Statement of Principles for Financial Reporting Interpretation for Public Benefit Entities

PAPER 2

1 Introduction

1.1 The Accounting Standards Board (ASB) published its long awaited Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting (the interpretation) in June 2007. In publishing the interpretation the ASB recognised that the Statement of Principles on which the interpretation is based is now almost 10 years old and that it will need to be reviewed in the light of conceptual framework projects being taken forward by both the International Accounting Standards Board and the International Public Sector Accounting Standards Board. The ASB recognise that the interpretation may be superseded in the short to medium term.

1.2 Whilst nothing in the interpretation over-rides existing standards or SORPs, the interpretation exists, in part, to provide a coherent frame of reference to be used in the development of SORPs and to assist preparers and auditors faced with new and emerging issues. For example, where SORP is silent on an issue then the interpretation will be relevant to preparers of accounts in determining their accounting treatment.

1.3 The current SORP enjoys a high degree of consistency with the interpretation although there are a number of areas where the interpretation may point to a somewhat different solution or may arrive at a similar conclusion by a somewhat different route. This paper looks at these issues and also looks at a number of issues that were perceived as controversial when SORP 2005 was published in March 2005 and now are more clearly supported by this interpretation of the conceptual framework.

2 Multi-period liabilities (Interpretation - paragraphs 4.29 to 4.34)

2.1 SORP 2005 noted that certain grants may contain specific conditions that closely specify a particular service to be performed where the conditions for payment are linked to the performance of a particular level of service or units of output delivered. Often the grant maker will have negotiated the services to be provided to it or its beneficiaries. The SORP refers to such grants as performance-related grants and they are recognised as resources expended to the extent to which the specified services have been provided.

2.2 Under SORP 2005 grant liabilities may also arise as a result of a constructive obligation. Where a multi-year funding agreement has been entered into and a specific funding commitment made to a grant recipient then a liability results and the conditions attaching to the grant will determine whether a liability is recognised for the full funding commitment.

2.3 In developing the interpretation the ASB's Committee on Accounting for Public-benefit Entities (CAPE) gave considerable thought to this issue. The SORP's approach is consistent with that of the interpretation.

2.4 The interpretation confirms that a general or policy statement of an intention to provide goods and services to beneficiaries in accordance with objectives will not necessarily give rise to a liability. The accounting treatment of specific commitments depends on whether:

- The obligation is such that the entity cannot realistically withdraw from it;
- The commitment has been communicated to the other party; and
- The commitment is performance related.

The interpretation states that where the commitment, giving rise to the obligation, is not performance related a liability arises at the time the commitment is made.

3 Residual interests and designations (Interpretation - paragraphs 4.41 to 4.44)

3.1 Residual interests are disclosed as "funds" in charity accounting and are arrived at by deducting all of an entity's liabilities from its assets. The interpretation recognises there may be different classes of residual interest that require disclosure, in particular, where resources are held for a particular purpose (a restricted fund) this creates a separate class of residual interest in the balance sheet.

3.2 The nature of the residual interest should be clear from the disclosure in the accounts. The interpretation, however, goes a stage further than the existing SORP by stating that where, in the event of a winding-up, the ultimate interest would be required to be distributed in a particular way then that fact should be disclosed. Charity law would require a distribution on winding-up to reflect the nature of the restriction represented by a restriction or special trust. Whilst uncommon, some dissolution clauses in governing documents of charities may be more prescriptive and in such cases, to be consistent with the interpretation, an additional disclosure would be required by a minority of charities.

3.3 The interpretation, however, does not regard designations as creating a separate class of residual interest. This is consistent with the SORP where designations are defined as being part of unrestricted funds earmarked for a particular project. The designation has an administrative purpose only and does not legally restrict the trustees' discretion to apply the fund.

3.4 Paragraph 325 of the SORP reminds trustees that where part of the unrestricted fund is earmarked this intention to expend funds in the future is not recognised as a provision but may be recorded by setting up a designated fund. The SORP does not create a requirement to set-up designations and is silent on how designations are disclosed apart from reminding trustees that designations remain part of the charity's unrestricted funds.

3.5 Designations were first introduced into the SORP to help explain that funds disclosed within the balance sheet should not be equated with funds immediately available for expenditure as they may have been "earmarked" for a particular purpose. Designations should, under the SORP, also be quantified and explained within a charity reserves policy (paragraph 55) – this was an attempt by SORP to help ensure designations were not used purely as a window dressing technique.

