. 'It is too difficult' or 'we have never done it that way' are not persuasive arguments.
- Where issues present practical difficulties, explain in detail the potential impact (wherever possible). For example, the risk of increased auditing costs.
- It is not necessary to respond to every question. If particular areas are more important than others to your organisation, please do respond on them even if you do not have time to comment on the whole document.
- Feed back comments, suggestions and practical examples to CFDG. We will be making a response on behalf of our members.

3.0 The FRSPBE

The FRSPBE, which is being consulted on as FRED 45[1], is part of a wider work programme. Due to time constraints at the ASB, this represents the first version of this. The main provisions in the FRSPBE deal with:

- Incoming resources from non-exchange transactions
- Impairment of assets: Public benefit considerations
- Entity combinations
- Funding commitments
- Concessionary loans
- Property held for the provision of social benefits

There are topics which are not touched on in this first version of the FRSPBE which may be incorporated into a future updated FRSPBE. These areas include narrative reporting, the format of primary financial statements, 'fresh start' accounting (a possible new approach for merger accounting), associates, social benefit obligations and fund accounting (restricted funds etc).

Some sections in the draft FRSPBE contain an appendix. Although this is not technically part of the FRSPBE, it provides important explanatory detail and should be read to gain understanding of the implications of the proposed accounting standard.

This following section looks in more detail at specific aspects of the FRSPBE which are likely to have an impact on the way your organisation reports in the future.

Quick Reference

Do you..?	**See...**
Have charity shops	Section 3.1 p.8
Receive legacy income	Section 3.1 p.10
Have volunteers	Section 3.1 p.10
Hold assets to deliver activities (i.e. buildings)	Section 3.2 p.11
Have an interest in merging	Section 3.3 p.12
Provide funding to other entities	Section 3.4 p.12
Give loans below market rate	Section 3.5 p.13

[1] Full document available here:
http://www.frc.org.uk/images/uploaded/documents/FRED45%20Web%20Optimised.pdf

3.1 Incoming resources from non-exchange transactions

Are you a charity that…?

- **Has charity shops that operate either through your charity or through a trading subsidiary;**
- **Receives donations of cash goods or services;**
- **Receives legacy income;**
- **Makes use of volunteers?**

A non-exchange transaction is defined as, *"a transaction whereby an entity receives value from another entity without directly giving approximately equal value in exchange."*

In a charity context a non-exchange transaction is, in effect, a donation. Donations of cash, goods or services, grants (except government grants) and legacy income are all adressed in the same section of the standard. Unless there are performance conditions attached, the income is to be recognised when goods or services are receivable. This could suggest the current treatment of deferring income when the funder specifies it is to be spent in the future accounting periods will no longer exist, and such income will be recognised in full upon receipt.

An 'entity' can include an individual. However, the donation of services by volunteers is specifically excluded from the requirements for recognition where it is not "possible to reasonably quantify the contribution made".

⇨ **CFDG would like to hear charities' views on the following:**

- **Is the definition of a non-exchange transaction appropriate for charities?**
- **Do you agree with the recognition criteria for non-exchange transactions? For example, should a charity be able to recognise a pledge for a donation from an individual or a company made before its year end but received at a later date, say, before its accounts are signed?**

Donated goods for sale

Arguably the biggest issue in this section arises from the provision that:

"An entity shall measure resources from non-exchange transactions at the fair value of the resources received or receivable."

This applies to donated goods, including those received by charity shops, which are currently not recognised until sold. In the future such goods will need to be valued on receipt, with unsold donated goods valued on the balance sheet as stock.

The ASB assert that it is possible for the value of these goods to be estimated. An example of this would be for charity shops to estimate an average value for each bag of donated goods for sale which they receive. However, this is unlikely to be accurate and has the potential, practically speaking, to be very difficult to do. There may also be a cost associated with stock taking, both internally and from external audit costs.

One option may be for the principle to remain in place, but for charities to only need to provide an indicative value within the Trustees' Report of the value of donated stock along with an explanation, much like some do now with volunteer time. This could give the user of the financial statements similar information at a much lower cost.

Others may believe that the principle itself is wrong, and that goods donated for sale in charity shops have no value until they are sold.

Some charities operate a Gift Aid system within their charity shops, therefore, acting as agents for the seller when they are eligible for Gift Aid and then subsequently claiming the Gift Aid on the proceeds of sale. This would further complicate stock take procedures.

Charities operating shops through non charitable trading subsidiaries would have to adhere to these valuation requirements when consolidating their accounts even though the subsidiary would not value the donated stock. In the subsidiary the donated stock would be valued at the lower of cost and net realisable value, which is virtually nil.

