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Dear EFRAG Secretariat,

EFRAG's Discussion Paper: *Non-Exchange Transfers – A Role for Societal Benefit?*

Background

The Charity Commission for England and Wales, the Charity Commission for Northern Ireland, and the Office of the Scottish Charity Regulator act together as the joint SORP-making body for UK charities, and our comments on the Discussion Paper are made in that capacity. The SORP-making body has been in place since 1995 and has a great depth of experience in not-for-profit reporting and accounting, in particular financial reporting by charities.

The Charities SORP (Statement of Recommended Practice) provides guidance on accounting and reporting by charitable entities preparing accounts under UK-Irish GAAP. The guidance supplements accounting standards in order to reflect the special factors prevailing or transactions undertaken in the charity sector. The Charities SORP is developed by the joint SORP-making body, as authorised by the UK's Financial Reporting Council (FRC), and is advised by the Charities SORP Committee. Our comments incorporate the views and advice we have received from this Committee.

For further information about the UK-Ireland Charities SORP, please refer to the website: www.charitysorp.org. The Charities SORP may also be downloaded from this website.

Relevance to UK charities

We welcome EFRAG's efforts to further thinking on this important subject and the opportunity to offer feedback on its proposals. We recognise that the discussion paper is framed with specific reference to for-profit companies in attempting to address perceived inconsistencies in applying existing IFRS Standards.

Currently the development of UK-Irish GAAP is based on EU-adopted IFRS. UK-Irish GAAP covers accounting for Non-Exchange Transfers (NETs) and includes requirements which are specific to the public benefit entity sector, which includes charities. Therefore the proposals in the Discussion Paper might in time be expected to influence charity reporting in the UK and Ireland. Our comments are made in the light of existing approaches to accounting for NETs by UK charities as set out in current UK-Irish GAAP and the Charities SORP.

General comment

Public benefit entities are defined in UK accounting standards as entities whose primary objectives is to provide goods or services for the general public, community or social benefit, and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members. NETs commonly occur in public benefit entities, where they represent a major source of income and expenditure and include a wide range of transactions with many different organisations and individuals.

The Discussion Paper deals with transactions between private sector entities and public sector entities, largely focusing on non-voluntary transactions (for example, levies and income taxes). As a result, it is not always clear how the approach outlined in the Discussion Paper would be expected to apply to public benefit entities. By not taking into account the diversity of these transfers, the proposals run the risk of leading to unintended consequences for these entities should the proposals be the basis for the accounting treatment of NETS by public benefit entities. For example, the application of steps 2 and 3 could radically change the way that restricted income and funding commitments are recognised by UK and Irish charities, which would, in our view, lead to inappropriate accounting and impair the transparency and accountability of reporting in this area.

We would encourage EFRAG to give greater consideration to the impact of its proposals on public benefit entities. Doing so would ensure the proposals could be generally applied and address the full range and diversity of NETS and the area is considered on a more comprehensive basis. As the scope of the IASB and IPSASB does not include public benefit entities, considering the topic from this perspective also represents a significant contribution and could have a significant impact on the development of financial reporting in this sector. To do so, we recommend EFRAG look to the existing and current work undertaken by IPSASB in this area, as well as the approach for non-exchange transactions in current UK and Irish accounting standards, as supplemented by the Charities SORP.

Our comments on the specific questions raised in the Discussion Paper are set out in an annex to this letter. We hope this is a helpful contribution to EFRAG's work. If you have any questions about this submission, please contact CIPFA (e: easton.bilsborough@cipfa.org, t: +44(0)20 7543 5750), as secretariat to the joint Charities SORP-making body.

Yours sincerely,

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Annex to Charities SORP-making body's response to EFRAG's Discussion Paper: *Non-Exchange Transfers - A Role for Societal Benefit?*

Question 1 - Objective of the project

1.1 Do you agree that NETs have differentiating characteristics that warrant the development of a specific accounting treatment?

We agree that NETs have differentiating characteristics. We also agree that existing IFRS Standards covering these transactions is fragmented and inconsistent.

The analysis presented in Chapter 1 correctly notes the absence of explicit guidance for donations and grants from parties other than Government within existing IFRS Standards. Current UK and Irish accounting standards include specific requirements for accounting for donations and grants. These are included in Section 34 of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, which provides a clear and robust set of recognition criteria for NETs. These requirements are specific to public benefit entities (PBEs) where NETs represent a major source of funding and expenditure. In principle the accounting treatment for NETS should be principles based and so sector-eneutral between for-profit, government (public) and not-for-profit sectors.