3.6 The Interpretation concludes that designations reflect no more than management intention and correctly points out, as does SORP, that a separate class of residual interest (a fund) is not created. The interpretation is however more specific and states that a transaction should not be reflected in the financial statements (paragraph 4.44). Such information could be disclosed in the notes to the accounts but would more normally be disclosed in the accompanying information (i.e. Trustees Annual Report in the case of a charity).

3.7 In so far as the SORP is silent on how designations are disclosed there is no significant contradiction between SORP and the interpretation. Indeed the explanation of designations required within reserve policies takes us a long way towards the approach provided within the interpretation

3.8 The SORP Committee had considered these issues in the context of the development of the 2005 SORP but had rejected a paper recommending a similar line to that proposed by the interpretation. The Committee had taken the view that designation provided useful information helping users understand the funding position of a charity. It has also been pointed out that there is no legal prohibition on providing additional information within the separate categories of funds identified by the balance sheet.

4 Donated services (Interpretation - paragraphs 4.47 to 4.51)

4.1 The issues surrounding the recognition of the contribution of volunteers in charity accounts has been the subject of sector debate for a number of years. The interpretation confirms that where an event, volunteering, has an economic impact on an entity that impact should be reflected in the accounts but highlights that in practice it may not be possible to measure some services with sufficient reliability and consequently such services should not be recognised.

4.2 If reliability of measurement issues can be overcome then recognition would take place provided the charity would otherwise have purchased the service (evidence of economic contribution). Under this approach a charity would need to demonstrate that the services provided to the charity would be purchased if volunteers were not available - in effect perhaps differentiating between "softer volunteering" and the "economic contribution" that a charity would pay for in order to carry out their activities in the absence of volunteers.

4.3 The SORP also recognises that donated services should be recognised where the benefit (economic contribution) is reasonably quantifiable and measurable. The SORP concludes that these tests are likely to be met where the service is provided by an individual (volunteer) as part of a trade or profession but excludes volunteers generally on the basis that their contribution cannot be reasonably valued in financial terms. Whilst the interpretation does not over-ride a SORP, and the underlying principle is similar, the interpretation places emphasis on whether the service would be purchased in the absence of volunteers whilst the SORP looks at whether the service is provided in the course of a trade of profession and excludes the valuation of “general” volunteers.

5 Grants for financing capital projects (Interpretation - paragraphs 5.32 to 5.37)

5.1 The interpretation states that grants and donations should be recognised as gains unless there are conditions to be met. Where conditions are substantially or virtually certain to be met the gain should be recognised.

5.2 The interpretation points out that a repayment condition applying to a capital grant, in the event of a future sale of the asset, would not prevent recognition where the decision to sell was within the reporting entity’s control.

5.3 Whilst the interpretation recognises that a capital grant can represent a subsidy there is no mention of a deferral of its recognition although if the gift establishes an interest (presumably for the donor) in the residual interests then the transaction should be treated as a capital contribution.

5.4 The approach put forward by the interpretation is seen as consistent with SORP 2005.

6 Accounting for business combinations (Interpretation - paragraphs 8.10 to 8.14)

6.1 Despite the direction taken by International Financial Reporting Standards, the interpretation continues to recognise that an amalgamation of two or more reporting entities can take a number of different forms. The interpretation points out that the fact that a business combination involves public benefit entities does not in itself influence whether the business combination is accounted for as an acquisition or a merger. This is again consistent with the accounting options allowed by SORP.

6.2 Helpfully the interpretation also explains that under acquisition accounting where the acquisition is carried out at nil or nominal consideration the excess of fair value of the assets acquired over the fair value of the liabilities assumed should be treated as a gain and recognised as income (or a loss where net liabilities are acquired). The SORP is currently silent on this matter. This approach is consistent with the accounting advice currently provided by the Commission with the exception that restricted funds that constitute a special trust would normally be dealt with by a transfer of trusteeship and the accounting would reflect the legal nature of such transactions

Questions:

1. **Is the SORP Committee satisfied that the SORP is consistent with the interpretation and there are no fundamental issues that require addressing through a revision of the SORP?**

2. **Are there any issues arising that could usefully be explained in the proposed Information Sheet?**