

# **Financial Reporting Advisory Board**

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## **From the Chairman**

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The Financial Reporting Advisory Board (the Board) welcomes the publication of the Exposure Draft of the proposed Interpretation for public benefit entities of the Statement of Principles for Financial Reporting. As you know, I wrote to the then Chairman of the Accounting Standards Board noting the importance of this development after the original Discussion Paper was published in May 2003. The Board is well aware that interpreting the principles for public benefit entities is a difficult task and congratulates you, the Committee on Accounting for Public-benefit Entities and the Accounting Standards Board on the work done so far.

2. I apologise that this response arrives slightly after your deadline for comments of 30 November. The first opportunity that the Board had to discuss the proposed Interpretation was at its meeting on 28 November; this response reflects the outcome of those discussions. The Board had some difficulties with the text in certain areas, but believes, if it has understood the meaning correctly, that these difficulties could be removed by slight re-wording.

3. The Board is committed to the application of the principles when discussing with the Treasury proposals for developing accounting standards and policies for those entities that come under the Board's remit. The Government Financial Reporting Manual contains a section on the Statement of Principles. Section 2.2.2 of the Manual notes that the principles are, where necessary, interpreted for the entities covered by the requirements of the Manual. The Board will need to review the interpretations already in the Manual to ensure that they remain relevant once the Interpretation is issued.

4. The Board's detailed responses to the questions in the Invitation to Comment (ITC) are attached. As part of its discussions earlier this week, the Board considered the views expressed by respondents to a Treasury consultation of departments, non-

departmental public bodies and trading funds on the Exposure Draft. This response does not include the detail contained in those responses to the Treasury, but you might like to note that concerns were expressed about the key issues the Board identifies herein.

5. The remainder of this letter considers some of the issues raised in the ITC that are of particular interest to the Board, and comments on other matters in the Exposure Draft that are not the subject of questions on the ITC.

### **Liabilities**

6. Perhaps unsurprisingly, the area in which the Board has most interest is the discussion of liabilities. The question of accounting treatments in relation to the policy obligations of governments is, as the Exposure Draft acknowledges, the subject of an ongoing debate by the International Public Sector Accounting Standards Board (IPSASB). The Board believes that 'liabilities' of governments need to be considered very carefully to determine whether and/or when a liability should be recognised on an entity's balance sheet. The Board broadly supports the conclusions on liabilities as set out in the Exposure Draft, but believes that the text could be developed further in some areas to clarify the meaning behind the proposals.

7. If the Board's reading of the Exposure Draft is right, the Accounting Standards Board is suggesting that the delivery of policy obligations to the beneficiaries of the particular policy can be characterised as analogous to an executory contract: in that the benefit to the recipient is 'matched' by the achievement of an entity's objectives. Put another way, the net outflow of resources in these cases comprises the outflow of economic benefits to the beneficiary offset by an equal inflow, represented by policy delivery, to the public benefit entity. The Board notes, however, that public benefit entities cannot, by law or by virtue of their founding objects, do anything that is not covered by their objectives and questions whether such an interpretation might have the unintentional consequence of removing liabilities from balance sheets, particularly if one is considering how constructive obligations might arise in relation to social policy delivery.

8. The Exposure Draft notes that the Accounting Standards Board believes that the only area in which specific interpretation of the definition of a liability is required relates to commitments to provide public benefits. The Board acknowledges that the Exposure Draft is clear that identifying the point at which such a liability arises can be a difficult area for public benefit entities (Preface, paragraph 34). The Board agrees with the statement (Preface paragraph 36) that a general commitment, being a general or policy statement, does not create a liability. It also believes that a specific commitment will give rise to a liability when the entity can no longer avoid the transfer of resources (Preface paragraph 38). The Board believes the borderline between a general commitment and a specific commitment is not as clear as, perhaps, the Exposure Draft suggests.

9. Paragraph 42 of the Preface states that the Interpretation, following the Statement of Principles, draws a distinction between events within and outside the control of a reporting entity. The Exposure Draft notes that where satisfaction of the eligibility criteria is outside the control of the reporting entity the usual interpretation of the Statement would be that a liability should be recognised. Conversely, therefore, if the reporting entity can control the satisfaction of the eligibility criteria, a liability will not be recognised. The Board believes that this distinction is important, since eligibility is often key to determining whether an external party can receive support (in the form of goods,

services or cash) from a public benefit entity. The Board considers that a discussion about control in this context would be useful in the text of the proposed Interpretation.

