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Dear Jenny Carter

## **THE FUTURE OF FINANCIAL REPORTING IN THE UK AND REPUBLIC OF IRELAND**

### **REVISED FINANCIAL REPORTING EXPOSURE DRAFTS 46 47 & 48**

CIPFA is pleased to provide comments on the proposals in these exposure drafts.

In making this response we also have regard to CIPFA's response to the ASB's earlier consultations on the Future of UK GAAP, FRED 43, *Application Of Financial Reporting Standards*; FRED 44, *Financial Reporting Standard For Medium-Sized Entities*; and FRED 45, *Financial Reporting Standard for Public Benefit Entities*.

The ASB proposals have been reviewed by CIPFA's Accounting and Auditing Standards Panel, and members of specialist panels for the Charity, Further and Higher Education, and Social Housing sectors.

### **ASB development of UK GAAP**

The ASB has been developing its thinking for several years on how UK GAAP might become IFRS based or grounded in IASB derived standards and guidance, or otherwise based on high quality standards developed internationally rather than purely reflecting a UK perspective. The ASB has consulted on a number of proposals that have informed the development of the current Financial Reporting Exposure Drafts.

### **Comments on FRED 43 and 44**

CIPFA generally supported the proposals in these exposure drafts. Key observations included our view that some of the simplifying approaches which the IASB used in developing the IFRS for SMEs would result in both higher costs and less useful financial information when applied to some public benefit entities; and that these approaches were embedded in FRED 44, and if applied to more complex entities would require more work in transition from UK GAAP.

### **Comments on FRED 45**

CIPFA strongly supported the proposals in this exposure draft, whilst raising a number of detailed points where we thought further improvements were required, for example permitting the use of either the cost of valuation model of accounting for property, plant and equipment. We also considered that such changes would be best made in the proposed *Financial Reporting Standard For Medium-Sized Entities* rather than the *Financial Reporting Standard for Public Benefit Entities*.



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## **Comments on FREDs 46, 47 and 48**

CIPFA strongly supports the majority of the proposals in these exposure drafts. Consequently, our responses to the specific questions raised in the consultation only address those questions where we consider that further improvements could be made. In considering where further improvements could be made, we have concentrated on those issues that will be relevant to public benefit entities. Responses to specific questions raised in the exposure drafts are attached at Annex A.

In addition, we have identified three further areas where we consider additional improvements could be made. In considering where further improvements could be made, we have again concentrated on those issues that will be relevant to public benefit entities. Our comments on these areas are attached at Annex B.

Yours sincerely

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## Annex A

### The future of financial reporting in the UK and Republic of Ireland FREDs 46, 47 and 48

#### Responses to specific questions

**Q5: In relation to the proposals for specialist activities, the ASB would welcome views on:**

**(a) Whether and, if so, why the proposals for agriculture 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?**

(a) CIPFA has no comments to make on the proposals for agriculture activities.

(b) CIPFA considers that the proposals for service concession arrangements are sufficient to meet the needs of operators. However, the proposals do not address needs of grantors.

Whilst it is unlikely that public benefit entities reporting under the draft FRS 102 will have any service concession arrangements, it is possible that specific transfer arrangements could result in an academy being party to such an arrangement.

Following the publication of IPSAS 32 *Service Concession Arrangements: Grantor*, which is consistent with the approach taken in the draft FRS, it would be possible to include the grantor's accounting requirements as well as those for the operator.

In addition, although the draft FRS 102 (consistent with IFRS for SMEs and IFRIC 12) is framed in terms of a public – private concession, it is possible that similar private – private arrangements will exist. Requirements in respect of the grantor accounting could be applied by analogy in these circumstances.

The ASB is proposing that an entity shall apply draft FRS 100, and draft FRS 101 or draft FRS 102 where applicable, for accounting periods beginning on or after 1 January 2015. Early application is permitted for accounting periods beginning on or after the date of issue of those standards, subject to the additional requirement for a public benefit entity that it must also apply a public benefit entity SORP which has been developed in accordance with those standards.

