

**STATEMENT OF PRINCIPLES**

**FOR FINANCIAL REPORTING**

**INTERPRETATION FOR  
PUBLIC BENEFIT ENTITIES**



**ACCOUNTING  
STANDARDS  
BOARD**

**INTERPRETATION**

**STATEMENT OF PRINCIPLES**

**FOR FINANCIAL REPORTING**

**INTERPRETATION FOR PUBLIC**

**BENEFIT ENTITIES**

This Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting was agreed by the Accounting Standards Board in May 2007. At that time, the Board comprised:

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**ACCOUNTING  
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# **INTRODUCTION**

## **PURPOSE**

- 1 This Interpretation for Public Benefit Entities of the Statement of Principles for Financial Reporting (this Interpretation) sets out the principles that the Accounting Standards Board (the Board) believes should underlie the preparation and presentation of general purpose financial statements of public benefit entities<sup>1</sup>.
- 2 The principles in this Interpretation are consistent with those relevant to profit-oriented entities, as set out in the Board's Statement of Principles for Financial Reporting (the Statement). The Statement is now almost ten years old and 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. For this reason, the Board recognises this Interpretation may be superseded in the short to medium term. It should, however, make a useful contribution to the work that is being taken forward internationally as well as supporting the work of UK SORP making bodies until frameworks are agreed internationally.
- 3 Many of the principles are exactly the same as those that are relevant to profit-oriented entities. Any re-expression, change of emphasis or additions to the principles are designed to make them more relevant to public benefit entities and have been made only to clarify their application in situations specific to public benefit entities. Those principles that have been re-expressed in this Interpretation are detailed in Appendix 1, together with a brief explanation.

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<sup>1</sup> The term 'public benefit entities' is explained in paragraph 11.

- 4 The primary purpose of articulating the application of the principles to public benefit entities is to provide a coherent frame of reference to be used in the development of Statements of Recommended Practice (SORPs)<sup>2</sup> or other sector specific guidance for public benefit entities and to assist preparers and auditors faced with new or emerging issues. Nothing in this Interpretation overrides the requirements of existing accounting standards or SORPs.
- 5 The prescription of accounting requirements for the public sector in the United Kingdom is carried out by the Government. Where entities in the public sector prepare annual reports and accounts on commercial lines, the Government's requirements may or may not refer specifically either to accounting standards or to the need for the financial statements concerned to give a true and fair view. However, when they do, the Government's requirements accord with the principles underlying the Board's pronouncements subject to such adaptations as are considered necessary in the public sector context.

## STATUS

- 6 This Interpretation is not an accounting standard, nor does it have a status that is equivalent to an accounting standard. It therefore does not contain requirements on how financial statements should be prepared or presented. Where there may be an inconsistency between the principles set out in this Interpretation and an extant standard, such as SSAP 4 "Accounting for government grants", the standard should be followed.

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<sup>2</sup> SORPs are recommendations on accounting practices for specialised sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular sector. SORPs are not issued by the ASB, but by industry or sectoral bodies recognised for the purpose by the ASB. At present there are four SORPs relating to the public benefit sector addressing local authorities, education institutions, registered social landlords and charities.

- 7 Much of the wording in this Interpretation is based upon the Statement. This document is intended to supplement, not replace, the Statement and should therefore be read in conjunction with it.
- 8 To ensure there is adequate context for the information on the application of the principles to public benefit entities some of the material in the Statement has been repeated in this Interpretation. However, it should not be assumed that where material has been omitted it is not relevant to public benefit entities. Appendix 2 provides a comparison of this Interpretation with the Statement highlighting the source of material and those paragraphs of the Statement that have not been repeated.

## **SCOPE**

### *Types of entity*

- 9 The Statement is intended to be relevant to the financial statements of profit-oriented entities, regardless of whether they are private or public sector entities.
- 10 The principles in this Interpretation are intended to be relevant to the financial statements of public benefit entities, regardless of their size, whether or not they aim to make a surplus and whether they are private or public sector entities<sup>3</sup>.
- 11 Public benefit entities are reporting entities whose primary objective is to provide goods or services for the general public or social benefit and where any equity<sup>4</sup> has been provided with a view to supporting that primary objective rather than with a view to providing a financial return to equity shareholders.

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<sup>3</sup> Both the Statement and this Interpretation use the terms 'public' and 'private' in this context as mutually exclusive and to encompass between them all entities.

<sup>4</sup> Equity (for example, in the purchase of equity shares) is provided by investors.

- 12 The term ‘public benefit entities’ does not necessarily imply that the purpose of the entity is to exist for the benefit of the public as a whole. For example, many public benefit entities exist for the direct benefit of a particular group of people, although it is possible that society as a whole also benefits indirectly. The important factor is what the primary purpose of such entities is, and that it does not exist primarily to provide economic benefit to its investors. Organisations such as mutual insurance companies, other mutual co-operative entities and clubs that provide dividends or other economic benefits directly and proportionately to their owners, members or participants are not public benefit entities.
- 13 The use of the term does not mean that all entities that do not make a profit are for the public benefit. Neither does the term imply that all entities that make a profit (or surplus) are not for the public benefit. Furthermore, certain public benefit entities, such as housing associations or the trading arm of a charity, may aim to make a profit from some of their activities which is then utilised in furtherance of the entity’s primary objective. It is possible that an entity could undertake some activities that are intended to make a surplus, without the entity as a whole being profit-oriented<sup>5</sup>.
- 14 Public benefit entities may have contributions in the form of equity, even though the entity does not have a primary profit motive. However, because of the fundamental nature of public benefit entities, any such contributions are made by the equity holders of the entity primarily for the provision of goods or services rather than with a view to a financial return for themselves<sup>6</sup>. This is different from the position of lenders; loans do not fall into the category of equity.

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<sup>5</sup> Where a public benefit entity has a discrete division that is profit-oriented it may be useful to refer to the Statement in relation to that division, even though this Interpretation applies to the entity as a whole. Similarly, this Interpretation will not be directly relevant to any subsidiaries of public benefit entities that are not public benefit entities themselves.

<sup>6</sup> It does not follow that all contributions from funders and financial supporters are in the form of risk capital.

- 15 There is no exhaustive list of entities that are public benefit entities.

*Types of financial report*

- 16 Financial information takes many different forms. However, the Statement categorises financial information into three broad headings. These categories are:

- special purpose financial reports;
- general purpose financial reports; and
- other financial information.

- 17 General purpose financial reports include general purpose financial statements, for example the annual financial statements.

- 18 The primary focus of this Interpretation for public benefit entities is on those financial statements that are required to give a true and fair view of the reporting entity's financial performance and financial position. However, where the requirement to present a true and fair view is expressed in another form, for example 'presents fairly', this Interpretation still applies.

- 19 The principles in the Statement and this Interpretation have been developed in the context of entities that prepare accruals based financial statements. Accordingly, this Interpretation is not intended to be relevant to receipts and payments accounts and other non-accruals based general purpose financial statements, which would not give a true and fair view of the reporting entity's financial performance and financial position.

- 20 Whilst this Interpretation does not address to any significant extent other types of general purpose financial report, it will be relevant to such reports insofar as they provide financial information that is intended to be consistent with the financial statements.

*Legal requirements*

- 21 The financial statements of public benefit entities are subject to legal requirements. Such requirements may vary substantially between sub-sets of public benefit entities both in terms of the level of prescription (ie general or very specific) and in terms of quantity/sources. In order not to deny this Interpretation the opportunity to assist in the development of legal requirements, it has not been developed within the constraints imposed by legislation.

**REVISIONS TO THE STATEMENT**

- 22 The Statement may be revised from time to time in the light of the Board's experience of working with it and in response to developments in accounting thought. This Interpretation may also be revised from time to time.

## **CHAPTER 1: THE OBJECTIVE OF FINANCIAL STATEMENTS**

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*Put simply, the objective of financial statements is to provide information that is useful to those who use them. However, the objective needs to be expressed more precisely if it is to be of any use in determining the form and content of financial statements. This chapter does that by considering the persons for whom financial statements are prepared, the information needs of such persons and the role that financial statements play in meeting those needs.*

### **PRINCIPLES**

- The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.
- That objective can usually be met by focusing exclusively on the information needs of funders and financial supporters, the defining class of user.
- Funders and financial supporters need information about the reporting entity's financial performance and financial position that is useful in helping them to evaluate the proper and efficient use of the entity's resources and in assessing the entity's future cash needs and its financial adaptability.

### **EXPLANATION**

*The main differences between the principles and explanation relevant to profit-orientated entities, as expressed in Chapter 1 of the Statement, and their interpretation for public benefit entities, are in the defining class of user and the role stewardship plays in the preparation of financial statements. Additional material specific to public benefit entities has therefore been added to this chapter of the Interpretation, although Chapter*

*1 of the Statement should also be referred to for a full understanding of the discussion that follows. Additional explanation specific to users of public benefit entities financial statements has also been added, including other groups of user that may be interested in the performance of a public benefit entity, for example beneficiaries and government agencies.*

## THE OBJECTIVE OF FINANCIAL STATEMENTS

### *Useful to a wide range of users*

1.1 The Statement notes that many people may have an interest in the financial information of an entity. Certain bodies, such as regulators of public benefit entities, may have the power to insist on the preparation of special purpose financial reports. However, others will need to rely on general purpose financial reports, such as financial statements. These persons are referred to as the ‘users’.

### *Useful for making economic decisions*

1.2 The persons potentially interested in an entity’s financial statements need information on that entity for a variety of purposes. For public benefit entities the groups of users that are interested in an entity’s financial statements are largely consistent with those described in the Statement: some exceptions and clarifications are discussed below:

- (a) *Present and potential investors.* Public benefit entities rarely have such investors; therefore this class of user has been replaced with *funders and financial supporters*.
- (b) *Present and potential funders and financial supporters (hereafter generally referred to simply as ‘funders and financial supporters’).* Providers of resources are interested in information that helps them to assess how effectively management has fulfilled their stewardship role. They are also interested in information about the utilisation of the resources they supplied to the entity that might be useful in taking decisions about resources they may choose, or be required, to supply in the future.

- (c) *Lenders*. Lenders are interested in information that helps them to assess whether their loans and related interest will be paid, when due. Similarly, potential lenders are interested in information that helps them to decide whether to lend to the entity and on what terms.
- (d) *Beneficiaries/customers*. Beneficiaries and customers are interested in information about the entity's continued existence. That is especially so when they have a long-term involvement with, or are dependent on, the entity. Beneficiaries and customers are also interested in how resources have been applied by the entity in meeting its objectives.
- (e) *Governments and their agencies, including regulators*. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They may also have specific regulatory (or intermediary) roles, through which they aim to give the public confidence in the operations of the entities they regulate, perhaps performing a scrutiny role on behalf of the funders and financial supporters, or the general public. They require information that assists them in regulating the activities of entities and for example, for providing a basis for national statistics. Some of this information is obtained through special purpose financial reports, which will often need to be able to demonstrate consistency with general purpose financial reports.
- (f) *The public*. The interest the public may have in the financial statements of a public benefit entity will vary from that described in the Statement. For example, as part of the broad accountability of public benefit entities, the public may be interested in the quality of management's stewardship and in the relative allocation of resources between competing priorities. For a number of public benefit entities the public will be the funders and financial supporters of the entity.

- 1.3 Although those potentially interested in an entity's financial statements need that information for a variety of purposes, the Statement concludes that all the purposes involve taking economic decisions. The economic decisions made by users of the financial statements of profit-oriented entities may include whether to hold or sell their investments. They might also include whether to reappoint or replace the management of the entity. For public benefit entities, certain users will have the ability to make similar economic decisions. For example, funders and financial supporters may vary the level of financial support based on how effectively management have fulfilled their role. This might include a decision about whether to commence supporting an entity.
- 1.4 Some users, such as members of the public and taxpayers in relation to a local authority, will not have the same ability to make direct economic decisions. They may however have the ability to vote at elections and this may indirectly influence the level of resources contributed to entities.

#### *Assessing stewardship*

- 1.5 Stewardship plays an important role in the preparation of financial statements by public benefit entities. Accountability to a public benefit entity's stakeholders for the use of funds and the safekeeping of its resources is often of paramount importance and there may be a wide range of people having such an interest in the activities of the entity. For example, accountability to the public for the collection of taxation and its use in the provision of public goods and services is fundamental in public sector reporting. Therefore, a key objective of financial statements for public benefit entities is the provision of information to assist in a user's assessment of the efficient and effective use of funds and other resources.
- 1.6 To allow users to make a full assessment of the stewardship of an entity (perhaps including an assessment of the extent to which its public benefit objective has been met) additional information is likely to be required. Some of this information may accompany the financial statements but it

will not form part of the financial statements. This is known as accompanying information and is discussed in Chapter 7.

*Information on financial performance and financial position*

- 1.7 There is overlap in the financial information that is required by users although all are interested in the financial performance and financial position of the entity as a whole. General purpose financial statements focus on this common interest of users and are the principal means of communicating accounting information of an entity to interested parties.

*The limitations of financial statements*

- 1.8 Financial statements do not seek to meet all the information needs of users: users will usually need to supplement the information they receive from financial statements with information from other sources. Financial statements have various inherent limitations<sup>7</sup> which means that some information on the financial performance and financial position of the reporting entity can be only provided by general purpose reports other than financial statements. For example, a description of the environment in which the reporting entity operates and the strategies it has adopted might be more appropriately included in the accompanying information. Those users with the authority to obtain special purpose financial reports might also utilise that authority to supplement the information in the financial statements.
- 1.9 The need to supplement the financial statements with other information is at least as important for public benefit entities as for profit-oriented entities. In assessing the efficient and effective use of resources, the user is likely to need information in addition to that reported in a conventional presentation of financial performance and financial position.

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<sup>7</sup> Including the degree of aggregation, the focus on the financial effects of transactions and events and the fact that they are largely historical.

For example, information in the material accompanying the financial statements, such as the management commentary, might be needed in order to put the numerical information in the financial statements into context. Such information might include qualitative and quantitative information on services provided by the entity during the year.

- 1.10 Many public benefit entities also utilise other forms of presentation, which may include financial information that may or may not be provided with the financial statements. One example might be a comparison of actual results to budget, which might provide information on whether an entity has spent according to plan. Public benefit entities might also use methods of communication other than the financial statements to provide financial information, particularly to classes of user other than the defining class.

#### FUNDERS AND FINANCIAL SUPPORTERS AS THE DEFINING CLASS OF USER

- 1.11 The Statement notes that, in preparing the financial statements of profit-oriented entities, the rebuttable assumption is that financial statements that focus on the interest that investors have in the reporting entity's financial performance and financial position will, in effect, also be focusing on the common interest that all users have in that entity's financial performance and financial position.
- 1.12 However, public benefit entities often have no such investors (i.e. shareholders) and for those entities that do have shareholders, there may not be rights to participate in any surpluses or on winding-up<sup>8</sup>. For public benefit entities funders and financial supporters are similar to investors in profit-oriented entities in terms of their information requirements.

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<sup>8</sup> *In the event of a winding-up any remaining net assets would often be dealt with in accordance with the governing instrument of the entity. Usually this would involve the transfer of the net assets to another public benefit entity with similar objectives.*

- 1.13 The defining class of user for the financial statements of public benefit entities is funders and financial supporters. They provide a source of cash or other resources without the incentive of a direct return on their investment. Funders and financial supporters generally provide taxation, grants or donations to the entity. The defining class of user includes present and potential funders and financial supporters of the entity. Funders or financial supporters will also include an individual or entity that has made a contribution in the past if that contribution created an ongoing financial interest.
- 1.14 There are differences between a ‘financial supporter’ and a ‘funder’. A financial supporter is someone who has made a conscious decision to contribute, whereas this might not be true of a funder, such as a taxpayer. A lender, in his capacity as a provider of debt capital on which he receives a return, is neither a funder nor a financial supporter.
- 1.15 Where a public benefit entity has ‘members’ who are required to make a financial contribution in order to be admitted to the membership, they should be considered as financial supporters where the value of the contribution is unlikely to represent the fair value of the benefits available from membership (ie it is at least partly a mechanism to provide financial support, not the purchase of goods or services). As a result, to the extent that contributions are financial support, they should be recognised as revenue when received.
- 1.16 For many public benefit entities, funds are not received directly from their source, but are passed on through intermediaries (for example government entities providing grants). Often such intermediaries will be regulators that may have a statutory right to require certain information to be published in the financial statements. This information should be regarded as special purpose as it will not necessarily meet the information requirements of a general user of the financial statements (for example, where it relates to an amount of expenditure incurred under a specific piece of legislation). It is therefore necessary to look through

intermediary financial supporters to the original source to ensure that financial statements are prepared to provide general purpose rather than special purpose information.

