



Technical Advisory Group

AGENDA ITEM: TAGCP05-01

February 10, 2020 – Virtual Meeting

Definition of NPOs

Summary	This paper summarises the central approach to defining Non Profit Organisations (NPOs) that will be presented in the Consultation Paper. This will determine the scope of entities that the Guidance being developed for.
Purpose/Objective of the paper	<p>The objective of the project is to develop non-mandatory, internationally applicable financial reporting guidance for NPOs, with the initial focus on small and medium sized entities.</p> <p>The Consultation Paper will not provide any preliminary views but will give a central approach to determining the scope of the Guidance.</p> <p>This paper summarises that central approach. It provides an overview of how others have defined NPOs when examining financial reporting issues relevant to them, and developing financial reporting frameworks. It then advances a key characteristics approach to defining the broad properties of NPOs that will be in scope of the Guidance that will be included in the Consultation Paper for comment.</p>



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Other supporting items	TAGCP01-3 – Project Objectives
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Actions for this meeting	<p><u>Advise</u> on:</p> <ul style="list-style-type: none">• The approach to determining whether an entity is an NPO within the scope of the Guidance.
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Definition of NPOs

1. **Background**

- 1.1 The objective of the International Financial Reporting for Non Profit Organisations project is to develop non-mandatory, internationally applicable financial reporting guidance for NPOs, with an initial focus on small and medium sized entities.
- 1.2 The Guidance is planned to be developed in three phases, with the first phase focusing on the development of the Consultation Paper (CP) which will introduce the topics proposed for inclusion in the initial version of the Guidance with the aim of encouraging debate about possible options, rather than providing preliminary views on specific accounting treatment options at this stage.
- 1.3 As previously discussed with both the TAG and the PAG, the CP will be split into two parts, with the first part addressing high level issues, including the overall Guidance approach, such as defining its scope, guidance basis options, guiding concepts or principles for developing the guidance, users of the guidance and approach to specific issues.
- 1.4 Determining whether an entity is an NPO to which the Guidance will be relevant, and what is a small or medium sized NPO that the Guidance will be initially focussed on, will be a key issue that needs to be addressed in the first part of the CP. As presented in paper TAGCP01-3 Project Objectives, it was determined that this would be through a narrative descriptions approach which this paper now develops.

2. **Can existing approaches be used to assist in defining the scope of NPOs for financial reporting guidance?**

- 2.1 The entities that are potentially within scope for the Guidance are diverse. They range from small local membership organisations funded by and delivering services just to those members to large international charitable organisations providing a wide range of services globally and in receipt of significant donations and commercial revenue streams. These entities are also operating in a range of different legal and regulatory environments which may or may not recognise their status through, for example, special legal and fiscal status and privileges.
- 2.2 International Financial Reporting Standards (IFRS) have been developed for private sector entities that have a primary objective of maximising profit and returns to investors and owners, while International Public Sector Accounting Standards (IPSAS) developed for government and public sector organisations



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that do not operate as business entities. For those private entities whose primary objectives are non-financial which constitute the 'third sector', and that do not currently have international financial reporting guidance developed for them, non-profit could be tightly or loosely defined. A tight definition could exclude all entities that have operations which generate profits even if the goods and services are provided on a relatively non-commercial subsidised basis. It could also exclude any which distribute profits to either members or controlling owners even where this supports wider non-financial objectives. A looser definition could permit such entities, but potentially result in Guidance that was not focussed sufficiently on the issues of most relevance to those organisations who are for example solely reliant on voluntary income to fund service delivery.

- 2.3 Different studies and jurisdictions have taken different approaches to defining which entities financial reporting guidance aimed at the 'third sector' will apply to. This section examines some of these approaches and draws out questions relevant to defining the scope of the entities that the Guidance will be primarily developed for.

CCAB Study

- 2.4 In 2013, CCAB, the coordinating body for the UK and Ireland's Professional Accountancy Organisations, funded an independent study on the need for international financial reporting standards for NPOs. The study which reported in 2014¹ was focused on NPOs that are;
- constituted on a not-for-profit basis; and
 - self-governing; and
 - established for public benefit
- 2.5 The report defined NPOs in direct scope as Charitable NPOs – NPOs established for charitable purposes where that term has a specific meaning either in relation to protection of charitable assets or in terms of tax reliefs. This excluded commercial third sector entities such as social enterprises where members or investors received a share of profits. It also indirectly excluded NPOs with non-charitable purposes e.g. private societies, trade associations etc, which were deemed relevant but outside of the direct scope of the study.

Accounting standards frameworks

- 2.6 One of the key characteristics of NPOs that assisted in defining the focus of the CCAB study was whether an entity had been established for public benefit, i.e. it has a primary purpose of benefiting the public (or a sufficient section of the public) through its activities. This public benefit characteristic has been used in a number of jurisdictions to assist in defining the scope of entities to which separate accounting standards and financial reporting guidance will apply.

¹ *International financial reporting for the not-for-profit sector* – A study commissioned by CCAB published February 2014.



