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Charities need to respond to the draft FRS 102 (FRED 82)

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The FRC have proposed that for accounting periods beginning on or after 1 January 2025, a new version of FRS 102 will apply.

A revised Charity SORP will also be issued for consultation to take account of any changes that are relevant to charities. Charities do need to be engaged in the process so that we can make the accounting standard better for the sector. The regulators do tend to take on board charity comments in a feedback process more so than those from professional firms we generally find.

FRED 82 – which is the exposure draft of the changes to FRS 102 is currently out for consultation until 30 April 2023. Whilst responding to the consultation on changes to the Charities SORP will be important, it is also vital for charities to engage with this consultation, as changes to the Charity SORP can only happen if they are consistent with FRS 102.

We have set out below some of the key areas of FRS 102 which affect charity accounting. The views are informed by our involvement in the stakeholder Professional Group B engagement process and the general consensus reached by this group.

Income recognition

The current Appendix B to Section 34 on incoming resources from non-exchange transactions in FRS 102 is being deleted and instead the relevant parts of the guidance notes have been added into the draft of Section 34 itself, however there is no substantive change to the current requirements. This is a key area for charities to pick up and respond on as in its current form it will allow for little change to the forthcoming Charities SORP.

Grant accounting

Government grants are accounted for under Section 24 of FRS 102, which allows entities the option to use either the 'accruals model' or the 'performance model'. However, the Charity SORP does not allow charities to use the 'accruals model' for government grants but requires them to use the 'performance model' instead. The reason for this is that grants from non-government sources are accounted for under the non-exchange transaction requirements of Section 34 of FRS 102, which only allows the 'performance model' and the writers of the Charities SORP took the view that accounting for all types of grants should be consistent.

The draft standard maintains this position, which is likely to prevent the Charities SORP allowing the adoption of the 'accruals model' for any type of grant.

We recommend that FRS 102 define the 'accruals model' and the 'performance model' in the glossary. Furthermore we recommend that the scope of Section 24 should be expanded to cover grants from any source for entities receiving these, rather than just government grants. Government grants cover grants from entities like National Lottery (as a government body under the definitions) but not from charitable trusts and foundations, and there is little difference between the terms and conditions on such grants. Therefore, including grants from trusts and foundations would allow for a consistency of treatment on income recognition for income from such non-exchange transactions. Grant income is a key non-exchange transaction that needs special consideration as it differs in nature to a donation as usually it reimburses the charity for expenditure incurred, there are often conditions attached to the receipt of funds and the timing of receipt of funds does not always correlate to the year the funds were expensed. An accruals model allows income to be recognised as it is expensed and thereby reduces confusion for the reader of the accounts, removing potential 'surpluses or deficits' arising on grants which are purely related to timing differences. It also means that fund balances do not include advance receipts of funding which can inflate reserves and make it more difficult for charities to be able to explain their reserves policy, especially where such funds are unrestricted in nature. Many local authorities provide grants to charities in March just before their year-end and as many charities have a similar year-end, such receipts can inflate income and reserves for activities undertaken in the following year.

We recognise that such a change would allow all types of entities to account for non-government grants in this way, however most recipients of non-government grants are likely to be public benefit entities. This change is crucial to allow for the Charities SORP to then be amended to allow for a choice of accounting model adopted by charities, or for at least small charities to be allowed to adopt the accruals model for grant income. Such a change in accounting policy could be supplemented by having disclosures over the total amount of grant awarded versus the amount recognised added to the disclosure requirements of the notes, if it was felt that this information was required for a user of the statutory accounts.

By allowing 'accruals model' for accounting for grants would also be consistent with IAS 20, which allows the 'accruals model' for government grants.

Furthermore using the 'accruals model' can help consistency of treatment between charities and trading subsidiaries and avoid the need for consolidation adjustments where the subsidiary for instance is following another requirements like the Housing SORP that requires the 'accruals model' treatment.

Legacy accounting

PBE 34.70A has been added and this wording has been updated from the previous guidance notes in Appendix B to Section 34 to a more simplified statement, although it retains the same principles as previously.