## THE INFORMATION REQUIRED BY FUNDERS AND FINANCIAL SUPPORTERS

### *Financial performance*

- 1.17 Information on financial performance, amongst other things, provides an account of the stewardship of management and is useful in assessing the past and anticipated performance of the entity.
- 1.18 In the case of public benefit entities, stewardship is a particularly important part of reporting to users. Users require information to hold management to account for the safekeeping of the entity's resources and for their proper and efficient use.

### *Financial position*

- 1.19 An entity's financial position encompasses the economic resources it controls, its financial structure, its liquidity and solvency, its risk profile and risk management approach, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled and the use made of them in the past also helps in assessing the stewardship of management.

### *Cash needs*

- 1.20 Information on the ways in which an entity uses cash provides an additional perspective on financial performance that is largely free from allocation and valuation issues and is relevant to an assessment of its future cash needs.
- 1.21 Information on the generation and use of cash is important for public benefit entities. In certain cases, the entity may have a limit imposed on the amount of cash that it has

authority to spend each year. Where this is the case, information on the use of cash may be needed to demonstrate accountability and the effective use of funds.

- 1.22 An entity's financial adaptability is its ability to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities.
- 1.23 Financial adaptability can help an entity mitigate the risks associated with its activities, which in turn can help it survive during a time of low cash flows.

## **CHAPTER 2: THE REPORTING ENTITY**

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*It is important that entities that ought to prepare and publish financial statements, do, in fact, do so and that those financial statements report on all relevant activities and resources. This chapter focuses on these issues – in other words, on identifying and circumscribing the reporting entity.*

### **PRINCIPLES**

- An entity should prepare and publish financial statements if there is a legitimate demand for the information that its financial statements would provide and it is a cohesive economic unit.
- The boundary of the reporting entity is determined by the scope of its control. For this purpose, first, direct control, and secondly, direct plus indirect control are taken into account.

### **EXPLANATION**

*There are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 2 of the Statement, and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 2 of the Statement, which should be referred to for a full understanding.*

*Additional explanation specific to public benefit entities has been added covering assets held by an entity in a fiduciary capacity.*

### **ENTITIES THAT SHOULD PREPARE AND PUBLISH FINANCIAL STATEMENTS**

- 2.1 It is essential that entities that ought to prepare and publish financial statements, do so. For similar reasons, if there is no justification for an entity to prepare and publish financial statements, it should not be required to do so.

- 2.2 For the preparation of financial statements to be justified in any particular case, there needs to be a legitimate demand for the information that the financial statements would provide. This means, *inter alia*, that the information provided by the financial statements will need to be useful and that the benefits to be derived by providing the financial statements will need to exceed the costs of doing so.
- 2.3 The financial statements of an entity will report on the entity's transactions and on other events that affect its financial performance and financial position. However, if the information provided by the financial statements is to be useful, the entity that is the subject of the financial statements (the reporting entity) needs to be a cohesive economic unit. This ensures accountability – the reporting entity is held to account for all the things it can control – and it gives the reporting entity a determinable boundary – because activities and resources are either within its control or outside its control.

#### THE BOUNDARY OF A REPORTING ENTITY

- 2.4 The control an entity exerts can be direct or indirect.
- (a) An entity has direct control of an asset if it has the ability<sup>9</sup> in its own right to obtain future economic benefits<sup>9</sup> embodied in that asset and to restrict others' access to those benefits.
  - (b) An entity indirectly controls an asset if it has control of an entity that has direct control of the asset.
- 2.5 Direct control is used to determine the boundary of the reporting entity that prepares single entity financial statements. Direct plus indirect control is used to determine the boundary of the reporting entity that prepares consolidated financial statements.

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<sup>9</sup> *The future economic benefits to which a public benefit entity might have access are discussed in Chapter 4.*

- 2.6 It may be that, although an entity can influence another entity, it does not control it. Such entities do not comprise a single reporting entity.

#### WHAT IS CONTROL?

- 2.7 Control has two aspects: the ability to deploy the economic resources involved and the ability to benefit (or to suffer) from their deployment. To have control, an entity must have both these abilities.
- 2.8 Control in the context of assets and liabilities is considered in more detail in Chapter 4, which provides further details on the interpretation of “economic benefits” in the context of public benefit entities, in particular noting that access to future economic benefits includes the provision of goods and/or services to the benefit of the entity’s beneficiaries.

#### CONTROLLING AN ENTITY

##### *When does one entity control another?*

- 2.9 An entity will have 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 (which might be achieved through concurrence of objectives) or being exposed to significant risks inherent in the activities. Control of another entity need not involve share ownership.
- 2.10 There is no single piece of evidence that is proof of an investor’s control in all circumstances, although evidence that will help to determine whether control exists can be obtained by considering:
- (a) the respective rights held;
  - (b) the inflows and outflows of benefit; and
  - (c) exposure to risk – how and to what extent the investor suffers or gains from variability of outcome.

- 2.11 In the absence of any other factors, an agreement to provide funding would not be expected to constitute control.
- 2.12 In some circumstances a public benefit entity may be the trustee of charitable funds. Depending on the circumstances of the case, the charitable funds may form part of the reporting entity, particularly if the trustee both controls the charitable funds and has objectives that are concurrent.

*Powers of veto and reserve powers*

- 2.13 Control implies the ability to restrict others from directing the financial and operating policies of the controlled entity. Powers of veto and reserve powers are unlikely to form the sole basis of control because they do not provide a basis for deploying the resources nor do they ensure the corresponding flows of benefit.

*Predetermined operating and financial policies*

- 2.14 An entity whose operating and financial policies are predetermined will be controlled by another entity if that other entity gains the benefits arising from the former's net assets and is exposed to the risks inherent in them (ie the variability of outcome).

*Latent control*

- 2.15 If an entity has the ability to control another entity, it is usually presumed to be exercising control, even if such control is not apparent.

*Management but not control*

- 2.16 Control needs to be distinguished from management. If an entity manages a second entity on its own behalf, then it controls the second entity because it has the two abilities referred to in paragraph 2.7. On the other hand, if an entity manages the second entity on behalf of another party, it is not exposed to the benefits arising from, or risks inherent in,

the activities of the second entity because the manager's interest in the managed entity is normally limited to its fee. As such, it does not have the second ability referred to in paragraph 2.7 and therefore does not have control of the second entity.

#### ASSETS HELD IN A FIDUCIARY CAPACITY

- 2.17 A number of public benefit entities have a fiduciary role for assets that they do not control, for example, residents' valuables held by a local authority care home or artwork on loan for an exhibition. Since the boundary of the reporting entity is based on control, such assets should not be reflected in the balance sheet of the reporting entity. Where a fiduciary arrangement does not pass the control test, appropriate disclosures should be provided to indicate the nature and extent of the entity's fiduciary responsibilities. In some circumstances an entity may also be required to prepare separate financial information relating to the assets held in a fiduciary capacity.

## **CHAPTER 3: THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION**

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*In deciding which information to include in financial statements, when to include it and how to present it, the aim is to ensure that financial statements yield information that is useful. This chapter considers the qualities of financial information that make it useful.*

### **PRINCIPLES**

- Information provided by financial statements needs to be relevant and reliable and, if a choice exists between relevant and reliable approaches that are mutually exclusive, the approach chosen needs to be the one that results in the relevance of the information provided being maximised.
- Information is relevant if it has the ability to influence the economic decisions of users, or their assessment of the effectiveness of the stewardship of management, and is provided in time to influence those decisions or assessments.
- Information is reliable if:
  - (a) it can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and therefore reflects the substance of the transactions and other events that have taken place;
  - (b) it is free from deliberate or systematic bias and material error and is complete; and
  - (c) in its preparation under conditions of uncertainty, a degree of caution has been applied in exercising the necessary judgements.
- Information in financial statements needs to be comparable. As an aid to comparability, information in financial statements

needs to be prepared and presented in a way that enables users to discern and evaluate similarities in, and differences between, the nature and effects of transactions and other events over time and across different reporting entities.

- Information provided by financial statements needs to be understandable – that is its significance can be perceived by users that have a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.
- Information that is material needs to be given in the financial statements and information that is not material need not be given. Information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users, or their assessment of the effectiveness of the stewardship of management.

## **EXPLANATION**

*There are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 3 of the Statement and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 3 of the Statement, which should be referred to for a full understanding.*

*Additional explanation specific to public benefit entities has been added covering going concern, understandability and neutrality and prudence.*

## **RELEVANCE**

- 3.1 Relevance is a general quality that is used as a selection criterion at all stages of the financial reporting process. Information is relevant if it has the ability to influence the economic decisions of users, or their assessment of the effectiveness of the stewardship of management, and is provided in time to influence those decisions.
- 3.2 Relevant information has predictive or confirmatory value. It has predictive value if it helps users to evaluate or assess

past, present or future events. It has confirmatory value if it helps users to confirm or correct their past evaluations or assessments. Maximising the relevance of financial information involves maximising its predictive and confirmatory value.

### *Going concern*

- 3.3 There are a number of different perspectives from which an entity's financial performance and financial position could be viewed. The perspective that is usually most relevant is based on the assumption that the entity is to continue in operational existence for the foreseeable future. This perspective is commonly referred to as the going concern assumption.
- 3.4 In determining whether a public benefit entity is a going concern some of the factors, including legal requirements, to be taken into account may vary from those that would be considered in relation to profit-oriented entities. For example, an entity may have tax raising powers that give it the ability to raise revenue as any liabilities fall due, regardless of whether at the time the assessment is undertaken it has sufficient assets to cover its future liabilities.

## RELIABILITY

- 3.5 Information provided by financial statements needs to be reliable. Information is reliable if:
- (a) it can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent;
  - (b) it is free from deliberate or systematic bias (i.e. it is neutral);
  - (c) it is free from material error;

- (d) it is complete within the bounds of materiality; and
  - (e) in its preparation under conditions of uncertainty, a degree of caution (i.e. prudence) has been applied in exercising judgement and making the necessary estimates.
- 3.6 Faithful representation involves identifying all the rights and obligations arising from the transaction or event, giving greater weight to those that are likely to have an economic effect in practice, then accounting for and presenting the transaction or other event in a way that reflects that economic effect - in other words, in a way that reflects its substance.
- 3.7 The substance of a transaction or other event is not always consistent with that suggested by its legal form. A group or series of transactions that achieves an overall commercial effect will often need to be viewed as a whole in order to be accounted for in accordance with its substance.
- 3.8 The information provided by financial statements needs to be neutral - in other words, free from deliberate or systematic bias. Financial information is not neutral if it has been selected or presented in such a way as to influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

#### COMPARABILITY

- 3.9 Information in an entity's financial statements gains greatly in usefulness if it can be compared with similar information about the entity for some other period. Information about an entity is also much more useful if it can be compared with similar information about other entities.

#### *Consistency*

- 3.10 Comparability generally implies consistency throughout the reporting entity within each accounting period and from

one period to the next. Consistency can also be useful in enhancing comparability between entities, although this does not imply a need for absolute uniformity.

### *Disclosure of accounting policies*

- 3.11 In order to determine whether consistency exists or to assist in making comparisons despite inconsistencies, users need information on accounting policies adopted by entities and of any changes in those policies and the effects of such changes.

## UNDERSTANDABILITY

- 3.12 Information provided by financial statements needs to be understandable and users need to be able to perceive its significance. Whether financial information is understandable will depend on:
- (a) the way in which the effects of transactions and other events are characterised, aggregated and classified;
  - (b) the way in which the information is presented; and
  - (c) the capabilities of users.
- 3.13 When considering the capabilities of users of the financial statements of public benefit entities, it may not always appear appropriate to assume that they will have a reasonable knowledge of business and economic activities and accounting, for example where the defining class of user is the taxpayer. However, if financial statements are to be useful to a wide range of users for general purposes, the preparers must be able to assume a reasonable knowledge<sup>10</sup>. In this regard an important role is played by intermediaries, such as oversight and regulatory bodies, who often work on behalf of users such as taxpayers and donors, in assessing the

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<sup>10</sup> See also paragraph 3.25.

performance of an entity and its management. In these circumstances the capabilities of users might be determined by reference to the expected capabilities of the intermediary. However, the involvement of intermediaries in reviewing financial statements does not negate the need for a public benefit entity to communicate in an understandable way with other users, particularly its funders and financial supporters.

- 3.14 If there is to be informed public debate on the information provided by financial statements, then the basis on which it is prepared needs to be sound. Financial information will be more understandable to users if it is prepared on a true and fair basis (the concept of true and fair is discussed in the Statement).

## MATERIALITY

- 3.15 Materiality is the final test of what information should be given in a particular set of financial statements. The materiality test asks whether the information content is of such significance as to require inclusion in the financial statements.
- 3.16 When immaterial information is given in the financial statements, the resulting clutter can impair the understandability of the other information provided. In such circumstances, the immaterial information will need to be excluded.
- 3.17 An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessments of management's stewardship.
- 3.18 Whether information is material will depend on the size and nature of the item in question judged in the particular circumstances of the case. The principal factors to be taken into account are set out below. It will usually be a

combination of these factors, rather than any one in particular, that will determine materiality.

- (a) The item's size is judged in the context both of the financial statements as a whole and of other information available to users.
- (b) Consideration is given to the item's nature in relation to:
  - (i) the transactions or other events giving rise to it;
  - (ii) the legality, sensitivity, normality and potential consequences of the transaction;
  - (iii) the identity of the parties involved; and
  - (iv) the particular headings and disclosures that are affected.

3.19 If there are two or more similar items, the materiality of the items in aggregate as well as of the items individually needs to be considered.

#### CONSTRAINTS ON THE QUALITATIVE CHARACTERISTICS

3.20 On occasion, a conflict will arise between the characteristics of relevance, reliability, comparability and understandability. In such circumstances, a trade-off needs to be found that still enables the objective of financial statements to be met.

#### *Relevance and reliability*

3.21 Sometimes the information that is the most relevant is not the most reliable and vice versa. Choosing the amount at which to measure an asset or liability will sometimes involve just a conflict. In such circumstances, it will usually be appropriate to use the information that is the most relevant of whichever information is reliable.

*Neutrality and prudence*

- 3.22 There can also be tensions between two aspects of reliability – neutrality and prudence – as prudence is a potentially biased concept that seeks to ensure that, under conditions of uncertainty, gains and assets are not overstated and losses and liabilities are not understated. Where there is uncertainty, the competing demands are reconciled by finding a balance that ensures that the deliberate and systematic understatement of gains and assets and overstatement of losses and liabilities does not occur.
- 3.23 For public benefit entities there can also be tensions leading to the possibility of gains being understated and losses being overstated, for example where a certain level of spending must be achieved or to avoid the presentation of excessive surpluses.
- 3.24 As a result, neutrality must be the uppermost objective.

*Understandability*<sup>11</sup>

- 3.25 It may not always be possible to present information in a way that can be understood by all users. However, information that is relevant and reliable should not be excluded because it is too difficult for some users to understand.

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<sup>11</sup> *Understandability is considered in more detail in paragraphs 3.12 to 3.14.*

## **CHAPTER 4: THE ELEMENTS OF FINANCIAL STATEMENTS**

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*Elements of financial statements are the building blocks with which financial statements are constructed – the classes of items that financial statements comprise. This chapter identifies those elements and explains their attributes.*

### **PRINCIPLES**

- The elements of the financial statements are:
  - (a) assets
  - (b) liabilities
  - (c) residual interest
  - (d) gains
  - (e) losses
  - (f) contributions establishing a financial interest in the residual interest
  - (g) distributions to holders of a financial interest in the residual interest.
- Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
- Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.
- Residual interest is the amount found by deducting all of the entity's liabilities from all of the entity's assets<sup>12</sup>.

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<sup>12</sup> For profit-oriented entities this would be called the ownership interest.

- Gains are increases in residual interest not resulting from contributions establishing a financial interest in the residual interest.
- Losses are decreases in residual interest not resulting from distributions to holders of a financial interest in the residual interest.
- Contributions establishing a financial interest in the residual interest are increases in residual interest resulting from transfers from parties that establish a financial interest in that residual interest.
- Distributions to holders of a financial interest in the residual interest are decreases in residual interest resulting from transfers to parties holding a financial interest in that residual interest in their capacity as holders of a financial interest.

## **EXPLANATION**

*Other than in relation to the service potential of assets and commitments to provide public benefits, there are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 4 of the Statement, and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 4 of the Statement which should be referred to for a full understanding. Additional explanation specific to public benefit entities has been added covering the service potential of assets, control of economic benefits, commitments to provide public benefits, donated goods and services and designation of the residual interest.*

## **THE ELEMENTS OF FINANCIAL STATEMENTS**

*Depicting the effects of transactions and other events*

- 4.1 Financial statements need to reflect, in an appropriate manner, and as far as possible, the effects of transactions and other events on the reporting entity's financial performance and financial position. This involves a high degree of classification and aggregation. Order is imposed on this process by specifying and defining the classes of items – the

elements of financial statements – that encapsulate the key aspects of the effects of those transactions and other events.