10. The Exposure Draft uses the old-age pension as an example in the Preface. This is an area in which the Board has, of course, a keen interest – as it is the Board that will need, in due course, to agree (or otherwise) to the Treasury's proposals for accounting for the state old-age pension. The Board notes the view of the Accounting Standards Board (Preface, paragraph 42) that "for many of the population, the 'promise' to pay an old-age pension is a general commitment that does not give rise to a liability." In its own discussions, Board Members have been divided as to whether the 'promise' to pay a pension gives rise to a liability.

11. The Board's view is that the old-age pension is a good example of the difficulties that public benefit entities face in determining the point at which a liability should be recognised. Taking the definition that "Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events", the Board considers that there are hurdles that need to be successfully negotiated before one can determine whether a liability should be recognised.

12. First, is the promise to undertake a certain social policy an obligation? As the Exposure Draft notes, it is more likely in the case of public benefit entities that any obligation will be constructive rather than legal. For an obligation to be constructive, a decision to transfer economic benefits needs to be coupled with an event that both created a valid expectation that the entity involved would implement the decision and meant that the entity involved could not realistically withdraw from it (Exposure Draft paragraph 4.23). The Board considers that these arguments could be applied to the old-age pension. Many would argue that payment of a universal old-age pension since its introduction in 1946, together with the ongoing collection of national insurance contributions, creates a valid expectation that the transfer of economic benefits will continue and that there is no realistic prospect of the government withdrawing from the decision to pay pensions. The existence or otherwise of specific statutes may or may not be relevant, depending on how one applies the requirements of FRS 5. Those who argue thus would recognise a liability.

13. Secondly, what is the past transaction or event? The Board considers that, while it might seem conceptually straightforward to identify the past transaction or event, it does not seem to be so in practice. For example, if an entity has entered into a commitment to provide grant over the next five years, there are some who have argued that, under the requirements of FRS 12, the entity should account in year one for the full five years of the grant – notwithstanding the fact that the recipient has to 'perform' under the agreement. This seems to the Board to confuse past and future. The Board believes that it is possible (certainly in the central government sector) for there to be more than one event to consider in determining when to recognise a liability: it might be that a liability cannot be recognised until some future event has happened – a future event that is foreshadowed in some current arrangement that might be misinterpreted as the triggering event. It might be useful were the Interpretation to discuss potential difficulties in certain circumstances of identifying the true 'past' transaction or event.

14. A discussion of the distinction between events that are within or outside the control of the reporting entity appears to be appropriate in the context of a constructive obligation – that is, can the reporting entity realistically withdraw from the decision. If one considers the example of the old-age pension, an argument could be made that the reporting entity has no control over the satisfaction of the eligibility criteria – however they are

determined – other than by changing them and that a liability should be recognised, although this is contrary to the argument in the Exposure Draft, which characterises the old-age pension as a general commitment. (Preface paragraph 42 refers.)

15. The Exposure Draft (4.34) gives as examples of political commitments the general promise to provide health-care or education. It notes that governments make and amend such promises as part of their ongoing political processes and that they should not be viewed as constructive obligations. Whether or not one considers the old-age pension to be a general commitment, the ability of governments to change the eligibility criteria for the old-age pension might, using this argument, lead to the situation where no liability would be recognised in respect of the old age pension.

16. However, some might argue that experience over the past decades suggests that governments do not change the eligibility criteria in such a way as to withdraw completely from the decision to provide state old-age pensions. Thus, the ability to change in the absence of experience of change would not be sufficient to deny the existence of a valid expectation – which would lead to a conclusion that there is a constructive obligation and that a liability should be recognised.

17. The Board is not, at this stage, arguing one way or the other. Rather, the Board is of the view that the arguments are not as clear-cut as the Exposure Draft suggests, and would be disappointed if an Interpretation were issued without acknowledging that some of the issues raised in the Preface will require more research and development over time in the light of ongoing debate.

### **Capital contributions**

18. The Board agrees that capital contributions should be accounted for as increases in the residual interest. As you know, the Board is currently considering the question of the accounting treatment by the recipients of grants and grants-in-aid and that there is some reluctance by some central government entities to accept that central government is a 'controlling party' and has a residual interest in the recipient entity.

19. The Exposure Draft (2.9) notes that an entity has control of a second entity if it has the ability to direct that entity's operating and financial policies with a view to gaining economic benefit from its activities. Control does not mean that the first entity has day-to-day management control over the second entity, and it seems that this is an area that causes many public benefit entities to question the idea that a second entity can be the 'controlling party' of an independent entity. The Board considers that this point might be better emphasised if the section on management (2.16) were moved forward. And, given the importance of 'economic benefits' in the context of control, the Board believes it would be helpful to bring the interpretation of economic benefits to this chapter, rather than leaving it until Chapter 4.