- ⇨ **CFDG would like to hear charity perspectives on the accounting treatment of donated goods, in particular:**
  - **Do members agree with the concept of valuing donated goods at fair value on receipt?**
  - **What are the practical implications of the proposals for charities?**

- ⇨ **CFDG would also like to gather the following information from charities:**
  - **Do you sell stock donated for sale in charity shops through your charity or a non-charitable subsidiary?**

- **Would the value of stock donated for sale in charity shops be material for your organisation?**

- **Can you provide an estimate of the annual costs of valuing stock donated for sale in charity shops? How often do you undertake a stock take? This will help us to develop a stronger case for explaining the impact of the proposals.**

Legacy income

The accounting treatment for legacies has been a topic of debate of late. The current Charity SORP is thought by some to provide very conservative guidance about when legacy income should be recognised.

The FRSPBE states that donations from legacies are *"recognised when there is sufficient certainty that the legacy will be received and its value can be measured with sufficient reliability."* The guidance in the appendix states that these criteria are likely to be met following grant of probate, once the executor(s) of the estate has established that there are sufficient assets in the estate, after settling liabilities, to pay the legacy, although it does not rule out these criteria being met at a later stage.

⇨ **CFDG would like to hear charities view on accounting for legacy income, in particular:**

- **Do you think more guidance is needed on the meaning of 'certainty' and 'reliability' in the context of legacy recognition?**

- **Is probate an appropriate time for legacy recognition and measurement in a charity's accounts?**

- **Do you have examples where the final value received was materially different from probate value? Does this happen often?**

Volunteer time

The FRSPBE states that "*It may not be possible to reasonably quantify the contribution made by volunteers and, where this is the case, those services need not be recognised*". As a result, it would appear that the current prohibition (within the Charity SORP) from ever including volunteer time as income and expenditure in the financial statements may have been lifted.

⇨ **CFDG would like comments from members on valuing volunteer time, in particular:**

- **Would your organisation welcome the option of being able to value volunteer time in the financial statements?**

3.2 Impairment of assets

Are you a charity that…?

- **Holds assets such as buildings which are used in the delivery of activities?**

This section outlines some specific considerations for public benefit entities about impairment of assets. The FRSME requires that assets are impaired if the recoverable amount (higher of fair value less cost to sell and value in use) of the asset is less than the carrying amount. Value in use is normally determined by reference to the discounted cash flows of the assets. However, the FRSPBE allows alternative methods of calculating value in use for public benefit entities, such as depreciated replacement cost. This is in recognition that value in use for many public benefit entities is likely to be linked to service potential rather than generation of cash flows. Where that is the case the FRSME suggests that depreciated replacement cost or other approaches may be used.

Indicators of impairment

PBEs must consider the indicators of impairment outlined in the (draft) FRSME paragraph 27.9(a)-(g). PBEs will also have to consider impairment of service potential of an asset, for example, the cessation of demand for services the asset provides. This could itself present a significant increase in work load, as one of these indicators *is "The carrying value of the net assets of the entity is more than the* ***estimated value of the entity as a whole****"*.

Whilst this is relevant for the commercial sector, trying to determine the estimated value of a PBE as a whole will not produce any reliable figures. If this criterion is not met, PBEs will then have to calculate the depreciated replacement cost of its assets. This may take time and/or money. PBEs will also have to consider impairment of service potential of an asset, for example, the cessation of demand for services the asset provides.

⇨ **CFDG propose responding to the ASB, suggesting the carrying value of net assets in proportion to the fair value of an entity criterion is not appropriate to PBEs. Do you agree?**

3.3 Entity combinations

A significant feature of the FRSPBE is that unlike the FRSME, it recognises that for PBEs there will be circumstances where genuine mergers take place. Section 4 of the draft FRSPBE on entity combinations outlines the accounting treatment for combinations that are mergers and those that are in substance a gift of one entity to another.

Mergers – definition and criteria

"A merger is an entity combination that results in the creation of a new reporting entity formed from the combining parties, in which the controlling parties of the combining entities come together in partnership for the mutual sharing of risks and benefits of the newly formed entity and in which no party to the combination in substance obtains control over any other, or is otherwise seen to be dominant."

The criteria include no party being portrayed as the acquirer or the acquiree; no significant change to the class of beneficiaries or the benefits provided; all parties participate in establishing the management structure of the combined entity. There are no relative size criteria stipulated here in respect of the parties that are merging.

Some organisations may be concerned with the second of these criteria. In some circumstances the rationale for two charities combining their activities may mean a change in the beneficiary group or in the services delivered. This will especially be the case if the entity combination is resulting from a recognised change in service needs of a shared beneficiary group. If these changes were significant then merger accounting would not be permissible.

⇨ **CFDG seek comments from charities on the merger criteria, in particular:**
  - **Is the definition of a merger sufficiently wide?**
  - **If you are a charity which has participated in a merger, would your circumstances meet the criteria as proposed here?**

3.4 Funding Commitments

Are you a charity that…?