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

CIPFA supports the proposed effective date, and the additional requirement for a public benefit entity to apply the appropriate SORP. We would note that all public benefit entity SORPs will need to be developed sufficiently early to allow public benefit entities to implement their requirements.

## Annex B

### The future of financial reporting in the UK and Republic of Ireland FREDs 46, 47 and 48

#### Areas where CIPFA considers additional improvements could be made to draft FRS 102

##### ***A: Accounting for Grants and other Non-Exchange Income***

Section 24 of the draft FRS 102 sets out the requirements for accounting for income from government grants. A government grant is defined in paragraph 24.1 as 'assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity.' This definition of a government grant does not seem to include grants provided unconditionally. Such grants must presumably be treated as donations. **If this is the case, CIPFA considers that this distinction may be confusing to preparers and users of the financial statements alike.**

The draft FRS 102 permits two accounting treatments for recognising income from grants – the performance model and the accrual model.

Under the performance model, grant income is recognised when it becomes receivable unless there is a 'performance condition', in which case income is recognised when the condition is satisfied. This treatment is essentially the same as that required by IFRS for SMEs (and IPSAS 23) **and, subject to some clarifications to the requirements that are discussed later in this response, CIPFA supports the proposals for the performance model.**

Under the accrual model, government grants are classified as either relating to revenue or relating to assets. Grants relating to revenue are recognised as income systematically over the periods in which the entity incurs the related costs for which the grant is intended to compensate. Grants relating to assets are recognised as income systematically over the expected life of the asset. The model is broadly in line with that required under IAS 20, albeit that the IASB recognises that IAS 20 is inconsistent with its conceptual framework.

The accrual model has been introduced in recognition of the fact that entities in the public benefit entity (PBE) sector have often adopted this approach and as a result of comments from respondents. Inclusion of the accrual model is also consistent with the ASB's intention to permit additional treatments that were previously available under UK GAAP and which would be available under full IFRS. **In line with this intention, CIPFA accepts that the accrual model is a pragmatic approach that may often be justified on cost-benefit grounds.**

However, the accrual model will result in the recognition in the statement of financial position of deferred income as a liability. This is inconsistent with the Concepts and Pervasive Principles section of the draft FRS 102, as deferred income does not meet the definition of a liability in paragraph 2.15:

'A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.'

As such, paragraph 2.45 would prohibit an entity from recognising deferred income:

'This [draft] FRS does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or of liabilities regardless of whether they result from applying the notion commonly referred to as the 'matching concept' for measuring profit or loss.'

**CIPFA recommends that the Concepts and Pervasive Principles section of the draft FRS 102 is amended to avoid the inconsistency with the accrual model. Our preferred approach would be to include additional text to acknowledge that the FRS may require recognition of elements that do not meet the definitions in the FRS, as a result of permitting treatments contained within older IASB standards. Ideally this should be an interim measure, with future developments of the FRS removing accounting treatments that are not principles based.**

Requirements in respect of income from other non exchange transactions are set out in paragraphs PBE34.62 – PBE34.72 of section 34 Specialised Activities of the draft FRS 102.

Paragraph PBE34.64 states that the definition of non-exchange transactions includes donations of cash. This could therefore lead to a potential uncertainty as to which transactions should be accounted for as grants and which should be accounted for as donations. This uncertainty is exacerbated by two additional factors:

- Whilst paragraph 24.1 provides a definition of **government** grants, it also states that 'This section specifies the accounting for all grants by **government and others**' (my emphasis). The equivalent provisions of IFRS for SMEs, on which the requirements are based, only apply to government grants.
- The recognition model for non-exchange income within section 34 is essentially the same as the performance model for grants; as such the requirements address the possibility of conditional donations of cash.