4.2 The elements of financial statements are:

- (a) in the case of the balance sheet (or statement of financial position) – assets, liabilities and residual interest;
- (b) in the case of the statement of financial performance – gains and losses;
- (c) contributions establishing a financial interest in the residual interest; and
- (d) distributions to holders of a financial interest in the residual interest.

### *Recognition*

4.3 The criteria that need to be met before the effects of a transaction or other event on the elements will be recognised are considered in Chapter 5.

## ASSETS

### *Definition*

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.

### *Rights or other access*

4.4 An asset is not the item of property itself, but rather the rights or other access to some or all of the future economic benefits derived from the item of property<sup>13</sup>.

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<sup>13</sup> The term ‘item of property’ is taken from the Statement. It is used to differentiate between the control of rights or other access to future economic benefits (the asset) and the thing from which those benefits are derived (the item of property).

- 4.5 These rights can be obtained in various ways. Often they are obtained by legal ownership of the underlying item of property. However, legal rights to future economic benefit derived from an item of property can be obtained without having legal ownership of the property itself, for example, where property is leased.
- 4.6 Other legal rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or trademark.

*Future economic benefits*

- 4.7 Capacity to obtain future economic benefits is the essence of an asset. Therefore, to be an asset, the rights or other access must be capable, singly or in combination with other assets, of yielding economic benefits.
- 4.8 Many assets held by public benefit entities do not result in direct cash inflows for the entity. The economic benefits that arise from such assets are often in the form of services to the beneficiary or consumer. Furthermore, in many cases, assets are used to provide goods or services to the beneficiary or customer that are free or subsidised. An item can meet the definition of an asset if it is used either directly or indirectly to provide goods and/or services that are used in furtherance of an entity's objectives.
- 4.9 Therefore although the Statement notes that 'future economic benefits eventually result in net cash inflows to the entity,' this may not be the case for public benefit entities where access to future economic benefits includes:
- an eventual net inflow of cash to the entity; but also
  - the provision of goods and/or services to the entity or for the benefit of the entity's beneficiaries.
- 4.10 This means that, for public benefit entities, an asset can embody service potential as well as, or instead of, cash flows.

Service potential is the ability to be utilised to provide expected future goods and/or services (i.e. to fulfil a need or want of the identified customers/beneficiaries) in furtherance of the entity's objectives<sup>14</sup>.

4.11 In principle, all items meeting the definition of an asset should be recognised. These include heritage assets such as:

- Historic assets: which are of acknowledged historic, scientific or artistic importance, the continuing retention, preservation and use of which is in direct furtherance of an entity's objectives.
- Inalienable assets: which the entity is required by law to retain indefinitely for its own use in furtherance of its objectives and which therefore cannot be disposed of without external consent.

4.12 These items meet the definition of an asset because they provide future economic benefits; they are used to provide services to the benefit of the entity's beneficiaries. It is possible that even where, for example, such items are not on display, their preservation alone will meet the asset definition.

#### *Controlled by the entity*

4.13 The definition of an asset requires that the rights or other access to future economic benefits are controlled by the reporting entity. Control of economic benefits means the entity must have the ability both to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits.

4.14 With public benefit entities, the economic benefits that arise from an asset need not flow to the entity itself. As noted above, the assets may instead be used to provide benefits for

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<sup>14</sup> Measuring the replacement cost of the service potential of an asset is considered in paragraphs 6.7 to 6.10.

the beneficiaries of the entity. In the context of such assets, it is therefore the *capacity to provide* future economic benefits that must be controlled by the entity.

- 4.15 Accordingly, for the purposes of public benefit entities, control of economic benefits is reformulated as follows. An entity will control the rights or other access to future economic benefit if it has the ability:
- both to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits; or
  - to meet its objectives by determining the allocation to beneficiaries of future economic benefits (whether goods or services), including preventing or limiting the access to any future goods or services to be provided.
- 4.16 Public benefit entities that have custody of an asset may not have all the legal powers of ownership, such as the ability to sell the item. There may also be restrictions on the entity's use of the asset. However, this does not necessarily mean that the entity does not control access to future economic benefits. To satisfy the requirement for control, the entity does not need unlimited power over the physical item. Instead, it is the rights or access to future economic benefits that need to be controlled.
- 4.17 The requirement that the rights or other access should be controlled by the entity treating them as its asset means that a particular right or other access to future economic benefits will appear in only one set of single entity financial statements. This is because such rights or access can be directly controlled by only one entity.
- 4.18 On the other hand, a single item of property may give rise to assets of more than one entity. If two entities control the rights to different future economic benefits from the same item of property, both entities will have an asset (subject to the other aspects of the definition being met).

*Past transactions or events*

- 4.19 If the reporting entity's control of the rights or other access to future economic benefits involved is to represent an asset, it needs to be the result of *past* transactions or events.

LIABILITIES<sup>15</sup>*Definition*

Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.

*Obligations*

- 4.20 For there to be a liability there must be an obligation that might result in the transfer of economic benefits.
- 4.21 The notion of an obligation implies that the entity is not free to avoid the outflow of economic resources. If an obligation exists, although an entity may offer inducements to its creditors to cancel or postpone settlement, it will not be able to insist that they accept such an offer.
- 4.22 Although many liabilities are based on legal obligations, a legal obligation is not a *necessary* condition: a liability can exist in the absence of legal obligations if other considerations create a constructive obligation which leaves the entity with little, if any, discretion to avoid the transfer of economic benefits.
- 4.23 A decision to transfer economic benefits does not, in itself, create a constructive obligation, because the transfer can be avoided by changing the decision. On the other hand, a constructive obligation would be created if such a decision was coupled with an event that both created a valid expectation that the entity involved would implement the

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<sup>15</sup> *There is a decision tree for commitments to provide public benefits at Appendix 3.*

decision and meant that the entity could not realistically withdraw from it. For example, a constructive obligation may be created by communicating a decision to follow a particular course of action to another party. Such an obligation may also be created by an established pattern of past practice.

*Transfer of economic benefits*

- 4.24 Certainty that the obligation *will* result in a transfer of economic benefits is not necessary. Obligations that are not likely to result in a transfer of economic benefits – such as a guarantee of another entity’s debt where that entity is expected to remain solvent – are liabilities even though they may not be recognised in financial statements (or may be recognised with a carrying amount of nil).
- 4.25 Similarly, although many liabilities involve transfers of known amounts of cash, that need not be the case: a liability could involve an obligation to transfer an uncertain amount, and it could involve an obligation to transfer economic benefits other than cash – for example, by providing services.

*Past transactions or events*

- 4.26 For a liability to exist at the balance sheet date, the obligation to transfer economic benefits must have resulted from a *past* transaction or event.
- 4.27 Sometimes a series of events must take place before the entity will have an obligation to transfer economic benefits. In such circumstances, whether the obligation exists depends on whether any of the events that have still to take place are under the entity’s control. If they are, the entity retains discretion to avoid the transfer, so no obligation exists. For example, as long as it is possible to avoid a penalty clause in a contract by performing, a liability in respect of the penalty will not arise.

4.28 An obligation to make an exchange in the future, which is still equally unperformed by both sides (often called an executory contract) does not usually result in the immediate recognition of a liability. An example is an order to purchase new office furniture: no liability is recognised by the purchaser until the furniture has been delivered

*General commitments*

4.29 A general or policy statement that the entity intends to provide goods and services to certain classes of potential beneficiaries in accordance with its objectives will not necessarily give rise to a liability. Such statements do not of themselves create an obligation such that the entity cannot withdraw or amend the terms on which the goods and services will be provided. Potential beneficiaries of the goods and services may envisage they will receive them, but they do not have the ability to insist on their receipt.

4.30 Examples of general commitments are political commitments made by governments, for example the announcement of a forthcoming new initiative to provide cash benefits to members of the public. Governments make, and amend, such promises and policies as part of their ongoing political processes to manage the economy and redistribute wealth within or between periods and generations. As such they do not give rise to constructive obligations. Equally a charity would not have a liability as a result of a general policy of providing grants and/or other services to certain classes of people or entities.

*Specific commitments*

4.31 Where an entity has made a specific commitment that it will provide funding to another party, consideration of whether a liability exists depends on whether:

- (a) the obligation is such that the entity cannot realistically withdraw from it;

- (b) the commitment has been communicated to the other party; and
- (c) the commitment is performance-related.

4.32 A performance-related grant has the characteristics of a contract in that the terms of the grant require the performance of a specified service with payment being conditional on the service being provided. If the undertaking to pay is, in substance, performance-related, no liability would arise in advance of performance. Examples of such arrangements include a five-year grant to finance a meals-on-wheels service, where the amount is calculated based on the number of meals served.

4.33 Where there are service or performance conditions attached to a grant but they are insignificant in the context of the arrangement, the substance of the arrangement will be that it is not performance-related.

4.34 Where an entity has made a commitment that results in an obligation to transfer economic benefits and it is not performance-related, the financial consequences of that commitment will amount to a liability at the time the commitment is made.

#### *Other matters*

4.35 Where an entity has potential obligations that do not result in the recognition of liabilities it is appropriate to consider whether the disclosure of information relating to these potential obligations should be provided.

4.36 There may be circumstances in which a reporting entity is acting as an agent for another entity, where, for example, cash has been received by the entity to be passed on to persons meeting certain specific criteria specified by the other entity. Depending on the nature of the arrangement it is possible that a liability should be recognised to match the receipt of the cash prior to its dispersal. Such a liability

would represent an obligation to the entity providing the cash, not to the ultimate recipient.

#### OFFSETTING RIGHTS AND OBLIGATIONS

- 4.37 When a transaction or other event gives rise to a number of rights and obligations, it is necessary to consider whether some or all of those rights and obligations need to be offset either with each other or with rights and obligations that arise from other transactions or events.
- 4.38 If a right to receive future economic benefits and an obligation to transfer future economic benefits exists, and the reporting entity has the ability – which is assured – to insist on net settlement of the balances, the right and obligation together form a single asset or liability regardless of how the parties intend to settle the balances.
- 4.39 When an entity enters into an agreement with another, it usually obtains certain rights and, in exchange, accepts certain obligations. Before any act of performance under the agreement has taken place, the entity does not have control of the future economic benefits arising from performance, nor does it have an obligation to transfer economic benefits that arise on performance. What it *does* have, however, is a contract that represents a net position comprising a combined right and obligation either to participate in the exchange or alternatively to be compensated (or to compensate) for the consequences of the exchange not taking place. Initially, the rights and obligations are likely to be exactly offsetting, although that will often not remain the case. The rights and obligations arising under such unperformed executory contracts together represent a single asset or liability. Consistently with the discussion of restrictions in Chapter 5, the receipt of resources with restrictions attached does not usually delay their recognition as an asset and a gain.
- 4.40 It may be that the contract has been performed partially but is equally proportionately unperformed – in other words,

that both parties to the contract have still to perform to an equal degree the actions promised by and required of them under the contract. In such a case, although the rights and obligations relating to the performed part of the contract may represent separate assets and liabilities, the rights and obligations relating to the unperformed part will together represent a single asset or liability.

## RESIDUAL INTEREST

4.41 Residual interest is defined as follows:

Residual interest is the amount found by deducting all of the entity's liabilities from all of the entity's assets.

4.42 The distinction between liabilities and residual interest is significant. Creditors have the ability to insist that a transfer of economic benefits is made to them regardless of the circumstances. In contrast, the residual interest represents resources that the entity retains for the provision of future benefits. In certain forms of entity, these resources may be held under trust, either to be retained for the generation of future income, or to be spent on particular restricted purposes. The nature of the residual interest should be clear from disclosure in the financial statements. Where, in the event of a winding-up, the ultimate interest would be required to be distributed in a particular way, that fact should be disclosed.

4.43 In some cases, there may be more than one class of residual interest. The existence of different classes of residual interests requires disclosure within the financial statements.

4.44 Where resources are held on trust for a particular purpose, this creates a separate class of residual interest in the balance sheet. Designation, reflecting no more than management intention, does not create a separate class of residual interest and should not lead to the recognition of a transaction in the financial statements. Such information could be disclosed in the notes to the accounts but would more normally be

provided in the accompanying information (see paragraphs 7.15 to 7.20).

## GAINS AND LOSSES

### *Definitions*

Gains are increases in residual interest not resulting from contributions establishing a financial interest in the residual interest.

Losses are decreases in residual interest not resulting from distributions to holders of a financial interest in the residual interest.

- 4.45 The terms ‘gains’ and ‘losses’ therefore include items that are often referred to as ‘revenue’ or ‘income’ and ‘expenses’.
- 4.46 Chapter 5 provides guidance on the recognition process for transactions and events that have an effect on the financial statements. If neither a transaction nor an event has occurred, there will be no change in the reporting entity’s assets and liabilities and, consequently, no gain or loss to recognise.

## DONATED GOODS AND SERVICES

- 4.47 Some public benefit entities receive donations of goods<sup>16</sup> or services.
- 4.48 Where a donation involves the receipt of cash or goods (for example works of art or furniture), it should be recognised based on the current value to the recipient (measures of current value are discussed in Chapter 6), provided it can be measured with sufficient reliability.
- 4.49 In contrast other donations involve the receipt of services

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<sup>16</sup> For this purpose ‘goods’ includes cash and financial instruments.

that are immediately consumed (for example, volunteers' time, free occupation of premises and free professional services); these are events that potentially have an economic effect on the reporting entity. In principle, because such an event has an economic impact on a reporting entity it should be reflected in the financial statements. In practice, however, it may not be possible to measure some services with sufficient reliability for the financial statements and these services should not therefore be recognised.

4.50 Provided they can be reliably measured, donated services that would normally have otherwise been purchased should be recognised in the financial statements based on the estimated value to the recipient. Where donated services are recognised in the financial statements it would be as income and, usually, expenditure of an equal amount.

4.51 Where donated services are not recognised in the financial statements but disclosure of the nature and scale of the services received would help the user gain a better understanding of the entity's activities, this information could be disclosed in the notes to the accounts although, it will often be more practicable and appropriate for it to be provided in the accompanying information.

## CONTRIBUTIONS ESTABLISHING A FINANCIAL INTEREST IN THE RESIDUAL INTEREST

### *Definition*

Contributions establishing a financial interest in the residual interest (capital contributions<sup>17</sup>) are increases in residual interest resulting from transfers from parties that establish a financial interest in that residual interest.

4.52 Capital contributions include only those transactions that establish a financial interest in the residual interest.

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<sup>17</sup> Here 'capital contribution' does not necessarily refer to the gift of an endowment.

Transactions with the same parties that are not entered into in this capacity (for example those as customers, beneficiaries, donors or suppliers) result in gains and losses.

- 4.53 A financial interest in the residual interest is one that conveys a right to participate in the residual interest (either on an ongoing basis or in a winding-up).
- 4.54 Capital contributions involve parties making a contribution of economic benefits (which may, for example, be in the form of cash or assets providing service potential) to the entity. In practice, for public benefit entities, although capital contributions establish a financial interest in the net assets of the entity, it may be that the contribution enables the entity to keep operating. The contribution may also have the effect of reducing the level of a potential future deficit to be met in the event of the entity being wound-up.
- 4.55 Some public benefit entities have a controlling party<sup>18</sup> (for example, as a result of powers to appoint the members of its governing body), although the controlling party may not be a legal “owner” of the reporting entity. Contributions from a controlling party may or may not include capital contributions. However, due to the nature of the relationship between an entity and its controlling party the impact on the financial performance and financial position of a public benefit entity of any resources received that are not capital contributions should be clear.

#### DISTRIBUTIONS TO HOLDERS OF A FINANCIAL INTEREST IN THE RESIDUAL INTEREST

##### *Definition*

Distributions to holders of a financial interest in the residual interest (capital distributions) are decreases in residual interest

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<sup>18</sup> Consistent with Chapter 2, a controlling party is an individual or entity that has control of a second entity.

resulting from transfers to parties holding a financial interest in that residual interest in their capacity as holders of a financial interest.

- 4.56 The Statement includes “distributions to owners” as one of the elements of the financial statements. As noted above, most public benefit entities do not have owners, and those that do are often unable to make distributions (for example, it may be prohibited by the governing instrument). As a result, capital distributions are not likely to be common.
- 4.57 Capital distributions include the payment of dividends and the return of capital. Where public benefit entities make capital distributions, achieving this financial return would not be their primary objective.

