INTERNATIONAL FINANCIAL REPORTING STANDARDS AND NOT FOR PROFIT ENTITIES

BDO Public Benefit Accounting Group (PBAG) Briefing Note

July 2011

BDO

INTRODUCTION

The BDO Public Benefit Accounting Group (PBAG) is an initiative of BDO and the Charity Finance Directors' Group (CFDG), but now also represents the interests of all public benefit entities (PBEs). It held its fourth meeting on 14 June 2011 where there were contributions from approximately 20 organisations, with representation in the charity, education, housing, and membership sectors as well as observers from the Institute of Chartered Accountants in England and Wales (ICAEW) and the UK's Accounting Standards Board (ASB). This briefing note summarises the matters discussed at that meeting, namely:

- Update on the ASB's proposals and recent developments
- Consideration of the timeline
- An overview of the draft Financial Reporting Standard for Public Benefit Entities (FRSPBE).

RECAP OF THE ASB'S PROPOSALS

The ASB have proposed a 3 tier framework which would replace current UK GAAP with a new reporting regime based on public accountability and size to take effect from periods beginning on or after 1 July 2013. The proposals consist of three Financial Reporting Exposure Drafts (FREDs)

- **FRED 43 Application of Financial Reporting Requirements** sets out the framework for reporting by entities based on a three tier system driven by size and public accountability.
- **FRED 44 Financial Reporting Standard for Medium Sized Entities** (or FRSME for short), contains all the accounting rules to be applied by entities in tier 2 and is based on the International Financial Reporting Standard for Small and Medium-Sized Entities (IFRS for SMEs) issued by the International Accounting Standards Board (IASB).
- **FRED 45** dealing with public benefit issues, the draft Financial Reporting Standard for Public Benefit Entities (FRSPBE).

The comment period for FREDs 43 and 44 closed on 30 April 2011, while the comment period for FRED 45 closes on 31 July 2011. A total or 292 responses to FREDs 43 and 44 have been received, with an approximate split of responses by type of entity shown in the table below:

Charities	4%
Higher education institutions	0%
Registered providers of social housing	45%
Accountancy bodies and other special interest groups	10%
Other PBEs	2%
Credit unions	17%
Accountancy firms	7%
Other	15%
	100%

STOP PRESS

The ASB have uploaded on to their website some tentative decisions all of which were predicted at the PBAG meeting. Specifically, they have tentatively decided:

1. To remove from FRED 43 & 44 the requirement for publicly accountable entities to prepare accounts under EU-adopted IFRS. As a consequence the application of EU-adopted IFRS will not be extended beyond the current requirements in law;
2. To change the principles for amending the IFRS for SMEs to permit or require accounting options that exist in current UK & Republic of Ireland Financial Reporting Standards at the transition date that align with EU-adopted IFRS; and
3. To defer the effective date to 1 January 2014.

It would therefore seem that:

- An entity will not be required to prepare financial statements in accordance with full IFRS unless individual regulators and exchanges decide otherwise.
- Accounting treatments such as the capitalisation of borrowing costs, revaluations of fixed assets and deferral of capital grants may be available after all.
- Most higher education and further education institutions will now get an extra year's preparation time given their July year-ends.

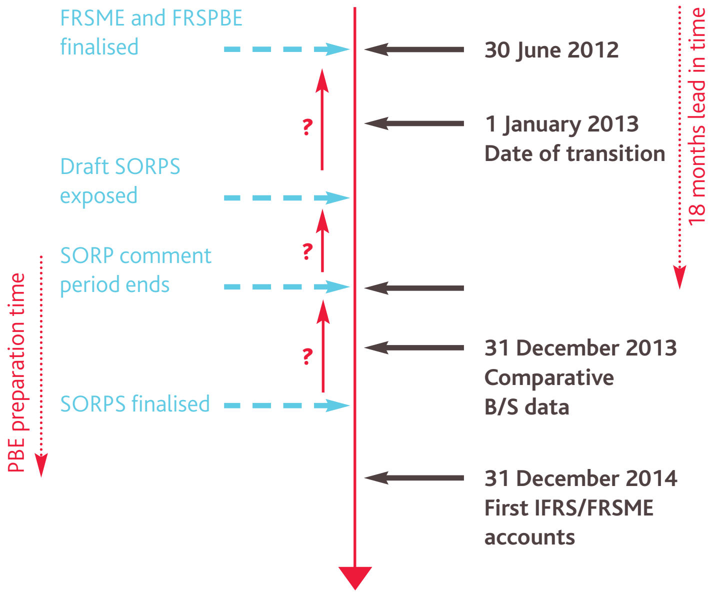
The proportion of responses from PBEs was significant, largely due to the contribution from registered providers. This was a sector which motivated its constituents to respond given the adverse implications that the ASB's proposals would have had for them. It is unclear whether the few responses received from the corporate (for-profit) sector and user groups indicates tacit support for the ASB's proposals, indifference, or simply a lack of engagement and understanding of the potential impact of the proposals.