It is possible that the reference to 'government and others' in paragraph 24.1 is only intended to cover government and quasi-government organisations (such as the EU); this scope would be broadly in line with the narrow scope of IAS 20. However, if the intention was that the scope of section 24 should only cover grants from governments, it is not clear why the definition of a government grant needs to exclude unconditional grants.

We would also note that there has long been a view in the PBE sector that there is no distinction between a grant and a donation – particularly when it comes to accounting.

**CIPFA therefore considers that there are two options for the ASB to consider. If the ASB wishes to maintain separate accounting requirements, we would recommend removing the words 'and others' from paragraph 24.1 of the draft FRS 102, to provide clarity for preparers. We would also recommend that the definition of government grants is amended to remove the exclusion of unconditional grants from government.**

**Alternatively, given that the economic substance of a grant or donation is the same irrespective of the donor, the same accounting treatment could be applied to both grants and other non-exchange income. This would be CIPFA's preferred option. Given our comments on the accrual model above, we consider that, at least initially, any common accounting treatment would need to permit both the performance and accrual models.**

FRED 48 (in the glossary) defines a restriction as 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.’ Paragraph PBE34.66 of the draft FRS states that:

‘The existence of a restriction does not prohibit a resource from being recognised in income when receivable.’

Some commentators in the charity sector have expressed concern that the definition of a restriction in the FRED may be inconsistent with the requirements of charity and trust law in respect of restricted income.

CIPFA considers it likely that the term restriction was not intended by the ASB to refer to restricted income as defined in charity and trust law. The term does not appear in IFRS for SMEs in this context, and it would appear that, in seeking to provide additional guidance on conditions, the ASB has imported terminology from IPSAS 23.

It is clear that the use of the term ‘restriction’ may cause confusion for preparers, particularly in the charity sector. In addition, the draft FRS 102 uses the term ‘restriction’ a number of times in its natural sense but only once (in paragraph PBE34.66) as defined in the glossary. **CIPFA therefore recommends that paragraph PBE34.66 is redrafted to avoid the use of the term ‘restriction’ and that the glossary entry is removed accordingly.**

Concern over restricted income is being exacerbated in some cases by a reading of the draft FRS 102 that suggests that income cannot be recognised whilst there is a possibility of repayment. CIPFA does not consider that this is the intended outcome of the draft FRS 102, but the concern being expressed by some preparers suggests that further clarification of the circumstances in which income can, and cannot, be recognised would be helpful.

Paragraph PBE34.69 of the draft FRS 102 states that:

‘An entity shall recognise a liability for any resource with specified performance conditions that becomes repayable due to non-compliance with the performance conditions, when that repayment becomes probable.’

This suggests a different type of performance condition than that set out in paragraph PBE34.65 of the draft FRS 102, which states:

‘transactions that do impose specified future performance conditions on the recipient are recognised in income only when the performance conditions are met.’

CIPFA’s understanding of these paragraphs is that there are two types of performance condition being referred to in the draft FRS

- Performance conditions that prevent initial recognition of income, as until these conditions are met the PBE would not have unconditional control of the income.
- Performance conditions that do not prevent initial recognition of income, as a breach of a condition requiring repayment will only arise on the occurrence or non-occurrence of a specified future event.

**CIPFA recommends that the glossary entry for ‘performance condition’ is extended based on the two bullet points above, to provide additional guidance for preparers.**

## ***B: Non-Exchange Income – Measurement Issues***

Paragraph PBE34.71 of the draft FRS 102 requires PBEs to 'measure resources from non-exchange transactions at the fair value of the resources received or receivable.' There are no complications where the resources are in the form of cash; but difficulties can arise when measuring the value of goods, services and assets received.

The guidance on this requirement (which is an integral part of the draft standard) is set out in paragraph PBE34B.15, which states that '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.'

It is clear from paragraph 10.31 of Part 3 Development of the FRS and Impact Assessment that fair value is intended to be the open market value for the goods, services or assets, not the value to the PBE (which might be lower, for example where premises are made available that are larger than the PBE would otherwise require).