- **Provides funding or resources to other entities, perhaps in the form of grants?**

Section 6 of the FRSPBE outlines the accounting treatment of commitments to provide future funding to another entity. This is largely concerned with the time at which a liability should be recognised. The criteria are that the obligation is recognised if the entity *“cannot realistically withdraw from it”* and that there are no performance conditions attached to the funding.

The appendix to section 6 of the draft FRSPBE gives further important information. As well as explaining the meaning of ‘performance-related conditions’ the appendix states that the recipient should have a ‘valid expectation’ of the payment. The liability exists when the *“commitment has been communicated to the recipient.”* It is not clear what degree of communication is necessary for the liability to be recognised.

⇨ **CFDG would like to hear from charities on the following issues in relation to grants:**

- **When do you believe funding commitments such as these should be recognised in the accounts?**
- **Is the guidance provided in the draft FRSPBE sufficient?**
- **Should a multi-year grant commitment usually be accounted for its full term immediately once the commitment is made or should multi-year grant commitments be accounted for in line with the use of the grant by the grantee?**

3.5 Concessionary Loans

Are you a charity that…?

- **Provides loans at a below market rate to beneficiaries or other organisations; this may also include programme-related investments?**

“Concessionary loans are loans made or received between a public benefit entity and a third party at below the prevailing market rate of interest which are not repayable on demand.”

The FRSPBE departs from the FRSME in permitting charities to continue to account for concessionary loans as they do presently, but with new disclosures (using treatment set out in 2.4-2.11 of the draft FRSPBE). The FRSPBE requires that initial measurement to be at the amount received or paid. Subsequently the carrying amount of the concessionary loan should be adjusted to reflect accrued interest. If a loan is irrecoverable it will be recognised as an impairment loss. Concessionary loans should be recorded either as a separate line item on the statement of financial position or in the notes to the financial statements.

The draft FRSPBE states that there is also an option for concessionary loans to be accounted for using section 11 ‘Basic Financial Instruments’ of the draft FRSME (initial measurement at fair value, subsequent measurement at amortised cost). In practice this would mean discounting the loan when it was made and unwinding this discount over the term of the loan. This would involve an initial charge to the Statement of Financial Activities (SoFA) and a credit to the SoFA in subsequent years as the loan approached redemption.

⇨ **If you are a charity which provides concessionary loans, CFDG would like to hear from you, in particular:**

- **Which of the two options would you choose, to account for loans as you do now or at fair value as is required by the FRSME?**

3.6 Property held for the provision of social benefit

This section states that property held for the provision of social benefit (for example social housing) will not be classed as investment property and will instead be classed as property, plant and equipment. The main issue with this for many organisations is that the FRSME does not allow revaluation of property, plant and equipment. This issue was raised by many organisations, including CFDG in their response to the draft FRSME in FRED 44.

4.0 Other issues

Detailed guidance provided in the FRSPBE

The FRSPBE sets out many issues at a high level and so does not always provide a lot of detail of required accounting treatments. This means that the next Charity SORP may have considerable flexibility in the guidance that it provides to charities over accounting matters. The potential problem with this approach is that there may be less consistency than there could be between the different PBE SORPs.

⇨ **Are you happy for the FRSPBE to remain at a high level and leave the detailed guidance to the sector-specific SORPs or would you prefer more specific in the guidance in the FRSPBE itself?**

Costs of the implementing the FRSPBE

The Exposure Draft of the FRSPBE contains an impact assessment that suggests that the cost of implementing the FRSPBE will not be significant for PBEs.

⇨ **Do you think that there are costs involved with implementing the FRSBPE that the ASB have not take account of?**

⇨ **If so, please provide us with an estimate of what these will be for your charity. The costs of accounting for stock donated to charity shops are dealt with separately in this document, so please do not include these costs here.**

Charities that consolidate the activities of other charities

The FRSPBE does not provide specific guidance of what it means for one charity to control another for accounting purposes. It is considered that the indicators of control provided in the FRSME (paragraphs 9.4 – 9.6), are sufficient.

⇨ **Do you think that the FRSPBE should give specific guidance on what it means for one charity to control another for accounting purposes?**

5.0 Useful Links

FRED 45 (draft FRSPBE) full document:

http://www.frc.org.uk/images/uploaded/documents/FRED45%20Web%20Optimised.pdf

FRED 43 & 44 (outline of proposed framework and draft FRSME) full document:

http://www.frc.org.uk/images/uploaded/documents/Part%201%20Web%20Optimized.pdf

BDO briefing paper – The Financial Reporting Standards for Medium-Sized Entities and Public Benefit Entities:

http://static.bdo.uk.com/assets/documents/2011/03/5260_IFRS_Report_2011.pdf

To contact CFDG with responses to any of the questions in this document, or for general information, please email Policy Officer Katherine Smithson at katherine.smithson@cfdg.org.uk