Under UK accounting standards, a PBE is defined as an entity whose primary objective is to provide goods or services for the general public, community or social benefit, and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members. The specific nature of PBEs impacts on their reporting framework. Therefore the recognition and reporting requirements associated with NETs need to reflect their operational objectives, which differ to for-profit entities.

Therefore whilst we agree NETs warrant a specific accounting treatment, it should be suitable for the wide range of entities applying IFRS Standards. The approach explored in the DP applies a model that addresses limited NETs encountered by for-profit entities and does not consider the wide range of transactions encountered by PBEs. Doing so risks developing accounting treatments which do not reflect all the characteristics of NETs encountered by entities operating in the PBE sector and the information needs of users of their reports and accounts.

We believe that all sectors need to be looked at in their own right, given the fundamental differences between each. To do so, we suggest EFRAG look to the existing UK accounting standards, which include specific requirements for accounting for NETs by PBEs within FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. These requirements are reflected in guidance for financial reporting by UK charities, contained in modules 5, 6 and 7 of the '*Statement of Recommended Practice – Accounting and Reporting by Charities (FRS 102)*' ('Charities SORP'). The requirements and accompanying guidance provide a practical approach to accounting for NETs which is suitable for the PBE, but which nonetheless still fits with the principles of the underlying standard.

Question 2 - Scope of the project

2.1 Do you agree with how the scope has been defined? If not, is there a different scope that would provide a better basis for developing a comprehensive approach?

The identification of NETs and how they should be accounted for considers the potential accounting from the perspective of the private sector alone. However, NETs are commonly encountered by public benefit entities (PBEs). In these sectors, the vast majority of transactions undertaken meet the definition of a NET. This compares to the private sector, where NETs occur in limited and specific circumstances.

Therefore we believe the scope of the project should give greater consideration to the accounting requirements of PBEs. This would acknowledge the needs of the wide variety of PBEs that apply international accounting standards and the predominance of NETs within the PBE sector. Limiting the scope by intention or default to for-profit entities means the issue is considered from a narrow perspective that fails to develop a comprehensive approach to accounting for NETs.

2.2 Is the definition of NETs and the guidance around the assessment of their existence sufficiently clear and operational?

The definition of a NET agrees with the definition in UK accounting standards, contained within FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*.

We agree that deciding whether a transaction is a NET is not straightforward. The categorisation between exchange and NETs can be subjective and difficult to make in practice. Within the PBE sector, there is a spectrum of NETs which can make their assessment complex.

Paragraph 2.7 refers to the involvement of Government in aiding this assessment. NETs occur in a variety of situations and involve a wide range of entities. Within the PBE sector, this will often extend to bodies outside of Government. Similarly, transactions with Government, which relate to the supply of goods or services under contract, can meet the definition of an exchange transaction. Therefore the involvement of Government should not be considered a determining factor in whether a transfer is or contains a NET. Instead, the substance of the transfer with Government should be considered on an individual basis.

We support identification of the tripartite nature of NETs in paragraph 2.9, where the beneficiary is generally receiving resources from one party and providing services to other parties. This is a key feature of transfers in the charity sector where resources are used for the provision of goods or services for beneficiaries. This is linked with the concept of 'public benefit', which distinguishes charities as a separate type of entity within UK accounting standards with specific reporting requirements for NETs. Public benefit would appear to be aligned with the concept of 'societal benefit' used in the DP.

EFRAG could link societal benefit more clearly to the tripartite nature of NETs. The DP does not align the notion of a party involved in a NET having an implicit goal of 'societal benefit' with the existence of a beneficiary. This could be aided by defining societal benefit, which is not included in the glossary in Appendix 1 of the DP. Doing so may also help support the idea that societal benefit could be used as a basis for recognition, as explored in Step 3 of the proposed approach.

We suggest this is done in reference to the current review being undertaken by IPSASB on its standard on non-exchange revenue, and the development of a standard on non-exchange expenses. IPSASB's work places the existence of 'service potential' as defining the accounting treatment of a NET. The concept of 'service potential' in the context of public sector resonates with the DP's discussion of 'societal benefit'. Considering societal benefit in parallel with IPSASB's current work would encourage consistency of accounting for NETs in the private and public sectors. We would strongly encourage such an approach. In our view, divergences between these sectors drives specialisation and creates complexity which is inconsistent with greater transparency and accountability in financial reporting.