TIMELINE

As noted above, it would appear that the timetable is now set to slip by six months with a revised effective date of periods beginning on or after 1 January 2014 (rather than 1 July 2013). Given that the ASB has stated it will publish final standards at least 18 months prior to the ultimate effective date, arguably there are still significant pressures that could make it difficult to finalise everything by June 2012:

- Firstly, depending on the extent of the revisions to the previously exposed version of the FRSME, it might be necessary to re-expose them for further public comment.
- Secondly, there are currently significant revisions taking place to full IFRS (with some new standards already having been published in final form) with an effective date of 1 January 2013. With the possibility that the IFRS for SMEs may be updated on the back of these revisions, it might be expected that the FRSME would then be updated accordingly. This could in turn lead to UK companies being faced with accounting changes on transition to the FRSME only for further changes taking place shortly thereafter. The ASB might consider delaying introduction of the FRSME until it is known the extent to which the known and likely changes to full IFRS will filter down.
- Thirdly, it seems likely that the revised SORPs may not expected until sometime after publication of the final FRSME and FRSPBE, reducing the amount of time PBEs have to fully prepare compared to entities not subject to a SORP. The National Housing Federation has indicated that the housing SORP might be expected in final form in March 2014, which would mean that the final piece of the jigsaw would be in place only 12 months before the majority of Registered Providers' first annual accounts under the new regime (March year-ends). If the writers of the charity SORP work to the same timetable, then many will not have all pieces of the jigsaw in place until only 9 months before the end of the first reporting period affected (December 2014).

TENTATIVE REVISED TIMELINE



FRED 45 'FINANCIAL REPORTING STANDARD FOR PUBLIC BENEFIT ENTITIES (FRSPBE)

FRED 45 was issued in March 2011 and sets out the proposed accounting for a number of issues that are of specific relevance to PBEs. Although originally intended to be a "gap" standard setting out the accounting for matters not addressed by the FRSME, in two areas (concessionary loans) and entity combinations) tier 2 PBEs would be permitted to depart from the requirements of the FRSME.

Although not mandatory for tier 1 entities, the ASB suggest that in areas other than concessionary loans and entity combinations (where the guidance conflicts with full IFRS) the rest of the FRSPBE would form best practice guidance for them. The ASB are consulting on the extent to which the FRSPBE should be mandatory as opposed to best practice guidance for tier 3 entities applying the FRSSE.

DEFINITION OF A PUBLIC BENEFIT ENTITY

The FRSPBE provides a definition of a PBE, and further explanatory guidance to help identify which entities would be subject to the FRSPBE. The important factor in determining an entity's PBE status or otherwise is that it does not exist primarily to provide a return to investors. The term "not-for-profit" is not used in the definition or explanatory guidance,

While it seems clear that all charities, registered providers and higher/further further education institutions would fall to be treated PBEs, it is less clear whether all membership organisations such as trade unions and professional bodies would be classified as a PBE.

CONCESSIONARY LOANS

A concessionary loan is one that is made or received between a public benefit entity and a third party at below the prevailing market rate of interest and which is not repayable on demand. Whereas all non PBEs are required under the FRSME to measure such loans at fair value and account a market rate of interest over the period to repayment, on cost-benefit grounds the FRSPBE permits PBEs to record such loans at the amount borrowed or lent.

EXAMPLE

An entity makes an unsecured £100,000 loan interest free to another entity repayable in 5 years. The market rate of interest for such a loan is 10%, which means that the fair value of the loan is on £62,092. The accounting for such a loan by a tier 2 PBE and non-PBE is as follows:

	Tier 2 PBE		Tier 2 non-PBE	
Initial recognition of loan	Dr Loan receivable	100,000	Dr Loan receivable	62,092
	Cr Cash	100,000	Cr Cash	100,000
			Dr I&E cost	37,908
Year 1 interest	None		Dr Loan receivable	6,209
			Cr I&E interest income	6,209

As noted above, a tier 1 PBE would not be able to apply the above simplified treatment to concessionary loans, rather must follow the same treatment as a non-PBE

PROPERTY HELD FOR THE PROVISION OF SOCIAL BENEFITS

The FRSPBE clarifies that any property which is held primarily for the provision of social benefits (such as social housing) is to be accounted for as owner occupied property and not as investment property.

It is unclear what is meant by "primarily" in this context. For example does it mean that where passing rent is in excess of 50% of market rent that the property would be accounted for as investment property, or is it looking at the proportion of a development that is used for providing social benefits? This might be something which the housing SORP would provide further guidance on.

ENTITY COMBINATIONS

The FRSPBE distinguishes three types of entity combinations. The first is acquisitions (i.e. market takeover situations), to which the accounting set out in the FRSME must be applied

The second is combinations that are in substance a gift. One entity (the donor) transfers its operations to another (the donee), usually for nil consideration. The donee entity records the fair value of the net assets received at fair value and reflects donation income rather than negative goodwill.

