Accounting Standards Board

Newsletter December 2020 Edition

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"Small entities": Should there be different GRAP requirements for them?

Stakeholders shared concerns with the Board about the ability of "small entities" to prepare financial statements in accordance with Standards of GRAP. The main reason for their concerns was that small entities have constrained human and financial resources.

What was the Board's response?

To determine possible actions, it was necessary for the Board to obtain a clear understanding of the problem. The Board responded by researching the financial reporting environment of these entities in 2018/19 to determine what could be done. The research focussed on:

(a) Identifying the characteristics that could be used to classify entities as "small".

Because no definition or description of "small entities" exists in Standards of GRAP, the Board needed to understand what makes an entity small.

(b) The challenges and issues faced by "small entities" to prepare GRAP financial statements.

While the Board decided not to introduce separate reporting requirements for "small" entities, they were of the view that the results of the research would be helpful to stakeholders. The results were published in a Research Paper, which is available on the ASB's website.

What could a "small" entity be in the public sector?

As there is no definition of a "small" entity in the public sector in the Standards of GRAP the Board consulted stakeholders on what a "small" entity could be.

Stakeholders considered whether "small" entities should be identified based on specific characteristics or whether specific types of entities, e.g. certain types of municipalities or certain public entities could be considered "small". Stakeholders were not in favour of classifying certain types of entities as "small", because within each type, entities vary in size and the complexity of their operations differ.

On balance, stakeholders supported the use of a combination of characteristics, both qualitative and quantitative. Most notably, stakeholders were in favour of using the following characteristics:

- Value of revenue.
- Number of employees.
- Functions performed by the entity.
- Value of the budget.
- Value of expenditure.

The detailed information on the characteristics supported by stakeholders is included in the Research Paper, along with additional issues raised, such as who should perform the assessment, and whether this could change over time.

What issues do small entities face in preparing financial statements?

As part of the research it was necessary for the Board to obtain a clear understanding of the issues that small entities face in preparing their financial statements using Standards of GRAP. The following challenges were identified.

<u>Accounting challenges</u>

These challenges often relate to areas where judgement is required. Small entities do not have the necessary skills to apply judgement, nor do they have the resources to acquire those skills. Areas were also identified where the requirements of the Standards of GRAP may be misunderstood and misapplied. The most prevalent areas are:

(a) Accounting for non-current assets. The challenges include:

- Determining fair value, which was raised as an on-going challenge and not only once-off.
- Applying judgement to separate assets into components.
- Applying judgement to determine useful lives and residual values of assets and adjusting for fully depreciated assets still in use.

(b) Applying materiality.

(c) Keeping up-to-date with changes in the reporting framework.

(d) Standards of GRAP are complex and may be difficult to interpret, particularly for less skilled finance staff.

(e) Accounting for, and disclosure of, financial instruments.

<u>Broader small entity environment</u>

A number of issues impact on entities' ability to prepare GRAP financial statements when they are small. These are not directly related to specific accounting issues. The key issues are set out below:

(a) Human resource capacity and skills.

(b) Budget constraints.

(c) Lack of daily and monthly controls, including record keeping.

(d) Overreliance on consultants.

(e) Difficulty complying with legislation.

What did the Board decide?

The Board considered a number of factors in deciding whether there should be different requirements for small entities. These factors included:

- The legislative environment, including the need for consistent financial norms and standards across the sector.
- The need for consistent reporting to prepare consolidated financial statements at various levels, including eventually for "RSA Inc", i.e. the whole public sector. .
- The need for consistent reporting to meet other reporting requirements, e.g. statistical reporting.
- The effectiveness of solutions to address the problem.
- Stakeholder views. Most stakeholders did not support a different reporting framework for small entities, for the following reasons:
    - Concerns were expressed by users about the information they need for small entities no longer being available in financial statements. This is particularly the case where there is a drive for consistent reporting across the sector. The information produced by entities is used by a number of users, and it is important that it is reported consistently and comprehensively.
    - Entities cannot get the basics right and adding another framework would not resolve the issues.