## **CHAPTER 5**

# **RECOGNITION IN FINANCIAL STATEMENTS**

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*When the reporting entity undertakes a transaction or when some other relevant event occurs, the effect of that transaction or event on the elements of financial statements will need to be recognised in the financial statements if certain criteria are met. This chapter considers that recognition process.*

### **PRINCIPLES**

- If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect will be recognised if:
  - (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and
  - (b) the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability.
- In a transaction involving the provision of goods or services for a net gain, the recognition criteria described above will be met on the occurrence of the critical event in the operating cycle involved.
- In a transaction involving the receipt of resources, other than for the provision of goods or services for a net gain, the recognition criteria described above will often be met when there is clear evidence of a right to receive the resources.
- An asset or liability will be wholly or partly derecognised if:
  - (a) sufficient evidence exists that a transaction or other past event has eliminated all or part of a previously recognised asset or liability; or

- (b) although the item continues to be an asset or a liability, the criteria for recognition are no longer met.

## **EXPLANATION**

*Other than in relation to revenue recognition, there are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 5 of the Statement and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 5 of the Statement, which should be referred to for a full understanding.*

*Additional explanation specific to public benefit entities has been added covering historic and inalienable assets and the various aspects of revenue recognition.*

### **THE RECOGNITION PROCESS**

*The stages of the recognition process*

- 5.1 The objective of financial statements is achieved to a large extent through the recognition of elements in the primary financial statements – in other words, the depiction of elements both in words and by monetary amounts and the inclusion of those amounts in the primary financial statement totals. This recognition process has the following stages:
- (a) initial recognition, which is where an item is depicted in the primary financial statements for the first time;
  - (b) subsequent remeasurement, which involves changing the amount at which an already recognised asset or liability is stated in the primary financial statements; and
  - (c) derecognition, which is where an item that was until then recognised ceases to be recognised.

*Transactions and events other than transactions*

- 5.2 The recognition process requires that all events that may have an effect on elements of the financial statements are, as far as is possible, identified and reflected in an appropriate manner in the financial statements.
- 5.3 Transactions are the most common form of such events and are therefore the most common reason for recognising and derecognising items. Events other than transactions may nevertheless also result in the recognition or derecognition of items. For example, events such as discovery or innovation may result in the creation of new assets that may meet the recognition criteria. Events, such as a fire, that cause damage to an asset may result in a need to derecognise the asset or liability involved.

*The effect of transactions and other events*

- 5.4 The starting point for the recognition process is the effect that the transaction or other event involved has had on the reporting entity's assets and liabilities. The interrelationship between the elements means that the recognition of one item as an element will inevitably result in the recognition of, or change in, another element. Thus, if a new asset is recognised, there will also be recognised a decrease in another asset, a new or increased liability, a gain, or a contribution from owners (or a combination of these).
- 5.5 A transaction or other event could have one of several effects on a reporting entity's assets and liabilities.
- (a) It might create a new asset or liability or add to an existing asset or liability. When this is the case, it will be necessary to determine whether the new asset or liability (or the addition thereto) should be recognised, because not all assets and liabilities are recognised.
  - (b) It might provide additional evidence about an existing

but unrecognised asset or liability and, as a result, enable that item to be recognised.

- (c) It might change some aspect of an already recognised asset or liability.
  - (d) It might involve transferring, using up or consuming an asset or settling, extinguishing or transferring a liability. On the other hand, it might leave intact certain of the rights to future economic benefits inherent in an asset whilst transferring, using up or consuming others, or it might leave intact certain obligations inherent in a liability whilst settling, extinguishing or transferring others.
- 5.6 The non-cash effects of transactions and other events should, as far as is possible, be reflected in the financial statements in the accounting period in which they occur and not, for example, in the period in which any cash involved is received or paid. This is commonly referred to as the 'accruals concept'.

#### *Uncertainty and the recognition process*

- 5.7 Entities operate in an uncertain environment and this uncertainty may sometimes make it necessary to delay the recognition process.
- 5.8 If uncertainty exists, totally reliable information will become available only when the uncertainty has resolved itself. However, to defer recognition until the uncertainty has resolved itself will often reduce the relevance of the financial statements. It may also reduce their reliability because they will not represent faithfully the transactions and other events of the reporting period. Financial statements achieve a balance between these competing demands by seeking to provide information that has no more than an acceptable degree of uncertainty but not seeking to provide information that is totally free from uncertainty.

- 5.9 There may be circumstances in which it is not possible to reduce the uncertainty to an acceptable level. If that is the case, the recognition process will be deferred until such time as the uncertainty has been reduced to an acceptable level (and the effect of the transaction or other event will instead usually be reported in the notes to the financial statements).

## INITIAL RECOGNITION

### *Categories of uncertainty*

- 5.10 In the initial recognition process, there are two broad categories of uncertainty that could arise:
- (a) element uncertainty, which involves uncertainty whether an item exists and meets the definitions of the elements of financial statements; and
  - (b) measurement uncertainty, which concerns the appropriate monetary amount at which to recognise the item.

### *Element uncertainty*

- 5.11 Element uncertainty is countered by evidence – the more evidence there is about an item and the better the quality of that evidence, the less uncertainty there will be over the item's existence and nature. To recognise an item it is necessary to have sufficient evidence, both in amount and quality, that the item exists and is an asset or liability of the reporting entity. One of the criteria for initial recognition is that sufficient evidence must exist that a new asset or liability has been created.
- 5.12 What constitutes sufficient evidence is a matter of judgement, although while the evidence needs to be adequate, it need not be (and often cannot be) conclusive. The main source of evidence will be past or present experience with the item itself or with similar items.

*Measurement uncertainty*

- 5.13 To recognise an item, it is necessary to attribute a monetary amount to it. This involves two steps: selecting a suitable measurement basis (i.e. historical cost or current value) for the item and determining an appropriate monetary amount for the basis chosen.
- 5.14 Uncertainty about the appropriate monetary amount at which to recognise the item (in other words, measurement uncertainty) is reflected in the second of the criteria for initial recognition, which requires that the new asset or liability or addition to an existing asset or liability can be measured at a monetary amount with sufficient reliability.
- 5.15 The purchase or receipt of an asset should be measured and included in the financial statements, provided it can be measured reliably. Thus where an historic or inalienable asset<sup>19</sup> is received, it should, in principle, be reflected in the financial statements. In some cases, sufficiently reliable information may not exist, but for assets that are newly acquired, reliable measurement information is likely to be available.

*Prudence*

- 5.16 The exercise of prudence does not justify the omission of assets or gains when there is sufficient evidence of occurrence and reliability of measurement or the inclusion of liabilities or losses when there is not. Nor does it justify any other deliberate and systematic overstatement of liabilities or losses or deliberate and systematic understatement of assets or gains.

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<sup>19</sup> See also paragraphs 4.11 and 4.12.

## DERECOGNITION

*Derecognition because the asset or liability has been eliminated*

- 5.17 Assets tend, in due course, to be consumed, transferred or otherwise disposed of, or they expire. Similarly, liabilities tend to be settled, extinguished, transferred, or they expire. In such circumstances, it may be necessary to derecognise some or all of the asset or liability involved.
- 5.18 It is usually relatively simple to determine whether and when a previously recognised asset or liability needs to be derecognised. However, some transactions leave intact certain of the rights to future benefits inherent in an asset (or obligations inherent in a liability) while eliminating others. In such circumstances, analysis is required to ascertain whether the effect of the transaction should be reflected by derecognising some or all of the assets and liabilities involved.
- 5.19 Ideally, an asset or liability would be derecognised as soon as it has been eliminated. However, there will sometimes be uncertainty about an item's continued existence. In such circumstances, derecognition will not take place until sufficient evidence exists that the transaction or other event has resulted in the elimination of the item. When there is uncertainty, prudence usually requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets than is required for liabilities. This tends to mean that, if there is any significant uncertainty about an asset's continued existence, it will be derecognised. However, in the case of a liability, more evidence of its elimination will be needed before it will be derecognised.

*Derecognition because the criteria for recognition are no longer met*

- 5.20 It is possible that although there has been no significant change in the inherent nature of an already recognised asset or liability – in other words, although the asset or liability has

not been eliminated – the criteria for recognition are no longer met. For example, an event may have created additional uncertainty and, as a result, a previously recognised asset or liability can no longer be measured with sufficient reliability. On the rare occasions when this is the case, that asset or liability will be derecognised even though it has not been eliminated.

## REVENUE RECOGNITION

5.21 Assuming that no capital contribution is involved:

- (a) if the effect of a transaction or other event is to increase the entity's recognised net assets, a gain will be recognised.
- (b) a loss will be recognised if, and to the extent that, previously recognised assets have been reduced or eliminated or cease to qualify for recognition as assets without a commensurate increase in other assets or reduction in liabilities. Similarly, a loss will be recognised when, and to the extent that, a liability is incurred or increased without a commensurate increase in recognised assets or a reduction in other liabilities.

5.22 However, although the starting point for the recognition process may be the effect on assets and liabilities, the notions of matching and the critical event in the operating cycle will often help in identifying these effects.

### *Matching*

5.23 Matching has two forms.

- (a) Time matching involves the recognition of receipts (and payments) directly associated with the passage of time as gains (and losses) on a systematic basis over the course of the period involved.
- (b) Revenue/expenditure matching involves the recognition of expenditure directly associated with the

generation of specific gains as a loss in the same period as the gains are recognised, rather than in the period in which the expenditure is incurred.

- 5.24 Almost all expenditure is undertaken with a view to acquiring some form of benefit in exchange. Consequently, if matching were used in an unrestricted way, it would be possible to delay the recognition in the performance statement of most items of expenditure insofar as the hoped-for benefits still lay in the future. The Statement imposes a degree of discipline on this process because only items that meet the definitions of, and relevant recognition criteria for, assets, liabilities or ownership interest (or residual interest for public benefit entities) are recognised in the balance sheet. This means that the Statement does not use the notion of matching as the main driver of the recognition process.

*Critical event in the operating cycle*

- 5.25 Sometimes it is easier to identify the appropriate point at which to recognise gains arising from the provision of services or goods – and therefore changes to the entity’s assets and liabilities – by focusing on the operating cycle of the reporting entity and, in particular, on the critical event in that cycle.
- 5.26 The critical event is the point in an operating cycle at which there will usually be sufficient evidence that the gain exists and it will usually be possible to measure that gain with sufficient reliability.
- 5.27 For many types of transaction, the critical event in the operating cycle is synonymous with full performance. In such cases a gain will be recognised when the entity providing the service or goods has fully performed. That need not, however, be the case: the critical event could occur at other times in the cycle and there could be more than one critical event in the cycle.

5.28 The identity of the critical event or events of an operating cycle will depend on the particular circumstances involved. For certain public benefit entities the concept of the critical event has direct application to revenue arising from fees and charges and performance-related grants<sup>20</sup>. However, for other sources of revenue, such as taxation and donations, gains may occur that are unrelated to the provision of specific goods or services. There may therefore not be a need to look for a critical event in the operating cycle as part of the recognition process. Instead, the focus will be on whether an asset exists and whether or not it has led to a corresponding liability. As such the recognition criteria are likely to be met when the recipient has a right to receive the resources (in some cases this will not be prior to actual receipt of the resources).

*Should all gains be treated as revenue?*

5.29 Fees and charges and performance-related grants that arise as a result of a critical event in the operating cycle of the entity should be classified as revenue. In this context revenue should be taken to mean “turnover”, or the revenue arising from the operating activities of the reporting entity.

5.30 Gains<sup>21</sup> that arise, for example, from the raising of taxes, or through an appropriation or grant-in-aid, or donations, should also be classified as revenue, and be recognised when there is sufficient evidence that a gain exists and it can be measured with sufficient reliability.

5.31 Other gains, such as those arising from the sale of fixed assets, do not normally give rise to revenue.

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<sup>20</sup> 'Performance-related grants' is used in this context to refer to a grant that has the characteristics of a contract, where a specified amount of grant is receivable for a specific output.

<sup>21</sup> In accordance with the definition, gains exclude capital contributions.

*Grants for financing capital projects*

- 5.32 Some public benefit entities receive grants or donations intended to finance capital projects, such as the acquisition or construction of a fixed asset. Grants or donations for financing capital projects are often made because the asset will be used to provide goods or services that are provided at a subsidised rate or for free. Providing a subsidy for an asset that provides a service can be an alternative to an ongoing commitment to subsidise the revenue costs of providing the service.
- 5.33 Transactions that establish an interest in the residual interest of an entity should be treated as capital contributions (even if that contribution is subsequently used to acquire a capital asset) and not as grants or donations.

*Conditions and restrictions attached to grants and donations*

- 5.34 Grants and donations should be recognised as a gain unless there are conditions, in which case they should be recognised when any conditions are substantially met or are virtually certain to be met. For example, if the only condition attached to a grant is that the recipient must provide a copy of its annual report to the grantor, it would be appropriate to recognise the grant as a gain on receipt.
- 5.35 Where there are no conditions attached, the grant or donation should be recognised as a gain. In some cases, the conditions of the agreement are such that it amounts to a performance-related grant. Where this is the case, gains should usually be recognised as performance is delivered.
- 5.36 One common condition of capital grants to public benefit entities is that the grant must be repaid in the event of the recipient subsequently selling the asset. Where a decision on the sale of the asset is within the reporting entity's control, there is no liability and the grant should be recognised as a gain notwithstanding this condition.

5.37 Where grants and donations are subject to restrictions that limit their use, these restrictions do not affect the recognition of the asset or the grant. Restrictions should not therefore prevent recognition as a gain providing all conditions have been substantially met or are virtually certain to be met. Additional disclosure may be required to reflect the nature of any restrictions.

## **CHAPTER 6**

# **MEASUREMENT IN FINANCIAL STATEMENTS**

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*Measuring an asset or liability entails deciding on the measurement basis to be used and determining the monetary amount that is appropriate for that basis. It may also involve revising the monetary amount when certain events occur. This chapter describes the measurement process and explains how a choice is made between the measurement bases available.*

### **PRINCIPLES**

- In drawing up financial statements, a measurement basis – either historical cost or current value – needs to be selected for each category of assets or liabilities. The basis selected will be the one that best meets the objective of financial statements and the demands of the qualitative characteristics of financial information, bearing in mind the nature of the assets or liabilities concerned and the circumstances involved.
- An asset or liability being measured using the historical cost basis is recognised initially at transaction cost. An asset or liability being measured using the current value basis is recognised initially at its current value at the time it was acquired or assumed.
- Subsequent remeasurement will occur if it is necessary to ensure that:
  - (a) assets measured at historical cost are carried at the lower of cost and recoverable amount;
  - (b) monetary items denominated in foreign currency are carried at amounts based on up-to-date exchange rates; and
  - (c) assets and liabilities measured on the current value basis are carried at up-to-date current values.

- Such remeasurements, however, will be recognised only if:
  - (a) there is sufficient evidence that the monetary amount of the asset or liability has changed; and
  - (b) the new amount of the asset or liability can be measured with sufficient reliability.

## **EXPLANATION**

*There are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 6 of the Statement and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 6 of the Statement, which should be referred to for a full understanding. Additional explanation specific to public benefit entities has been added covering alternative measures of current value.*

### **ALTERNATIVE BASES OF MEASUREMENT**

- 6.1 Assets and liabilities have several different monetary attributes that could be represented in financial statements. The single most important characteristic that distinguishes these monetary attributes (which are known as measurement bases) is whether they are based on historical cost or current value. This chapter concentrates on that distinction.
- 6.2 The mixed measurement system permits the measurement basis to be selected separately for each category of assets or liabilities. It also permits the use of historical cost (or current value) for all assets and liabilities if historical cost (or current value) is the most appropriate measure for each of those categories. Thus it can be adapted to fit the particular circumstances involved.
- 6.3 The Statement therefore envisages that the mixed measurement system will be used and it focuses on the mix of historical cost and current value to be adopted.

## ALTERNATIVE MEASURES OF CURRENT VALUE

6.4 The current value of an asset could be determined by reference to entry value (replacement cost), exit value (net realisable value) or value in use (discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner). For some assets, for example fixed assets specific to the entity's activities, differences between the alternative measures can be material.

*Selection of a measure of current value*

6.5 It is necessary to select from these alternative measures of current value the measure that maximises the relevance of the current value basis. Current value is at its most relevant when it reflects the loss that the entity would suffer if it were deprived of the asset involved. That measure, which is often referred to as the 'deprival value' or the 'value to the business', will depend on the circumstances.

- (a) In most cases, the public benefit entity will be fully using the asset in order to further its objectives and therefore the entity will, if deprived of the asset, replace it, and the current value of the asset will be its current replacement cost.
- (b) An asset will not be worth replacing if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset's current value is that recoverable amount. This will be either net realisable value or value in use, depending on the circumstances.
  - (i) When the entity would further its objectives to the greatest extent by selling the asset, the asset's recoverable amount will be the amount that can be obtained by selling it, net of selling expenses; in other words, its net realisable value.
  - (ii) When the entity would further its objectives to the greatest extent by consuming the asset – for example

by continuing to operate it – its recoverable amount will be its value in use.

- 6.6 Many public benefit entities have assets that are specialised in nature, where there may be no viable market for the asset's sale. As a result, assets are infrequently valued on the basis of net realisable value because it is often difficult to estimate as a result of the lack of an active market.