The third is mergers, with the accounting for the combined entity reflecting the same accounting for mergers as is practised under current UK GAAP. In order to achieve merger accounting all of the following conditions must be met:

- no party to the combination is portrayed as either acquirer or acquiree, either by its own board or management or by that of another party to the combination
- there is no significant change to the class of beneficiaries of the combining entities or the benefits provided as a result of the combination
- all parties to the combination, as represented by the members of the board, participate in establishing the management structure of the combined entity and in selecting the management personnel, and such decisions are made on the basis of a consensus between the parties to the combination rather than purely by exercise of voting rights.

IMPAIRMENT OF ASSETS

As with current UK GAAP, the FRSPBE permits an assessment of an asset's service potential in determining whether it needs to be impaired. It suggests that an asset's service potential may be taken to be the same as its depreciated replacement cost, although other approaches may be used where appropriate. The revised housing SORP would probably need to address the use of the planned subsidy approach common in the social housing sector. Given that it might not be possible to account for capital grant received as deferred income, a planned subsidy approach to impairment could give rise to an immediate impairment on social housing properties.

FUNDING COMMITMENTS

The FRSPBE clarifies that a PBE is only permitted to recognise a liability for a funding commitment to another party if:

- the obligation is such that the entity cannot realistically withdraw from it
- the commitment does not depend on the performance of the recipient.

The FRSPBE does not envisage that there will be many situations where liabilities would be recognised because "entities rarely make irrevocable commitments without requiring future performance from the recipient." It would seem not all PBAG members are fully in agreement with this assertion.

INCOMING RESOURCES FROM NON-EXCHANGE TRANSACTIONS

The section on incoming resources from non-exchange transactions is essentially setting out the treatment for donations, with the FRSPBE requiring deferral of in the balance sheet when there are performance conditions which must be met to become entitled to the donation. Specifically, it:

- requires charity shops to recognise at fair value unsold donated goods
- permits legacies to be recognised only once probate has been received and executors have established there are sufficient assets to pay the legacy
- does not permit volunteer time to be recognised as income unless its value can be reliably measured

PBAG members thought that further clarification was needed to:

- distinguish donations with performance conditions from income received for specific purposes (restricted funds)
- determine whether or there was a prohibition on recognition of donated volunteer time (in line with the current charity SORP) or whether there were circumstances under which it could be measured reliably to warrant recognition.

HERITAGE ASSETS

With publication of the FRSPBE, the ASB noted their intention to incorporate a section dealing with heritage assets to the FRSME. This will enable all entities, not just PBEs to apply the specified accounting, although clearly its application will be most relevant to PBEs. The proposed accounting is in line with current UK GAAP (FRS 30).

APPLICATION TO TIERS 1 AND 3

Other than the accounting for concessionary loans and entity combinations (which cannot be applied by tier 1 PBEs applying full IFRS), the ASB suggests that all other accounting matters addressed by the FRSPBE would be constitute best practice guidance. The ASB are requesting views on whether it should be mandated for tier 3 entities applying the FRSSE.

CONSULTATION QUESTIONS

The ASB are asking constituents 14 specific questions related to the above proposals on the future of UK GAAP, with the deadline for responses set at 31 July 2011.

NUMBER	QUESTION
1	Is the definition of a public benefit entity and the accompanying application guidance sufficiently clear to enable an entity to determine if it is a public benefit entity?
2	Do you agree with the proposed effective date (periods beginning 1 July 2013) and the prohibition on early adoption for entities also subject to a SORP?
3-11	Do you agree with the various accounting treatments proposed for the transactions covered by the FRSPBE?
12	Are the issues that have been identified for potential inclusion in future versions of the RSPBE appropriate and complete ?
13	Do you believe that further guidance is required to interpret the indicators of control included in Section 9 *Consolidated and Separate Financial Statements* of the draft FRSME for application by public benefit entities?
14	Do you believe the requirements of the draft FRSPBE should be extended to entities that apply the FRSSE?

NEXT MEETING

The next meeting of the BDO PBAG has provisionally been set at 10.30am on Thursday 26th January 2012 at BDO LLP's offices, 55 Baker Street, by which time the ASB may have issued the final versions of the standards.

In the meantime, if you want to discuss further the implications of the ASBs proposals on the future of UK GAAP and how it affects your organisation, please do not hesitate to contact **Don Bawtree** or **James Nayler** at BDO.

ABOUT BDO

BDO provides a comprehensive range of business advice and accounting services throughout the UK and world-wide. BDO is an award-winning UK Member Firm of BDO International, the world's fifth largest accountancy network, with more than 1,000 offices in over 100 countries.

If you would like more information on our services, please contact your local BDO contact or:

DON BAWTREE, Partner
don.bawtree@bdo.co.uk
01372 734 305

www.bdo.co.uk

This document is printed on 9lives 80, a paper containing 80 per cent recycled fibre and 20 per cent virgin Totally Chlorine Free (TCF) fibre sourced from sustainable forests. 9lives 80 is produced by an ISO 14001 accredited supplier.