20. The 'controlling party' generally has a financial interest in the residual interest by virtue of the fact that, in the event that the controlled entity is wound up (and the functions are not passed to another entity), the sponsoring department (the 'controlling party') will either receive the residual net assets or finance the residual net liabilities. The Board notes that there might be concerns about the ability of Trustees of charitable organisations to act independently in the interests of beneficiaries if the concept of a 'controlling party' were to be applied. In the case of charitable organisations, it might be that a 'controlling party' does not have a financial interest in the residual interest, because the net residual assets of that entity (for example, a charitable non-

departmental public body) must, by virtue of the founding legislation, be passed to another charitable organisation having the same, or very similar, objects. Despite the lack of a financial interest in a residual interest, however, the charity might for other reasons clearly be part of the public sector and controlled by a particular entity within the public sector – for example, because the charity is providing the other entity with the ‘benefit’ of delivering part of the sponsoring entity’s policy agenda. The Interpretation will need to consider these concerns.

### **Capital grants**

21. The question of the accounting treatment of capital grants is interesting insofar as the entities covered by the requirements of the Government Financial Reporting Manual are concerned. This is because, in many cases, the grant will come from the ‘controlling party’ and is likely to add to the financial interest in the residual interest. It is not clear whether the proposals in the Exposure Draft would permit such grants to be accounted for through reserves – which the Board believes would be an appropriate treatment.

22. In those cases where capital grants are received from entities not considered to be ‘controlling parties’, the Board has been informed that the respondents to the Treasury’s consultation did not believe that the proposed treatment as income would be meaningful. Such grants are currently taken to a Government Grant Reserve and released to the Operating Cost Statement to match depreciation.

### **Voluntary gifts**

23. The Board’s response focuses on accounting for the receipt of voluntary services, which is the subject raised in the ITC. The Board has reservations about the proposal to recognise voluntary services as an asset or a gain, which is expensed immediately. The Board has two concerns.

24. First, the Board questions whether the proposals are consistent with the statement in the Preface (paragraph 50) that “if neither a transaction nor an event has occurred there will be no changes in the reporting entity’s assets and liabilities and consequently no gain or loss to recognise”. Looking at this the other way round, it could be argued that voluntary services do not create any (net) changes in the reporting entity’s assets or liabilities and do not have an impact on the profit or loss (surplus or deficit) of the reporting entity. So has a transaction or an event occurred within the meaning of the proposed Interpretation?

25. Secondly, the Board has concerns about the increased subjectivity that would be introduced into the accounts. For example, if a charity received a certain level of services voluntarily, would it necessarily have bought that level of service – or bought the service at all? How does it decide? And there will be considerable difficulties associated with measuring the value of a wide range of voluntary services. The Exposure Draft gives the example of volunteer time: the Board believes this includes all types of volunteer time, including accounting, auditing and legal services. Although the Exposure Draft notes that services should be included only if they can be measured reliably, the Board considers that public benefit entities should consider carefully the cost-benefit aspects of accounting for voluntary services, and, as a general rule, would not expect voluntary services to be accounted for.

26. The Board believes that the users of financial statements will be interested in the amount of voluntary services given to a public benefit entity, and believes that this discussion can be provided in the Operating and Financial Review or equivalent report.

### **Notional transactions**

27. You are aware that central government accounts might contain one or more of the following costs not involving the transfer of a cash payment: the cost of capital charge, the costs of shared services, and the cost of the audit. It appears to the Board that these are notional transactions within the meaning inferred from paragraph 50 of the Preface to the proposed Interpretation. The lack of cash transfers in respect of shared services and audit costs is, however, a reflection of the way in which government is structured – for example, the National Audit Office is Supply-financed.

28. The Board has started to consider the cost of capital charge, looking at the rationale for including it in the financial statements and at the base on which it is charged (currently on total net assets or liabilities with certain items exempted or attracting a nil rate). The Board understands the theory that notional transactions should not be included in financial statements. However, it has also to consider the objective of financial statements, the needs of the users and the qualitative characteristics of financial information. The Board's present view is that the costs noted above need to be retained in the financial statements of entities in the central government sector if those statements are to provide the information that users need.

