



HM TREASURY

Financial Reporting Advisory Board Paper

EXPOSURE DRAFT ON THE STATEMENT OF PRINCIPLES FOR PUBLIC BENEFIT ENTITIES – LIABILITIES: COMMITMENTS TO PROVIDE PUBLIC BENEFITS

Issue:	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 Liabilities: commitments to provide public benefits
Impact on guidance:	None
UK GAAP adaptation?	N/A
IAS/IFRS compliant?	N/A
IPSAS compliant?	No
Recommendation:	The FRAB is invited to consider the points made in the paper and to comment accordingly.
Timing:	N/A

DETAIL

Background

1. The ASB issued an exposure draft on the *Statement of Principles for Public Benefit Entities* in July 2005. Its proposals in respect of commitments to provide public benefits are contained in paragraphs 4.32 to 4.44, with a further explanation in the Preface, paragraphs 33 to 41.

ED proposals

2. The ED focuses initially on the main definition of liabilities, and its explanation, which applies to all liabilities. This is followed by its interpretation in the context of commitments to provide public benefits, classified into the following separate categories for discussion purposes:

- a. General commitments to provide public benefits;
- b. Specific commitments to provide public benefits; separated into:
 - (i). Contracts;
 - (ii). Performance-related grants;
 - (iii). Other specific commitments to provide public benefits.

General commitments to provide public benefits

3. These are general or policy statements of intention, that the entity stands ready to provide goods or services to certain classes of potential beneficiaries in accordance with its objectives. As a principle, these general commitments would not create a liability for the reporting entity because they do not of themselves create an expectation such that the entity cannot withdraw, or amend the terms.

4. General commitments are expected to include political commitments made by governments, e.g. the announcement of a forthcoming new initiative to provide cash benefits to members of the public meeting certain criteria. Political commitments are different from commercial contracts, and whether express or implied, are political promises, e.g. the general promises to provide healthcare or education. Government make, and amend, such promises and policies as part of their ongoing political processes to manage the economy and redistribute wealth within or between periods and generations. As such they should not be viewed as constructive obligations.

Specific commitments to provide public public benefits

Contracts

5. Contracts are expected to provide an exchange of goods or services of approximately equal value between a seller and a purchaser. This would include employment contracts where they form part of a scheme to provide public benefits. In formal contractual arrangements it is usually relatively straightforward to determine whether an entity is not free to avoid an outflow of resources.

Performance-related grants

6. Performance-related grants are regarded as analogous to contracts. These grants, payable (or receivable) by public benefit entities, have the characteristics of a contract, where for example, the grantee provides a service to, or on behalf of, the grantor over a specified period of time and/or a specified amount of grant is receivable per unit of output. An example is an agreement to provide a fixed grant per person per meal served in order to finance a meals-on-wheels service over a five-year period. Such grants have the substance of contracts and therefore should be accounted for as such.

Other specific commitments to provide public benefits

7. This would include a specific commitment, or promise, to provide specified goods or services to a beneficiary, even though it may be subject to conditions. This category would include grants that are not performance-related and is likely to include most benefits provided directly to individuals.

8. Where a public benefit entity is providing goods or services to its beneficiaries in pursuance of its objectives (regardless of being free or subsidised), the obligation to any particular recipient can be

thought of as initially an executory contract (in which the provision of goods or services is balanced by the achievement of objectives). No liability arises in respect of such activity until the stipulated delivery date for the goods and services, since the achievement of objectives and the provision of goods and services are simultaneous.

9. For a grant (or other payment) that is not performance-related, there may still be an element of 'performance' by the recipient, which should govern the recognition of a liability (and a loss/expense) by the donor entity.

10. If a public benefit entity offers a conditional payment and retains ultimate discretion to determine whether or not the grantee has met the original objectives for receiving the grant, then until that decision is made one of the remaining events is under the entity's control (unless other factors make it impossible for the entity to withdraw, the entity has no liability prior to the decision being made). As this is an executory arrangement, the fact that it is simply more likely than not that the payment will ultimately be made (because it is more likely than not that the grantee will meet the objectives of the grant), does not automatically lead to the recognition of a liability when the arrangement is agreed, because no 'performance' has yet been undertaken by the recipient.

11. There may be circumstances in which a reporting entity is acting as an agent for another entity, where for example, cash has been received by the entity to be passed on to persons meeting certain specific criteria specified by the other entity. Depending on the nature of the arrangement it is possible that a liability should be recognised to match the receipt of the cash prior to its dispersal. Such a liability would represent an obligation to the entity providing the cash, not to the ultimate recipient.