Based on these factors, the Board decided not to introduce reporting requirements or guidance for small entities. The Board instead identified other actions that would be more appropriate for the environment, including:

- A number of the Board's projects and related guidance would assist entities with their accounting challenges. These are identified in the Research Paper. Most notably, the Guideline on *The Application of Materiality to Financial Statements* contains guidance that would be useful to address some of these challenges.
- Publishing the results of the research and the resources available in the Research Paper.

A number of issues were identified that are outside the Board's mandate to address (inherent to small entities and their environment). These have been communicated to stakeholders that may be able to assist small entities.

Can decisions about materiality today affect future reporting periods?

The answer is no, unless an entity made an error in how it assesses and applies materiality.

Different views have been expressed about materiality decisions and their effect on future periods

Historically, preparers, auditors and others have expressed different views in practice about whether decisions can affect future reporting periods or not. Some were of the view that entities should assess whether past decisions about materiality could become material cumulatively over time, while others were of the view that decisions about materiality are period specific.

Given the diversity of views, the Board developed and issued a proposed Interpretation on *The Effect of Past Decisions on Materiality* (ED 185) for comment.

What does ED 185 say about materiality decisions?

GRAP 3 on *Accounting Policies, Changes in Accounting Estimates and Errors* is applied by entities when accounting policies are developed. Paragraph .07 indicates that "Standards of GRAP set out accounting policies that the ASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial".

This means that entities develop and apply:

- "Accounting policies" based on the principles in the Standards of GRAP for items, transactions and other events ("items") that are material. For example, recognising assets in accordance with the principles in GRAP 17 on *Property, Plant and Equipment.*
- "Alternative accounting treatments" for items that are immaterial. These alternative accounting treatments should not be inconsistent with the *Conceptual Framework for General Purpose Financial Reporting*. For example, expensing items that would otherwise meet the definition of an asset in GRAP 17 because they are immaterial quantitatively and qualitatively.

Accounting policies and alternative accounting treatments are applied based on an assessment of materiality during the reporting period and at the reporting date. As a result, the assessment of, and decisions about materiality are period-specific, and do not affect subsequent reporting periods, unless an entity made an error (discussed below).

Materiality is assessed based on all the relevant facts and the circumstances that exist at the time of the assessment. The effect of applying materiality is assessed for items (or groups of items) individually as well as collectively. Accounting policies and alternative accounting treatments are applied consistently to similar items or groups of items.

If an entity applies an accounting policy for items that were previously immaterial, this is not a change in an accounting policy in terms of GRAP 3. As a result, no retrospective adjustments are made.

As GRAP 3 allows entities to apply the Standards of GRAP to material items only, applying alternative accounting treatments is not a departure from the Standards of GRAP, nor is it an error. ED 185 indicates that the following instances may give rise to errors in the application of materiality:

(a) Immaterial items are omitted from the financial statements.

(b) An inappropriate alternative accounting treatment is applied because of a failure to use, or misuse of, reliable information that was available or could reasonably have been expected to be used at the reporting date.

(c) An alternative accounting treatment is applied to immaterial items to achieve a particular presentation or outcome in the financial statements.

(d) An incorrect assessment of materiality is made resulting in material transactions being accounted for as immaterial transactions.

How can you access ED 185?

The Board needs your feedback on the proposals in ED 185. The comment deadline is 26 February 2021. ED 185 and supporting materials can be accessed by following this link.

Update from the ASB's December Board meeting

The Board met on the 1st of December 2020. The Board's deliberations focused on the results of the post-implementation review of GRAP 103 on Heritage Assets.

Both users and preparers of the financial statements expressed broad support for the Standard as it resulted in better management of heritage assets. Concerns were expressed about the cost of implementing the Standard, the skill and capacity at entities to apply its concepts and technical aspects of the Standard.

The issues related to cost and skill and capacity will be shared with the Department of Arts and Culture and National Treasury as the resolution of these issues is within their respective mandates. The matters related to the technical aspects of the Standard were debated by the Board and potential actions identified. The key proposals are discussed below.