FRS 102 requires legacy payments to be accrued where it was clear that the executors had agreed before the reporting date that the payment could be made. This statement is extremely problematic and difficult to determine because the requirement is for the charity to determine when the executors "agreed" that a payment could be made when notification is made shortly after the year-end. It therefore needs to be clearer as to what the standard means by this, and how the Trustees establish this. Are they expected to contact the executors or just review the correspondence received or other evidence they may already have? The correspondence can be from a solicitor who may not be the executor, or if the executor is an individual dealing with a family bereavement it seems inappropriate that the charity needs to be in communication to determine when they "agreed" that a payment could be made, as they will not understand why the charity will be asking this. We recommend this wording is removed.

Furthermore currently the recognition of legacy income is based on three criteria one of which is identifying these as 'probable'. Yet the recognition criteria for assets now has the word 'probable' removed. This income recognition criteria can lead to legacies being recognised earlier and there is insufficient consideration as to whether it is a contingent asset instead, for example because there is a possibility that the Will may be disputed even if this has not happened before the accounts are approved. It is important that legacies are only recognised when appropriate, or it can lead to amendments in subsequent years, some examples we have seen are as follows:

- there has been challenge on the estate by relatives and the derecognition in a future accounting period;
- the impairment of the legacy in a future period as the assets (like property) have been difficult to dispose of and their value has significantly fallen;

Funders do look at balance sheet reserves levels and do not necessarily understand legacy debtors that may not be paid for some time and therefore is not cash that the charity can use. Smaller charities have suffered because of potential funders not being able to assess the charity's financial position sufficiently for grant funding. Therefore, the accounting policy has real consequences for smaller charities.

Funders may cease funding them due to their significant reserve levels and can impact on their ability to raise funds from new funders or sources and to survive. We have seen many charities over the years struggle to fundraise due to high reserve balances that are as a result of legacies which are not yet received and cannot be spent; and similarly with grant income receipts that are being carried to future accounting periods to be expensed. There is a recent example in the charity press that resulted in a charity going into liquidation as a result of accrued legacy income showing as a significant debtor that was not received after the year-end, and was a longer term debt and the charity ran out of cash, even though it had £1M of unrestricted free reserves as these were illiquid. This is particularly an issue as long term debtors are still normally included within current assets and, even if disclosed separately, funders still look at the net current asset position.

We recommend that the income recognition criteria be tightened so it is very clear when a legacy is recognised and when it is just disclosed as a contingent asset. The wording in FRS 102, as maintained in FRED 82, gives indicators of when legacies would be classed as receivable but is not definitive in its guidance that has led to different charities adopting different policies around legacy income recognition. There is a lack of consistency in the charity sector, and we would suggest that there is a consultation with lawyers and legacy specialists to confirm more definitive guidance for the sector on income recognition in this area. Such an approach was taken in relation to gift aid payments made by trading subsidiaries and the subsequent update on the tax treatment in FRS 102 and additional guidance in the notes helped ensure a consistency of approach.

Furthermore the income recognition criteria of legacies does need to also be tied into the definition of the recognition of a contingent asset under FRS 102. Paragraph 21.13 states that: 'An entity shall not recognise a contingent asset as an asset. Disclosure of a contingent asset is required by paragraph 21.16 when an inflow of economic benefits is probable. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.'

The definition of a contingent asset is that it is probable, and only when virtually certain does this change to income recognition. It is therefore important that income recognition for legacies versus contingent assets recognition are very clearly specified to give clarity over this conundrum.

Charities having different accounting policies used on legacy income recognition means that the policy adopted is not consistent or comparable from one charity to another. The level of subjectivity in legacy income recognition should be removed from FRS 102 and/or the Charities SORP should be tasked with clarifying income recognition in this area. Thus FRS 102 needs to remove PBE 34.70A to allow for this consultation and debate to take place.

Donated goods and services

The draft FRS 102 looks to retain the need for charities to value donated goods and services and include this as donated income and expenditure, or as an asset if relating to a fixed asset, in the statutory accounts. The value at which such donations are to be recognised is at the value the charity would have purchased the goods or services, not the actual cost of this if supplied at a premium (PBE 34.73A and PBE 34.73B). Volunteer time is still exempted from this requirement and is not to be valued or recognised (PBE39.69A).