ED Questions

12. The ED invited general comments, but specifically sought comments on the following questions:

- a. Do you agree with the discussion of liabilities in the context of 'commitments to provide public benefits'?
- b. Do you agree that performance-related grants are analogous to contracts? If not, why not?
- c. Do you agree that, for non-performance related commitments (similarly to assets), benefits can be obtained by achieving an entity's objectives such that a commitment to provide public sector benefits will have the substance of an executory contract and liabilities will not usually arise until the transfer of resources becomes due? If not, why not?
- d. Do you believe that there are any circumstances where an entity has entered into a commitment in furtherance of its objectives, but nevertheless a liability has been created when the commitment was given? If so, please describe the circumstances of such a liability?

Responses from commentators

13. Departments, agencies, trading funds and NDPBs were asked to comment on the proposals in the ED. There were disappointingly few responses, and they are at Annex A.

14. Responses, with the exception of the NAO, generally indicated agreement with the discussion of liabilities in the ED, and some indicated agreement with the questions posed on performance-related grants and non-performance related commitments.

15. The NAO takes a different view that the Interpretation on commitments to provide public benefits is flawed, particularly in its attempt to straightjacket such commitments within contractual concepts. The approach is viewed as inconsistent with FRS 12 and particularly the concept of constructive obligations. In effect, the Interpretation is viewed as attempting to scope out public benefits from FRS 12.

Treasury view

16. The responses received from commentators may in some cases generally suggest a less than fully understood appreciation of the potential impact of the Interpretation related to the proposals put forward on liabilities. For the reasons given, the NAO takes a clear view that the Interpretation is flawed, and we would not disagree with this conclusion.

17. The ED rightly acknowledges that the identification of the point at which a liability arises can be difficult for public benefit entities, due to many commitments not stemming from contractual arrangements.

18. Whilst agreeing in principle the view that general or policy statements of intention to provide public benefits would not create a liability for the reporting entity, it nevertheless remains that a careful application of FRS 5/FRS 12 principles needs to be applied in determining whether a liability would exist in specific circumstances. The difficulty in identifying the point at which a liability may arise is well illustrated in the Preface of the ED by the example of the 'old age pension', where the promise to pay an old-age pension is regarded as a general commitment that does not give rise to a liability until payment becomes due. This contrasts with the IPSASB view that in order for a liability to be recognised a pensioner must meet eligibility criteria, including staying alive, until each payment date is reached. It follows that alternate views of the point at which a liability should be recognised are clearly possible, and consequently the conclusion drawn in the ED appears somewhat premature and lacks clarity. It is viewed that further and more in-depth consideration and discussion is required on the type and nature of public sector commitments and the circumstances leading to whether or when a commitment could give rise to a liability, taking into account any developments in the work conducted by IPSASB.

IPSAS compliance

19. The ED takes a different approach to IPSASB on the principles underlying liability recognition.

Summary and recommendation

20. This paper summarises the proposals in the ED *Statement of Principles for Public Benefit Entities* in respect of the accounting treatment of **Liabilities: commitments to provide public benefits**.

21. Responses from departments etc, with the exception of the NAO, generally indicated agreement with the discussion of liabilities in the ED, and some indicated agreement with the questions posed on performance-related grants and non-performance related commitments. The NAO takes a clear view that the Interpretation is flawed, and we would not disagree with this conclusion.

22. It is viewed that further and more in-depth consideration and discussion is required on the type and nature of public sector commitments and the circumstances leading to whether or when a commitment could give rise to a liability, taking into account any developments in the work conducted by IPSASB, and that the Interpretation should be re-exposed.

23. The FRAB is invited to comment.

CA TEAM

28 November 2005

SUMMARY OF RESPONSES TO QUESTIONS re LIABILITIES: COMMITMENTS TO PROVIDE PUBLIC BENEFITS

Ser	From	Comment
1	DWP	The department agreed with the discussion of liabilities in the ED.
2	UKHO	No difficulty with any aspect of the discussion of liabilities in the ED – including agreement that performance-related grants are analogous to contracts and the proposed approach for handling non-performance related commitments.
3	MOD	The department agreed the view in the ED on general commitments, performance-related grants and other specific commitments – non performance related.
4	DFPNI – Dept of Education	<p>Did not disagree with the discussion of liabilities in the ED – but believes clearer distinction required between liabilities requiring recognition in financial statements and commitments which require disclosure by way of note to the financial statements.</p> <p>Agreed that performance-related grants are no doubt similar in substance to contracts but believe they require consideration on a case-by-case basis to determine any commitments to which entities may be party.</p> <p>Agreed view in ED on non-performance related commitments.</p>
5	DFPNI – Dept for Regional Development	<p>Largely agree with the discussion of liabilities in the ED.</p> <p>Of the opinion that no liability exists in relation to performance-related grants until an action actually occurs.</p> <p>Agreed view in ED on non-performance related commitments.</p>
6	DCA	As with FRS 12 there is a theoretical sensibility to the proposals in the ED.
7	Welsh Assembly	Do not believe that performance-related grants are analogous to contracts and believe that if treated as such it may impact on competitive tendering arrangements and may have VAT implications.
8	NAO NAO	<p><i>General</i></p> <p>Believe that the Interpretation on commitments to provide public benefits is flawed, particularly in that it attempts to straightjacket such commitments within contractual concepts. This approach seems inconsistent with FRS 12 and particularly the concept of constructive obligations. In effect, the Interpretation is attempting to scope out public benefits from FRS 12.</p>