*Current values reflecting the service potential of an asset*

- 6.7 Service potential was defined in paragraph 4.10. In the public sector, value in use may be difficult to calculate in practice. Many assets do not generate cash flows at a market rate because they are involved in the production of goods and services that are provided at a subsidised rate or for free. In such cases, assets should be stated at the replacement cost of the asset's service potential.
- 6.8 It is important that valuations properly reflect the asset's value to the entity and that reviews of asset values are carried out where there is evidence of impairment of service potential or, where relevant, cash flows. Such reviews should consider both the capacity of the asset to deliver services and the demand for these services and should be carried out regardless of how an asset is funded or whether the cost or valuation method has been used.
- 6.9 For example, if a hostel had been constructed to provide accommodation for fifty people, the fact that occupants are not charged a commercial rent would not in itself necessarily lead to an impairment. However, if at a later date it became clear that, because of changes in demographics, the hostel would in the future be occupied by no more than thirty people, even at periods of peak demand, then the capacity to deliver service potential would be diminished and the valuation of the hostel should be reviewed for impairment. This review might involve consideration of the replacement cost of a thirty-bed hostel.

- 6.10 Since current value under this model represents the loss the entity would suffer if it were deprived of an asset, consideration needs to be given to the most efficient method of obtaining equivalent services to those derived from using the asset. If, for example, it is considered that the most efficient method, at present, would be to engage an external contractor rather than obtaining the services directly by using the asset owned by the reporting entity, then the asset's current value will be the higher of its net realisable value and the present value of the cash flows that would be incurred in obtaining equivalent services from the external contractor.

#### *Current value of liabilities*

- 6.11 It is possible to select a current value for a liability in a similar manner to the 'deprival value' or 'value to the business' method used for assets (using the concept of 'relief value'). The relief value of a liability is the lowest amount at which the entity could divest itself of the obligation involved - in other words, the lowest amount at which the liability could, hypothetically, be settled<sup>22</sup>.

#### THE MEASUREMENT PROCESS

- 6.12 It is not the function of financial statements to represent directly the total value that the reporting entity would fetch in an exchange transaction. Instead, the financial statements provide information designed to assist users to make judgements about the entity's financial performance and financial position. The purpose of the measurement process is therefore to measure the effects of the transactions and events of the period on the financial performance and financial position of the entity.

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<sup>22</sup> In October 2002 the ASB published "Liabilities and how to account for them: an exploratory essay", which suggests that this definition could be expanded to be the higher of consideration and settlement amount (being the lower of the cost of performance and the cost of release).

*Initial recognition*

- 6.13 An asset or liability that is being measured using the historical cost basis will be recognised initially at transaction cost or, if an event other than a transaction is involved, at its fair value<sup>23</sup> at the time it was acquired or assumed.
- 6.14 An asset or liability that is being measured using the current value basis will be recognised initially at its current value at the time it was acquired or assumed.
- 6.15 This means that, regardless of the measurement basis used, assets and liabilities that arise from transactions carried out at fair value - which is the vast majority of assets and liabilities - will be measured on initial recognition at their transaction cost. That is because, in the case of such a transaction, the fair value of the consideration paid or received (i.e. the transaction cost) is equal to the current value of the asset or liability at the time of acquisition.
- 6.16 It can generally be assumed that, in the absence of evidence to the contrary, a transaction has been carried out at fair value. In such circumstances, the transaction cost involved can be determined by reference to the fair value of either the asset (or liability) acquired or the consideration paid (or received); whichever fair value is easiest to measure will usually be used.
- 6.17 If an asset or liability arises from a transaction that was not carried out at fair value, it will often be more appropriate to measure the asset or liability at current value rather than historical cost. For example, an asset might be received as a gift or donation, in which case it should be recognised at its current value to the entity on the date it is received. As discussed in paragraphs 6.5 and 6.7 to 6.9, the current value is likely to be the replacement cost of the service potential of the asset, which will reflect its expected utilisation.

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<sup>23</sup> The term "fair value" has been repeated from the Statement and may not therefore reflect the sense in which it has been used in more recent work by standard setters.

*Subsequent remeasurement*

- 6.18 If a pure historical cost measurement basis is being used, the carrying amount of an asset or liability will always be the amount at which it was initially recognised; in other words, there is no subsequent remeasurement stage. The carrying amount of an asset or liability measured at historical cost may nevertheless need to be changed so that the item remains at cost. For example, in the case of assets that are consumed over more than one accounting period (such as fixed assets), the amount at which the asset was recognised initially will be reduced over the expected life of the asset so as to allocate the asset's cost over its expected life. These adjustments are not remeasurements; they are adjustments to maintain the carrying amount at an amount based on historical cost.
- 6.19 In practice, however, this 'pure historical cost basis' is rarely used. Instead, to make historical cost more relevant to the needs of users, a variation is used that involves a limited amount of remeasurement. The purpose of this remeasurement is to ensure that:
- (a) assets are not reported at amounts greater than their recoverable amount<sup>24</sup>; and
  - (b) monetary assets and liabilities denominated in currencies other than the reporting currency are stated at an amount that is based on up-to-date exchange rates.
- 6.20 When the current value basis of measurement is being used, remeasurement takes place to ensure that the assets or liabilities involved are measured at an up-to-date current value. Such remeasurements will, however, be recognised in the financial statements only if:
- (a) there is sufficient evidence that the amount of the asset or liability has changed; and

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<sup>24</sup> Recoverable amount might be determined by reference to the asset's service potential.

(b) the new amount of the asset or liability is capable of being measured with sufficient reliability.

6.21 What constitutes sufficient evidence is a matter of judgement in the particular circumstances, although whilst the evidence will need to be adequate, it need not be conclusive. Relevant considerations will include its persuasiveness and whether the change implies that a gain or loss has occurred.

6.22 The issues to be considered in deciding whether the new amount of the asset or liability is capable of being measured with sufficient reliability are identical to the reliability of measurement issues considered in the context of initial recognition.

#### CHOOSING A MEASUREMENT BASIS AND DECIDING WHETHER TO CHANGE IT

6.23 In choosing the measurement basis to be used for a particular category of assets or liabilities, the aim is to select the basis that is most appropriate bearing in mind:

(a) the objective of financial statements and the qualitative characteristics of financial information, in particular relevance and reliability;

(b) the nature of the assets or liabilities concerned; and

(c) the particular circumstances involved.

6.24 Although these factors may not change, the measurement basis that best meets them may. For example, measurement bases that were once thought unreliable may become reliable.

## MEASUREMENT ISSUES

*Going concern*

- 6.25 Financial statements are usually prepared – and measures are usually arrived at – on the basis that the reporting entity is a going concern because measures based on break-up values tend not to be relevant to users seeking to assess the entity's financial performance.

*Discounting*

- 6.26 Historical cost and replacement cost are both market prices and will therefore generally take into account the time value of money and the risk associated with the future expected cash flows.
- 6.27 To be consistent, these factors need also to be reflected in the other measures that can be used to determine the carrying amount of assets (in other words, value in use and net realisable value) and the carrying amount of any liabilities measured by reference to expected future cash flows. It follows that, when basing carrying amounts on future cash flows, those cash flows will need to be discounted.
- 6.28 The discount rate used will reflect the risks associated with the future expected cash flows involved (unless those future expected cash flows are already risk-adjusted) and the time value of money. As such it will reflect the risks specific to the item being measured but not the more general risks of the entity as a whole.

*Arriving at a measure in the face of uncertainty*

- 6.29 If uncertainty exists, the only way to determine an appropriate monetary amount for the asset or liability is through the use of estimates. As long as a generally accepted estimation method is used and the measure is supported by a reasonable amount of confirmatory evidence – prudence

requires a greater reliability of measurement for assets (and gains) than for liabilities (and losses) – the use of estimates is acceptable and will not prevent the measure from being sufficiently reliable to be used in the financial statements.

- 6.30 If the monetary amount at which an asset or liability is recognised is subject to significant uncertainty, the degree of uncertainty surrounding the estimate will usually be disclosed in order to avoid the impression that the outcome is certain. Such a disclosure might provide details of the significant assumptions and measurement basis used, the range of possible outcomes, and the principal factors that affect the outcome.

#### CAPITAL MAINTENANCE ADJUSTMENTS AND CHANGING PRICES

- 6.31 General price changes can affect the significance of reported surpluses/deficits and of residual interest. If this problem is acute, an approach will need to be adopted that involves recognising surpluses/deficits only after adjustments have been made to maintain the purchasing power of the entity's financial capital.
- 6.32 Specific price changes can affect the significance of reported surpluses/deficits and financial position. If the problem is acute, it will be necessary to adopt a system of accounting that informs the user of the significance of specific price changes for the entity's financial performance and financial position.

## CHAPTER 7

# PRESENTATION OF FINANCIAL INFORMATION

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*Good presentation ensures that the essential messages of the financial statements are communicated clearly and effectively and in as simple and straightforward a manner as possible. This chapter explains what good presentation entails. It also considers the information that often accompanies financial statements and explains some of the roles fulfilled by such information.*

### PRINCIPLES

- Financial statements comprise primary financial statements and supporting notes that amplify and explain the primary financial statements. The primary financial statements themselves comprise the statement of financial performance<sup>25</sup>, the statement of financial position or balance sheet, and the cash flow statement.
- The presentation of information on financial performance focuses on the components of that performance and on the characteristics of those components.
- The presentation of information on financial position focuses on the types and functions of assets and liabilities held and on the relationships between them.
- The presentation of cash flow information will show the extent to which the entity's various activities generate and use cash, and will distinguish in particular between those cash flows that result from operations and those that result from other activities.

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<sup>25</sup> *Although many entities in the UK and the Republic of Ireland at present prepare two statements of financial performance, the number of statements prepared is a matter of convention and legal requirement; no significant financial reporting principle is involved. For simplicity, however, the Statement generally refers to 'the statement of financial performance'.*

- Disclosure of information in the notes to the financial statements is not a substitute for recognition and does not correct or justify any misrepresentation or omission in the primary financial statements.

## **EXPLANATION**

*There are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 7 of the Statement and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 7 of the Statement, which should be referred to for a full understanding. Additional explanation specific to public benefit entities has been added covering presentation in the balance sheet and accompanying information.*

### PRESENTATION OF INFORMATION IN FINANCIAL STATEMENTS

*Clear, effective and simple communication*

- 7.1 As financial statements are a means of communication, the objective of the presentation adopted is to communicate clearly and effectively and in as simple and straightforward a manner as is possible without loss of relevance or reliability and without unnecessarily increasing the length of the financial statements.

*Highly structured and aggregated*

- 7.2 The presentation of information in financial statements involves a high degree of interpretation, simplification, abstraction and aggregation – in other words, a loss of detailed information. Nevertheless, if this process is carried out in an orderly manner, greater knowledge will result because such a presentation will:
- (a) convey information that would otherwise have been obscured;
  - (b) highlight those items, and relationships between items, that are generally of most significance;

- (c) facilitate comparability between different entities' financial statements; and
  - (d) be more understandable to users.
- 7.3 The primary focus of the financial statements of public benefit entities is to provide information to assist with accountability for the efficient and effective use of funds. This focus is met through a set of interrelated reports (known as the primary financial statements) on:
- (a) financial performance (the operating cost statement and the statement of total recognised gains and losses are examples of financial performance statements);
  - (b) financial position (the balance sheet); and
  - (c) cash inflows and outflows (the cash flow statement),
- and a series of supporting disclosures (the notes to the financial statements).
- 7.4 The notes and primary financial statements form an integrated whole, with the notes amplifying and explaining the statements by, for example, providing:
- (a) more detailed information on items recognised in the primary financial statements;
  - (b) context for, or an alternative view of, items recognised in the primary financial statements; and
  - (c) relevant information that it is not practicable to incorporate in the primary financial statements, for example because of pervasive uncertainty.
- 7.5 The notes to the financial statements therefore represent a very important part of the overall information package. Nevertheless, disclosure of information in the notes is not a substitute for recognition and does not correct or justify any

misrepresentation in or omission from the primary financial statements.

### *Classification*

- 7.6 To facilitate the analysis of the information provided, items that are similar are presented together in the financial statements and distinguished from dissimilar items.

## GOOD PRESENTATION

### *Statement of financial performance*

- 7.7 The financial performance of a reporting entity is made up of components that exhibit differing characteristics in terms of, for example, nature, cause, function, relative continuity or recurrence, stability, risk, predictability and reliability. Information on financial performance needs to be presented in a way that focuses attention on these components and on their key characteristics.
- 7.8 Good presentation of financial performance information typically involves:
- (a) recognising only gains and losses in the statement of financial performance;
  - (b) classifying components by reference to a combination of function (such as administrative) and of the nature of the item (such as employment costs);
  - (c) distinguishing amounts that are affected in different ways by changes in economic conditions or business activity (for example, by providing segmental information); and
  - (d) identifying separately:
    - items that are unusual in amount or incidence judged by the experience of previous periods or expectations of the future;

- items that have special characteristics, such as financing costs and taxation; and
  - items that are related primarily to the results of the future, rather than current, accounting periods, such as some research and development expenditure.
- 7.9 Gains and losses are generally not offset in presenting information on financial performance. However, gains and losses will be offset if:
- (a) they relate to the same event or circumstance; and
  - (b) disclosing the gross components is not likely to be useful for an assessment of either future results or the effects of past transactions and events.

### *Balance Sheet*

- 7.10 In assessing the financial position of an entity, users are most interested in the types and amounts of assets and liabilities held and the relationship between them, and in the function of the various assets. Information on the reporting entity's financial position therefore needs to be presented in a way that focuses attention on these aspects. Good presentation typically involves:
- (a) recognising only assets, liabilities and residual interest in the balance sheet;
  - (b) delineating the entity's resource structure (major classes and amounts of assets) and its financial structure (major classes and amounts of liabilities and residual interest); and
  - (c) distinguishing assets by function. For example, assets held for sale will be reported separately from assets held on a continuing basis for use in the entity's activities.

- 7.11 In presenting information on the reporting entity's assets, it is necessary that the amount and nature of assets<sup>26</sup> that are subject to legal restrictions over their application are disclosed and explained.
- 7.12 In presenting information on the reporting entity's financial position, assets will not be offset against liabilities.
- 7.13 For some public benefit entities there may also be some focus on the presentation of different types of residual interest, for example of the extent to which restricted (including endowment) funds exist. Where, as noted in paragraph 7.11, legal restrictions exist over the application of assets, it should be clear how the relevant amount is reflected in the residual interest as well as in the assets themselves.

#### *Cash flow statement*

- 7.14 Cash flow information will be of most use if it shows the extent to which the entity's activities generate and use cash, distinguishing in particular cash flows that are the result of operations from cash flows that result from other activities.

#### ACCOMPANYING INFORMATION

- 7.15 Financial statements are often accompanied and complemented by information that does not form part of the financial statements. Examples of such information include trend information, operating and financial reviews, reports from the entity's governing body (eg directors' report, trustees' report), statements by the chief executive, key performance indicators, such as information on waiting lists, cost of refuse collection per household, and other indicators of a charity's performance. The Statement refers to such information as accompanying information.

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<sup>26</sup> In some cases the assets might constitute a portfolio that at times includes liabilities. The disclosure requirements would also apply to any liabilities within such a portfolio.

- 7.16 The primary objective of public benefit entities is to provide goods or services for the general public or social benefit. Therefore, the accompanying information is often of high importance for users of such entities' financial statements in assessing the performance of the entity as a whole.
- 7.17 Although accompanying information generally has the same objective as financial statements, it usually comprises a different kind of information, some of which deals with matters that are not in the financial statements and some which deals with matters that are in the financial statements, but from a different perspective. For example, it often includes:
- (a) narrative disclosures describing and explaining the entity's activities;
  - (b) historical summaries and trend information;
  - (c) non-accounting and non-financial information, including performance indicators; and
  - (d) evolutionary or experimental disclosures that are not considered suitable for inclusion in the financial statements.
- 7.18 The more complex entities become, the more users need an objective and comprehensive analysis and explanation of the main features underlying their financial performance and financial position. Such disclosures are best presented in the context of a discussion of the entity's business as a whole. This may include a discussion of what the residual interest represents and, where appropriate, management's future intentions regarding the net assets the residual interest represents.

#### *Comparison to budget*

- 7.19 Many funders and financial supporters will be interested in the extent to which actual expenditure compares to that forecast, for example where it is used to determine the

extent of a compulsory levy. In addition, where a grant has been provided, the provider will be interested in the extent to which it covered the associated expenditure.

- 7.20 As a result it may be useful to provide information on a comparison to budget, or an outturn position for grants, within general purpose financial reports, as part of the accompanying information. However, in providing such information it is necessary to ensure that, for example:
- (a) the information provided is of general use and not solely regulatory (or special purpose); and
  - (b) the information is provided at an appropriate level of detail or aggregation (such that it is useful, understandable and not so voluminous as to mask the key messages).