2.3 Do you agree with the proposed exclusions from the project? In particular, do you think that the approach could be fit also for income taxes?

Proposed exclusion

Generally, we consider that exclusions are not helpful in trying to address the type of anomalies that have led to the need for the discussion paper in the first place. Without testing the proposed changes in the context of the full range of NETs as whole runs the risk of creating solutions that are of limited application in the longer term. This includes NETs which are commonly encountered by both for-profit entities, as well as public benefit entities.

In considering the proposed exclusions detailed in Chapter 2, we observe that paragraph 2.21 states that income tax is not included in the scope of the project. The basis for this exclusion appears to be due to concerns about the approach to the measurement of income taxes under the current standard. However, this is not supported by the focus of the DP, which explores the timing and pattern of recognition of NET rather than measurement issues. Moreover, income tax and levies are referenced throughout the paper, the latter of which is broadly similar in substance to income taxes.

Application of the approach for income taxes

No comment is offered in respect of application of the approach for income taxes, as a transaction which is commonly encountered by entities in the private sector. However, we observe that approach explored by the DP appears to be directly informed by the fact pattern associated with income taxes and substantially influenced by these type of transactions (i.e. non-voluntary NETs).

Question 3 - Transactions that include a NET

3.1 Which of the methods presented in paragraph 2.11 do you support, and why?

We support method (b) being applied where a transaction includes a non-exchange and a NET. However, we would expect the most appropriate method to be determined by the underlying principles of financial reporting, and supported by the basis of accounting for NETs which is consistent with these principles. We believe the discussion about the alternative methods should reference an underlying conceptual framework, rather than be considered as part of the project's scope.

Whilst method (b) is considered to be the most appropriate option of those presented in paragraph 2.11, it is observed that identifying the predominant component can be nuanced for public benefit entities. For example, sponsorship agreements will commonly involve both exchange and non-exchange components. In these transfer agreements a public benefit entity receives resources for the provision of goods or services to beneficiaries. In exchange the resource provider may be credited by the entity in its marketing material and receive exposure as a 'sponsor' of the entity. Therefore the sponsor receives benefits from the sponsorship agreement. However, the nature and value of the benefits received by the resource provider mean these transfers may not involve an exchange of equal value, and are considered to be NET in substance.

Whilst we consider method (c) to be technically sound, identifying and allocating the NET element is likely to be difficult in practice. In these circumstances, identifying and allocating an amount to the exchange component using the residual method in IFRS 15 would be complex, often prone to error and create an additional cost for preparers. We doubt that the additional information provided to users of the accounts would justify the additional cost of applying this method.

Question 4 - Application of Step 2

4.1 Which of the approaches presented in paragraph 3.13 do you support, and why?

Application of Step 2

The approach for recognising NETs in Step 2 differs to the one set out in paragraphs 5.3 to 5.19 of the Charities SORP.

It is common for transfers to be linked to identifiable underlying activities in the PBE sector, for example, resources which must be used for a particular purpose. The Charities SORP specifies that where a resource provider limits or directs the purpose for which a resource may be used, this creates a 'restriction' rather than a performance-related condition. A restriction does not prevent the recognition of a NET. The Charities SORP requires recipients to recognise NET income subject to restrictions where there is evidence of entitlement, receipt is probable and its amount can be measured reliably. Therefore NETs subject to restrictions tend to be recognised immediately and not deferred.

We believe this approach allows NETs to be accounted for appropriately by PBEs. The approach results in the recipient recognising an asset that may be expended by the recipient for the purposes specified by the resource provider. Deferring the NET income would not reflect that the recipient having both control over, and a right to, the transferred asset; therefore we do not support the approach for recognising NETs presented in Step 2.

Application of Step 1 – Existence of performance-related conditions

The Charities SORP separately defines NETs subject to 'restrictions' and 'performance-related conditions'. The latter are conditions that require a specific level of performance or output from the resource recipient. In these instances, the conditions for payment are linked to the achievement of a particular level of service or units of output delivered. The Charities SORP requires income subject to performance conditions to be recognised to the extent that the recipient has provided the specified goods or services. This is done on the basis of the recipient not being entitled to the income until the performance-related conditions are met.

