



HM TREASURY

Financial Reporting Advisory Board Paper

Exposure Draft: Statement of Principles for Financial Reporting –
Proposed Interpretation for Public Benefit Entities. General Consultation

Issue:	<p>The results of consultation on the following issues included in the proposed <i>Interpretation</i> and how they affect the FReM:</p> <ul style="list-style-type: none">• Funders and financial supporters as the defining class of user• Definitions of the elements of financial statements• Presentation of residual interest and disclosure of restrictions over assets• Budget reporting.
Impact on guidance:	Proposed amendments for inclusion in the FReM for 2006/07
UK GAAP adaptation?	No
IAS/IFRS compliant?	Yes
IPSAS compliant?	Yes
Impact on budgetary regime?	No
Recommendations:	<p>That the Board:</p> <ul style="list-style-type: none">• Changes the wording in paragraph 2.2.1 of the FReM from 'ownership interest' to 'residual interest'• Consider the alternatives to 'taxpayer equity'• Consider the issue of budget reporting again following publication of the IPSASB Exposure Draft and the results of the House of Commons Scrutiny Unit's consultation.
Timing:	2006/07

DETAIL

Background

1. The ASB issued the *Statement of Principles for Financial Reporting* in December 1999. Although the *Statement* is of relevance to the financial statements of profit-orientated entities in both the private and public sectors, the ASB believes that the principles it sets out have wider application and, in May 2003, issued a discussion paper seeking comments on the application of those principles to public benefit entities. Comments received on the discussion paper have been incorporated into an Exposure Draft *Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities*, issued by the ASB on 11 August 2005. It is available from <http://www.asb.org.uk/asb/press/pub0853.html>.

2. There are a number of proposals in the Exposure Draft and the Treasury has sought the views of RABIG members and departments on how they affect the FReM. This FRAB paper deals with **Funders and financial supporters as the defining class of user, Definitions of the elements of financial statements, Presentation of residual interests and disclosure of restrictions over assets, and Budgetary reporting.**

Funders and financial supporters as the defining class of user

3. Financial reports are focussed on a defining class of user: for profit-making entities, the *Statement* makes the assumption that present and potential investors are the defining class and that by focussing on their interests in preparing financial reports, the common interests of other users will also be met. The *Interpretation* notes that public benefit entities often have no such investors, and that the defining class of user is, therefore, present and potential funders and financial supporters. A financial supporter is one who has made a choice to support the entity; a funder, for example a taxpayer, would not have a choice.

4. Paragraphs 2.2.3 and 2.2.4 of the FReM (see Appendix A) refer to funders and financial supporters and the fact that the general purpose statements produced by some of the entities covered by the requirements of the FReM will meet the needs of that defining class of user. Other entities need to demonstrate accountability to Parliament (and this really refers to government departments) and need to produce some form of statement of parliamentary accountability – and that might be classed as a special purpose financial report.

Results of consultation

5. In light of what is already in the FReM, the consultees agreed that no changes are required to the FReM in respect of the defining class of user.

Recommendation

6. No changes are required to the FReM in respect of the defining class of user.

Definitions of the elements of financial statements

7. The elements of financial statements as set out in the proposed *Interpretation* are assets, liabilities, residual interest, gains, losses, contributions establishing a financial interest in the residual interest, and distributions to holders of a financial interest in the residual interest.

8. Paragraph 2.2.1 of the FReM (see Appendix A) refers to the need for accounts preparers to be familiar with the elements of financial statements as set out in the *Statement of Principles*. It refers to 'ownership interest' and not to 'residual interest'. In practical terms, company balance sheets often refer to 'total shareholders' interest' or 'equity shareholders' funds' as the ownership interest.

9. Residual interest is defined in the proposed *Interpretation* as the amount found by deducting all of the entity's liabilities from all of the entity's assets. Resource accounts refer to this on the balance sheet as 'taxpayers' equity' – a term which has been described as misleading, since it implies that the funds are available for distribution to taxpayers.

Results of consultation

10. On balance, the consultees favour changing the reference in paragraph 2.2.1 from 'ownership interest' to 'residual interest' once the *Interpretation* has been published.

11. The consultation also covered suggestions for an alternative term to the title 'taxpayers equity' in resource accounts balance sheets. Various alternatives have been proposed, they are:

- Government Equity
- National Equity
- Parliamentary Interest
- Public Net Assets
- Represented by

12. The results of the consultation are not conclusive. However, the term 'represented by' is the least confusing and removes the implication that the funds are available for distribution to taxpayers or any individual group.

Recommendation

13. Change the wording in paragraph 2.2.1 of the FReM from 'ownership interest' to 'residual interest' once the *Interpretation* has been published. Consider the alternatives to the title 'taxpayers equity' in resource accounts balance sheets.

Presentation of residual interest and disclosure of restrictions over assets

14. Public benefit entities might have more than one class of residual interest, particularly where there are restricted funds. The Exposure Draft notes that restriction differs from designation, with the latter being management's intention at the balance sheet date to designate parts of the remaining unrestricted funds for use for a particular purpose. Designated funds are generally treated in today's balance sheets (mainly in the third sector) in the same way as restricted funds, and the proposal is that the practice should be outlawed, but that disclosures should be encouraged.

15. Although the present accounting treatment reflects a restriction in residual interest, the substance of the situation is that there will also be restrictions over the use of certain assets. The Exposure Draft proposes that such restrictions should be disclosed.

Results of consultation

16. The consultees agreed that the proposals in this area are likely to affect only charitable non-departmental public bodies (NDPBs), and there seems no reason not to require full compliance (in chapter 7 of the FReM) with the principles outlined in the Exposure Draft. These principles will also provide a coherent framework for a revised Charities Statement of Recommended Practice (SORP) by the Charities SORP Working Group.