In this paragraph, the ASB noted:

'Being able to achieve the same service potential from a lower value asset might suggest that the value of the donated asset should be at the lower value. However, FRED 48 requires donated assets to be valued at their fair value. This reflects that the circumstances described above would rarely occur. In many cases, an entity would be able to sell the donated asset and if appropriate, purchase a cheaper asset with the equivalent service potential.'

Some commentators have expressed the view that the circumstances are not as unusual as the ASB seems to think. They have also noted that in many cases (such as donated medical supplies), the PBE would not be permitted to sell the item. Whilst CIPFA does not have any quantitative evidence regarding the frequency with which such circumstances will occur, anecdotal evidence does suggest that there will be occasions when charities in particular receive goods or services that will have a value to the donor that is significantly higher than the value to the entity. One example would be where a pharmaceutical company provides brand-name drugs to a medical charity; the value of the brand-name drug could be many times that of its generic equivalent, which the charity would otherwise have purchased.

This fair value approach being taken in the FRED reflects the general focus in the draft FRS 102 (and the underlying IFRS for SMEs) on profit-making entities, as is demonstrated by the definition in paragraph 2.17 of an asset in terms of 'its potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity'; there is no discussion of service potential.

However, the draft FRS does recognise that there may be occasions where service potential is relevant; for example, there is a separate definition (in the glossary) of 'value in use (in respect of assets held for their service potential)'.

**CIPFA considers that there will be occasions where use of the value to the entity model would provide more useful information (for both preparers and users of public benefit entity financial statements) than the fair value model. We would therefore recommend that paragraph PBE34.71 and the guidance in paragraph PBE34B.15 be amended to permit the use of the value to the entity model where donated goods, services and assets are held or used for their service potential, and where resale is either not permitted or not practical. The appropriateness of the value to the entity model would also need to be reflected in the Concepts and Pervasive Principles section of the draft FRS 102.**

## **C: Funding Commitments**

FRED 48 notes that entities 'often make commitments to provide cash or other resources to other entities. In such a case, it is necessary to determine whether the commitment should be recognised as a liability. The definition of a liability requires that there be a present obligation, and not merely an expectation of a future outflow.'

This suggests that the usual approach to recognising and measuring liabilities should be used when assessing whether to recognise a funding commitment. Paragraphs 34.55 – 34.61 of the draft FRS 102 set out the accounting requirements in respect of funding commitments, which CIPFA considers to be consistent with the general principles applicable to accounting for liabilities.

FRED 48 also provides additional guidance in Appendix I to section 34. Commentators have expressed concern that part of this guidance may go beyond the general principles applicable to accounting for liabilities. Paragraph 34A.2 states:

'A general statement that the entity intends to provide resources to certain classes of potential beneficiaries in accordance with its objectives does not in itself give rise to a liability, as the entity may amend or withdraw its policy, and potential beneficiaries do not have the ability to insist on their fulfilment. 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.'

Whilst CIPFA would agree that a general statement could not give rise to a liability, is not clear that a promise to provide cash conditional on the receipt of future income should not give rise to a liability. For example, the promise may have been communicated to the potential recipient in a grant agreement letter covering more than one year, and created a valid expectation that funding will be provided. It may also be the case that, notwithstanding the condition regarding receipt of future income, settlement of the commitment is highly probable; this could arise where the receipt of future income was itself almost certain.

As such, there may be cases where the guidance provided in Appendix I of the draft FRS 102 is inconsistent with the Concepts and Pervasive Principles section of the draft FRS 102. This could result in SORPs being drafted that were inconsistent with part of the draft FRS 102, a situation CIPFA would not wish to see arise.

**CIPFA would therefore recommend that the final sentence of paragraph 34A.2 be removed to ensure consistency with the Concepts and Pervasive Principles section of the draft FRS 102.**