As a result, we broadly support the approach for recognising NETs in Step 1, as it reflects the approach set out in the Charities SORP. However, for those NETs where there are no such conditions, the transfer should be recognised when there is evidence of entitlement, receipt is probable and the amount can be measured reliably.

Underlying activity affects the financial position and performance in two different periods

The difference between the approach in Step 2 and the Charities SORP is illustrated by the transfer in paragraph 3.12 and the alternative approaches presented in paragraph 3.13. PBEs applying the Charities SORP are normally entitled to income associated with capital grants when the income is receivable. The entire grant is recognised immediately as income in the current reporting period. This accounting treatment is different to the two alternative approaches presented in paragraph 3.13, which suggests the income is deferred and recognised when the asset is purchased, or over the life of the asset. As a result, we do not support either approach.

Question 5 - Application of Step 3

5.1 Do you agree with the outcome? And do you believe that the notion of 'societal benefit' provides a conceptually adequate basis to support the outcome?

Application and outcome of Step 3

The approach for recognising NETs in Step 3 differs to the approach set out in paragraphs 5.3 to 5.12 of the Charities SORP.

Resources received by PBEs are commonly available to be spent on furthering any of the entity's purposes. The Charities SORP classifies income from such a NET as 'unrestricted income' and requires recipients to recognise unrestricted income where there is evidence of entitlement, receipt is probable and its amount can be measured reliably. NETs of this type are commonly recognised immediately and not deferred. This approach results in the recipient recognising incoming resources where there is control and a right to spend the assets being transferred. We believe this allows NETs to be accounted for appropriately by PBEs

For example, a donor may make a regular donation to an entity which is paid during the second half of the entity's accounting period. PBE's applying the Charities SORP would be expected to recognise the entire donation immediately as income in the current in the current reporting period. As described above, this approach is considered to faithfully represent the entity having both control over and a right to the income. This accounting treatment is different to the application of Step 3, which suggests that the donation would be recognised on a straight-line basis between two payment dates (i.e. a linear recognition pattern, resulting in the income being spread across two accounting periods). This approach does not acknowledge the entity's control and right to the resource. Therefore we do not agree with the outcome, nor support the approach for recognising NETs in Step 3.

'Societal benefit' in the context of the PBE sector

In the DP the application of Step 3 and concept of 'societal benefit' focuses on transactions with Government. This addresses the timing and recognition of income taxes and levies as expense generating transfers. As noted in our response to Question 2, NETs are commonly encountered by PBEs where the majority of transactions meet the definition of a NET. In the PBE sector, these transfers occur in a variety of situations and with different entities. We therefore recommend that the accounting approach in Step 3 should be considered from a wider perspective which considers the broad range of NETs that can occur in practice.

We believe that extending the concept of 'societal benefit' to the wider PBE sector also challenges the outcome and conceptual underpinning of Step 3.

Step 3 is based on an entity's contribution to 'societal' benefit occurring in a constant pattern over the period of time. It is unlikely for any entity to be in possession of complete information about its effects on societal benefit, and whether these are consumed or received on a continuous basis. However in those situations were a PBE carries out its activities over a defined period each year (i.e. its principle activities are seasonal), the pattern that the benefits are consumed or received is unlikely to be continuous. We would question whether in such circumstances, requiring recognition of a straight-line basis would be appropriate.

Step 3 raises the question of whether 'societal benefit' is analogous to 'public benefit' and supports there being a definition of 'societal benefit'. Whilst the objectives of a PBE may focus on generating public benefit as a whole, for charitable organisations, this benefit will be generated through meeting its charitable objects to benefit of the charity's beneficiaries. This benefit will be for a defined group, rather than society at large. To this extent, the concept of 'societal benefit', which is framed around public services provided by Government, may differ from the concept of 'public benefit' applicable to charitable organisations.

Step 3 also raises the question of whether transactions that create 'societal benefits' (i.e. NETs) should impact on the financial position of those entities which generate these benefits and do so as part of their objectives. Under current UK-Irish accounting standards, the timing and pattern of recognition of NETs by PBEs is not influenced by how the entity's beneficiaries 'enjoy' these benefits. The entity's impact on its beneficiaries is not linked to its financial performance and position. However, we see no conceptual rationale for this approach within the DP. The discussion of Step 3 provides no explanation of why the recognition of NET on the basis of 'societal benefit' would be particularly useful to any readers of the financial statements and therefore consistent with the IASB's *Conceptual Framework for Financial Reporting*. This is a significant omission in defining the principles being applied.