### **Budget reporting**

29. As you know, departmental resource accounts contain a Statement of Parliamentary Supply (with supporting notes) that reports the outturn against the Estimate. This is the key statement of parliamentary accountability. The Board notes that this approach is in line with the proposals contained in IPSASB's Exposure Draft 27 *Presentation of Budget Information in Financial Statements*.

30. The Board agrees with your view (Preface paragraph 72) that the issue of budget comparisons requires further debate. The Board believes that the thrust of the IPSASB Exposure Draft is that the 'budget' against which the results are being judged is the amount authorised by the legislature (or equivalent in the case of local authorities). The Board sees no requirement in financial reporting for a comparison against internal, management budgets since these are dynamic, changing as the needs of the business dictate, but there is a debate to be had on whether public sector entities ought to report against budget limits imposed on them by sponsoring departments or, in the case of departments, by the Treasury.

### **The defining class of user**

31. Funders and financial supporters, the defining class of user identified in the Exposure Draft, can be interpreted in the context of the entities covered by the Board's remit as Parliament (not only in terms of Parliament's role in voting resources but also as a proxy for taxpayers) and the Treasury (in relation to the Treasury's role in setting and monitoring overall budgets). For these users, the material in the accompanying information is usually just as important as the information contained in the financial statements. The Board suspects that the same might be true for the users of the financial statements of other public benefit entities. The Board suggests that the text in paragraph 7.16 is amended, and that the positioning of the text is reconsidered – it would seem appropriate for some mention of the importance of the accompanying information to be made in chapter 1.

## Going concern

32. Paragraphs 3.3 and 3.4 note that some of the factors that need to be considered in looking at the concept of 'going concern' for public benefit entities might vary from those that need to be considered in relation to profit-orientated entities. The example that is then given, however, is very narrow – referring only to tax raising powers. The majority of public benefit entities do not have tax raising powers, and the Board considers that the Interpretation should give further guidance. The Financial Reporting Manual has the following text, which you might like to consider and adapt as necessary for a wider audience:

“For non-trading entities in the public sector, the anticipated continuation of the provision of a service in the future, as evidenced by inclusion of financial information in published documents, is normally sufficient evidence of going concern. However, a trading entity needs to consider whether it is appropriate to continue to prepare its financial statements on a going concern basis where it is being , or is likely to be, wound up.

“Sponsored entities whose balance sheets show total net liabilities should prepare their financial statements on the going concern basis unless, after discussion with their sponsors, the going concern basis is deemed inappropriate.

“Where an entity ceases to exist, it should consider whether or not its services will continue to be provided (using the same assets, by another public sector entity) in determining whether to use the concept of going concern in its final set of financial statements.”

## Conclusion

33. The Board believes that the principles underpinning the specific matters raised in the Invitation to Comment are key to achieving the highest possible standards of financial reporting by public benefit entities. The Board believes that the proposed Interpretation provides a significant contribution to achieving that aim but that some clarification of the proposals as currently drafted is needed, and perhaps an acknowledgement that the debate on some of the issues will continue.

34. I hope these comments prove useful in the ongoing work to finalise the Interpretation.

*Yours sincerely*

*Elwyn Eilledge*

**ELWYN EILLEDGE**

## STATEMENT OF PRINCIPLES FOR FINANCIAL REPORTING

### PROPOSED INTERPRETATION FOR PUBLIC BENEFIT ENTITIES

#### INVITATION TO COMMENT

#### RESPONSES OF THE FINANCIAL REPORTING ADVISORY BOARD

##### **Liabilities**

*(a) Do you agree with the discussion of liabilities in the context of 'commitments to provide public benefits'? In particular:*

- (i) Do you agree that performance-related grants are analogous to contracts? If not, why not?*
- (ii) Do you agree that, for non-performance-related commitments (particularly to assets), benefits can be obtained by achieving an entity's objectives such that a commitment to provide public benefits will have the substance of an executory contract and liabilities will not normally arise until the transfer of resource become due? If not, why not?*

The Board does not believe the recognition of liabilities by public benefit entities is as straightforward as the Exposure Draft appears to suggest. The Board is concerned that the application of the proposals in the proposed Interpretation will lead to certain liabilities being removed from balance sheets, prevent the recognition of others and cause confusion for preparers of financial statements as they try to interpret the definition of a liability for certain types of transactions. Please see the covering letter for further discussion.

*(b) Do you believe that there are 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 and characteristics of such a liability.*

The Board believes that this debate has yet to run its course. The work of the International Public Sector Accounting Standards Board needs to be considered in this context. IPSASB's initial Invitation to Comment on Accounting for Social Policies of Governments considered a range of things that government does. Depending on how a policy is delivered, it is not inconceivable that a commitment could give rise to a liability.