The only exception remains as to whether the charity would have purchased the goods or services if they had not been free, and where not then the value of such to the charity is zero (PBE 34.73A and PBE 34.73B). Certain items are specifically exempted from being treated at zero value like leases for office space – the new updated wording states that where the lease payments are significantly below market rents then 'the incoming resources shall be accounted for as a contribution to the cost of the right-of-use asset.' (PBE 34.70A)

We recommend that instead of including donated goods and services in the income and expenditure, the amounts should just be recognised as additional disclosure in the notes to the statutory accounts. We have seen charities move into the requirement to be audited because of the inclusion of such items pushing them over £1M income, and could move them into and out of audit depending on the nature of these transactions and frequency. Furthermore, by valuing the transaction at the value to the charity this causes the following issues:

- the donor of services may not appreciate the value being shown at less than the perceived cost to them of providing the goods or services and thereby the recognition is otherwise perhaps higher than would have been the case as the charity may feel obliged to show the transaction at the cost to the donor. The potential damage to the relationship with the donor invariably impacts the charity when considering the value used in the statutory accounts; or

- the charity has insufficient detail of the services provided from the donor or expertise to be able to otherwise attribute a value to these services to be able to determine any other value on the services other than cost provided. Examples include digital marketing or legal costs for instance, where the only way the charity could determine the value to itself would be to seek prices/tenders for services which were provided pro bono. Suppliers would not normally spend time and effort in providing a quote/tender purely to assist in providing information to inform an accounting estimate as they would need to be informed they are not being appointed; or

- establishing the value to the charity is subjective in itself as the expense may never be incurred by a charity – for instance it has always received its premises for free/heavily subsidised and therefore has no reason to determine what a budget would have even been in such circumstances. Therefore, any cost attributed is arbitrary and not meaningful. If the premises were no longer available, the charity could determine if it wants no office space at all as individuals could work from home, or a much smaller space than currently utilised. The Trustees may have not even determined their policy decision on something which is provided free/heavily subsidised as to what they would do if it was not available. For instance, marketing - especially digital – given to the charity for free and the charity may not have entertained such marketing costs but had managed to secure these for free. Therefore the marketing costs were part of a plan but had no real scope or quantum established as the free support stopped the need for the budgeting process to be concluded and in such circumstances the charity is trying to work out what it might have done if this support had not been forthcoming. All very arbitrary and subjective.

Auditors can challenge the values used on donated goods or services but as identified above, it is difficult to determine the value to the charity as it can be so subjective. Whether they used the figures provided as the only basis for determining a meaningful figure or how else they determined the figure used means auditors are assessing what the charity would have done if the goods or services had not been provided for free. If the figure is material or could swing the charity from an independent examination into an audit it makes such review even more sensitive, especially as the amount is an accounting estimate and could lead to disproportionate audit time on a matter which is basically grossing up income and expenditure.

Finally, the section also covers donated goods for resale or distribution. The wording remains that where it is impractical to determine high volume, low value items when received, such items can be accounted for when sold. The wording has been updated to also add in 'when distributed' (PBE34.70). The main issue here is that by implication, high value items therefore should be valued on receipt. We would continue to recommend that this wording be simplified to allow the goods to be recognised on sale or distribution, and have explained below the reasoning. Otherwise such exemption should at least be provided to smaller entities.

Stock needs to be valued at the lower of cost or realisable value and for donated stock, the cost could be seen as 'nil', as there was no cost incurred by the charity whilst the value should be calculated as the value to the charity on donation, is this the achieved sale subsequently achieved or a lower value? The subsequent sale may have required the item to have been repaired or cleaned and would then complicate matters. Furthermore, the items will be in a shop which is incurring administrative costs and staffing to realise the sale, so its value should not be the subsequent amount received. If such stock is damaged or destroyed – as we have seen in the past where distribution centres of charities have burnt down – the stock is not insured and its replacement is via asking donors for support and help to provide more donated goods for sale. This further emphasises that its initial value should be 'nil'.

If the charity uses the Retail Gift Aid Scheme (RGAS) it would need to distinguish between such goods versus donated goods that should be valued as under RGAS the charity is only acting as agent and the goods are not its own goods.