Identifying heritage assets

Respondents to the review often raised questions about the identification of heritage assets. In particular, whether heritage assets should be identified based on legislation such as the National Heritage Resource Act, or by applying the definition of a heritage asset in GRAP 103. As the Standards of GRAP are used to prepare the financial statements, the definition in GRAP 103 should be used to identify heritage assets. Respondents indicated that there should be a closer alignment between the definition in GRAP 103 and legislation.

The Board agreed to review the definition of heritage assets in GRAP 103 and potentially align it more closely to legislation.

Classifying heritage assets

GRAP 103 currently requires heritage assets that are held for an alternative use to be accounted for in terms of that alternative use. As an example, if a heritage building is used in an entity's service delivery, it would be accounted for using GRAP 17 on Property, Plant and Equipment. When accounted for as property, plant and equipment (or investment property using the cost model), depreciation is recognised.

Respondents expressed diverse views about whether this treatment is appropriate. Those that supported the current treatment indicated that if heritage assets are used for other purposes, then they should be accounted for based on that purpose. They also observed that recognising depreciation is appropriate as this reflects the cost of using the asset in providing goods and services.

Respondents that did not support the current treatment were of the view that the main objective for holding heritage assets is to preserve and manage them for current and future generations because of their cultural, artistic, scientific etc. significance. A key concern was that the line item "heritage assets", as presented in the financial statements, is incomplete as heritage assets held for an alternative use could be presented as property, plant and equipment, investment property, etc. They also did not support recognising depreciation as heritage assets are often preserved and maintained at a higher level than other assets which means that they may not necessarily depreciate. The depreciation may also be very low given the long useful lives of many heritage assets. These respondents proposed that all heritage assets should be accounted for using GRAP 103.

The Board agreed with the views expressed about why the current treatment is inappropriate and supported a change to GRAP 103 and related Standards.

Measuring heritage assets

At present, GRAP 103 does not require the recognition of heritage assets if a reliable measure cannot be determined on initial recognition. As many heritage assets were acquired many years before the adoption of the Standard, historical information may not have been available. In these instances, entities were allowed to value the heritage asset using the fair value on the date of adoption. Fair value can also be used when heritage assets are gifted or donated to entities in a non-exchange transaction.

Respondents indicated that the measurement of heritage assets had caused significant difficulty in the application of the Standard. It was observed that it was unclear when a "reliable" measure is considered unavailable. Concerns were also expressed by preparers about how fair value was being determined and the perceived lack of market information. Valuation experts provided a different context and noted that in most instances, fair value would be determinable. Exceptions could be one of a kind archaeological artefact, human remains, etc.

The Board agreed to provide guidance on when a reliable measure of a heritage asset cannot be determined. It was also agreed that entities could potentially use "peer data" if other entities held and valued similar assets. These proposals would result in amendments to GRAP 103.

The International Public Sector Accounting Standards Board (IPSASB) will issue a proposed Standard on the measurement of assets and liabilities in early 2021 for comment. Some of the proposed guidance responds directly to the issues observed by preparers. As a result, the Board did not propose any specific actions related to the valuation methods and their application.

Applying GRAP 103

Several specific application issues were raised by preparers. One of the most significant issues raised related to the treatment of heritage assets before assessing whether they are heritage assets. A typical scenario is where an entity receives artefacts from an external party. The entity would need to assess whether the artefacts meet the definition of a heritage asset in GRAP 103. Respondents noted that they often do not recognise these assets in the financial statements, or they recognise them at a value of R1 prior to the assessment being completed.

The Secretariat will issue a Frequently Asked Question to provide guidance on this issue. Based on other application issues identified, new FAQs will be issued, or existing FAQs revised.

Way forward

The Board's proposed actions will either result in changes to GRAP 103 or guidance from the Secretariat. Revisions to GRAP 103 would need to be developed and issued for comment. The Board will consider proposed revisions to GRAP 103 in September 2021. The FAQs will be issued at the same time.

The full results of the review and comments received with related responses will be published on the ASB's website in due course.

Season's Greetings

We would like to take this opportunity to thank all of you that participated in our discussions, contributed to our projects, and for the ongoing and open interactions. This ensures that our work is relevant, credible and makes for a robust standard-setting process.

We wish you and your family well over the festive season and hope to see you all in 2021.

Until we meet again.

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