##### **Residual interest and restricted assets**

*(c) Do you agree that information should be provided in the financial statements to explain the amount and nature of any assets that are subject to restrictions over their application? If not, why not?*

The Board agrees that it is important that users of financial statements understand which assets are subject to restrictions over their use.

*(d) Do you agree that the mere designation of a portion of the residual interest does not result in a transaction for recognition on the financial statements, but could instead be discussed in accompanying information? If not, why not?*

The Board agrees that management's intentions for the future use of unrestricted reserves might be discussed in information accompanying the financial statements, but should not be accounted for as if the intentions were restrictions. The Board notes that the Charities and Local Authority SORPs would need to be updated to reflect this requirement.

### **Business combinations**

*(e) Do you agree that, having taken the circumstances of business combinations between public benefit entities into account, it is likely that the majority (other than those involving entities under common control) will be acquisitions? If not, why not?*

The entities covered by the Board's remit (departments, non-departmental public bodies and trading funds) are considered to be 'under common control' and so will continue to adopt the principles underpinning merger accounting when functions are transferred between existing entities or passed to new entities established by the government. The Board recognises that many business combinations in the wider public benefit sector will take the form of acquisitions. However, the Board believes that acquisition accounting will not necessarily be appropriate in the case of combinations between different parts of the public sector: for example, local government reorganisation or changes in service delivery between local and central government do not involve entities under common control, but acquisition accounting is likely to give an inappropriate view of the effects of the changes. The Board, is therefore, very interested in the concept of 'Fresh Start' accounting and urges the Accounting Standards Board to accord high priority to developing proposals.

### **Capital contributions**

*(f) Do you agree that capital contributions (being those establishing a financial interest in the residual interest of a public benefit entity) should not be accounted for as gains, but as an increase in the residual interest? If not, why not?*

The Board agrees, but please see the covering letter, which considers this issue further. The Board notes that, where Charities have a 'controlling party' (which would be the case for charitable non-departmental public bodies in the central government sector), the Charities SORP would need to be reviewed to take account of these proposals if the principles are to apply equally to all public benefit entities.

*(g) Do you agree that any resources received from a controlling party, whether or not they are capital contributions, should be disclosed due to the impact they have on the financial performance and financial position of the reporting entity? If not, why not?*

The Board agrees that such information might be useful (particularly, for example, where an entity relies on the controlling party for the majority of its 'business'). The Board infers from the language of the ITC that the proposal is for the information to be disclosed in the notes to the accounts. This has the advantage of the information being covered by the audit opinion. The Board believes that it might also, depending on the type of public benefit entity, be necessary for additional discussion in the information accompanying the financial statements.

### **Capital grants**

*(h) Do you agree that capital grants should be recognised as gains when any conditions attaching to their receipt are met, and that assets financed by capital grants should be subject to an impairment test once they are ready for use? If not, why not?*

Please see the Board's covering letter, which considers the accounting treatment of capital grants. The Board notes that the Charities SORP may need to be reviewed to ensure consistency with the proposals.

The Board notes that assets held by public benefit entities might be valued by reference to future service potential. Thus it is not clear that a capital grant for an asset would indicate that its purchase may not have satisfied the economic criteria of the reporting entity. The Board believes that assets financed by grant should be reviewed for impairment in the same way as any asset is reviewed for impairment.

*(i) In particular, do you agree that the existence of a clause requiring the repayment of a capital grant in the event that the asset if financed is sold is not a barrier to recognising the grant as a gain? If not, why not?*

The Board questions whether this proposal is completely in line with the amendments to FRS 12 as exposed in FRED 39. Please see the covering letter for a discussion of this point.

### **Voluntary gifts**

*(j) Do you agree that those voluntary services that would have been purchased, if not given voluntarily, should be recognised based on the value to the recipient (providing it can be reliably measured), but that otherwise voluntary services should not be recognised in the financial statements? If not, why not and how would you resolve any measurement issues that might arise?*

While the Board can see some merit in a discussion of the voluntary services received, it is not convinced that these should be recognised in the financial statements. The Board notes that the Charities SORP will need to be reviewed in the light of these proposals. This issue is also discussed further in the covering letter.

**Other**

*(k) Do you believe that any other guidance or re-expression of the principles is needed? If so, please provide details.*

The Board does not see the need for other guidance or re-expression of principles in an Interpretation. Particular types of public benefit entities might need to develop guidance (for example, in or alongside the Local Authority SORP or in the Charities SORP).