



# HM TREASURY

## Financial Reporting Advisory Board Paper

### EXPOSURE DRAFT ON THE STATEMENT OF PRINCIPLES FOR PUBLIC BENEFIT ENTITIES – NOTIONAL TRANSACTIONS

<b>Issue:</b>	Consideration of the proposals in the Exposure Draft (ED) on the <i>Statement of Principles for Public Benefit Entities</i> regarding the accounting treatment of <b>Notional Transactions</b> .
<b>Impact on guidance:</b>	None
<b>UK GAAP adaptation?</b>	Yes
<b>IAS/IFRS compliant?</b>	N/A
<b>IPSAS compliant?</b>	N/A
<b>Recommendation:</b>	The FRAB is invited to consider the points made in the paper and to comment on the proposal.
<b>Timing:</b>	N/A

## DETAIL

### Background

1. The ASB issued an exposure draft on the *Statement of Principles for Public Benefit Entities* in July 2005. Paragraph 47 of the ED relates to notional transactions and notes that if neither a transaction nor an event has occurred there will be no change in the reporting entity's assets and liabilities and consequently no gain or loss to recognise in financial statements.
2. This conclusion is based on discussion at Chapter 5 of the ED of the general principles and the recognition process applying to financial statements.

## **Recognition process**

3. The recognition process requires that all events that may have an effect on elements of the financial statements are, as far as is possible, identified and reflected in an appropriate manner in the financial statements.

4. The ED notes that whilst transactions are the most common form of such events, and therefore the most common reason for recognising and derecognising items, events other than transactions may nevertheless also result in the recognition or derecognition of items.

## **The effect of transactions and other events**

5. The starting point for the recognition process is the effect that the transaction or other event involved has had on the reporting entity's assets and liabilities. The interrelationship between the elements means that the recognition of one item as an element will inevitably result in the recognition of, or change in, another element. Therefore, for example, if a new asset is recognised, there will also be recognised a decrease in another asset, a new asset, a new or increased liability, a gain, or a contribution from owners (or a combination of these).

## **ED conclusion**

6. The proposed Interpretation concludes (and effectively defines) that a notional transaction is where there is no change to a reporting entity's assets and liabilities, and consequently there is no gain or loss to recognise in financial statements, due to a non-occurrence of a transaction or event.

## **Responses from commentators**

7. Departments, agencies, trading funds and NDPBs were asked to comment on whether they agreed with the conclusion reached within the Interpretation. Responses generally indicated that they agreed the rationale set out in the ED and were in agreement with the conclusion reached. However, specific points raised were:

- The NAO recognised that there are good economic and incentivisation arguments for retaining the cost of capital charge and believed these arguments could be equally applied to other notionals such as the audit fee;
- DWP thought that the omission of notional audit fees from financial statements may be misleading to the readers of the accounts;
- DEFRA were concerned that if any substantial item were not declared it would give a false view of the organisation's effectiveness – in some cases the recognition of notional costs, such as the audit fee, may be a significant factor in the setting of fees and charges;
- MOD viewed the conclusion on notional transactions as non-contentious and unlikely to have a material effect on the accounts of most public sector bodies – providing this did not include the cost of capital charge;
- DCA was not convinced that notional audit fees would be excluded as the section in the Interpretation dealing with voluntary services (which specifically includes professional services) states that '.....Those services that would otherwise have been purchased should

be recognised in the financial statements based on their value to the recipient (providing it can be reliably measured).’

Board members are requested to note that the cost of capital charge is subject to a separate FRAB paper, to be presented at the FRAB meeting on 7 February 2006, and is not considered further in this paper.

### **Voluntary Gifts/Services**

8. FRAB (76)06B(ii) considers that section of the ED dealing with Voluntary Gifts, which includes the receipt of voluntary services, including those professional services received by a reporting entity at a reduced fee or free of charge.

9. An example of such professional services is the audit service received free of charge by a reporting entity, which currently includes a notional audit fee within its financial statements in accordance with the FReM, although the actual cost of the services is borne elsewhere within the Exchequer.

10. In determining the appropriate accounting treatment for voluntary professional services FRAB (76)06B(ii) concludes that such notional costs, which are an allocation of costs borne elsewhere within the Exchequer, fall within the definition of notional transactions in the ED, and therefore in principle should not be recognised in departmental resource accounts or accounts prepared by other entities covered by the FReM.

### **Proposal**

11. There is agreement in principle to the conclusion reached in the ED on notional transactions in that in such transactions where there is no change in a reporting entity’s assets and liabilities, there will be no gain or loss to recognise in financial statements.

12. However, when considering the objective of public sector financial statements and the information requirements for the users of such statements, there are several factors which argue for the continued inclusion of notional costs within financial statements, excluding the cost of capital charge for the purposes of this paper.

13. Transparency of full costs. Notional costs within financial statements provides transparency on the full cost of resource usage by the reporting entity in delivering its objectives. It informs stakeholders and users of the financial statements accordingly. Not to include such costs in financial statements could lead to accusations of understating the true cost of operating a government entity.

14. Recovery of full costs. Fees and Charges policy requires the recovery of full costs (including notional costs) by an entity when setting its fees or charges for a service provided.

15. Resource budgeting implications. Resource budgeting involves using the information in resource accounts as the basis for planning and controlling public expenditure. The exclusion of notional costs from the financial statements would result in a divergence between resource accounting and budgeting.

16. For the reasons given it is proposed that notional costs continue to be included within financial statements.

**UK GAAP compliance**

17. The proposal is not UK GAAP compliant.

**IAS/IFRS compliance**

18. Not applicable.

**IPSAS compliance**

19. Not applicable.

**Impact of amendment on Department Yellow**

20. No amendments to Department Yellow are proposed.

**Summary and recommendation**

21. This paper summarises the proposals in the ED *Statement of Principles for Public Benefit Entities* in respect of **Notional Transactions**.

22. There is agreement in principle to the conclusion reached in the ED on notional transactions in that in such transactions where there is no change in a reporting entity's assets and liabilities, there will be no gain or loss to recognise in financial statements.

23. However, there are specific factors, detailed at paragraphs 12 to 15, which argue for the continued inclusion of notional costs within financial statements.

24. The FRAB is invited to comment.

CA TEAM

28 November 2005