

Financial Reporting Advisory Board Paper

Secretariat paper

Statement of Principles for Financial Reporting – proposed interpretation for public benefit entities

Issue:	The proposed Interpretation for public benefit entities of the ASB's Statement of Principles: update on progress and potential impact on the FReM.
Impact on guidance:	To be determined following general and specific consultation.
UK GAAP adaptation?	No
IAS/IFRS compliant?	N/A: IASB Framework does not cover public sector
IPSAS compliant?	N/A: IPSASB does not have a separate conceptual framework.
Impact on budgetary regime?	No
Recommendation:	That the Board agrees (a) to the general and specific areas for consultation (see paragraphs 2 and 3) and (b) that it should respond formally to the Exposure Draft once it has been issued.
Timing:	2006-07

DETAIL

Background

1. The Accounting Standards Board (ASB) has since 2001 had a project to develop an *Interpretation* for public benefit entities of its 1999 *Statement of Principles for Financial Reporting*. The ASB published a Discussion Paper in May 2003, and the Board's 2003-04 Report notes that the Chairman wrote to the ASB noting the importance of the development. The consultation period ended on 1 August 2003, and the Board's 2004-05 Report notes that an Exposure Draft is expected

in mid-2005. The Report also says, "The Board has already approved the incorporation of the principles outlined in the *Statement of Principles* into the Government Financial Reporting Manual, but will discuss with the Treasury whether the text needs to be amended in the light of the content of the *Interpretation*." The text relating to the *Statement* is reproduced for ease of reference in Annex A.

2. This paper updates the Board on the ASB's progress to date on completing the Exposure Draft of the proposed *Interpretation*, outlines the main issues arising from the comments on the Discussion Paper as the Exposure Draft has been developed, and seeks the Board's views on what place, if any, it envisages for the *Interpretation* in the Government Financial Reporting Manual (FReM). The Board is invited to provide views in response to the questions raised in paragraphs 8, 12, 16, 19, 23, 24, 26, 29, 31 and 33.

3. Formal consultation with constituents will take place once the Exposure Draft has been issued. There will be a general consultation on the *Interpretation*, with **specific** consultations on certain areas – as suggested in the following paragraphs.

Progress towards an Exposure Draft

4. The ASB's Public Sector and Not-for-Profit Committee (PSNC) is likely to complete its consideration of an Exposure Draft by the early summer, with the ASB approving it shortly thereafter. Publication is expected in September. Depending on the time it takes to consider responses and the impact that they might have on the text in the Exposure Draft, the *Interpretation* itself is unlikely to be available before Spring 2006.

Main issues – and the potential impact on the FReM

5. This section of the paper gives a brief outline of the main issues arising as the Exposure Draft has been developed. Each issue is assessed in terms of what might be the impact on the FReM.

FUNDERS AND FINANCIAL SUPPORTERS AS THE DEFINING CLASS OF USER

6. Financial reports are focussed on a defining class of user: for profit-making entities, the *Statement* makes the rebuttable 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.

7. Paragraphs 2.2.3 and 2.2.4 of the FReM (see Annex 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.

8. In the light of what is already in the FReM, does the Board agree that no changes are required in respect of the defining class of user? This would be subject to general consultation.

DEFINITIONS OF THE ELEMENTS OF FINANCIAL STATEMENTS

9. 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.

10. Paragraph 2.2.1 of the FReM 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.

11. 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.

12. Once the *Interpretation* has been published, it would seem appropriate (a) to change the reference in paragraph 2.2.1 from 'ownership interest' to 'residual interest' and (b) to consider changing the title in the balance sheet. Does the Board agree? This would be subject to general consultation.

LIABILITIES: COMMITMENTS TO PROVIDE PUBLIC BENEFITS

13. The Discussion Paper noted that the recognition of liabilities is a difficult area for public benefit entities, particularly in determining the point at which a constructive obligation has been created. The Discussion Paper suggested that the nature of the commitments (that is, whether general or specific) would determine whether or not a liability had been incurred. There was a divergence of views from respondents, and the text on liabilities has been looked at in some detail. The proposals are that:

- general commitments that are a general or policy statement of intention do not create a liability;
- specific commitments that are analogous to contracts to provide some tangible performance should be accounted for as executory contracts;
- other specific commitments, where the promised resources are provided in furtherance of an entity's objectives, are also in substance executory. A liability would be recognised as the transfer of resources becomes due; and
- in seeking to clarify the treatment of 'apparently unconditional promises' such as an unconditional multi-year grant, there is an obligation (there are no conditions to allow the grantor to avoid payment) but it is expected that the payment will not be a transfer. Instead, it will be an exchange in which the grantor makes the payment and furthers its objectives. This means that a liability for the total grant period does not arise at the time the commitment is made.