Finally, in relation to goods for distribution, there are many issues to consider that affect the ability for recognition as income and expenditure. For medicines for instance, the charity might never be able to purchase the medicine being provided for free for onward distribution, it might never actually receive and verify the existence of the goods as these are passed straight onto the ground for distribution, or it may be passed to third parties who distribute the items in country and the charity no longer has details once the items leave the UK. Therefore it is unclear as to whether it is recognised as an expense when passed to third parties to distribute or when they pass it onto beneficiaries by the third parties, even though the charity is not in control of this aspect of the process.

Comparatives

We are all aware that FRS 102 requires full comparative information which has led to the statutory accounts of charities becoming overly cluttered – full comparative funds notes, detail of restricted versus unrestricted breakdowns being required for comparatives, detailed comparative expenditure and support costs notes as examples. As these are Charities SORP only disclosures we would recommend that the FRC allows the Charities SORP to confirm which comparative information is required in statutory accounts. Disclosures in full are provided in the prior year financial statements so anyone wishing to assess this information is able to do so with little difficulty. Therefore, we recommend that the comparative information requirement provides this exemption to refer to the Charities SORP in the draft FRS 102.

Tiers

The draft FRS 102 has predominately not changed the tiers and reporting requirements and exemptions applying thereon. One of the recommendations to the SORP making body was to introduce a 'micro', 'small' and 'large' charity banding. The intention being that the various banding would be allowed to have 'micro' charities exempted from many disclosures; 'small' charities to be required to disclose more information and 'large' to have no exemptions.

One aspect which did receive a lot of debate and consideration was around expansion of the Receipts and Payments regime allowed for Trusts to Companies and CIOs (Charitable Incorporated Organisations). Under the Companies Act requirements, companies are required to produce Accruals accounts and are therefore unable to follow Receipts and Payments. For such smaller incorporated entities, currently with incomes up to £250k, it would seem appropriate that both incorporated and unincorporated entities should be allowed to follow the Receipts and Payments regime. Similarly as FRS 102 has exemptions allowed for Micro entities. We would recommend a change to the Companies Act to allow for this and that FRS 102 recognises this distinction too.

We therefore recommend that the draft FRS 102 gives the flexibility to allow for these tiers to be introduced by the Charities SORP. Furthermore, the exemptions available to accounting treatments and disclosures need to be built into FRS 102 as indicated in part above.

There are other planned changes made to FRS 102 which are following further implementation of International Standards, and these are as follows:

Contract income

Section 23 on Revenue and been replaced by Revenue from Contracts with Customers is based on the IFRS 15 five-step model for revenue recognition, as simplified. This requires revenue recognition to be allocated to the promises in a contract with a customer, as those promises are satisfied. This will impact on an organisation who has recognised upfront non-returnable fees in income at the start as these will now be spread over the contract; and if the promises are all at the end of the contract then income would only be recognisable at that point. This will have implications on revenue recognition for some charities.

Lease accounting

New Section 20 on lease accounting based on the IFRS 16 on-balance sheet model, as simplified. This results in all leases being recognised as assets and liabilities, including 'operating leases'. There is an exemption to these requirements for short-term leases and leases of low value (that is based on the value of the asset at the start of the lease, not on the value of the payments made). Low value assets are defined in paragraph 20.11 and includes personal and tablet computers, printers, phones, televisions etc.

Concepts and Pervasive Principles

Section 2 has been updated to reflect the IASB's Conceptual Framework for Financial Reporting, issued in 2018.

Fair value measurement

New Section 2A to reflect the principles of IFRS 13 and Appendix to Section 2 is removed.

Other

Removal of the option to newly adopt the recognition and measurement requirements of IAS 39 under paragraphs 11.2(b) and 12.2(b), in preparation for the eventual removal of this option, but permitting entities already applying the option to continue to do so in the meantime.

Comments

In order to comment, organisations need to send their comments to ukfrsperiodicreview@frc.org.uk by 30 April 2023. There are 10 specific comments in the consultation but question 9 does ask for any other comments which is where the above points will be raised by us in our response. We encourage you to take part and assist in changing FRS 102 as indicated.

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