Question 6 - The role of uncertainty

6.1 Do you think that the recognition of expense-generating and income-generating transfers should be subject to a symmetrical or asymmetrical approach? Please explain your answer.

Role of uncertainty

The role of uncertainty in recognising income-generating and expense-generating NETs is covered in paragraphs 5.8 and 7.5 of the Charities SORP respectively. The recognition of income requires it to be 'more likely than not' that the economic benefits associated with the transfer will flow to the entity. Similarly, the recognition of expenditure requires it to be 'more likely than not' that the transfer will be required in settlement. Therefore probability is a condition of recognition for both income and expenditure.

More specifically, paragraphs 5.16 to 5.19 of the Charities SORP cover the recognition of income from NETs that are conditional on future events, as discussed in paragraph 4.3 of the DP. As noted in our response to Question 4, the Charities SORP requires income subject to performance-related conditions to be recognised to the extent that the recipient has provided the specified goods or services. This is done on the basis of the recipient not being entitled to the income until the performance-related conditions are met. Paragraphs 5.20 to 5.25 cover those instances where the conditions are not wholly within the control of the recipient. Under these circumstances, the Charities SORP requires income is deferred and only recognised when the conditions are met. Where the receipt is assessed as being probable once these conditions are met, the income should be disclosed as a contingent asset.

On the other side, paragraph 7.17 to 7.24 of the Charities SORP covers the recognition of expenditure from NETs that are conditional on future events. This includes accounting for liabilities and expenditure arising from performance-related grants. The Charities SORP requires the resource provider to recognise the liability and expenditure arising from grants subject to performance-related conditions to the extent that the recipient has provided the specified goods or services. Where a condition falls outside the control of the resource provider, a liability arises and expenditure must be recognised if the payment of the grant is probable.

The approach for the recognition of expense-generating transfers and income-generating transfers in the Charities SORP covers the notion of uncertainty. However, it is framed around the concept of probability as a condition of recognition. As there will always be an element of uncertainty regarding the occurrence of the transfer in any NETs, we believe this approach more appropriately addresses the nature of these transfers. Allowing uncertainty to play an explicit role as a factor affecting the recognition of NETs risks a return to cash accounting, which we believe would undermine the relevancy and transparency of reporting in this area.

We therefore recommend that the role of uncertainty is considered in relation to the general principles of income and expenditure recognition. This supports the development of a more credible accounting approach whereby preparers are required to consider the notion of uncertainty in relation to defined principles, which includes the consideration of prudence.

Asymmetrical recognition

Having regard to the above, we believe that the recognition of expense-generating and income-generating NETs need not be subject to a symmetrical approach. Asymmetry is not uncommon in financial reporting and largely depends on the facts and circumstances of a particular transaction which will affect the resource provider and recipient in different ways. This reflects the approach set out in the Charities SORP, which does not aim for the symmetrical recognition of assets and liabilities by resource providers and resource recipients

For example, the treatment for grants involving resources being transferred on an on-going basis (e.g. multi-year grants) in the Charities SORP will not result in symmetrical recognition of assets and liabilities associated with the NET in all cases. The recognition of multi-year grants by resource providers tends to be dependent on the existence of a constructive obligation and whether there are conditions attached to the grants payment. On the other side, multi-year grants tend to be recognised by resource providers when there is evidence of entitlement to the resource being transferred. The criteria for recognition is irrespective of whether a liability for the grant has been recognised by the resource provider or not. Therefore the accounting treatment does not aim to mirror the treatment of the resource provider. This is on the basis of the transfer being undertaken by different entities applying the accounting principles in order to reflect transactions based on the best information available to them.

Based on the analysis presented in Chapter 1, a symmetrical approach would only be achieved at the expense of prudence and the other principles of the IASB's Conceptual Framework. We do not consider this to be desirable as the accounting approach should be consistent with the concepts and principles of the relevant underlying accounting framework. We also question the practicality of a symmetrical approach as resource providers and recipients' access to information and assessment of risk will often be different.