Recommendation

17. There should be full compliance (in chapter 7 of the FReM) with the principles outlined in the Exposure Draft.

Budget reporting

18. The Exposure Draft states that comparison against budget might be part of general-purpose financial statements where it would be useful to users. It also notes that the International Public Sector Accounting Standards (IPSAS) Board is due to issue (actually issued on the 11 October) an Exposure Draft on budget reporting, recommending that comparison against budgets should be included in the general-purpose financial statements. The Exposure Draft defines 'budget' as 'legal authorisation'.

19. Departments generally prepare an analysis of outturn against the amounts voted by the relevant Parliament/Assembly. Other entities covered by the FReM (for example, non-departmental public bodies and trading funds) are not required to provide a comparison.

Results of consultation

20. On balance, the consultees agreed that there is no need to change the status quo and the requirements should not be extended to require a budget comparison for all entities covered by the FReM. They also note that there are separate developments to include a reconciliation to the resource budget outturn in a department's Operating Financial Review (OFR), which is the subject of a separate consultation by the House of Commons Scrutiny Unit.

Recommendation

21. Consider this issue again following publication of the IPSAS Board Exposure Draft and the results of the House of Commons Scrutiny Unit's consultation.

UK GAAP compliance

22. These issues do not affect GAAP compliance.

IAS/IFRS compliance

23. These issues do not affect IAS/IFRS compliance.

IPSAS compliance

24. IPSASB has issued an Exposure Draft recommending that comparison against budgets should be included in the general-purpose financial statements. Government Departments are already compliant with these proposals.

Proposed amendment to the Government Financial Reporting Manual

25. The proposed FReM changes resulting from this paper are detailed at Annex A.

Summary and recommendations

Funders and financial supporters as the defining class of user

26. Financial reports are focussed on a defining class of user. For public benefit entities the *Interpretation* defines the class of user as present and potential funders and financial supporters. No changes are proposed to the FReM as it also uses this definition for class of user.

Definitions of the elements of financial statements

27. The *Interpretation* refers to 'residual interest' as one of the elements of financial statements. Paragraph 2.2.1 of the FReM currently refers to 'ownership interest' but the recommendation is to change this wording to 'residual interest' to be consistent with the *Interpretation*.

28. In resource accounts, residual interest is referred to as 'taxpayers equity', although this implies that the funds are available for distribution to taxpayers. Alternatives suggested by consultees include 'Government Equity', 'National Equity', or simply 'Represented by'.

Presentation of residual interest and disclosure of restrictions over assets

29. Public benefit entities may have more than one class of residual interest, particularly where there are restricted funds. This is likely to affect only charitable NDPBs. The Exposure Draft proposes that such restrictions should be disclosed, as does chapter 7 of the FReM, and consultees saw no reason the exempt NDPBs from full compliance with the FReM. These principles will also form the basis of any revisions to the Charities SORP.

Budget reporting

30. The Exposure Draft states that comparison against budget might be part of general-purpose financial statements where it would be useful to users. IPSASB has also issued an Exposure Draft on this subject, and concurs with this view. There are also separate developments to include a reconciliation to the resource budget outturn in a department's OFR, which is the subject of a separate consultation by the House of Commons Scrutiny Unit. Other entities covered by the FReM, such as NDPBs, are not required to provide a comparison to budget and consultees opted to maintain the status quo. The recommendation is to consider this matter further following publication of the IPSASB Exposure Draft and the results of the House of Commons Scrutiny Unit's consultation.

Central Accountancy Team
HM Treasury

TEXT IN THE GOVERNMENT FINANCIAL REPORTING MANUAL RELATING TO THE STATEMENT OF PRINCIPLES

- 2.2.1 The Accounting Standards Board's *Statement of Principles for Financial Reporting* sets out the principles that the ASB believes should underlie the preparation and presentation of general purpose financial statements. The ASB has issued a draft *Interpretation* of these principles for public benefit entities, and the entities covered by this Manual should have regard to the *Statement* and its *Interpretation*. In particular, accounts preparers should be familiar with the principles of:
- relevance, reliability, comparability, understandability and materiality;
 - the elements of financial statements, including assets, liabilities and residual interest;
 - recognition in financial statements, including initial recognition and derecognition;
 - measurement in financial statements; and
 - presentation in financial statements.
- 2.2.2 This Manual refers to these principles in this and subsequent chapters and, where necessary, interprets them for the particular circumstances of the type of entity covered by the Manual.
- 2.2.3 The *Statement* categorises financial information into three broad headings: special purpose financial reports, general purpose financial reports, and other financial information. The *Statement* notes that financial statements do not seek to meet all the information needs of users, and that users will usually need to supplement the information they obtain from the general purpose financial statements (the operating cost statement balance sheet and cash flow statement and supporting notes) with information from other sources. The *Interpretation* notes that this issue is at least as important for public benefit entities, if not more so. The *Interpretation* recognises that there is more than one class of user for a public benefit entity's general purpose financial statements and identifies as the defining class of user its funders and financial supporters.
- 2.2.4 Some of the entities covered by the requirements of this Manual will prepare general purpose financial statements that are sufficient for the needs of their funders and financial supporters. However, for departments that are required by the relevant legislation to demonstrate accountability to Parliament, the financial statements that conform to generally accepted accounting practice (as adapted in the public sector context) do not provide sufficient information. They are required to prepare a statement on parliamentary accountability, which, within the meaning of the *Statement*, can be seen as a special purpose financial report.