#### HIGHLIGHTS AND SUMMARY INDICATORS

- 7.21 Financial statements and accompanying information sometimes include amounts, ratios and other computations that attempt to distil key information about the reporting entity's financial performance and financial position. Such highlights and summary indicators cannot, on their own, provide a basis for meaningful analysis or prudent decision-making. It is therefore essential that they are not presented in a way that exaggerates their importance.
- 7.22 However, well-presented highlights and summary indicators are useful to some users, who perhaps only require very basic information, or plan to use that information to identify areas to analyse further.
- 7.23 Notwithstanding the limitations of highlights and summary indicators, if such information is provided it needs to be presented in a manner and context that enables its meaning to be communicated to users. This will often entail explaining the reasons for changes in the relative or absolute size of the figures from one period to the next.

## **CHAPTER 8**

# **ACCOUNTING FOR INTERESTS IN OTHER ENTITIES**

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*Financial statements need to reflect the effect on the reporting entity's financial performance and financial position of its interests in other entities. This involves various measurement and presentation issues. Rather than being dealt with in the relevant chapters and therefore in isolation from each other, they are dealt with together in this chapter. For similar reasons, various consolidation issues are dealt with in this chapter.*

### **PRINCIPLES**

- Single entity financial statements and consolidated financial statements present the interests the reporting entity may have in other entities from different perspectives.
- In single entity financial statements, interests in other entities are dealt with by focusing on the income and/or expenditure and (depending on the measurement basis adopted) capital growth arising from those interests.
- In consolidated financial statements, the way in which interests in other entities are dealt with depends on the degree of influence involved.
  - (a) An interest that involves control of another entity's operating and financial policies is dealt with by incorporating the controlled entity as part of the reporting entity.
  - (b) An interest that involves joint control of, or significant influence over, another entity's operating and financial policies is dealt with by recognising the reporting entity's share of that other entity's results and resources in a way that does not involve showing those results and resources in the performance statement and balance sheet as if they were controlled by the reporting entity.

- (c) Other interests are dealt with in the same way as any other asset.
- Although consolidated financial statements are the financial statements of the group as a whole, they are prepared from the perspective of the parent and, as a result, ultimately focus on the parent's interest in its subsidiaries. The effect on benefit flows of any outside interest in the subsidiaries will therefore be separately identified.
  - Consolidated financial statements reflect the whole of the parent's investment in its subsidiaries, including, where applicable, purchased goodwill.
  - A transaction involving the amalgamation of two or more reporting entities is reflected in the consolidated financial statements in accordance with its character. Therefore, a transaction that is of the character of:
    - (a) an acquisition is reflected in the consolidated financial statements as if the acquirer purchased the acquiree's assets and liabilities as a bundle of assets and liabilities on the open market; and
    - (b) a merger is reflected in the consolidated financial statements as if the new reporting entity, comprising all the parties to the transaction, had always existed.

## **EXPLANATION**

*There are few fundamental differences between the principles and explanation relevant to profit-oriented entities, as expressed in Chapter 8 of the Statement and their interpretation for public benefit entities. Therefore much of what follows is a summary of the discussion in Chapter 8 of the Statement, which should be referred to for a full understanding. Additional explanation specific to public benefit entities has been added covering business combinations.*

## DEGREE OF INFLUENCE

- 8.1 Although an entity's interest in a second entity may take many different forms, the key factor in determining its effect on the first entity's financial performance and financial position is the degree of influence it exerts over the operating and financial policies of the second entity involved.
- 8.2 The highest degree of influence that an entity can have is control. As Chapter 2 explains, control comprises the ability to deploy the economic resources involved and to benefit (or to suffer) by their deployment. Other degrees of influence have these same aspects; in effect, the ability to influence the activities of the entity with a view to gaining economic benefits from that influence.
- 8.3 Although it is possible to classify the degree of influence that an entity has over an entity in an almost infinite number of ways, it is sufficient for the purposes of the Statement and this Interpretation to classify it as follows:
- (a) *Control* – where one entity controls another entity.
  - (b) *Joint control* – where the entity does not itself control the other entity, but shares control through some form of arrangement jointly with others.
  - (c) *Significant influence* – where the entity has neither control nor joint control, but exerts a degree of influence over the entity's operating and financial policies that is at the least a significant influence and at the most just short of control.
  - (d) *Lesser or no influence* – where any influence that the entity has over the entity's operating and financial policies is less than a significant influence.

## REFLECTING THE EFFECTS OF INTERESTS IN OTHER ENTITIES

*Consolidated financial statements and single entity financial statements*

- 8.4 The effect on the entity's financial performance and financial position of an interest in an entity is reflected in the first entity's financial statements in different ways depending on the type of financial statements being prepared.
- (a) Financial statements of a reporting entity whose boundary has been drawn by reference to the scope of its direct control – single entity financial statements – take a narrow view of the reporting entity's interests in other entities and reflect only the income and capital growth arising from those interests.
  - (b) Financial statements of a reporting entity whose boundary has been drawn by reference to the scope of the entity's control (both direct and indirect) – consolidated financial statements – present an expanded view of the reporting entity's interests in other entities that reflects the reporting entity's influence over, and its accountability for, the activities and resources of these entities.

*Interests involving control*

- 8.5 If an entity controls one or more other entities, the controlling entity (the parent) and the controlled entities (the subsidiaries) will be a reporting entity (the group). The group financial statements (consolidated financial statements) are prepared by aggregating the gains, losses, assets, liabilities and cash flows of the parent and its subsidiaries. This ensures that the effects on the parent's financial performance and financial position of its interests in its subsidiaries are fully reflected in the financial statements.

*Interests involving joint control or significant influence*

- 8.6 If the reporting entity shares joint control of, or exercises

significant influence over, another entity, it will be directly involved in and affected by that other entity's activities. Its interest is therefore reflected in the consolidated financial statements in a way that:

- (a) recognises the reporting entity's share of the results and net assets of the investee; and
- (b) does not misrepresent the extent of its influence over the investee – in other words, it does not treat activities and resources that are not controlled by the reporting entity as if they are controlled by the reporting entity.

*Interests involving lesser or no influence*

- 8.7 If the reporting entity's influence does not involve control, joint control or significant influence, the reporting entity will not be accountable for the entity's activities. In such circumstances, the only amounts recognised in the consolidated financial statements will be the investment (if any) and any income derived therefrom.

## CONSOLIDATED FINANCIAL STATEMENTS

- 8.8 The gains, losses, assets, liabilities and cash flows of all subsidiaries are reflected in full in the consolidated financial statements, even if a subsidiary is not wholly-owned. This reflects the parent's ability, through its control, to deploy both its own economic resources and those of its subsidiaries even where it does not wholly own the subsidiaries.
- 8.9 This Chapter separates general purpose financial statements into single entity financial statements and consolidated financial statements; such distinctions are not necessarily observed in regulatory requirements, which may require combined financial statements for a number of entities that do not meet the criteria for a reporting entity. An example would be financial statements showing the combined results of related initiatives where different elements may be carried out by different entities.

## ACCOUNTING FOR BUSINESS COMBINATIONS

- 8.10 An amalgamation of two or more reporting entities – sometimes referred to as a business combination – can take a number of different forms. All these forms can be characterised as either:
- (a) a purchase (for public benefit entities potentially at nil or nominal consideration) – such transactions are commonly referred to as acquisitions<sup>27</sup>; or
  - (b) a uniting of interests – such transactions are commonly referred to as mergers.
- 8.11 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, representing the enlargement of a continuing entity, or as a merger, representing the creation of a new combined entity. It is important to consider the individual circumstances of each combination in determining the appropriate accounting.
- 8.12 An acquisition is a business combination that is in the nature of an acquisition by one entity of another entity (ie one entity is the acquirer). The transaction therefore results in an existing reporting entity being enlarged and is reflected in the consolidated financial statements by treating the assets and liabilities of the entity acquired and any purchased goodwill as if the transaction was the purchase of a bundle of assets and liabilities on the open market.
- 8.13 On the other hand, a merger is in the nature of a coming together of two entities to form a new reporting entity. This is reflected in the financial statements of the new reporting entity comprising all the parties to the transaction as if that entity had always existed. As a result, the assets and liabilities

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<sup>27</sup> *An acquisition is something that has been acquired by any means and therefore includes something that has been gifted as well as something that has been purchased.*

of each party to the transaction are treated as if they were acquired by the new reporting entity at the time that they were acquired by the party concerned<sup>28</sup> with none of the assets or liabilities treated as being purchased at the time of the business combination as part of a bundle of assets and liabilities on the open market.

- 8.14 Where an acquisition is carried out at nil or nominal consideration:
- (a) the excess of the fair value of the assets acquired over the fair value of the liabilities assumed should be treated as a gain. The gain represents the gift of the value of one business to another and should be recognised as income;
  - (b) if the fair value of the liabilities assumed exceeds the fair value of the assets acquired, the deficit of the fair value of the liabilities in comparison to the assets should be treated as a loss. The loss represents the net obligations assumed, for which the acquiring entity has not received a financial reward, which will therefore result in a decrease in residual interest.

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<sup>28</sup> This description of ‘merger accounting’ has been repeated from the Statement. However, although the Board continues to believe that there can be circumstances where a business combination does not have the characteristics of an acquisition, merger accounting has generally lost favour as a means of faithfully representing the economic substance of the combination that has occurred. In substance, it can be argued that a new entity has been created from the date of the business combination, which acquired the combined assets on that date. A more suitable presentation might be for all the assets and liabilities to be treated as if they were acquired on the open market on the date the combination took place.

## APPENDIX 1 –

### THE PRINCIPLES THAT HAVE BEEN RE-EXPRESSED

Many of the principles within this Interpretation are exactly the same as those that are relevant to profit-oriented entities. Those that have been amended or inserted are as follows:

<b>Principle as expressed in the Statement of Principles for Financial Reporting</b>	<b>Principle as re-expressed in this Interpretation</b>	<b>Discussion</b>
<p><b>Chapter 1</b></p> <ul style="list-style-type: none"> <li>• That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user.</li> </ul>	<ul style="list-style-type: none"> <li>• That objective can usually be met by focusing exclusively on the information needs of funders and financial supporters, the defining class of user.</li> </ul>	<p>Amended to reflect a different defining class of user.</p>
<p><b>Chapter 1</b></p> <ul style="list-style-type: none"> <li>• Present and potential investors need information about the reporting entity's financial performance and financial position that is useful to them in evaluating the entity's ability to generate cash (including the timing and certainty of its generation) and in assessing the entity's financial adaptability.</li> </ul>	<ul style="list-style-type: none"> <li>• Funders and financial supporters need information about the reporting entity's financial performance and financial position that is useful to them in helping to evaluate the proper and efficient use of the entity's resources and in assessing the entity's cash needs and its financial adaptability.</li> </ul>	<p>Amended to reflect a different defining class of user and a slightly different emphasis on the use of the information.</p>

<b>Principle as expressed in the Statement of Principles for Financial Reporting</b>	<b>Principle as re-expressed in this Interpretation</b>	<b>Discussion</b>
<p><b>Chapter 3</b></p> <ul style="list-style-type: none"> <li>Information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions.</li> </ul>	<ul style="list-style-type: none"> <li>Information is relevant if it has the ability to influence the economic decisions of users, or their assessment of the effectiveness of the stewardship of management, and is provided in time to influence those decisions or assessments.</li> </ul>	<p>Amended to include reference to the use of information in assessing the effectiveness of the stewardship of management.</p>
<p><b>Chapter 3</b></p> <ul style="list-style-type: none"> <li>Information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users.</li> </ul>	<ul style="list-style-type: none"> <li>Information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users, or their assessment of the effectiveness of the stewardship of management.</li> </ul>	<p>Amended to include reference to the use of information in assessing the effectiveness of the stewardship of management.</p>

<b>Principle as expressed in the Statement of Principles for Financial Reporting</b>	<b>Principle as re-expressed in this Interpretation</b>	<b>Discussion</b>
<p><b>Chapter 4</b></p> <ul style="list-style-type: none"> <li>• The elements of the financial statements are:               <ul style="list-style-type: none"> <li>(a) assets;</li> <li>(b) liabilities;</li> <li>(c) ownership interest;</li> <li>(d) gains;</li> <li>(e) losses;</li> <li>(f) contributions from owners;</li> <li>(g) distributions to owners.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• The elements of the financial statements are:               <ul style="list-style-type: none"> <li>(a) assets;</li> <li>(b) liabilities;</li> <li>(c) residual interest;</li> <li>(d) gains;</li> <li>(e) losses;</li> <li>(f) contributions establishing a financial interest in the residual interest;</li> <li>(g) distributions to holders of a financial interest in the residual interest.</li> </ul> </li> </ul>	<p>Amended due to the different nature of owners and financial interests in the context of public benefit entities.</p>
<p><b>Chapter 4</b></p> <ul style="list-style-type: none"> <li>• Ownership interest is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.</li> </ul>	<ul style="list-style-type: none"> <li>• Residual interest is the amount found by deducting all of the entity's liabilities from all of the entity's assets.</li> </ul>	<p>Amended due to the different nature of owners in public benefit entities.</p>
<p><b>Chapter 4</b></p> <ul style="list-style-type: none"> <li>• Gains are increases in ownership interest not resulting from contributions from owners.</li> </ul>	<ul style="list-style-type: none"> <li>• Gains are increases in residual interest not resulting from contributions establishing a financial interest in the residual interest.</li> </ul>	<p>Amended due to the different nature of owners and financial interests in the context of public benefit entities.</p>

<b>Principle as expressed in the Statement of Principles for Financial Reporting</b>	<b>Principle as re-expressed in this Interpretation</b>	<b>Discussion</b>
<p><b>Chapter 4</b></p> <ul style="list-style-type: none"> <li>Losses are decreases in ownership interest not resulting from distributions to owners.</li> </ul>	<ul style="list-style-type: none"> <li>Losses are decreases in residual interest not resulting from distributions to holders of a financial interest in the residual interest.</li> </ul>	<p>Amended due to the different nature of owners and financial interests in the context of public benefit entities.</p>
<p><b>Chapter 4</b></p> <ul style="list-style-type: none"> <li>Contributions from owners are increases in ownership interest resulting from transfers from owners in their capacity as owners.</li> </ul>	<ul style="list-style-type: none"> <li>Contributions establishing a financial interest in the residual interest are increases in residual interest resulting from transfers from parties that establish a financial interest in that residual interest.</li> </ul>	<p>Amended due to the different nature of owners and financial interests in the context of public benefit entities.</p>
<p><b>Chapter 4</b></p> <ul style="list-style-type: none"> <li>Distributions to owners are decreases in ownership interest resulting from transfers to owners in their capacity as owners.</li> </ul>	<ul style="list-style-type: none"> <li>Distributions to holders of a financial interest in the residual interest are decreases in residual interest resulting from transfers to parties holding a financial interest in that residual interest in their capacity as holders of a financial interest.</li> </ul>	<p>Amended due to the different nature of owners and financial interests in the context of public benefit entities.</p>

<b>Principle as expressed in the Statement of Principles for Financial Reporting</b>	<b>Principle as re-expressed in this Interpretation</b>	<b>Discussion</b>
<b>Chapter 5</b>	<ul style="list-style-type: none"> <li>In a transaction involving the receipt of resources not related directly to the provision of goods or services, the recognition criteria described above will be met when there is clear evidence of a right to receive the resources.</li> </ul>	<p><u>New principle</u> relating to the receipt of resources other than for net gain.</p>
<b>Chapter 8</b> <ul style="list-style-type: none"> <li>In single entity financial statements, interests in other entities are dealt with by focusing on the income and (depending on the measurement basis adopted) capital growth arising from those interests.</li> </ul>	<ul style="list-style-type: none"> <li>In single entity financial statements, interests in other entities are dealt with by focusing on the income and/or expenditure and (depending on the measurement basis adopted) capital growth arising from those interests.</li> </ul>	<p>Amended to include reference to expenditure, because the entity might be contributing to the interest, rather than receiving income from it.</p>
<b>Chapter 8</b> <ul style="list-style-type: none"> <li>Consolidated financial statements reflect the whole of the parent's investment in its subsidiaries, including purchased goodwill.</li> </ul>	<ul style="list-style-type: none"> <li>Consolidated financial statements reflect the whole of the parent's investment in its subsidiaries, including, where applicable, purchased goodwill.</li> </ul>	<p>Amended because purchased goodwill may arise only rarely.</p>

## **APPENDIX 2 –**

### COMPARISON TO MATERIAL IN THE STATEMENT

The following table compares the material that is included in this Interpretation with that in the Statement in order to provide an indication of which material:

- (a) is the same, or substantially the same, as the Statement;
- (b) from the Statement has been omitted, but is equally relevant to public benefit entities;
- (c) has been inserted specifically to address the circumstances of public benefit entities.