14. Unanimity of views remains difficult to achieve, particularly around the proposal in relation to 'apparently unconditional promises', where it could be argued that it goes against the principles of recognition of a liability. On the one hand, there is a concern that the proposals might lead to the treatment of all commitments as analogous to executory contracts, leading to fewer on-balance sheet liabilities. On the other hand, there is a view that the nature of the public sector generally needs to be

considered further in determining the point at which a liability might be recognised – that is, the statement in the Discussion Paper that this is a difficult area for public benefit entities holds true and that there is a need for further reflection in this area.

15. The section on the *Statement of principles* does not refer specifically to liabilities. But this is an area where the FReM will need to be clear on its guidance on the recognition of liabilities, particularly in relation, for example, to grant agreements for more than one year, where conditionality and the nature of the exchange will need to be carefully considered. It is possible that there will need to be a link to the work that the Treasury is currently undertaking on accounting for grants and grants-in-aid.

16. Liabilities are covered in chapter 6 of the FReM, and thus it would be appropriate for any material on recognition or measurement of liabilities arising out of a consideration of the proposals in the *Interpretation* to be included in that chapter. Does the Board agree that it should seek from the Treasury **specific** proposals on what the proposals in the *Interpretation* in relation to liabilities will mean to the entities covered by the requirements of the FReM?

PRESENTATION OF RESIDUAL INTEREST AND DISCLOSURE OF RESTRICTIONS OVER ASSETS

17. 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. Some PSNC members argue that the balance sheet should reflect management's intention and that the current practice should be allowed to continue.

18. 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.

19. The proposals in this area are likely to affect only charitable non-departmental public bodies, and there seems no reason not to require full compliance (in chapter 7 of the FReM) with the principles outlined in the Exposure Draft. Does the Board agree? This would be subject to general consultation.

NOTIONAL TRANSACTIONS

20. The Discussion Paper specifically addressed notional transactions, and said that they do not meet the definition of a gain or loss where they do not give rise to an equivalent asset or liability; thus notional transactions should not be recognised. The proposed *Interpretation* does not have a specific reference to notional transactions. But the intention remains the same, and the proposed *Interpretation* says, "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."

21. Arguably, the FReM requires accounts to include a notional transaction: the cost of capital charge. In an earlier version of the draft Exposure Draft, the word 'economic' was inserted before 'transaction' and 'event', but several members of the PSNC pointed out that an argument could be made for certain 'notional' transactions being economic in nature.

22. The Treasury has started a project to look at charging for the cost of capital. The main issues that need to be addressed are currently being discussed within the Treasury prior to wider (**specific**) consultation. The Board is due to consider a paper at its November meeting. Proposals could be presented then as to what effect, if any, the section on notional transactions will have on the FReM. Is the Board content with this approach?

VOLUNTARY GIFTS

23. The proposed *Interpretation* makes a distinction between gifts of goods and gifts of services. Gifts of goods should be recognised based on their current value to the recipient. The *Interpretation* notes that gifts of services are economic transactions and should, in principle, be recognised, but acknowledges that there may be factors that prevent recognition. To help, the *Interpretation* proposes that gifts of services can be sub-divided into those that, had they not been provided free of charge, would have to have been purchased and those that would not. The former should be recognised at their current value to the recipient, and disclosures made of any voluntary services that are not recognised.

24. In theory, the section on voluntary gifts could impact on charitable non-departmental public bodies and on the health sector, although it appears unlikely, given the nature of their operations, that there are any voluntary gifts of goods or services that will need to be recognised. It would seem appropriate, however, to ask the Treasury to seek **specific** views on the extent to which the proposals would impact and to consider how best to present them in the FReM. Does the Board agree?

CAPITAL CONTRIBUTIONS

25. A capital contribution is one that establishes an ongoing interest in an entity; it is not a capital grant. An ongoing interest is a right to participate in the residual interest (and; although the *Interpretation* does not explicitly say so, it could also be an obligation to meet accumulated deficits, where appropriate). The *Interpretation* proposes that capital contributions should be accounted for as an increase in residual interest.

26. The treatment of Supply financing in resource accounts and executive agency accounts reflects the treatment proposed in the *Interpretation*. The treatment of grant-in-aid is the subject of on-going debate, and the Treasury may well use this section of the *Interpretation* in looking anew at the topic. Thus the impact of this section of the *Interpretation* is or will be covered by the requirements in the FReM on the treatment of income and is subject to **specific** consultation. Is the Board content to continue to receive separate papers on capital contributions as part of the work on grant-in-aid?