	<p>NAO</p>	<p><i>Discussion of liabilities</i></p> <p>The approach of the Interpretation seems category bound, attempting to categorise various types of arrangement made by public benefit entity's, and compare them to contractual arrangements. This approach is not particularly helpful. For example, although both performance-related grants, and other specific commitments to provide public benefits (including non-performance related grants), are <i>both</i> regarded as being, in substance executory contracts, the point of recognition of liabilities arising is different.</p> <p>Furthermore some of the discussion seems redundant: para 4.39 of the ED recognises that 'it can be difficult to determine whether grants are performance-related or not' and discusses a research grant that might appear to be non-performance related but has an element of performance. If it were determined that it was indeed a performance related grant, then a liability would arise as performance occurred, although this would <i>depend on the terms of the commitment</i> (para 4.36(b)). If the recognition of the liability depends on the terms of the commitment, why is it necessary to decide whether it is a performance-related or non-performance related grant?</p> <p>In fact para. 4.38 accepts that to the extent that elements of an agreement (in this case, a performance-related grant) are performed, a liability arises, but a liability would not usually arise for any (presumably non-performance related) other elements of the agreement. In other words, for those elements of an agreement that are performance-related, a liability will arise upon performance; for those elements of an agreement that are non-performance related, a liability will arise when transfer of resources becomes due. This is an approach based on the substance of the agreement. There seems little need to add this, unless performance-related and non-performance related elements within the same agreement cannot be identified. The Interpretation does no address this.</p> <p>We would prefer an approach which addressed the substance of an agreement (whether a contract or arrangement, or other commitment). The Interpretation would set out common or usual features of the types of commitments to provide public benefits, relate these to the definition and explanation of liabilities, and thus indicate the appropriate accounting treatment. This might be conveniently be summarised in tabular form. The approach should conform to existing accounting standards – in this case FRS 12.</p> <p>We note that the Interpretation defines 'general commitments to provide public benefits' as 'general or policy statements of intention, that the entity stands ready to provide goods and services..' This echoes the terminology of FRED 39.24 and 39.25 in describing certain unconditional obligations – 'stand ready obligations' which do give rise to recognised liabilities. The use of the term 'stand ready' in describing general commitments, which do not give rise to liabilities, would seem to be at</p>
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	NAO	<p>odds with FRED 39. Again, this could, if FRED 39 is adopted, lead to inconsistency between the Interpretation and FRSs.</p> <p><i>Performance-related grants</i></p> <p>Agree that where performance-related grants have the characteristics of a contract, then they are analogous to a contract and should be accounted for as such. However, given that all other specific commitments to provide public benefits are also executory contracts, this appears superfluous. As already noted, the Interpretation concedes in para 4.36(a) that a liability will arise as performance occurs 'depending on the terms of the commitment'. This suggests that, correctly in our view, the substance of the agreement should determine its accounting treatment, rather than its classification or otherwise as a performance-related grant.</p> <p><i>Non-performance related commitments</i></p> <p>We do not believe that non-performance related commitments have the substance of executory contracts.</p> <p>There are many types of arrangement under which public sector benefits may be provided where no consideration or performance is required of or given by the beneficiary. The Interpretation wishes to get around this problem by equating the 'achievement of objectives' with performance, thus allowing it to regard the arrangement as an executory contract, though one under which the consideration and performance are undertaken by the same party.</p> <p>There seems to be a distinction between the specific commitment by a Public Benefit Entity to provide benefits to particular recipients in pursuance of its objectives (para 4.40), and the commitment to provide benefits to general classes of people or entities as articulated through the objects of the Public Benefit Entity (para 4.32). The degree of particularity required for this distinction is not given, though in neither case would the commitment give rise to a liability under the Interpretation.</p> <p>Where there is a specific commitment on the part of a Public Benefit Entity to transfer out economic benefits, that commitment should be accounted for in accordance with FRS 12. We do not believe it necessary to draw a parallel between such commitments and contracts.</p> <p><i>Commitments in furtherance of objectives</i></p> <p>Given the Interpretation's assertion that Public Benefit Entity's must always operate within their objectives, by definition, any valid commitment made by a Public Benefit Entity to provide benefits must be either a general commitment or an 'other specific commitment', neither of which, as noted above, give rise to liabilities (paras 4.33 and 4.36(b)).</p>
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		We would maintain that such a commitment may give rise under FRS 12 to a liability when the commitment is given.
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