The table does not consider the principles themselves, which are addressed in Appendix 1.

<b>Chapter</b>	<b>Comparison with the Statement</b>
Introduction	<p><i>Purpose</i></p> <p>Paragraphs 1 and 4 are substantially the same as paragraphs 1 to 4 of the Statement. Paragraphs 2, 3 and 5 are additional.</p> <p><i>Status</i></p> <p>Paragraph 6 is substantially the same as paragraph 5 of the Statement. Paragraphs 7 and 8 are additional.</p> <p><i>Scope</i></p> <p>Paragraphs 9 to 15 replace paragraph 9 of the Statement, although paragraphs 11 to 14 include a significant amount of new material. Paragraphs 16 to 20 are substantially the same as paragraphs 6 to 8 of the Statement, although paragraphs 18 and 19 include a significant amount of new material.</p> <p><i>True and fair</i></p> <p>Paragraphs 10 to 13 of the Statement have not been repeated.</p> <p><i>The standard-setting process</i></p> <p>Most of paragraphs 14 to 17 of the Statement have not been repeated, but paragraph 15(a) is reflected in paragraph 21 of this Interpretation.</p>

Chapter	Comparison with the Statement
	<p><i>Revisions to the statement</i></p> <p>Paragraph 22 is substantially the same as paragraph 18 of the Statement.</p>
Chapter 1	<p><i>The objective of financial statements</i></p> <p>Paragraph 1.1 is a summarisation of paragraphs 1.1 and 1.2 of the Statement. Paragraphs 1.2 to 1.4 expand on paragraphs 1.3 and 1.4 of the Statement. Paragraphs 1.5 and 1.6 are additional. Paragraphs 1.5 to 1.7 of the Statement have not been repeated, although paragraph 1.7 provides a brief summary. Paragraph 1.8 summarises paragraphs 1.8 and 1.9 of the Statement. Paragraphs 1.9 and 1.10 are additional.</p> <p><i>Defining class of user</i></p> <p>Paragraph 1.11 is substantially the same as paragraph 1.11 of the Statement. Paragraphs 1.10 and 1.12 of the Statement have not been repeated. Paragraphs 1.12 to 1.16 are additional.</p> <p><i>Information required by funders and financial supporters</i></p> <p>Paragraphs 1.17 to 1.23 summarise paragraphs 1.13 to 1.22 of the Statement with added public benefit entity context.</p>
Chapter 2	<p><i>Entities that should prepare and publish financial statements</i></p> <p>Paragraphs 2.1 to 2.3 are the same as the Statement.</p> <p><i>The boundary of a reporting entity</i></p> <p>Paragraphs 2.4 to 2.6 summarise paragraphs 2.4, 2.6 and 2.7 of the Statement; paragraph 2.5 has not been repeated.</p> <p><i>What is control?</i></p> <p>Paragraph 2.7 is the same as paragraph 2.8 in the Statement. Paragraph 2.8 repeats part of paragraph 2.10 in the Statement with added public sector context. Paragraph 2.9 has not been repeated.</p> <p><i>Controlling an entity</i></p> <p>Paragraphs 2.9 to 2.16 summarise paragraphs 2.11 to 2.20 of the Statement.</p> <p><i>Assets held in a fiduciary capacity</i></p> <p>Paragraph 2.17 is additional.</p>
Chapter 3	<p><i>Relevance</i></p> <p>Paragraph 3.1 is the first sentence of paragraph 3.1, and paragraph 3.2 of the Statement. Paragraph 3.2 is the first part of paragraph 3.3 and paragraph 3.5 of the Statement. The remainder of paragraphs 3.1 and 3.3 and paragraph 3.4 in the Statement are not repeated.</p>

Chapter	Comparison with the Statement
	<p>Paragraph 3.3 is substantially the same as paragraph 3.6 in the Statement. Paragraph 3.4 is additional.</p> <p><i>Reliability</i></p> <p>Paragraph 3.5 is the same as paragraphs 3.7 and 3.8 in the Statement. Paragraph 3.6 is the same as paragraph 3.12 in the Statement. Paragraph 3.7 is the first sentence of paragraph 3.13 and paragraph 3.14 in the Statement. Paragraph 3.8 is the same as paragraph 3.15 in the Statement. Paragraphs 3.10, 3.11, the remainder of 3.13 and 3.16 to 3.20 of the Statement have not been repeated.</p> <p><i>Comparability</i></p> <p>Paragraph 3.9 is substantially the same as paragraph 3.21 in the Statement. Paragraphs 3.10 and 3.11 summarise paragraphs 3.23 to 3.25 in the Statement. Paragraph 3.22 of the Statement has not been repeated.</p> <p><i>Understandability</i></p> <p>Paragraph 3.12 summarises paragraphs 3.26 and 3.27 in the Statement. Paragraphs 3.13 and 3.14 are additional.</p> <p><i>Materiality</i></p> <p>Paragraphs 3.15 to 3.19 are substantially the same as paragraphs 3.28 to 3.32 in the Statement.</p> <p><i>Constraints on the qualitative characteristics</i></p> <p>Paragraph 3.20 is the same as paragraph 3.33 in the Statement. Paragraphs 3.21, 3.22 and 3.25 summarise paragraphs 3.34, 3.36 and 3.37 in the Statement. Paragraph 3.35 of the Statement has not been repeated. Paragraphs 3.23 and 3.24 are additional.</p>
Chapter 4	<p><i>The elements of financial statements</i></p> <p>Paragraphs 4.1 and 4.2 are substantially the same as paragraphs 4.1 and 4.2 in the Statement. Paragraphs 4.3 and 4.4 of the Statement have not been repeated. Paragraph 4.3 is the same as the second sentence of paragraph 4.5 in the Statement.</p> <p><i>Assets</i></p> <p>The definition is the same as paragraph 4.6 in the Statement. Paragraph 4.4 is the same as paragraph 4.8 in the Statement. Paragraph 4.5 summarises paragraphs 4.9 and 4.10 in the Statement. Paragraph 4.6 is the same as paragraph 4.11 in the Statement. Paragraph 4.7 is substantially the same as paragraph 4.13 in the Statement. Paragraph 4.13 is substantially the same as paragraph 4.17 in the Statement. Paragraphs 4.17 and 4.18 summarise paragraphs 4.19 and 4.20 in the Statement. Paragraph 4.19 is</p>

Chapter	Comparison with the Statement
	<p>the first sentence of paragraph 4.22 in the Statement. Paragraphs 4.8 to 4.12 and 4.14 to 4.16 are additional. Paragraphs 4.7, 4.12, 4.14 to 4.16, 4.18 and 4.21 of the Statement have not been repeated.</p> <p><i>Liabilities</i></p> <p>The definition is the same as paragraph 4.23 in the Statement. Paragraphs 4.20 to 4.22 are the same as paragraphs 4.24 to 4.25 in the Statement, except that paragraph 4.22 includes some additional material. Paragraph 4.23 is the same as paragraph 4.27 in the Statement. Paragraph 4.24 is the same as paragraph 4.29 in the Statement. Paragraphs 4.25 to 4.27 are the first part of paragraphs 4.30 to 4.32 in the Statement. Paragraphs 4.28 to 4.36 are additional. Paragraph 4.28 of the Statement has not been repeated.</p> <p><i>Offsetting rights and obligations</i></p> <p>Paragraphs 4.37 to 4.40 are essentially the same as paragraphs 4.33 to 4.36 in the Statement, except that the sub-paragraphs of 4.33 have not been repeated.</p> <p><i>Residual interest (referred to as ownership interest in the Statement)</i></p> <p>Paragraph 4.41 reflects the public benefit entity context of paragraph 4.37 in the Statement. Paragraph 4.42 includes much of the material from paragraph 4.38 in the Statement. Paragraphs 4.43 and 4.44 are additional.</p> <p><i>Gains and losses</i></p> <p>The definition and paragraph 4.45 are substantially the same as paragraphs 4.39 and 4.40 in the Statement. Paragraph 4.46 is additional. Paragraphs 4.47 to 4.51, on donated goods and services, are also additional. Paragraph 4.41 in the Statement has not been repeated.</p> <p><i>Contributions establishing a financial interest in the residual interest</i></p> <p>Paragraph 4.52 relates to paragraph 4.43 in the Statement. Paragraph 4.54 builds on paragraph 4.44 in the Statement, providing additional public benefit entity context. Paragraphs 4.53 and 4.55 are additional.</p> <p><i>Distributions to holders of a financial interest in the residual interest</i></p> <p>Paragraph 4.56 is additional. The first sentence of paragraph 4.57 is the first sentence of paragraph 4.45 in the Statement with additional public benefit entity context.</p>

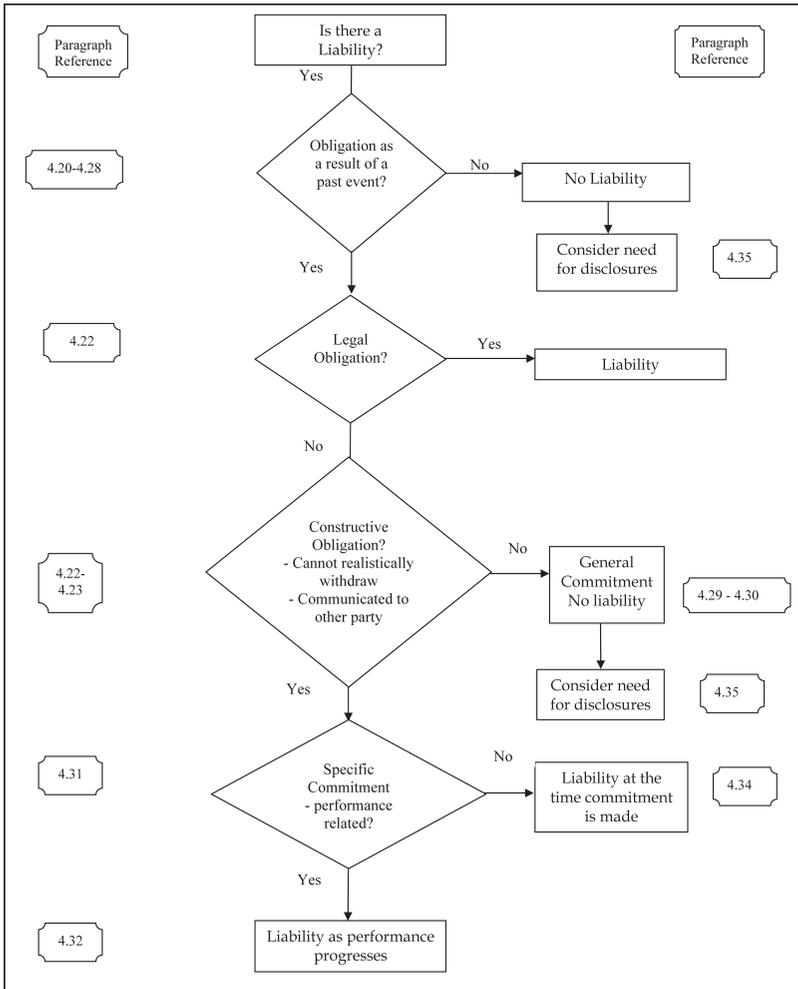
Chapter	Comparison with the Statement
Chapter 5	<p><i>The recognition process</i></p> <p>Paragraphs 5.1 and 5.2 are the same as paragraphs 5.1 and 5.2 in the Statement. Paragraphs 5.3 to 5.6 summarise paragraphs 5.3 to 5.6 in the Statement. Paragraphs 5.7 to 5.9 are substantially the same as paragraphs 5.8, 5.9 and 5.11 in the Statement. Paragraphs 5.7 and 5.10 of the Statement have not been repeated.</p> <p><i>Initial recognition</i></p> <p>Paragraph 5.10 is the same as paragraph 5.12 in the Statement. Paragraphs 5.11 and 5.12 summarise paragraphs 5.14 and 5.15 in the Statement. Paragraphs 5.13 and 5.14 are the same as paragraphs 5.16 and 5.17 in the Statement. Paragraph 5.16 is substantially the same as paragraph 5.19 in the Statement. Paragraph 5.15 is additional. Paragraphs 5.13 and 5.18 in the Statement have not been repeated. Paragraph 5.20 and 5.21 of the Statement have not been repeated.</p> <p><i>Derecognition</i></p> <p>Paragraphs 5.17 to 5.20 summarise paragraphs 5.22 to 5.25 in the Statement.</p> <p><i>Revenue recognition</i></p> <p>Paragraphs 5.21 to 5.24 summarise paragraphs 5.26 to 5.30 in the Statement. Paragraphs 5.25 to 5.27 are the same as paragraphs 5.33 to 5.35 in the Statement, except that the second sentence of paragraph 5.34 has not been repeated. Paragraphs 5.31 and 5.32 in the Statement have not been repeated. The first sentence of paragraph 5.28 is the same as the first sentence of paragraph 5.36 in the Statement, otherwise paragraphs 5.28 to 5.37 are additional.</p>
Chapter 6	<p><i>Alternative bases of measurement</i></p> <p>Paragraph 6.1 summarises paragraph 6.1 in the Statement. Paragraph 6.2 is the same as paragraph 6.3 in the Statement. Paragraph 6.3 is substantially the same as the first sentence of paragraph 6.4 in the Statement. Paragraphs 6.2 and 6.5 of the Statement have not been repeated.</p> <p><i>Alternative measures of current value</i></p> <p>Paragraph 6.4 is substantially the same as paragraph 6.6 in the Statement. Paragraph 6.5 is based on paragraph 6.7 in the Statement. Paragraphs 6.6 to 6.10 are additional. Paragraph 6.11 is essentially the same as paragraph 6.9 in the Statement. The diagram in paragraph 6.8 of the Statement has not been repeated.</p>

Chapter	Comparison with the Statement
	<p><i>The measurement process</i></p> <p>Paragraphs 6.12 to 6.17 are substantially the same as paragraphs 6.10 to 6.15 in the Statement, except that the sub-paragraphs of 6.14 have not been repeated and there is additional public benefit entity context in paragraph 6.17. Paragraph 6.16 of the Statement has not been repeated. Paragraphs 6.18 to 6.22 are substantially the same as paragraphs 6.17 to 6.22 in the Statement, except that paragraph 6.21 has not been repeated.</p> <p><i>Choosing a measurement basis and deciding whether to change it</i></p> <p>Paragraph 6.23 is the same as paragraph 6.23 in the Statement. Paragraph 6.24 is the same as the first part of paragraph 6.24 in the Statement. Paragraphs 6.25 to 6.29 of the Statement have not been repeated.</p> <p><i>Measurement issues</i></p> <p>Paragraph 6.25 is substantially the same as paragraph 6.30 in the Statement. Paragraph 6.26 is the same as part of paragraph 6.32 in the Statement. Paragraphs 6.27 and 6.28 are the same as paragraphs 6.33 and 6.34 in the Statement. Paragraph 6.29 is the same as paragraph 6.36 in the Statement. Paragraph 6.30 is the same as paragraph 6.38 in the Statement. Paragraphs 6.31, 6.35, 6.37 of the Statement have not been repeated.</p> <p><i>Capital maintenance adjustments and changing prices</i></p> <p>Paragraphs 6.31 and 6.32 are the same as the sub-paragraphs of 6.42 in the Statement. Paragraphs 6.39 to 6.41 of the Statement have not been repeated.</p>
Chapter 7	<p><i>Presentation of information in financial statements</i></p> <p>Paragraphs 7.1 to 7.6 are the same, or substantially the same, as paragraphs 7.1 to 7.6 in the Statement. Paragraphs 7.7 and 7.8 of the Statement have not been repeated.</p> <p><i>Good presentation</i></p> <p>Paragraphs 7.7 to 7.12 summarise paragraphs 7.9 to 7.13 in the Statement, except that paragraph 7.11 is additional. Paragraph 7.13 is additional. Paragraph 7.14 summarises paragraph 7.14 in the Statement.</p> <p><i>Accompanying information</i></p> <p>Paragraph 7.15 is substantially the same as paragraph 7.15 in the Statement. Paragraph 7.16 is additional. Paragraph 7.17 summarises paragraphs 7.16 and 7.17 of the Statement. Paragraph 7.18 summarises paragraph 7.18 in the Statement. Paragraphs 7.19 and 7.20 are additional.</p>

Chapter	Comparison with the Statement
	<p data-bbox="367 217 684 240"><i>Highlights and summary indicators</i></p> <p data-bbox="367 248 893 304">Paragraphs 7.21 to 7.23 are substantially the same as paragraphs 7.19 to 7.21 in the Statement.</p>
Chapter 8	<p data-bbox="367 316 538 339"><i>Degree of influence</i></p> <p data-bbox="367 347 960 427">Paragraphs 8.1, 8.2 and 8.3 are the same as paragraphs 8.1, 8.3 and 8.4 in the Statement. Paragraph 8.2 has not been repeated.</p> <p data-bbox="367 435 799 459"><i>Reflecting the effects of interests in other entities</i></p> <p data-bbox="367 467 960 603">Paragraphs 8.4 to 8.6 are substantially the same as paragraphs 8.5, 8.7 and 8.9 in the Statement. Paragraph 8.7 is substantially the same as paragraph 8.10 in the Statement. Paragraphs 8.6 and 8.8 of the Statement have not been repeated.</p> <p data-bbox="367 611 667 635"><i>Consolidated financial statements</i></p> <p data-bbox="367 643 960 722">Paragraph 8.8 is the same as paragraph 8.11 in the Statement. Paragraph 8.9 is additional. Paragraphs 8.12 and 8.13 of the Statement are not repeated.</p> <p data-bbox="367 730 698 754"><i>Accounting for business combinations</i></p> <p data-bbox="367 762 960 842">Paragraphs 8.10, 8.12 and 8.13 are substantially the same as paragraphs 8.14 to 8.16 in the Statement. Paragraphs 8.11 and 8.14 are additional.</p>

## APPENDIX 3 –

### DECISION TREE FOR COMMITMENTS TO PROVIDE PUBLIC BENEFITS



## **APPENDIX 4**

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### THE DEVELOPMENT OF THE INTERPRETATION

#### **Introduction**

- 1 This Appendix explains the development of the Interpretation. It sets out the relationship between the Statement of Principles for Financial Reporting (the Statement) and this Interpretation. It also explains why the Accounting Standards Board (the Board) decided to publish an Interpretation of the Statement and sets out the main stages of its development and the main issues considered.
- 2 As with the Discussion Paper, the Board's Committee on Accounting for Public-benefit Entities (CAPE) played a leading role in the development of this Interpretation from preparing the Discussion Paper and the Exposure Draft through to publication of this final version. The Board gratefully acknowledges this significant and important contribution.