CAPITAL GRANTS

27. Capital grants are grants given to an entity to finance the purchase of a fixed asset. The *Interpretation* proposes that capital grants should be recognised as a gain when the conditions attached to the receipt of the grant have been satisfied. The Exposure Draft notes that the requirement to repay a capital grant if the relevant asset is sold amounts to a condition but that the actual repayment could be avoided by deciding to retain the asset and thus this condition is not a barrier to recognising the grant as a gain.

28. The proposed treatment moves away from that in SSAP 4 *Accounting for government grants*. The Discussion paper noted that SSAP 4 is not wholly consistent with the definitions of the elements of financial statements as set out in the *Statement of Principles*. The Discussion Paper also noted

that the IASB has confirmed that it intends to revise IAS 20 *Accounting for government grants and disclosure of government assistance* – under the convergence programme, SSAP 4 would also be revised. The expectation is that the accounting treatment currently set out in the FReM (treatment of the grant as deferred income) will no longer be allowed. The IASB timetable does not currently give any indication of when changes to IAS 20 will be exposed.

29. In the meantime, given what is likely to happen, it would seem sensible to ask the Treasury to include changes to the treatment of capital grants in its **specific** consultation on accounting for grants and grants in aid. Does the Board agree?

BUDGET REPORTING

30. The Exposure Draft notes that the International Public Sector Accounting Standards Board is expected to issue later this year an Exposure Draft on budget reporting, recommending that comparison against budgets should be included in the general purpose financial statements. The text of the Exposure Draft has yet to be finalised, although it is likely to say that comparison against budget might be part of general purpose financial statements where it would be useful to users.

31. 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. There would seem no need to change the status quo. Do Board members agree? This would be part of the general consultation.

BUSINESS COMBINATIONS

32. The Exposure Draft reaffirms the ASB's previous conclusion that the majority of business combinations are likely to be acquisitions, except where the entities involved are under common control. Where they are under common control, merger accounting would apply. The Exposure Draft also acknowledges that some public sector business combinations (those that involve entities not under common control) have the characteristics of a merger and has proposed a variation of acquisition accounting: where the business combination is in substance a gift of one business to another, the fair value of the net assets or liabilities acquired should be recognised as a gain or loss and not as goodwill.

33. In the context of the entities covered by the FReM, business combinations normally arise as a result of machinery of government changes (which might involve government departments and/or executive agencies and/or non-departmental public bodies), which come into effect from a specific date. These business combinations should continue to be accounted for as mergers. There may be occasions where a new entity is created by amalgamating the functions of two or more entities over a period of time (an example is Ofcom), and it would appear that this type could use the modified acquisition accounting method as set out in the *Interpretation*. The FRAB Report for 2004-05 notes that it awaits the Treasury's consideration of the impact on the FReM (chapter 2) of changes to FRS 2. It would seem appropriate for that work to incorporate a consultation on the proposals in the *Interpretation*. Does the Board agree?

Responding formally to the Exposure Draft

34. The Board saw the development of the proposed *Interpretation* as a significant step on the way to providing an important base document for government accounting. As shown in the paragraphs above, there are some weighty topics for the Board to consider – particularly in areas where I recommend the Board ask the Treasury to carry out specific consultation (or where the Treasury is

already working) on the proposals: liabilities, notional transactions, voluntary gifts, capital contributions, and capital grants. It would appear appropriate for the Board to respond in the Autumn to the Exposure Draft. It would be useful to be able to consider a response in the light of comments from constituents, and I propose that a draft response be referred to the Board's November meeting. Does the Board agree?

Summary and recommendation

35. The Exposure Draft of the proposed *Interpretation of the Statement of Principles* for public benefit entities is nearly finalised. It is due to be considered by the PSNC at its July meeting and by the ASB at the meeting on 21st July, and should be published in September. There are several areas where the Treasury needs to consult on the application of the *Interpretation*: some of them as part of a general consultation on the application of the *Interpretation* to the accounts of the entities covered by the FReM (which seems likely to change very little in the Manual). Other topics could have a greater impact, and this paper suggests that they need to be subject to separate consultation exercises.

36. The Board is invited to agree those areas where general consultation and specific consultation are required, based on the main issues discussed in the near-final Exposure Draft. The Board is also invited to agree that it should respond formally to the ASB later in the Autumn, once the Exposure Draft has been published.

David Watkins
Secretary
June 2005

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 ownership 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.