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2.7 The United Kingdom Accounting Standards Board for example, in its "Statement of principles for financial reporting – interpretation for Public Benefit Entities" noted that "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 has been provided with a view to supporting that primary objectives rather than with a view to providing a financial return to equity shareholders."²

2.8 The Financial Reporting Council in the United Kingdom when developing FRS 102 (which modifies IFRS for SMEs and is designed to apply to the general purpose financial statements and financial reporting of entities including those not constituted as companies and those that are not profit oriented) refined this definition to note that a public benefit entity is:

*"An entity whose primary objective is to provide goods or services for the general public, community or social benefit and where any equity is provided with a view to supporting the entity's primary objectives rather than with a view to providing a financial return to equity providers, shareholders or members."*³

2.9 A similar definition is also utilised in New Zealand's accounting standards framework for for-profit and public benefit entities (both not-for-profit and public sector entities). XRB A1 Appendix A defines public benefit entities

*"as reporting entities whose primary objective is to provide goods or services for the general public or social benefit and where any equity has been provided with a view to supporting that primary objective rather than with a view to providing a financial return to equity holders."*⁴

2.10 The United Kingdom and New Zealand definitions of public benefit entities do not exclude entities that may make profits provided that this isn't their primary objective. It also, unlike the CCAB study definition, does not exclude entities that may distribute profits to owners or members, providing that equity or other financing has not been provided primarily with the objective of obtaining a financial return.

2.11 In Canada, by contrast the non-authoritative *A guide to accounting standards for not-for-profit organisations in Canada* incorporates a test of public benefit purpose but also focuses more specifically on the not-for-profit characteristics of an entity and in particular financial returns. It defines a not-for-profit private organisation (NFPO) as being:

"an entity, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. An NFPO's members,

² *Statement of Principles for Financial Reporting - Interpretation Statement for Public Benefit Entities – Accounting Standards Board - June 2007*

³ *FRS 102 The Financial Reporting Standard Applicable in the UK and the Republic of Ireland - Financial Reporting Council – March 2018*

⁴ *External Reporting Board Standard A1 – Application of the Accounting Standards Framework – Appendix A - External Reporting Board New Zealand – May 2019*



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contributors and other resource providers do not, in such capacity, receive any financial return directly from the organization.”⁵

Questions relevant to defining scope

- 2.12 These different ways of defining the scope of non-profit entities to which accounting standards and financial reporting guidance may apply draw out a number of issues of relevance to this project. Restricting the scope to charitable entities for example would potentially rely on the existence of the legal concept of a charity and charitable purposes, which would not be applicable internationally. It would also exclude NPOs with non-charitable purposes which could also benefit from the Guidance.
- 2.13 As noted above though, focussing on a public benefit entity definition without also examining how profits are made and utilised is an issue that also needs to be addressed. A public benefit entity definition could include entities that charge service users on a near commercial basis, and are profit-making and distributing provided that they have an overarching 'social' purpose. This could raise questions as to the extent to which the Guidance is aimed at and being developed for non-profit organisations.

3. Proposed central approach to determining which NPOs the Guidance is to be primarily developed for.

- 3.1 Each jurisdiction defines the entities to which standards and guidance apply based on its own reporting needs and the broader legal, regulatory and financial reporting framework that is in place. The more restrictive the definition of an NPO the higher the likelihood that entities that would benefit from the Guidance are put out of scope. In order to ensure that the project meets its objectives, however, there does need to be some determination of the NPOs that the Guidance is aimed at. This will ensure the Guidance is developed to meet their reporting needs, and does not focus on the more general financial reporting issues of entities which are met by existing guidance aimed at either the for profit private sector or the government and wider public sector.
- 3.2 When developing its Conceptual Framework and Standards, the IPSASB had to determine the scope of public sector entities to which they would be designed to apply.⁶ To do so it focussed on the key features of the public sector and the economic events and transactions that were relevant to it. These included:
- The volume and financial significance of non-exchange transactions;
 - The importance of the approved budget;
 - The nature of public sector programmes and the longevity of the public sector; and

⁵ *A guide to accounting standards for not-for-profit organisations in Canada* – Canadian Institute of Chartered Accountants - 2012

⁶ *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* - International Public Sector Accounting Standards Board - 2014



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- The nature and purpose of assets and liabilities in the public sector.
- 3.3 Based on these key features it has sought to design IPSAS's to apply to public sector entities that meet the following broad characteristics:
- (a) Are responsible for the delivery of services to benefit the public and/or to redistribute income and wealth;
 - (b) Mainly finance their activities, directly or indirectly, by means of taxes and/or transfers from other levels of government, social contributions, debt or fees; and
 - (c) Do not have the primary objective to make profits.
- 3.4 Instead of seeking to tightly define what an NPO is and exclude entities that may not meet all of a number of specific criteria, the proposed central approach for the Consultation Paper is to examine the key features of the not for profit sector and the economic events and transactions relevant to it. This will permit a broader characteristics based definition of non-profit organisations and the associated financial reporting issues that we would expect the Guidance to support.
- 3.5 Some of the key features of the not for profit sector and relevant economic events and transactions that lead to the need for the development of internationally applicable financial reporting guidance for NPOs are:
- The significance of non-exchange transactions;
 - The need to demonstrate to resource providers how funding has been utilised;
 - The prevalence of non-financial assets that are not held to maximise profit or economic returns; and
 - The importance of narrative and performance reporting given the primacy of non-financial objectives.
- 3.6 Based on these key features it is proposed that the central approach will be for the Guidance to be developed primarily to apply to NPO reporting entities that display the following broad characteristics:
- (a) **Financial objectives** – the entity's primary objective is to deliver goods or services for the general public, community or social benefit and not to maximise profits;
 - (b) **Use of profits** – any profits which are generated by the entity are used to further its primary objective; and
 - (c) **Funding sources** – funding through donation, grant or other form of non-exchange transaction is financially significant to the entity.
- 3.7 These broad characteristics will permit the Guidance to be developed with a focus on meeting the financial reporting issues that arise from the key economic events and transactions most relevant to a diverse range NPOs, even if some organisations do not meet all of the broad characteristics.



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Question 1: What are the TAG's views on the proposed central approach to determining which NPOs the Guidance is to be primarily developed for?

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