#### *Statement of Principles for Financial Reporting*

- 3 The Statement was issued by the Board in December 1999. It sets out the principles that the Board believes should underlie the preparation and presentation of general purpose financial statements.
- 4 The primary purpose of the Statement is to provide a coherent frame of reference to be used by the Board in the development and review of accounting standards and by others who interact with the Board during the standard-setting process. Publication of the Statement was also intended to assist preparers and users of financial statements, as well as auditors and others, to understand the Board's approach to formulating accounting standards and the nature and function of information reported in general purpose financial statements.

- 5 The Statement is primarily intended to be relevant to the financial statements of profit-oriented entities in the private and public sectors. However, the Board believes that a common set of principles should underlie financial reporting by all entities. This will assist users in understanding financial statements regardless of the nature of the entity producing them and allow comparability, where appropriate, between all entities.

#### *Scope of Interpretation*

- 6 The Interpretation is intended to be relevant to the financial statements of all public benefit entities, regardless of their size, whether or not they make a surplus and whether they are private or public sector entities. However, it does not apply to profit-oriented entities, including any in the public sector.
- 7 The Interpretation is intended to operate alongside the existing Statement, expanding on the common underlying principles for public benefit entities, and therefore, other than at the margin, there should be no difference in financial reporting resulting from applying the Statement or the Interpretation. As a result, the Board has decided not to produce a list of entities that it believes meet the definition of a public benefit entity.

#### **International developments and convergence**

- 8 An EU Regulation requires all listed companies in the EU to prepare their consolidated financial statements in accordance with EU-adopted international accounting standards from 2005. International Financial Reporting Standards (IFRSs), set by the International Accounting Standards Board (IASB), form the basis of these adopted standards. Other companies are permitted to adopt the same framework, unless they are charitable companies, in which case they must continue to report under UK accounting standards.
- 9 The government sector will continue to prepare accounts in

accordance with the Financial Reporting Manual (FReM), as published by the Treasury based on UK standards. However, the Chancellor of the Exchequer announced in the 2007 Budget that the accounts of central government departments and entities in the wider public sector will be produced from 2008-09 using IFRS, as interpreted for the public sector in an IFRS based FReM.

- 10 Nonetheless, it is expected that many public benefit entities will, in the shorter term at least, continue to prepare their financial statements in accordance with UK accounting standards and, where applicable, Statements of Recommended Practice (SORPs) that have been developed to provide guidance on the application of UK accounting standards in the circumstances of particular sectors.
- 11 The ASB is pursuing a programme of convergence between UK accounting standards and IFRS and has issued new UK standards that are based on IFRS. The Board is continuing its consultations and has proposed that further standards will be introduced by the ASB with a common effective date, currently estimated to be financial years beginning on or after 1 January 2009. The expectation is that, over time, all entities will be preparing their financial statements in accordance with standards based on the same core set of IFRS.
- 12 The IASB has on its agenda a major project to revise its conceptual framework. It is a joint project with the Financial Accounting Standards Board (FASB) in the USA and aims to develop a framework that combines and improves upon the existing frameworks. The IASB plans to consider the impact of the framework on not-for-profit entities towards the end of its project. The ASB, in collaboration with other National Standards Setters, is closely monitoring the IASB project and contributing views as this work progresses. In the longer term, the ASB will reflect upon the implications of this work for the Statement and this Interpretation.

*International Public Sector Accounting Standards Board (IPSASB)*

- 13 IPSASB<sup>29</sup> continues with its programme to develop and maintain International Public Sector Accounting Standards (IPSASs) for accounting by governmental bodies. Most of the 24 standards currently in issue are based on International Accounting Standards extant at 31 August 1997, including the 11 revised accrual basis standards that were issued by IPSASB in January 2007 and are intended to increase the clarity and usability of IPSASs. The 11 revised IPSASs are effective for reporting periods beginning on or after 1 January 2008.
- 14 The scope of this Interpretation, which includes all public benefit entities regardless of whether they are in the public or private sector, is wider than the work of the IPSASB, which covers only the public sector.
- 15 IPSASB's active work programme has recently seen it publish standards on public sector specific issues such as IPSAS 23 "Revenue from Non-Exchange Transactions (including Taxes and Transfers)" and IPSAS 24 "Presentation of Budget Information in Financial Statements". IPSASB is also taking forward a project to develop a standard on accounting for the social policies of government and is aiming to publish an Exposure Draft in 2007 that will focus on the presentation and disclosure of social benefits. This approach will allow IPSASB to consider further recognition and measurement issues, on which it hopes to publish a Consultation Paper in 2007.
- 16 IPSASB, in conjunction with a number of participating National Standard Setters, has also just started a long-term project to establish a public sector conceptual framework

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<sup>29</sup> IPSASB was previously known as the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC). IPSASBs aim is to converge IPSASs with IFRS, issued by the IASB, while at the same time also considering public sector specific issues and reflecting public sector emphasis within the IPSASs.

which is intended to be applicable to the preparation and presentation of general purpose financial reports of public sector entities.

- 17 During the development of this Interpretation the Board has had regard to pronouncements and proposals issued by IPSASB. This is highlighted in the following discussion of the main issues debated in developing this Interpretation, with several of these issues including a comparison to IPSASB requirements or proposals.

*Discussion Paper of Proposed Interpretation*

- 18 In May 2003 the Board issued a Discussion Paper ‘Statement of Principles for Financial Reporting: Proposed Interpretation for Public Benefit Entities’. The Discussion Paper sought comments on the Board’s views of the application of the principles within the Statement to public benefit entities.
- 19 The Board received a number of helpful responses to the Discussion Paper. These showed there was a great deal of support for the project and allowed the Board to redebate and take forward its work on a number of issues. The results of these deliberations were explained in the Preface to the Exposure Draft of the proposed Interpretation.

*Exposure Draft of Proposed Interpretation*

- 20 In August 2005 the Board issued an Exposure Draft that built upon the consultation on the Discussion Paper. As a result of the Board’s redeliberations, there were a number of areas where the Exposure Draft differed from the Discussion Paper, although neither the Discussion Paper, nor the Exposure Draft, attempted to redebate or update the Statement itself.

## **Main issues debated in developing the Interpretation**

- 21 The ten main areas that were debated by the Board in developing the Exposure Draft from the Discussion Paper were highlighted in the Preface to the Exposure Draft. These included the following issues where respondents were generally supportive of the approach being taken by the Board:
- Funders and financial supporters as the defining class of user;
  - Definitions of the elements of financial statements;
  - Notional transactions;
  - Capital contributions; and
  - Budget reporting.
- 22 There were however five other main areas where respondents to the Exposure Draft raised a number of significant concerns. These issues, including the Board's further deliberations, are set out below.

### *Liabilities*

- 23 Respondents to the Exposure Draft raised significant concerns with regard to the proposed Interpretation for commitments to provide public benefits. In particular, respondents disagreed with the executory contract analogy used in the Exposure Draft for non performance-related commitments. This stated that where resources are being provided in furtherance of the entity's objectives, the obligation to a particular recipient can be thought of as, in substance, an executory contract in which the provision of goods or services by the reporting entity is balanced by the achievement of its objectives.
- 24 Respondents argued this analogy was inappropriate on the grounds that no exchange was taking place. Respondents

also felt that non-performance-related arrangements are adequately dealt with by Financial Reporting Standard (FRS) 12 which provides guidance on the circumstances in which constructive obligations should be recognised as liabilities.

- 25 Respondents did however agree that FRS 12 did not fully address the issue of possible liabilities in the public sector where there may be constructive obligations that are not recognised as liabilities. One respondent provided the example of patients with chronic conditions, such as diabetes, who would probably die if the National Health Service did not continue to prescribe insulin. In such cases, it could be argued that a constructive obligation has been created which leaves little scope for avoidance, yet such commitments are generally not currently provided for in the accounts of public benefit entities.
- 26 In considering liabilities further, the Board noted that respondents were content with the proposed treatment of general commitments and performance-related commitments. The Board also acknowledged concerns over the executory contract analogy for non-performance-related commitments and accepted that this was an area that was exercising the minds of standard setters internationally and where further work was being carried out. The Board therefore agreed that the proposed Interpretation should not seek to develop the executory contract analogy proposed in the Exposure Draft for non-performance related commitments. Instead, the Board agreed to revert back to an FRS 12 based approach on the grounds it is underpinned by principles which have, in general terms, been found to be robust and are logically derived from the definition and recognition criteria for liabilities in the Statement.
- 27 The Board does however acknowledge that further work is required in relation to governments and commitments to provide public benefits. It will therefore continue to consider these matters further in conjunction with other standard setters, particularly in the context of the IPSASB

Conceptual Framework project. With this in mind, and working collaboratively with other National Standard Setters, the Board is involved in both contributing to the IPSASB project and in monitoring the IASB/FASB Conceptual Framework project, including the implications for public benefit entities.

- 28 The Board is also monitoring closely the IPSASB's project to develop an IPSAS on social policy obligations. Subject to the progress of these projects, and any other developments in terms of accounting for the social policy obligations of governments, the Board will consider further the need for an update to this Interpretation.

*Grants for financing capital projects*

- 29 The issue of capital grants generated more responses than any of the other questions raised in the Exposure Draft, particularly from Registered Social Landlords who were opposed to recognising capital grants as income (once any conditions attached to their receipt have been met). There were also respondents that did not support the need for an impairment test where the asset was fully or partially grant funded on the grounds that the manner in which an asset is funded should not influence the need for an impairment review.
- 30 In considering these comments, the Board agreed with the clarification requested by some respondents that where a capital grant meets the definition of a capital contribution it should be treated as such. However, the Board continues to feel that if a capital grant is not a capital contribution, and it results in an increase in net assets, then it should be recognised as a gain. Hence, in the case of a simple cash grant with no conditions attached, the Board's view is that there is clearly an increase in net assets; hence a gain should be recognised.
- 31 The Board acknowledges that the proposed approach for capital grants, whilst consistent with the principles in the

Statement and IPSAS 23 “Revenue from Non-Exchange Transactions (Taxes and Transfers)”, does differ from the two approaches set out in Statement of Standard Accounting Practice (SSAP) 4 “Government Grants”. However, the Board feels that it is important for the section on capital grants to remain consistent with the definitions of elements and other material in the Interpretation. The Board also feels that it would be neither possible nor appropriate for a principles document to attempt to provide solutions to issues facing a particular sector in how they account for capital grants. These are issues that will need to be addressed by the SORP-making bodies and by the Board in any future update of SSAP 4 or following any update by the IASB of IAS 20 “Accounting for Government Grants and Disclosure of Government Assistance”.

- 32 The Board therefore decided to remain faithful to the principle that, subject to not being a capital contribution, and once all conditions have been met, a capital grant which results in an increase in net assets should be recognised as a gain. The Board accepts that where capital grants are recognised as a gain, there is scope for explanatory material to be included in the information accompanying the financial statements.
- 33 Finally, the Board agreed with respondents that the manner in which an asset is funded should not influence the need for an impairment test. The section in the Interpretation on capital grants therefore focuses on initial recognition of the grant with valuation issues in relation to the asset funded being covered in section 6 of the Interpretation on Measurement.

#### *Business combinations*

- 34 Respondents disagreed with the emphasis in the Exposure Draft that the *majority* of business combinations would be acquisitions. There was also some concern from respondents with regard to the principle that where a business combination takes place at nil consideration, the net assets

should be recognised as a gain to the income and expenditure account (with net liabilities recognised as a loss).

- 35 The Board agreed with respondents that there should be no presumption in the Interpretation that whilst true mergers do occur it is likely that the majority of business combinations (other than those involving entities under common control) will be acquisitions. This presumption has therefore been removed with the emphasis now being on the need to consider the individual circumstances of each combination in determining whether it represents a merger or an acquisition.
- 36 The Board also decided to clarify that business combinations that are in substance a gift of one business to another are effectively acquisitions carried out at nil or nominal consideration – and that in these circumstances the principle should be that the net assets or liabilities should be treated as a gain or a loss in the income and expenditure account.

#### *Donated goods and services*

- 37 The Exposure Draft proposed the recognition of voluntary services based on the value to the recipient of those services that would have otherwise been purchased. The Exposure Draft also suggested these services would often be those which the provider would ordinarily carry out in the normal course of their usual trade or profession and for which they would ordinarily charge a fee commensurate to the services provided.
- 38 Just over half of respondents that commented on this issue disagreed with the proposal, albeit for differing reasons ranging from the view that no voluntary services should be recognised to recognising all voluntary services that can be reliably measured.
- 39 The IPSASB has adopted a high level principles based approach in IPSAS 23 “Revenue from Non-Exchange

Transactions (Taxes and Transfers)”. This requires the recognition of goods in-kind when it is probable that future economic benefits will flow to the entity and when the fair value of the assets can be measured reliability. The IPSAS then adopts a permissive approach to the recognition of services in-kind in that “*an entity may, but is not required to recognise services in-kind as revenue and as an asset.*”

- 40 It is because of the many uncertainties surrounding services in-kind, including the ability to exercise control over the services and measuring the fair value of the services, that led to IPSASB not requiring recognition. The Board however remains of the view that where services in-kind can be reliably valued they should be recognised in the financial statements. The Board acknowledges that where it is not possible to measure some services in-kind with sufficient reliability for the financial statements, then these services in-kind should not be recognised.
- 41 Respondents were generally content with the Board’s proposal that where donated services are not recognised in the financial statements, and where disclosure of this information would help the user gain a better understanding of the entity’s activities, then this information could be disclosed in the notes to the accounts or in the accompanying information.

### *Residual interest*

- 42 The Exposure Draft proposed that information on the designation of portions of the residual interest for specific purposes does not create a different class of residual interest and should not be reported as a transaction in the financial statements. Although all respondents agreed the designation of a portion of the residual interest did not represent a transaction, a significant number felt that careful designation by management can be informative and that it is unfair to place such a restriction on public benefit entities when profit-orientated entities are not prohibited from making such designations (albeit they are probably rare in practice).

- 43 After further deliberation the Board agreed that where designations were made as a result of trust or other legal requirements then these should be shown on the face of the balance sheet. However other designations, such as those reflecting management's future intentions, should be reported either in the notes to the accounts or in the accompanying information.

### **Other ASB projects**

- 44 The ASB is undertaking a review of the accounting for heritage assets. The project aims to develop practical proposals that will result in greater consistency and transparency in the financial reporting of heritage assets. Following publication of a Discussion Paper in January 2006, the Board published an Exposure Draft (FRED 40) in December 2006 with the intention of issuing a Financial Reporting Standard in 2007 that will apply for accounting periods commencing on or after 1 April 2009.
- 45 The IPSASB, in collaboration with the UK ASB, published a Consultation Paper on heritage assets in February 2006 which included at its core the UK ASB Discussion Paper. Following an analysis of the responses to the Consultation Paper, IPSASB has signalled its intention to continue with this project.

ISBN 978-1-84140-957-3



UP/ASBD-BI7344

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